

The PERAC Financial Bulletin



#7 | October, 2000

Financial Market Review | Third Quarter, 2000

As the longest bull market in over a century recently observed its tenth anniversary, experts are split as to whether this year's changed market direction represents a consolidation phase in a continuing advance, the beginning of a period of directionless, sideways performance, or the onset of a true bear market. Only time will tell, but the market has certainly reinforced the fact that successful investing goes beyond simply following market trends but requires the use of rigorous, disciplined financial analysis.

Furthermore, the third quarter of 2000 dramatically demonstrated the value of diversified asset allocation as all the trends of the late 1990s have turned upside down. Bonds outperformed stocks, value outperformed growth, small cap outperformed large cap, old economy outperformed new economy, and real estate outperformed everything.

As seen on the accompanying table, the stock market did have pockets of strength, but equities overall were pressured by a variety of factors including rising oil prices, the euro currency's decline, and disappointing earnings pronouncements amid signs of a slowing economy. The technology-laden NASDAQ Composite has been the hardest hit; its 7.4% loss for the quarter left it down 27% from its all-time high achieved in March.

The third quarter has historically been lackluster for stocks but market psychology at the end of this quarter was particularly weak and offered scant hope of a fourth quarter recovery. September is typically the market's weakest month, but the Dow Jones Industrial Average's 5% decline was its worst for that month in ten years, the S&P 500's 5.3% loss was its worst since 1986, and the NASDAQ Composite—with its 12.7% loss—suffered its worst September in its 29-year history.

Some winners were found among financial stocks, insurance companies, aerospace companies, homebuilders, and utilities, while the sector under the most pressure was clearly the previously red-hot technology sector. Amid signs of a slowdown in demand for personal computers and worries about growth in telecom, a number of prominent companies warned of earnings disappointments. Given their very high price-to-earnings ratios, companies reporting even a modest deviation from expected results were severely punished in the market. Among notable losers were Apple Computer, losing almost half its value one day in late September; Intel was down 22% on one day and 44% for September; and Priceline.com, down almost 70% for the quarter and 90% from its 1999 peak.

There were still many tech stocks showing impressive returns through the



The Public Employee Retirement Administration Commission Financial Bulletin

NUMBER 7 | OCTOBER, 2000

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first three quarters (i.e., Oracle, up 41%; Sun Microsystems, up 51%; EMC, up 82%; Juniper Networks, up 286%; et al) but they have been outnumbered by the losers. Many previous market leaders suffered sharp declines (such as AOL, down 30% year-to-date; Dell, down 40%; Microsoft, down 48%, Amazon.com, down 50%; Yahoo, down 58%; Lucent, down 59%; Qualcomm, down 60%, and CMGI, down 80%).

While the market bubble for dot.com startups has clearly burst and the high valuations of many established technology companies are being harshly adjusted, the market's unforgiving tone has not been limited to new economy stocks. For example, when Eastman Kodak warned of weak third quarter profits, its stock took a 30% drubbing in late September.

In terms of market cap and style, it's been a rewarding period for previous market laggards, as seen in the accompanying table. Large cap stocks have been the biggest losers, midcaps have been the best performers, while small caps registered small gains both for the quarter and year-to-date. In style comparisons, value stocks have been making an impressive recovery versus growth stocks (except in midcaps). While it is too early to declare that definitive trends have been established, the comebacks for small caps and value do confirm that while certain styles can lead or lag for extended periods, they inevitably do tend to revert to norm.

As seen in the negative returns for the MSCI-EAFE Index both for the third quarter and year-to-date, international stocks have failed to provide any diversifying benefits versus the weak US equity market. European economies have been generally healthy but their stock markets have been hurt by concerns over the euro, down almost 30% versus

the US dollar since its 1999 inception. Asian markets performed poorly, reflecting not only worries about falling global demand for personal computers and semiconductor chips but also concerns about stalled governmental and corporate reform efforts. Although returns have still been negative, Latin America has been a relative bright spot, as some exporting countries have benefited from rising oil prices.

The bond market was concerned about the possible inflationary implications of rising oil prices but was encouraged by the Federal Reserve's decision to forego further monetary tightening at

“While certain styles can lead or lag for extended periods, they inevitably do tend to revert to norm.”

this time. The major change in the market during the quarter was the trend toward reversing the US Treasury bond market's inverted yield curve. Thirty-year Treasuries remained unchanged at 5 7/8% while yields on 2-year notes declined from 6.34% to 5.97% and those on ten-year bonds fell from 6.01% to 5.80%. Bonds may also be benefiting from incremental demand from investors seeking a haven from the stock market's volatility. Treasuries as well as most investment grade corporate bonds and mortgage securities have generally posted positive returns while rising default rates have kept the high yield sector under pressure.

Another sector clearly benefiting

from this year's equity malaise has been real estate, where investors have taken advantage of very attractive valuations in REIT securities. Impressively rebounding after two years of underperformance, equity REITs are up almost 22% on average through the first three quarters of the year while private property holdings continue to register healthy returns of about 3% per quarter. Nationally, the real estate market is considered to be in sound condition with no notable imbalances in either supply or demand.

Venture capital, the asset class that provided astonishing returns for new economy investors in recent years, continued to offer impressive results through the first quarter of this year. However, no industry-wide returns are yet available covering the second or third quarters, during which technology stocks have generally fallen hard and the market for initial public offerings has significantly weakened.

No one knows how long the current “tech wreck” will last or whether the market will over-extend on the downside as it over-reached on the upside. The technology sector is certainly undergoing a painful weeding-out process and a readjustment from a period of over-optimistic valuations, but the information revolution is far from over and those companies that survive the shakeout will likely be strong performers for years to come. As for the overall stock market, it is not surprising from a historical perspective that it would have a flat-to-down year after the above-trend returns of the 1990s, but it seems unlikely that an extended weak market is at hand. The Fed may have been successful in slowing down the economy from its breakneck pace and removing some of the excesses from the stock market, but the economy does not seem headed for a recession. To be sure, major uncertainties

—both economic and political—remain. However, the economy still has considerable positive momentum, inflation remains under control, and no serious imbalances are apparent. Therefore, as vividly demonstrated during the past quarter and so far

this year, diversification through broad asset allocation remains the best long-run strategy—just in case. ☺

PLEASE NOTE:

The PERAC Investment Unit welcomes any comments you may have on this report & encourages all boards to contact us at any time for assistance relating to investment activities. Extra copies of this report are available.

Third Quarter, 2000 | Total Returns

U.S. Equity Market

INDEX	THIRD QUARTER RETURN	2000 YEAR TO DATE
DOW JONES INDUSTRIAL AVG.	2.36%	-6.31%
STANDARD & POOR'S 500	-0.97%	-1.39%
NASDAQ COMPOSITE	-7.39%	-9.74%
WILSHIRE 5000	0.16%	-0.60%
RUSSELL 400	6.81%	12.28%
RUSSELL 2000	1.11%	4.18%

Growth vs. Value

S&P 500 GROWTH	-8.79%	-6.42%
S&P 500 VALUE	8.81%	4.38%
RUSSELL MIDCAP GROWTH	2.52%	14.98%
RUSSELL MIDCAP VALUE	9.65%	8.90%
RUSSELL 2000 GROWTH	-3.97%	-2.80%
RUSSELL 2000 VALUE	7.34%	13.62%

Global Equity Markets

M.S.C.I. - E.A.F.E	-8.01%	-11.64%
M.S.C.I. - EMERGING MARKETS	-13.30%	-17.63%

Fixed Income

LEHMAN BROTHERS AGGREGATE INDEX	3.01%	7.12%
LEHMAN BROTHERS GOVERNMENT/ CORPORATE INDEX	2.87%	7.17%
FIRST BOSTON HIGH-YIELD INDEX	0.69%	-0.16%

Real Estate

NAREIT - EQUITY REAL ESTATE INVESTMENT TRUSTS	7.65%	21.83%
NCREIF PROPERTY INDEX	3.04(2Q)	8.55% (TRAILING 9 MONTHS)

Report on Second Quarter Investment Performance

As of this date, PERAC has received sufficient return data from 62 retirement systems to allow the calculation of total return for the first two quarters of 2000. These returns are listed below.

The returns appear generally favorable since a calculation of expected average performance based on composite asset allocation percentages and benchmark returns of major asset classes yield a

return of about 2%. Expected returns based on surveys and analysis done by investment consultants are also in the 1.5% to 2.5% range.

Recapitulating the financial market returns for the first six months of 2000, major asset class benchmark returns were -0.69% for US stocks (Wilshire 5000), -3.95% for international stocks (MSCI-EAFE), 3.98% for bonds (Lehman

Brothers Aggregate), 5.31% for private real estate (NCREIF), and 13.18% for publicly-traded real estate (NAREIT).

Going forward, PERAC urges all retirements to work toward having all investment return data submitted on a timely basis so that we may provide you with complete compilations and useful analyses of system-wide performance as soon as possible after each quarter. ☺

2000 Returns (Jan.-June)

Adams	1.86%	Melrose	0.16%
Amesbury	2.34%	Methuen	6.12%
Andover	6.51%	Milford	3.69%
Arlington	1.26%	Milton	4.00%
Athol	-3.66%	Minutemen Reg. Voc.	4.13%
Attleboro	0.73%	Montague	4.30%
Berkshire County	4.31%	Natick	0.45%
Beverly	4.10%	Needham	4.36%
Blue Hills	6.95%	Newburyport	3.90%
Cambridge	4.19%	Newton	2.06%
Chicopee	0.27%	North Adams	6.62%
Clinton	4.23%	Northampton	5.90%
Concord	1.98%	Northbridge	4.32%
Dedham	4.34%	Norwood	0.96%
Fairhaven	4.29%	Pittsfield	-0.60%
Fitchburg	7.49%	Reading	4.37%
Framingham	2.07%	Revere	2.86%
Gardner	4.48%	Salem	1.98%
Gloucester	1.18%	Saugus	4.33%
Greenfield	5.65%	Shrewsbury	0.44%
Hampden County	1.24%	Somerville	5.17%
Hingham	4.33%	State Employees	2.89%
Holyoke	1.49%	State Teachers	2.91%
Hull	1.25%	Stoneham	3.73%
Lawrence	1.02%	Taunton	2.79%
Lynn	0.36%	Wakefield	4.33%
Malden	7.64%	West Springfield	1.60%
Marblehead	2.89%	Westfield	2.60%
Marlborough	0.64%	Weymouth	4.07%
Mass Port	2.05%	Winchester	3.78%
Maynard	2.18%	Winthrop	-1.76%
Medford	6.69%		



Glossary

Dow Jones Industrial Average: A price-weighted index tracking thirty large industrial companies selected by the editors of *The Wall Street Journal*.

Standard & Poor's 500 Index: A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ: The National Association of Securities Dealers Automated Quotation System is an over-the-counter trading exchange used mainly by newer, technology-oriented companies.

Russell 2000: The major index that tracks small capitalization stocks.

Large Capitalization Stock: Total market value of outstanding stock exceeds \$5 billion.

Mid-cap stock: Between \$1.5-5 billion in market capitalization.

Small-cap stock: Less than \$1.5 billion market value of stock outstanding.

Growth stock: Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

Value stock: Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

Price/Earnings Ratio: Sometimes referred to as the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

Treasury yield: The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

Corporate bond spread: The "spread" is the incremental yield offered by corporate bond issuers over those of US Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

Federal Funds Rate: The rate at which reserve funds (\$1 million or more) are traded among commercial banks on an overnight basis.

High-yield ("junk") bonds: Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.