

# 2005 Financial Market & Retirement Board Performance Review

**F**or the US, 2005 was an unusual year that saw both the stock and bond markets basically tread water. The economy grew at a healthy clip and profit growth was impressive, yet, contrary to what would be expected under these conditions, stock prices failed to rise appreciably and bond prices stubbornly refused to fall. As a result, both the stock market and the bond market closed out the year very close to where they started, making it very difficult for pension plans who invest solely in these markets to meet their targeted rates of return.

## Equity Markets

For stocks, which typically register either decisively positive or negative performance, a year of flat performance is highly unusual. Considering the Dow Jones Industrial Average, its return of - 0.61% was its smallest percentage change since 1926 and its low-to-high range of about 10% was far below average.

Despite record high oil prices, devastating hurricanes, and rising short-term rates, the economy was projected to have grown at a 4.1% rate and earnings growth for the S&P 500 companies was estimated at almost 14%. Nevertheless, even after modestly positive returns for the fourth quarter, the S&P 500 was up only 3.00% (excluding dividends) for the year and the NASDAQ composite was up only 1.37%. One plausible explanation for the market's weak performance is that it is still working off the excesses of the late 1990s. Indeed, at year-end, the S&P 500 was still 18% below its record high reached in March 2000 and the NASDAQ Composite was still 56% off its record. One index that has achieved a new peak is the Russell

2000, reflecting the fact that small caps confounded many experts by outperforming large caps (S&P 500) for the sixth consecutive year, although the 2005 margin was very small. By a decisive margin, mid caps outperformed both small caps and large caps last year. Over the past five years, the annualized total return for the Russell 2000 (+8.22%) and the S&P MidCap 400 (+8.60%) far exceeded that of the S&P 500 (+0.54%). In style comparisons, there was no significant advantage between growth and value in 2005, although—after five years of dominance by value—growth appeared to be gaining the upper hand during the latter part of the year.

As always, even with muted returns overall, it was a stock-pickers market. Among the sectors of the S&P 500, energy was up 29% and utilities rose 13%, while telecom services declined 9% and consumer discretionary fell 7%. Among individual stocks, Apple was up 123% while Google spurred 115%. Reflecting the erosion of America's manufacturing prowess, General Motors and Ford were down 52% and 48%, respectively.

An important corollary of the market's lackluster advance despite strong growth in corporate profits is that price/earnings ratios have declined considerably. At about 18 at year-end, the P/E on the S&P 500 was close to its long-term average range of 15 to 16 and down considerably from the high of 40 reached during the bubble of the late 1990s.

For the third straight year, foreign stocks outperformed their US counterparts as the MSCI-EAFE index rose 13.54% during 2005. Japan was at last

enjoying a sustainable economic recovery, Latin America benefited from rising commodity prices and greater economic stability, Asia reaped the benefits of substantial inflows of foreign capital, and European markets surged as corporate restructuring led to greater than expected profit growth. For the past three years, the annualized return on MSCI-EAFE was 23.7%, compared to 14.4% for the S&P 500. Emerging markets registered another year of extraordinary gains as the MSCI-EM Index rose nearly 34%; this segment has had an annualized return of 37.9% over the past three years.

US investors would have profited even more from their investments in foreign stocks were it not for the surprising strength of the US dollar. Our currency was up about 15% versus both the Euro and the yen as the attractiveness of high interest rates in the US outweighed concerns over our large trade deficit. In local currency terms, the return on the MSCI-EAFE was 29% last year (in comparison to the dollar-adjusted return of 13.54%).

## The Bond Market

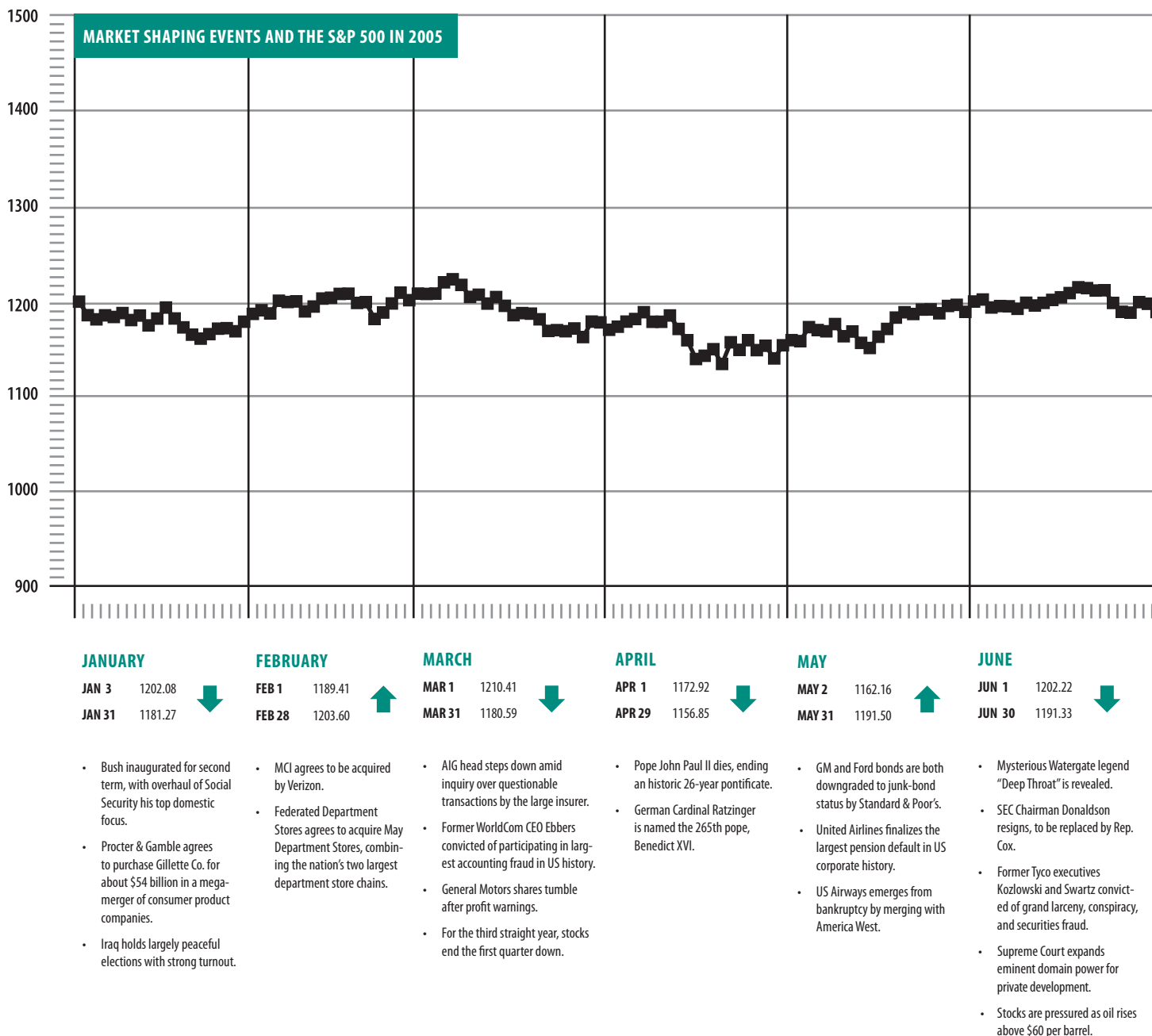
For the second straight year, predictions of higher long-term interest rates in the face of stronger economic growth have proven wrong. The Federal Reserve continued its tightening as the Federal Funds rate was lifted from 2.25% to 4.25%. Nevertheless, in a development that even Chairman Greenspan referred to as a "conundrum" earlier in the year, rates on the benchmark 10-year Treasury note increased only modestly from 4.22% to 4.39%. Despite the fact the bonds of both General Motors and Ford were

downgraded to below investment grade, the yield differential between high yield bonds and Treasuries widened only slightly, remaining well below the historical average. The Lehman Brothers Aggregate Index registered a return of 2.43% for the year while, within the index, performance for corporate and mortgage-backed bonds were generally in line with those of Treasuries. High yield bonds performed slightly better than the investment grade universe last year, but they have provided superior perfor-

mance over the past three years; as measured by the Merrill Lynch US High Yield Index, their annualized return was 13.44% versus 3.62% for the Lehman Aggregate.

At year-end, the bond market faced the unusual situation of an “inverted” yield curve for US Treasuries, where the 2-year interest rate slightly exceeded that of the 10-year. (Usually, long maturities carry higher yields than short maturities.) This phenomenon has

clear negative implications for institutions, notably banks, which profit by borrowing short and lending long, but there was debate over the most frightening possible implication of the inverted curve: that it has historically been the harbinger of a recession. Skeptics minimized the curve’s significance at this time by asserting that long rates were being kept artificially low as a result of continued heavy purchases by foreign central banks.



## Other Asset Classes

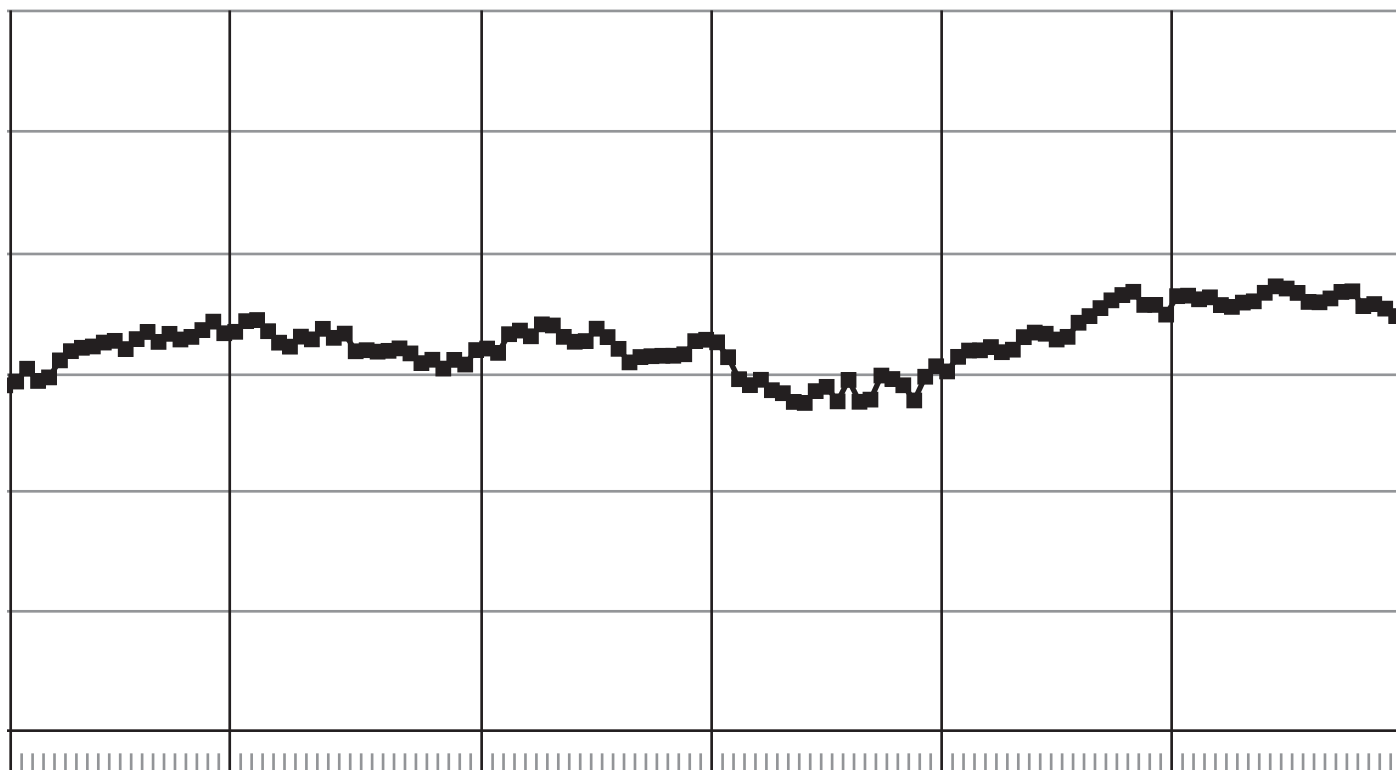
Real estate continued to offer impressive diversification benefits versus US stocks and bonds. While the residential housing market was under selling pressure in most regions, commercial real estate continued to be strong. Although quarterly returns have been on a downward trend after extraordinary gains over the previous two years, publicly-traded Real Estate Investment Trusts still rose 12.16% for the year. Over

the past five years, the annualized return from REITs was 19.08%, compared to 0.54% for the S&P 500. The NCREIF Index of private real estate investments (apartments, industrial, hotels, office, and retail) registered an impressive return of 20.0% for the year.

Performance results for venture capital and private equity are not yet available, but conditions in these crucial sectors were generally healthy as fundraising was proceeding well and valuations of initial invest-

ments were higher. Nevertheless, returns will likely be constrained by the weakness in the market for Initial Public Offerings, where both the number and the size of offerings were down from 2004 in line with the flat results of the public equity markets.

The hedge fund industry saw assets under management exceed \$1 trillion in 2005, up from \$400 billion five years ago. Composite year-end performance was in the range of 6-9%, higher than that of either US



JULY		AUGUST		SEPTEMBER		OCTOBER		NOVEMBER		DECEMBER	
JUL 1	1194.44	AUG 1	1235.35	SEP 1	1221.59	OCT 3	1226.70	NOV 1	1202.76	DEC 1	1264.67
JUL 29	1234.18	AUG 31	1220.33	SEP 30	1228.81	OCT 31	1207.01	NOV 30	1249.48	DEC 30	1248.29
<ul style="list-style-type: none"> <li>Terrorists attack London subways.</li> <li>John Roberts nominated to replace retiring Supreme Court Justice Sandra Day O'Connor. He was later nominated to succeed the late Chief Justice Rehnquist.</li> <li>Responding to pressure, China modestly revalues its currency.</li> </ul>		<ul style="list-style-type: none"> <li>The Federal Funds rate reaches 3.5% as the Federal Reserve raises rates for the tenth consecutive time.</li> <li>Hurricane Katrina devastates the Gulf Coast, causing a staggering economic impact and political recriminations.</li> </ul>		<ul style="list-style-type: none"> <li>Delta and Northwest Airlines file for Chapter 11 bankruptcy.</li> <li>While less severe than Katrina, Hurricane Rita wallops the Gulf Coast.</li> <li>Despite the major hurricanes' effects on income growth and energy prices, stocks rose modestly in the third quarter.</li> </ul>		<ul style="list-style-type: none"> <li>Reco Inc files for bankruptcy after the futures brokerage firm's CEO is charged with securities fraud.</li> <li>Wilma hits Florida, becoming the third costliest hurricane in US history.</li> <li>Iraq's new charter is approved, but US battle deaths exceed 2,000.</li> <li>GM slashes health-care coverage for unionized retirees as losses mount.</li> <li>Despite the hurricanes, third quarter GDP growth reported as a healthy 3.8%, marking the 16th consecutive quarter of growth.</li> <li>Bush's nomination of economist Ben Bernanke to succeed Greenspan as Fed Chairman is well received by the markets.</li> <li>Vice President's chief of staff indicted in the CIA-leak probe.</li> </ul>		<ul style="list-style-type: none"> <li>Samuel Alito nominated for Supreme Court.</li> <li>Democrats do well in off-year elections.</li> <li>GM shares fall to a 13-year low after re-statement of prior reported earnings. The company announces job cuts of 30,000 and closing of nine North American plants.</li> <li>Fears of bird flu rise in Asia.</li> <li>Google stock surges above \$400 as the search engine's capitalization exceeds that of Cisco, Coca Cola, and Time Warner.</li> </ul>		<ul style="list-style-type: none"> <li>Japan's Nikkei stock average surged to a five-year high.</li> <li>Gold rose to \$514 an ounce, its highest close since April 1981.</li> <li>Raising questions about the company's ability to recover, S&amp;P lowered GM's credit rating another two notches.</li> <li>The Fed's latest move left the Federal funds rate at 4.25%, the highest level in 4 1/2 years.</li> <li>Voter turnout is heavy as Iraqis choose a new government.</li> <li>President defends against domestic spying revelations.</li> <li>GM shares fall below \$20, marking a 23-year low.</li> <li>Stocks sagged during December, but still registered moderate advances for the fourth quarter.</li> </ul>	

stocks or bonds but, nevertheless, somewhat disappointing to investors paying high fees for these products. As a result, there were indications of slowing growth during the latter part of the year. Among the many distinct strategies that comprise hedge funds, short-selling, emerging markets, and distressed debt posted low double digit returns while convertible arbitrage posted a loss. It is generally agreed that the lack of volatility in the markets has diminished the existence of market aberrations and inefficiencies that hedge fund managers seek to profit from and that the huge inflow of money into hedge funds has further reduced the opportunities for profitable trading. There were some high profile hedge fund frauds and failures during 2005—most notably Bayou Management—and the industry awaited with uncertainty the official beginning of SEC regulation.

This year's markets have once again vividly demonstrated the vital importance of diversified asset allocation. It is increasingly apparent that it is not sufficient to invest solely in large cap US equities and in high-grade US bonds but a well-balanced investment program should also have allocations to small and mid-cap stocks and to higher-yielding bond sectors, and it should also invest internationally. Just as important, investors should consider the diversifying benefits of alternative asset classes such as real estate. Of course, it is equally vital to have consistently strong managers in all asset classes.

With a new Fed Chairman for the first time in almost 19 years and lingering uncertainties over energy prices, inflation, and economic growth, the investment outlook will continue to be challenging since no asset class appears particularly attractive or under-valued at this time. Trustees must continue to be very pro-active in positioning and monitoring their portfolios. At PERAC, we are committed to working closely with the Commonwealth's public retirement systems to help them meet their goals.

## 2005 Performance Review & Analysis

**A**s of December 31, 2005, the composite asset allocation for the 78 local systems that invested predominantly on their own was: 46.3% Domestic Equity, 14.9% International Equity, 26.5% Fixed Income (including high yield, TIPS, and international), 6.2% Real Estate, 0.3% Timber, 2.1% Alternative Investments, 1.5% Hedge Funds, 0.8% Other (PRIT Core or other balanced accounts), and 1.4% Cash. Assets in these systems totaled \$15.1 billion. The composite allocation of these systems is in line with reported average asset allocations from national surveys of state and local pension plans. Never-

theless, there is a wide divergence of asset allocations around the composites by the local Massachusetts systems. Furthermore, although all but 5 of these 78 systems had some exposure to international equity, 15 systems had no exposure to real estate, including 5 systems with assets in excess of \$100 million. Only 33 systems had any meaningful exposure to alternative investments and only 8 of these had allocations of 3% or more.

Twenty-six local systems with assets totaling almost \$1.8 billion invested entirely (or, in two cases, predominantly) with the PRIT Fund as of year-end. The asset allocation of that \$40.2 billion fund as of December 31, 2005, was 28.1% Domestic Equity, 16.1% International Equity, 6.6% Emerging Markets Equity, 23.7% Fixed Income (including TIPS and High Yield), 10.6% Real Estate (with leverage, 11.7%); 3.8% Timber, 6.1% Alternative Investments, and 5.0% Hedge Funds. In its below average allocation to domestic equities and above average exposure to non-traditional asset classes, PRIT's asset allocation is somewhat atypical of public pension funds nationwide. In addition to the 26 systems that invested essentially all their assets in the PRIT Core Fund, 7 systems had partial investments in the PRIT Core Fund and 39 systems participated in one or more of the PRIT's Fund's segmentation options.

Performance for 2005 for the 106 systems ranged from 3.73% to 12.95% and the composite return of all the systems was 11.41%. For the 78 local systems that invested on their own for the full year, the median return was 7.46%. The median return for all 106 systems was 8.42%.

The median return for the 23 local systems that invested totally (or predominantly) with PRIT for the full year approximated that of the Fund itself, which was 12.7%. Internal cash positions or cash flows, or returns from remaining non-PRIT investments, may have enhanced or subtracted from the returns of individual systems relative to PRIT's basic return. In recent years, a fundamental fact of institutional investing involving endowment funds, foundations, or pension funds, is that larger entities have performed better than smaller ones. Accordingly, the PRIT Fund's size has enabled it to invest in a wider range of asset classes than many of the local systems, and its clout has enabled it to gain access to the top tier of managers in these nontraditional asset classes. Thus, the Fund's performance in 2005 was enhanced by its holdings in Alternative Investments, up 40.4%; Emerging Markets Equity, up 39.5%; Timber, up 26.5%; and Real Estate, up 23.0%.

The returns for Massachusetts' public pension systems can be compared to the median return of the public fund universes of the following national databases:

New England Pension Consultants public funds median, 6.94%; Mercer public funds universe median, 8.30%; T.U.C.S., 7.55%; and Wilshire public funds universe, 6.45%.

As always, the major determinants of performance among the non-PRIT systems were asset allocation and the relative performance of investment managers. Demonstrating that it is difficult to generalize that large systems necessarily do better than smaller ones, seven of the ten best performing local systems had less than \$100 million in assets. In fact, five of these systems invest all their assets with one manager and have little exposure to nontraditional asset classes. What they did have last year, in addition to good overall exposure to equities, was superlative equity performance. Compared to the S&P 500's total return of 4.9% in 2005, some of these systems enjoyed domestic equity performance in excess of 15% as their manager had a year of superb individual stock selection (such as having overweight positions in Apple Computer, which rose 123% last year). In addition to healthy exposure to and strong relative performance from domestic equities, which typically involved having meaningful holdings of small and mid-cap stocks, other systems benefited from having above-average allocations to international equity and/or real estate and strong relative performance in these areas.

Seven of the ten lowest performing systems also had assets less than \$100 million. Among the lagging systems, the one with the lowest return was a very small system whose conservative (51% fixed income) asset allocation reflects its fully funded status. Other systems in this group had healthy exposure to equities but poor performance from their managers which was not offset by good returns from any alternative asset classes. Some had insufficient exposure to small and mid-caps; others just bad stock selection. One of the larger of the lagging systems, besides having no exposure to real estate, had an inexplicable negative return from its small cap manager. For the largest of the trailing systems, mediocre equity performance was aggravated by a decidedly negative return from its venture capital managers, an unfortunate phenomenon suffered by several other systems last year.

While it is difficult to predict which asset classes will do the best in any particular year, the returns for 2005 showed that a well-diversified asset allocation can not only dampen portfolio volatility over time but also improve returns in particular periods. The results also demonstrated that it is equally crucial to have investment managers who successfully fulfill—and sometimes exceed—their mandates. As always, asset allocation goes hand in hand with the diligent selection and careful monitoring of investment managers.