THE PERAC FINANCIAL BULLETIN

#9 | APRIL, 2001 | FINANCIAL MARKET REVIEW | FIRST QUARTER, 2001

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"Nothing sedates rationality like large doses of effortless money". This was legendary investor Warren Buffett's recent description of the psychology that stoked the US stock market during the late 1990s. As we know, the bubble finally burst in March 2000 when the market began a long and painful downward spiral that has continued through the first quarter of 2001. In brutally eliminating the excesses and inflated values that had characterized the unusually high returns of the recent past, the US stock market is undergoing a major re-valuation. As the market reverts to more reasonable long-term trends in returns, it is once again valuing companies based on traditional fundamentals and profitability rather than on fanciful expectations and unsustainable stock price momentum.

"The market is once again valuing companies based on traditional fundamentals."

The Standard & Poor's 500 Index of large cap stocks fell 12% during the quarter, its largest decline since the third quarter of 1990 and its worst first quarter since 1939. At month-end, it was down 24% from its peak. The technology-laden NASDAQ Composite declined 26%, following its record slide of 33% during the fourth quarter of 2000; it was down 64% from its record high of March 2000. Over 10% of NASDAQ stocks are down more than 90% from their peaks. The Russell 2000 Index fell 7%, indicating that small caps outperformed large caps. Among style indices, value stocks continued the trend which began in 2000 by significantly trouncing growth stocks; as seen in the accompanying table, value outperformed growth by as much as 60% in certain categories over the twelve month period ending March 31, 2001.

The downward trend of stock prices reflects what has been happening in the economy. Just as stocks have been adjusting from a period of unrealistic valuation, the economy is coping with the ramifications of excessive capital spending, particularly in technology. "If you build it, they will come" seemed to have been the creed of overzealous telecom companies,

wireless providers, and builders of fiber-optic networks. The resulting overcapacity, diminished demand, and falling prices have clearly contributed to the current economic slowdown.

With personal computer sales having achieved a measure of market saturation and with current machines satisfying the needs of most users, the PC market is enduring a brutal price war as overall industry revenues are actually declining for the first time since 1981. On the corporate side, many businesses have completed their technology buildup and with the dot-com threat receding and the Y2K hype well past, companies are also cutting back on tech investments, contributing to the bloated inventories affecting most suppliers. In contrast to the continuation of impressive profit growth projected by analysts last summer, profits of technology companies are now expected to decline this year.

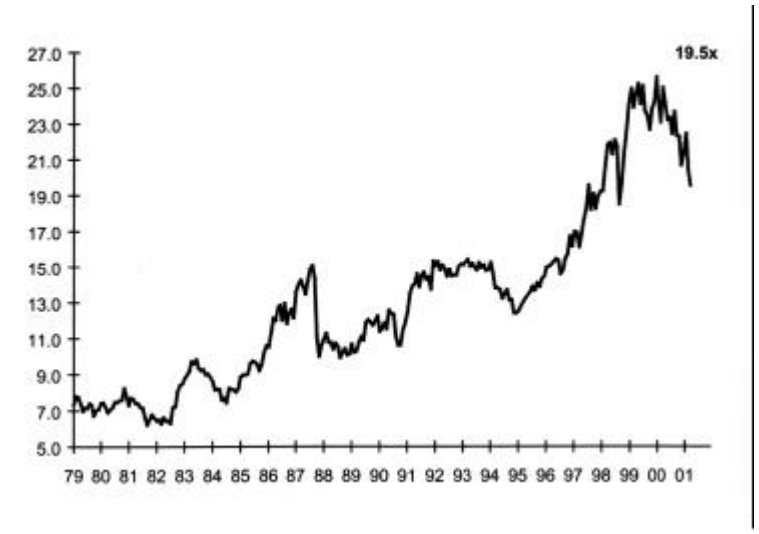
The first quarter saw not only the continuation of the tech rout but also the dragging down of many "old economy" stocks as well. Among the many companies issuing cautionary or lower earnings guidance, Dow Jones Industrial components Procter & Gamble, McDonald's, American Express, and Coca Cola were all off at least 20%. On the other hand, a few overlooked industrial sectors such as railroads and auto parts showed positive returns and some of 2000's worst performers, including Microsoft (+26%) and AT&T (+23%), recovered from their lows.

Investors have lost a staggering $5 trillion in market value since the highs of March 2000, an amount equivalent to over 50% of our annual Gross Domestic Product. Nevertheless, most analysts are not ready to declare the damage over because traditional stock valuations, while significantly lower than a year ago, are still not cheap by historical standards. (See accompanying charts.) Forward price-to-earnings ratios for the S&P 500 are about 20, compared to 14-15 at previous market bottoms and as low as 8 at the 1974 bottom. For NASDAQ companies, P/E ratios have declined significantly but still remain high because earnings are falling at least as rapidly as stock prices.

On the other hand, a number of strategists believe that higher P/E ratios are justified by inflation remaining low and interest rates being significantly lower than long-term averages.

HAVE VALUATIONS FALLEN ENOUGH? (PART 1)

Exhibit 1: S&P 500 P/E Valuation Based on I/B/E/S 12-Month Forward EPS



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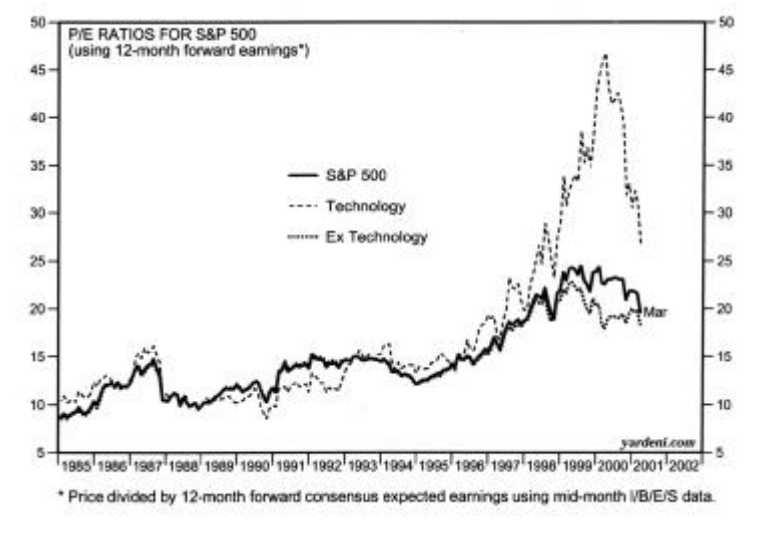
HAVE VALUATIONS FALLEN ENOUGH? (PART 2)



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One prominent strategist's model, utilizing interest rates and projected corporate profits, sees the current market being about 15% undervalued after being 55% overvalued a month before last year's peak. Another hopeful indicator may be that stocks have historically shown impressive advances twelve months after the Fed has cut rates three times, as it has over the past three months. Optimists also point out that the S&P 500 has not had consecutive years of losses since 1973-74.

The accompanying charts show that the S&P 500, while more than 20% off its high, still has most of its gains from the last decade intact. Also, the NASDAQ's collapse from its bubble valuation leaves it back in line with the S&P's long-term trend, which is how NASDAQ has historically tracked.

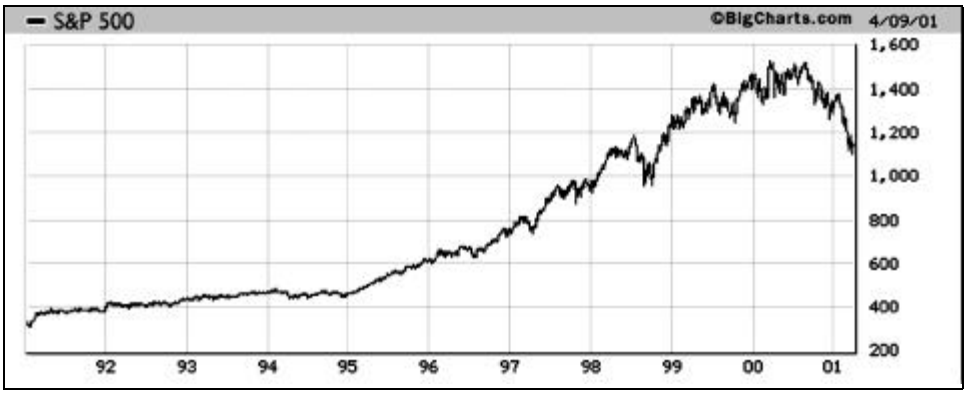
International stocks failed to provide any diversifying benefit to the weak US market. Instead of buttressing falling domestic demand, most foreign economies have been dragged down by the US economic slowdown. Japan's stock market fell to a 16-year low as that nation is still reeling under weak political leadership, high savings rates, and a troubled banking system.

The fixed income market was supported by three Fed easings (and expectations of more to come), the effects of a slowing economy, as well as enhanced demand arising from investors reducing their equity investments. Nevertheless, interest rates, having fallen substantially in 2000, have shown only modest further declines this year. (Falling rates mean higher bond prices for existing holders.) The benchmark 10-year Treasury bond yield fell 20 basis points to 4.91%. Investment grade corporate bond spreads relative to Treasuries remained historically wide, reflecting the weak economy. The high yield market showed healthy positive returns, recovering somewhat from its very weak showing in 2000.

Real estate is another asset class that offered investors the advantage of low correlation to equities. Although some areas have been noticeably affected by the collapse of dot-coms and the slowdown of the technology building boom, real estate markets have continued to enjoy a healthy equilibrium between supply and demand. After their extraordinary rebound in 2000, returns on publicly-traded REITS have been flat so far this year. Privately-held real estate continues to register positive returns of about 3% per quarter.

With the collapse of the NASDAQ market and the drastically reduced market for initial public offerings, venture capital partnerships have understandably struggled in recent

THE BEAR MARKET: A LONG-TERM PERSPECTIVE



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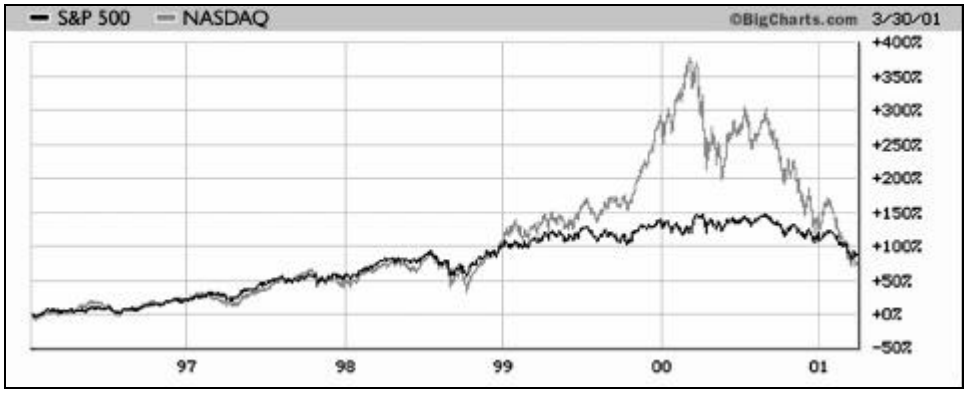
"International stocks failed to provide any diversifying benefit to the weak US market."

months after their extraordinary success in the late 1990s. Recently-released data from Venture Economics for the year 2000 indicated four quarters of declining returns for venture capital funds, with the fourth quarter showing a loss of 6.3%. Returns for the twelve-month period were still a robust 37.6%. (Returns for all private equity, including buyouts, were -4.0% for the fourth quarter and 20.0% for the year.) Returns for the year 2001 are expected to be very weak due to the continued decline of NASDAQ and the fact that year-end returns for 2000 did not reflect true market values of all underlying companies. Although recent results have confirmed that venture capital returns are closely tied to performance of the public equity market, it is also evident that institutional investors have not lost confidence in the sector as new flows into venture capital partnerships in 2000 were at a record high level.

S&P 500 VS. NASDAQ: LONG-TERM TREND



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S&P 500 VS. NASDAQ: 12.31.99 - 3.31.01

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As noted in previous reports, the markets tend to over-react on the downside just as they over-reach on the upside, so it is not possible to say if and when the market may be bottoming. While it is encouraging that the stock market has returned to a sense of normalcy and it is once again focused on fundamentals, the economic outlook remains cloudy. Consumer confidence has declined but remains generally high. Industrial production has fallen for five consecutive months but the unemployment rate—while having modestly risen—remains just slightly above a thirty-year low. The Fed appears committed to using monetary policy as a tool to prevent a recession, and a tax cut of uncertain proportions may be forthcoming from Washington. But falling interest rates may not be the answer for an economy whose major problem has been too much capital investment chasing too little returns, and any tax cuts may prove to be too little and too late. With households owning stocks in record proportions to their overall wealth, the current bear market—and particularly the utter decimation of NASDAQ—has itself had a clear negative effect on economic vitality.

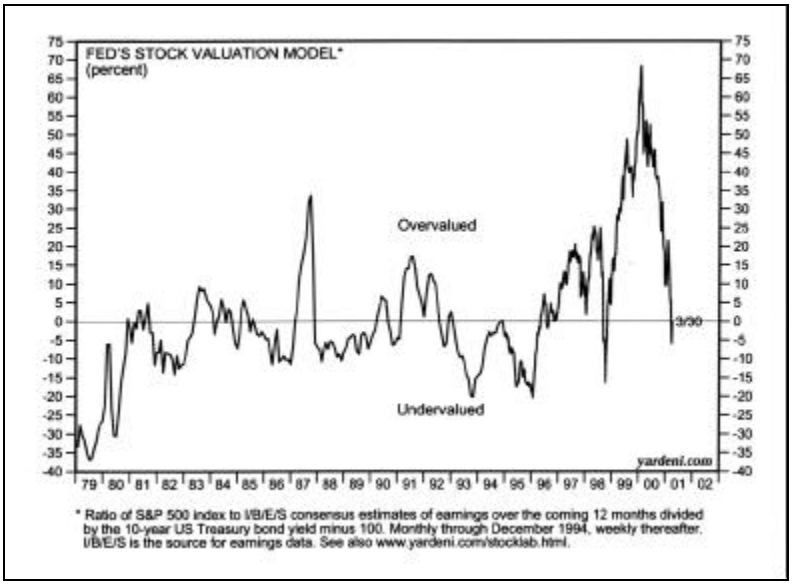
The recent period has been a difficult one for pension funds as sharply reduced investment returns may be causing the unfunded liabilities of some systems to increase. Most Massachusetts public pension funds appear to be weathering the storm as well as possible as a result of their

diversified asset allocation. Those investors who have suffered the most over the past year have been those who have been over-committed to growth stocks and large cap stocks, neglecting the fact that value stocks and small caps also have their cycles of superior performance, and forgetting that stocks are not only much more volatile than other asset classes but historically have had negative returns every four years.

It's difficult to generalize about the market but there is no question that stocks are more attractive today than at any time in the recent past, not only relative to company fundamentals but also compared to the low interest rates currently available in the fixed income market. For many investors whose equity allocations have fallen to or through the lower end of their target ranges as a result of the stock market decline, the current period may be an appropriate opportunity to begin rebalancing by adding to equity holdings.

As the estimable Mr. Buffett has noted, the technology stock bubble produced great (but possibly ephemeral) wealth for many but it was not a healthy market. "It was as if some virus, racing wildly among investment professionals as well as amateurs, induced hallucinations in which the values of stocks in certain sectors became decoupled from the values of the businesses that underlay them." Going forward, outsized gains from equities will be harder to attain but hopefully will be based on a much stronger foundation. ■

ARE STOCKS NOW FAIRLY VALUED?



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"The current bear market has itself had a clear negative effect on economic vitality."

As always, the Investment Unit welcomes your questions and comments. In addition to encouraging your suggestions for future research reports, we would welcome the opportunity to attend retirement board meetings for the purpose of discussing either specific or general investment topics.

FIRST QUARTER, 2001 | TOTAL RETURNS

INDEX	FIRST QUARTER 2001	12 MONTHS
US EQUITY MARKET		
Dow Jones Industrial Avg.	-8.02%	-8.07%
Standard & Poor's 500 (Large Cap)	-11.86%	-21.68%
NASDAQ Composite	-25.51%	-59.76%
Wilshire 5000 (Broad Market)	-12.34%	-24.77%
Russell Mid-Cap	-10.49%	-11.99%
Russell 2000 (Small Cap.)	-6.51%	-15.33%
GROWTH VS. VALUE		
S&P 500 Growth	-17.41%	-38.19%
S&P 500 Value	-6.53%	-1.07%
Russell Midcap Growth	-25.09%	-45.42%
Russell Midcap Value	-3.53%	+13.82%
Russell 2000 Growth	-15.20%	-39.81%
Russell 2000 Value	+0.97%	+19.45%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	-13.66%	-25.79%
M.S.C.I. - Emerging Markets	-4.92%	-35.53%
FIXED INCOME		
Lehman Brothers Aggregate Index	+3.03%	+12.53%
Lehman Brothers Government/Corporate Index	+3.20%	+12.41%
Lehman Brothers High Yield Index	+6.36%	+2.52%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+0.39%	+23.90%
NCREIF Property Index	+3.08 (Q4)	+12.03% (trailing 12 months)

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.