

THE PERAC FINANCIAL BULLETIN

#11 | OCTOBER, 2001 | FINANCIAL MARKET REVIEW | THIRD QUARTER, 2001

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The past few years have vividly demonstrated that the psychology of the financial markets, particularly the stock market, is often dominated by the extremes of greed and fear. We saw the face of greed in 1998 and 1999 as momentum investors bid the prices of many technology stocks up to totally unrealistic and unsustainable levels. After the tech bubble burst in 2000, the market has been increasingly characterized by fear of continually declining stock prices amid increasing evidence of a global economic slowdown. The horrific events of September 11 have added a totally new and unfathomable dimension of fear to an already skittish market.

The terrorist attacks caused an already bad quarter for stocks to become even worse. Although there was some recovery during the final week of September, the US equity market suffered its worst week ever after the resumption of trading. All the major indices fell back to 1998 levels, taking back much of the gains of the great bull market, as the Dow Jones Industrial Average fell 14.3%, the S&P 500 declined 11.7%, the NASDAQ composite dropped 16%, and the Russell 2000 gave up 14.4%. About \$1.4 trillion in market

value was eliminated during that emotionally-charged week.

The market's plunge during the third quarter was generally the worst in percentage terms since the quarter that included the crash of 1987. The Dow Industrials fell 16%, the S&P 500 15%, and the Russell 2000 21%, while the NASDAQ's 31% fall left the beleaguered index 70% below its March 10, 2000 peak.

The post-September 11 market left only a few havens of safety as precious metals and

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essential service sectors such as water utilities, food, and medical supplies showed gains for the quarter. Reflecting the fear that shook the economy, airline stocks fell almost 40% during the quarter while entertainment, casinos, and lodging joined the technology sector with losses in excess of 30%.

Even such market stalwarts as General Electric and Microsoft were savaged, losing

COMMONWEALTH OF MASSACHUSETTS
PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION



24% and 30%, respectively, during the quarter. Walt Disney lost 36%, reflecting dim prospects for leisure travel, while Boeing dropped 40%, reflecting the dire outlook for airlines.

Overall, large cap stocks did relatively better during the quarter but continued to underperform mid and small cap stocks year-to-date, while value stocks not only held up better than growth during the quarter but maintained a wide

rate cut on the morning of the market's September 17 re-opening was its eighth this year, bringing the federal funds rate to a 7-year low of 3%. An additional 50 basis point reduction on October 2 brought the key rate to 2.50%, its lowest level since 1962. The post-attack consensus was that the economy, already teetering on the brink of recession, would most likely fall into a period of negative growth over the

coming months. As the Federal Reserve statement accompanying its October 2 action declared: "The terrorist attacks have significantly heightened uncertainty in an economy that was already weak."

Both for the quarter and year-to-date, international investing failed miserably to provide any buffer to the declining US stock market. In fact, the MSCI-EAFE index has fallen even more than the S&P 500. European stocks fell amid fear that the US would not be able to lead a global economic recovery. Asia remained in similar doldrums, with Japan's stock market index falling to a 17-year low. Latin American markets were particularly weak as that region's economic prospects are especially dependent on a healthy US.

The fixed income market continued to offer an effective haven against equity weakness,

although returns were far from uniform. Rates on short-term US Treasury securities declined significantly in sympathy with the Fed's continued easing while long-term Treasury yields fell only slightly as the favorable inflationary implications from a weak economy were offset by concerns over the fiscal implications of the fed-

margin of outperformance year-to-date.

The market's continuing decline reflects disappointment over the economy's lackluster performance even in the face of fiscal stimulus (the tax rebates), lower energy prices, and, most significantly, the Federal Reserve's sustained aggressive easing. Its 50 basis point

S&P 500: A TEN-YEAR PERSPECTIVE

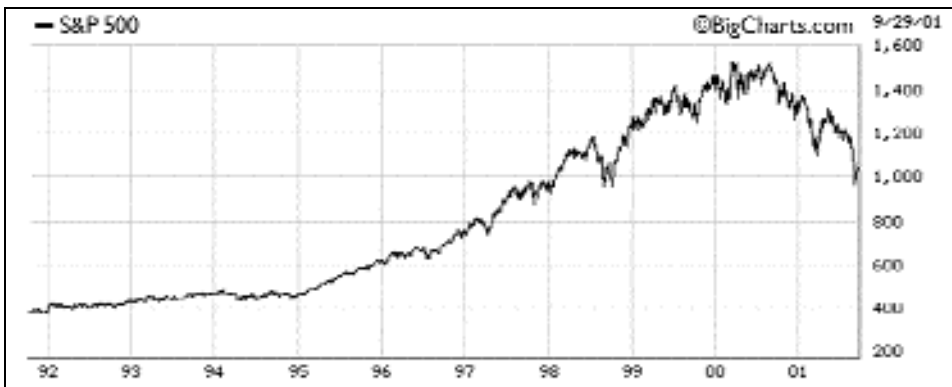


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FIVE-YEAR TREND: AFTER THE BUBBLE, THE S&P 500 AND NASDAQ ARE BACK IN LINE

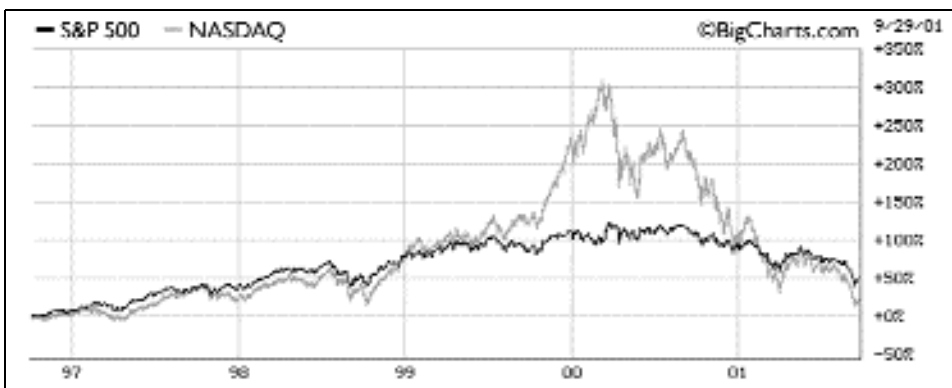


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eral budget surplus being substantially exhausted as a result of emergency spending aimed at stabilizing the economy and dealing with the disaster damage. At quarter-end, the Treasury yield curve was unusually steep, with the two-year note yielding 2.85% and the thirty-year bond 5.41%. Although returns have still been positive, corporate bonds underperformed somewhat as economic concerns caused yield differentials to widen. High-yield

("junk") corporate bonds, which typically trade in sympathy to the equity market, were particularly weak as their yield advantage versus Treasuries increased to about 8%, the widest spread in many years.

Real estate also continued to fulfill its expectation of providing returns with low correlation to the major markets. Although vacancy levels were rising throughout the country as a result of the weak economy, the industry has remained generally stable since, unlike previous cycles, it has not experienced any significant overbuilding in any particular sector or region. Returns were modestly negative on publicly-traded REITs for the third quarter but remain solidly positive for the year-to-date. Returns from privately-held real estate are lagged by a quarter but are not expected to show a significant deviation from the recent pattern of steady quarterly returns of 2-3%.

Not surprisingly, results from venture capital as well as other segments of private equity have closely reflected the dismal trends of the US stock market in general and the market for Initial Public Offerings in particular. Major surveys of VC performance are only available

through the first quarter (when they reflected losses of 9-15%) but, unless the markets have a major change in direction over the balance of the year, it seems inevitable that the typical partnership will show a double-digit loss for the year. Given the downward spiral of the major indices (particularly NASDAQ) and the virtual closing of the IPO market (issuance in the third quarter was the lowest in twenty five years),

S&P 500 VS. NASDAQ: THREE YEARS



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THE BEAR GROWLS: THE S&P 500 OVER THE PAST TWELVE MONTHS

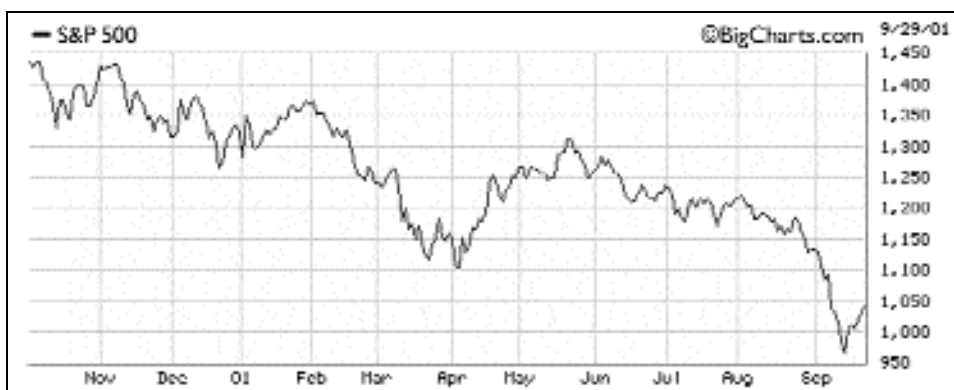


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general partners have been writing down the value of portfolio companies throughout the year. Although many industry participants feel that the lower valuations and tempered expectations make this an ideal time to invest in startups, activity has slowed down considerably. The number and volume of venture investments fell substantially from the second to third quarters

and was down more than 70% from the activity of 2000's third quarter.

As to where the markets go from here, it is certainly fair to say that while the markets' direction is always uncertain, the events of September 11 have added an entirely new and very large measure of uncertainty. Showing that the past is not necessarily prologue to the future, those prognosticators who cited historical

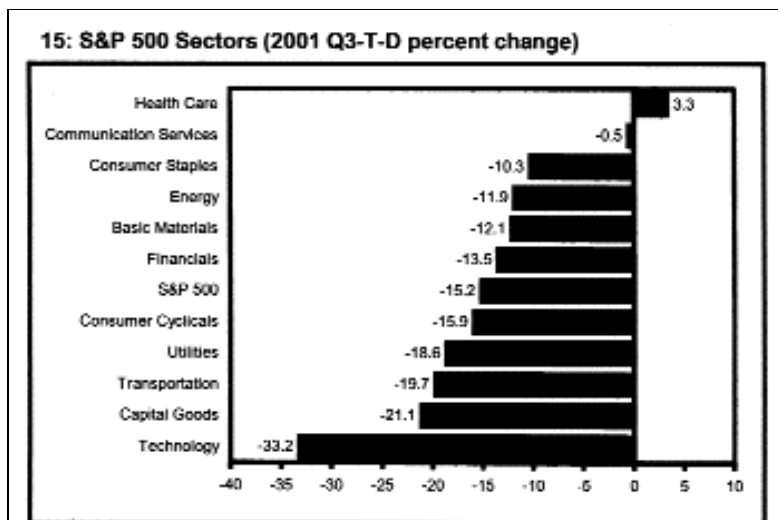
precedent and predicted that the market would soon recover following the Fed's first few easing moves earlier this year have been proven wrong. Similarly, in light of the totally unprecedented nature of the current situation, investors should be wary of the charts appearing in the financial press indicating impressive market recoveries after previous calamitous events that shook the market.

The one event that would most certainly boost consumer confidence and investor psychology would be a quick and decisive military strike by the US that substantially accomplishes the administration's goals. On the other hand, a protracted struggle, with the persistent threat of disruption to our normal lives, is likely to cause further dismay on Wall Street as well as on Main Street.

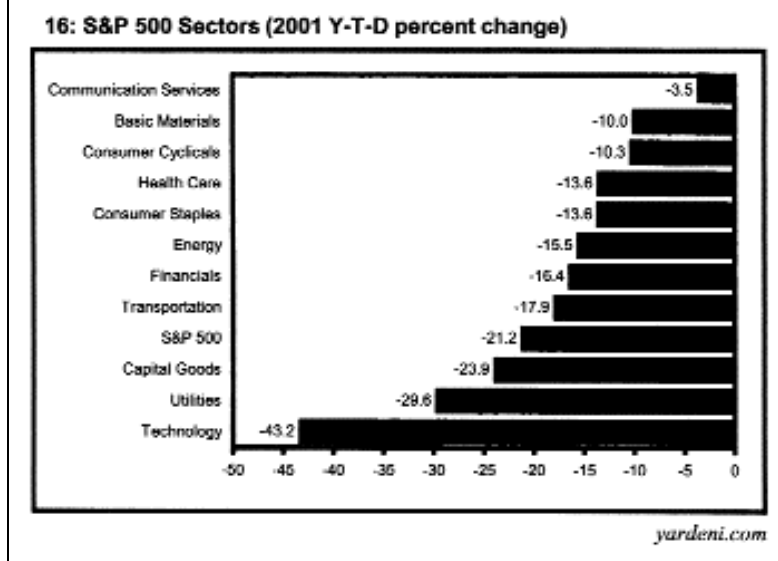
Taking a more narrow view, some analysts see today's stock market as a buying opportunity since the fiscal and monetary stimulation already in place should eventually take hold. Others take comfort in the Federal Reserve's valuation model that indicates that, comparing the ratio of the projected earnings of S&P 500 companies to their stock prices and the current yield level of 10-year Treasury bonds, stocks appeared 14% undervalued at quarter-end. On the other hand, while stock prices have plummeted over the past year-and-a-half, price/earnings ratios have come down only modestly because actual and projected corporate earnings have also fallen drastically. Thus, by that and other traditional standards, stocks do not appear historically cheap, although some strategists believe that above-average P/E ratios are justified during this period of low interest rates and very modest inflation. Furthermore, current composite P/E ratios are closer to historical averages if the still-expensive technology sector is eliminated.

Historically, it should not have been surprising that the roaring bull market of the 1990s, with its bloated excesses, should be followed by a crushing bear market. Markets tend to revert

SECTOR ANALYSIS: THE TECHNOLOGY DEBACLE CONTINUES



As of September 28, 2001



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to their mean rates of return and just as markets often overextend on the upside, they may well trade down to oversold levels before rebounding. In any case, the bottom line is that, for nearly all retirement boards in Massachusetts and every other state, 2001 is shaping up as the second consecutive year of disappointing returns. For many systems, these investment results will lead to actuarial losses. Consequently, significant appropriation increases may be necessary to amortize these losses.

It is important for board members to realize that there are no easy or magic solutions by which to cope with—or overcome—bear markets. Fixed income and real estate (and, of course, cash) can provide valuable buffers during markets like this, but it should not be forgotten that equities remain the appropriate asset class for long-term capital appreciation. It's impossible to predict the future and this is not intended to be a recommendation, but for those retirement systems currently under-invested in equities, the present time might represent a good opportunity to consider rebalancing into this asset class. Similarly, considering the widely erratic returns in the equity market's subclasses in recent years, boards may want to examine whether their portfolios have a reasonably diversified balance between large and small cap stocks and between growth and value stocks. ■

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 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.

STOCK VALUATIONS: CHEAPER BUT NOT CHEAP

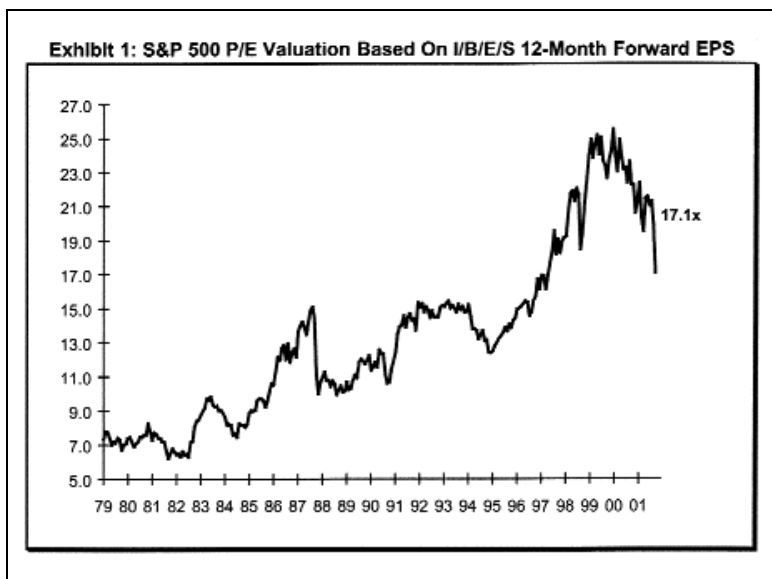


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INTEREST RATES FALL TO CYCLICAL LOWS



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THIRD QUARTER, 2001 | TOTAL RETURNS

INDEX	THIRD QUARTER 2001	NINE MONTHS 2001
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 15.0%	- 16.58%
Standard & Poor's 500 (Large Cap)	- 14.68%	- 20.39%
NASDAQ Composite	- 30.7%	- 39.3%
Wilshire 5000 (Broad Market)	- 15.90%	- 20.77%
Standard & Poor's Mid-Cap 400	- 16.57%	- 15.76%
Russell 2000 (Small Cap.)	- 20.79%	- 15.36%
GROWTH VS. VALUE		
S&P 500 Growth	- 13.20%	- 22.79%
S&P 500 Value	- 16.20%	- 18.22%
Russell Midcap Growth	- 27.80%	- 37.16%
Russell Midcap Value	- 11.55%	- 8.66%
Russell 2000 Growth	- 28.08%	- 28.05%
Russell 2000 Value	- 13.33%	- 2.31%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	- 13.96%	- 26.35%
M.S.C.I. - Emerging Markets	- 21.95%	- 23.18%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 4.61%	+ 8.39%
Lehman Brothers Government/Credit Index	+ 4.76%	+ 8.44%
First Boston High Yield Index	- 3.95%	+ 0.16%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	- 2.47%	+ 9.77%
NCREIF Property Index	+ 2.26% (Q2)	+ 4.59% (Q1, Q2)

Dow Jones Industrial Average

A price-weighted index tracking 30 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.

GLOSSARY