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Searching for Direction



Encouraged by the prospect of economic recovery but worried about high stock valuations amid continued international tensions, the stock and bond markets were essentially flat during the first quarter.

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PERAC | 5 Middlesex Avenue, Third Floor, Somerville, MA 02145
ph 617 666 4446 | *fax* 617 628 4002 | *tty* 617 591 8917 | *web* www.mass.gov/perac

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FINANCIAL MARKET REVIEW | FIRST QUARTER, 2002

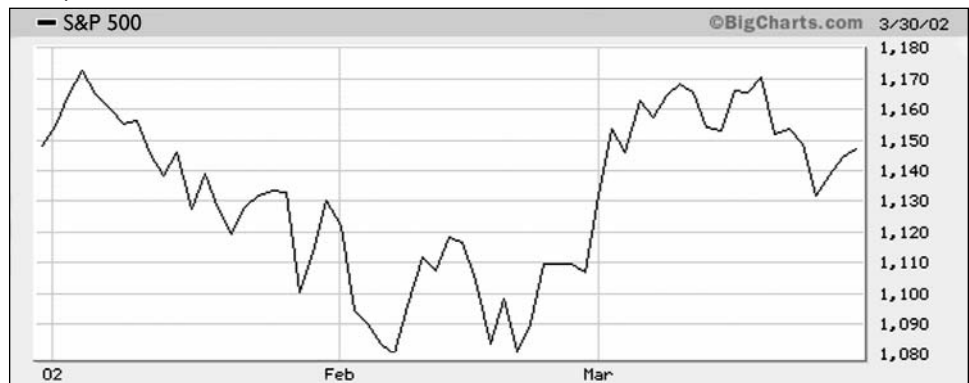
AFTER TWO YEARS OF WRENCHING VOLATILITY AND NEGATIVE RETURNS, THE MARKET'S COURSE FOR 2002 HAS YET TO BE DETERMINED AS RETURNS FROM BOTH STOCKS AND BONDS WERE ESSENTIALLY FLAT FOR THE FIRST QUARTER. Equity prices opened the quarter with a weak tone amid concerns over accounting integrity arising from the Enron bankruptcy, but prices generally recovered later in the quarter amid rising hope that the US economy may be coming out of recession. The Federal Reserve's aggressive easing moves during 2001 appeared to be achieving their desired effect as industrial production was improving, companies were replenishing inventories, housing remained strong, consumer confidence was higher, and inflation remained contained.

In anticipation of an improving economy, stock sectors like consumer cyclicals, retailers, utilities, and financials enjoyed unexpectedly strong gains during the quarter. Economically sensitive stocks like Boeing and General Motors both rose 24%, while Coca Cola, Walt Disney, and Procter & Gamble were among the companies showing double-digit gains. On the other hand, General Electric—the bluest of the blue chips in recent years—fell 6.6% as concerns were raised over the company's

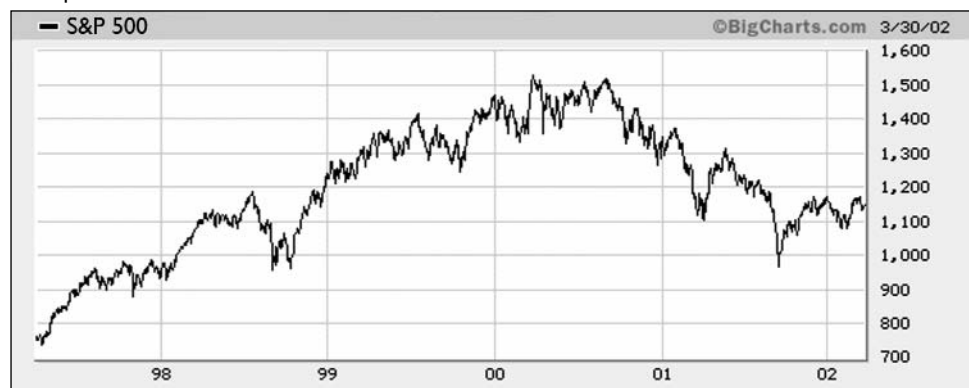
accounting and financial practices.

One of the cautionary attributes of the incipient economic recovery was that it was occurring despite a continued slump in the technology sector. While the Dow Jones Industrial Average rose 3.8% for the quarter and the S&P 500 was essentially unchanged, the technology-laden NASDAQ declined 5.4% as a result of persistent weakness in telecommunications and Internet stocks. Sprint PCS and WorldCom each lost more than half their value as the telecom component of the NASDAQ plummeted 26.6%

#1 | FIRST QUARTER, 2002: STOCKS DOWN, THEN UP



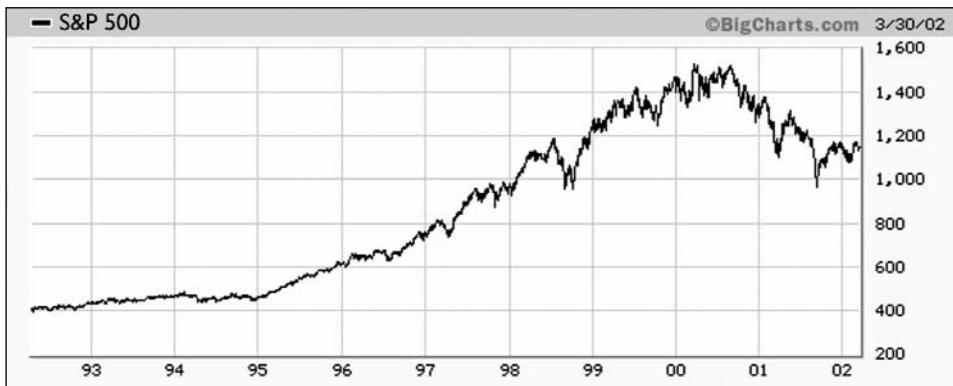
#2 | THE S&P 500, FIVE YEARS: STOCKS ARE BACK TO 1998 LEVELS



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Small & mid-cap stocks outperformed large caps once again, as did value stocks relative to growth.

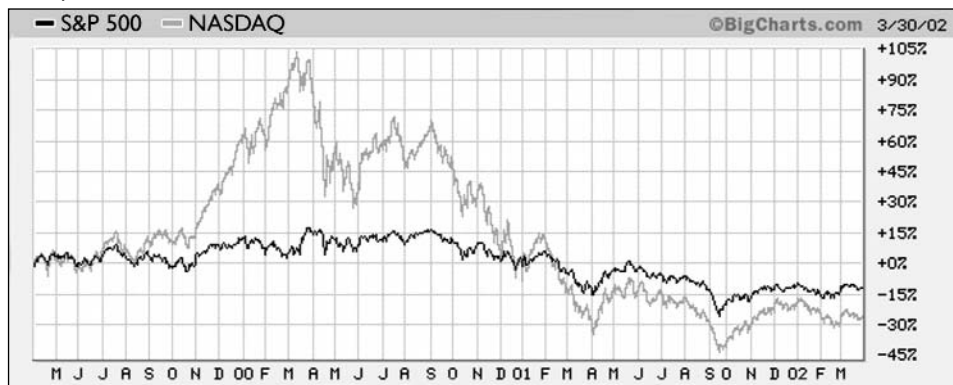
#3 | THE S&P 500, A 10 YEAR HISTORY: MOST OF THE DECADE'S GAINS ARE STILL INTACT



also the place to be during 2002's first quarter as the Russell Small Cap Value Index rose 9.6%. Over the trailing twelve month period, the broad market and large cap indexes showed little or no gain while small caps and mid caps enjoyed strong positive performance, particularly in value.

Looking ahead for equities, there are at least two major concerns. First, the pace of the economic recovery and the health of the stock market could be impacted by further increases in interest rates. The Fed's easing of short-term rates has come to an end as the central bank has reverted to a neutral stance and, although rates still remain low by historic standards, interest rates have begun to rise in sympathy

#4 | THREE YEARS: THE RISE & FALL OF NASDAQ VS THE S&P 500



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overall. Basic technology stocks remained under pressure as corporate spending on information technology has yet to recover from its precipitous decline of recent years.

In terms of equity styles and subclasses, the first quarter saw a continuation of recent trends. As seen in the accompanying table, small and mid-cap stocks outperformed large caps once again, as did value stocks relative to growth. The performance differentials between growth and value continued to be widest in small and mid-caps. Small cap value, the best performing style in 2001, was

with the improving economy. In addition to possibly dampening the pace of economic growth, higher interest rates would reduce the relative attractiveness of stocks compared to bonds.

Second, price/earnings ratios for stocks remain high. The recession of 2001 was mild by most economic benchmarks, and some economists now question whether a true recession even occurred since Gross Domestic Product actually rose 1.2% for the year. Nevertheless, it has been a brutal period for

International equity again failed to outperform the US market.

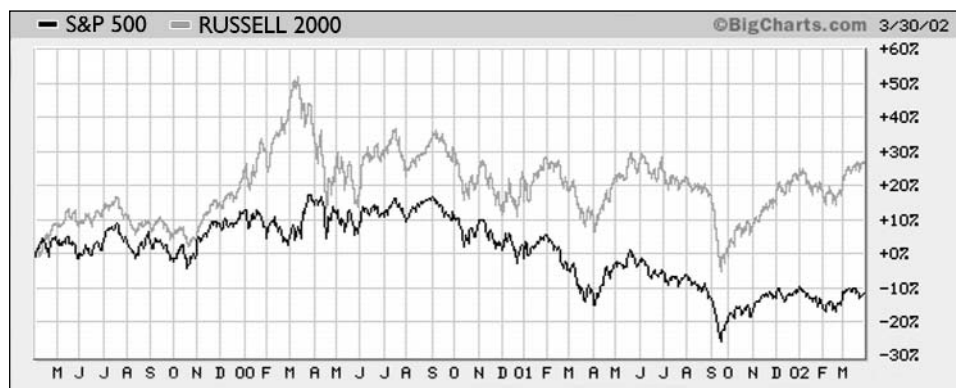
corporate profits. While labor costs remain a problem as a result of a still tight labor market and stubbornly high health care costs, intense global competition and excess capacity in factories and retail space have made it difficult for companies to raise prices. The strong dollar continues to hurt US companies' profits from overseas operations.

Thus, relative to profits, stock prices are only marginally more attractive than they were at the top of the market.

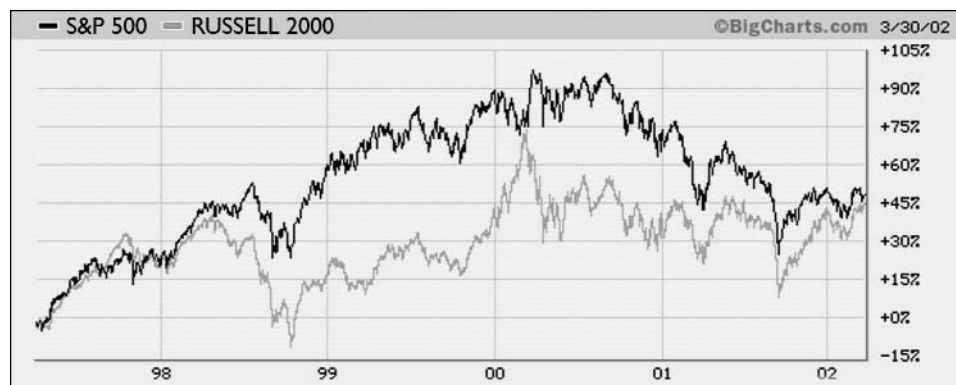
Although the market for Initial Public Offerings showed some signs of life during the first quarter, times continued to be tough for investors in venture capital and other private equity. After a year of stinging double-digit losses, the worst year ever for venture capital, new fundraising has significantly declined and new investment in startups remains weak as general partners focus on determining which of their existing company holdings are worthy of additional nurturing and which need to be written down even further in value. There were reports of institutional investors exerting pressure for a reduction in fees in light of disappointing returns and much lower investment activity by the partnerships.

Investors held out hope for better relative performance if and when the US dollar's

#5 | SMALL CAPS VS LARGE CAPS: FOR THE PAST THREE YEARS, SMALL IS BEAUTIFUL



#6 | SMALL CAPS VS LARGE CAPS: OVER FIVE YEARS, SMALL CAPS AND LARGE CAPS ABOUT EVEN



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strength begins to abate, but international equity again failed to outperform the US market. While some Asian economies showed surprising strength, Europe was unable to overcome the economic doldrums experienced in the US. Supported by attractive valuations and signs of economic and political stability in several countries, emerging markets were the best performing sector in international equity.

Returns from bonds were muted during the quarter. Prices of Treasury securities declined in all maturities as yields rose all

along the yield curve. The two-year note rose in yield from 3.04% to 3.70% while the ten-year yield rose from 5.02% to 5.43%. Short rates were impacted by the apparent end of the Fed's easing while long rates trended upward in reaction to the stabilization of both the economy and the stock market. The steepness of the current yield curve (i.e., the significant yield advantage of long rates over short rates) remains supportive of further economic growth. "Spread" products like corporate bonds and mortgage securities generally outperformed Treasuries as they typically do during the onset of economic recovery. High yield corporate bonds did particularly well as bankruptcy rates stabilized and investors took advantage of their historically wide yield advantage (about 700 basis points) versus high-grade securities.

Real estate has not been immune to the economic recession. While the residential market is only marginally weaker, the vacancy rate in commercial properties has risen to the highest level since 1994 (although still well below earlier peaks) and effective rents have declined. Nevertheless, with interest rates low, much less leverage in the system than in previous cycles, and supply and demand in reasonable equilibrium, real estate markets are not expected to suffer any major dislocations. While results for this year are not yet published, the NCREIF national property index's return for 2001 of 7.4% was down from its double-digit returns of previous years. The return on publicly traded REITs was seemingly unaffected by the national economic downturn as the quarterly index posted an impressive (but probably unsustainable) return of 8.25%.

Looking forward, the fixed income and real estate markets should continue to offer good diversification benefits, but with interest rates still historically low and real estate vulnerable to further market correction, neither

asset class has particularly favorable near-term prospects. Similarly, equities have made an impressive recovery from their September lows, but a reprise of double digit returns appears unlikely in the context of their full valuation and the uncertain, uneven pace of economic recovery. Consumer spending remains reasonably buoyant but major corporations—still making massive write-offs of plant and equipment purchased during the boom—remain focused on cutting costs in a highly competitive environment and no new surge in capital spending is anticipated. Oil prices have already begun rising and the hostilities between Israel and the Palestinians are the latest bloody reminder that we live in a dangerous, unstable world. In a market environment where achieving one's actuarial rate of return could continue to be a challenge for pension funds, there are no easy solutions other than to "stay the course" by maintaining a diversified and balanced asset allocation and closely monitoring whether investment managers are satisfactorily fulfilling their mandates.

As always, we welcome your comments on this report and encourage your suggestions for future investment research reports. For those systems that would like to discuss their portfolios and strategies in the context of the current market or to talk about any other relevant investment topics, we would welcome an invitation to attend one of your board meetings.

TOTAL RETURNS | FIRST QUARTER, 2002

INDEX	FIRST QUARTER 2002	TRAILING TWELVE MONTHS
US EQUITY MARKET		
Dow Jones Industrial Avg.	+ 4.26%	+ 8.24%
Standard & Poor's 500 (Large Cap)	+ 0.28%	+ 0.24%
NASDAQ Composite	- 5.39%	+ 0.30%
Wilshire 5000 (Broad Market)	+ 0.96%	+ 2.54%
Standard & Poor's Mid-Cap 400	+ 6.72%	+ 18.89%
Russell 2000 (Small Cap.)	+ 3.98%	+ 13.98%
GROWTH VS. VALUE		
S&P 500 Growth	- 0.79%	+ 4.83%
S&P 500 Value	+ 1.32%	- 4.29%
Russell Midcap Growth	- 1.77%	+ 4.70%
Russell Midcap Value	+ 7.90%	+ 14.45%
Russell 2000 Growth	- 1.96%	+ 4.95%
Russell 2000 Value	+ 9.58%	+ 23.74%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 0.57%	- 8.58%
M.S.C.I. - Emerging Markets	+ 11.41%	+ 13.64%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 0.09%	+ 5.35%
Lehman Brothers Government/Credit Index	- 0.47%	+ 4.64%
First Boston High Yield Index	+ 2.52%	+ 3.36%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 8.25%	+22.85%
NCREIF Property Index	+ 0.74% (Q4)	+7.41% (Trailing)

Commonwealth of Massachusetts
Public Employee Retirement Administration Commission
5 Middlesex Avenue
Third Floor
Somerville, MA 02145
ph 617 666 4446
fax 617 628 4002
tty 617 591 8917
web www.mass.gov/perac