

The PERAC Financial Bulletin

APRIL 2004 | NO. 21



Financial Market Review, 1st Quarter 2004

The financial markets have a way of usually confounding the “expert” prognosticators, and the first quarter of 2004 was a prime example.

The PERAC Financial Bulletin

NO. 21 | APRIL 2004

Commonwealth of Massachusetts
Public Employee Retirement Administration Commission

Domenic J. F. Russo, *Chairman*
A. Joseph DeNucci, *Vice Chairman*
C. Christopher Alberti
Kenneth J. Donnelly
Eric A. Kriss
James M. Machado
Donald R. Marquis

Joseph E. Connarton, *Executive Director*
Robert A. Dennis, C.F.A., *Investment Director*

Printed by 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



Contrary to the expectation that stocks would continue to rally this year and that bond prices would fall as interest rates inevitably rose, the first three months of the year saw a stock market that was essentially flat while bonds registered healthy positive returns.

Among the broad market indices, the S&P 500 was up 1.3%, the Dow Jones Industrials were down 0.9%, and the NASDAQ Composite was off -0.5%. To many observers, the stock market's

directionless quarter represented a normal pause after 2003's exuberant returns. Nevertheless, a number of basic fundamental concerns did overhang the market.

Prior to the healthy growth in jobs reported on April 2, 2004, the market was restrained by concerns over the jobless nature of the economic recovery. Also, with price/earnings ratios relatively high, further market appreciation was seen as dependent on continued growth in corporate profits, which were unlikely to rise more

than 10% from 2003 levels. Fears of terrorism, highlighted by the March 11 railroad bombings in Madrid and continued violence in Iraq, remained a concern. The sharp increase in oil prices, the

To many observers, the stock market's directionless quarter represented a normal pause after 2003's exuberant returns.

Chart 1 | Twelve Months: Post-Rally Pause

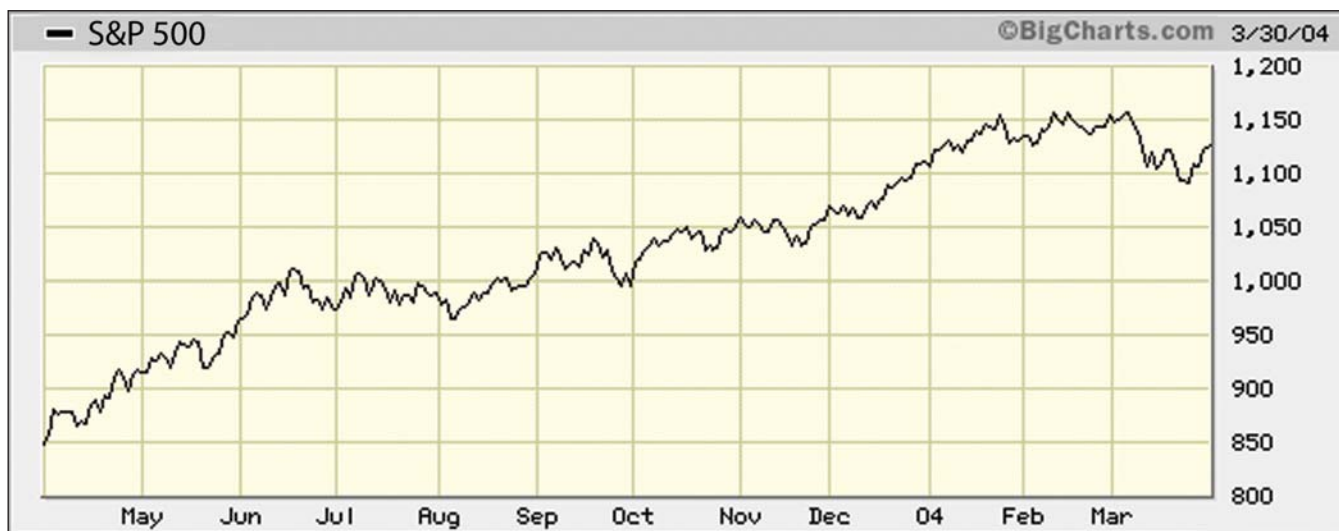
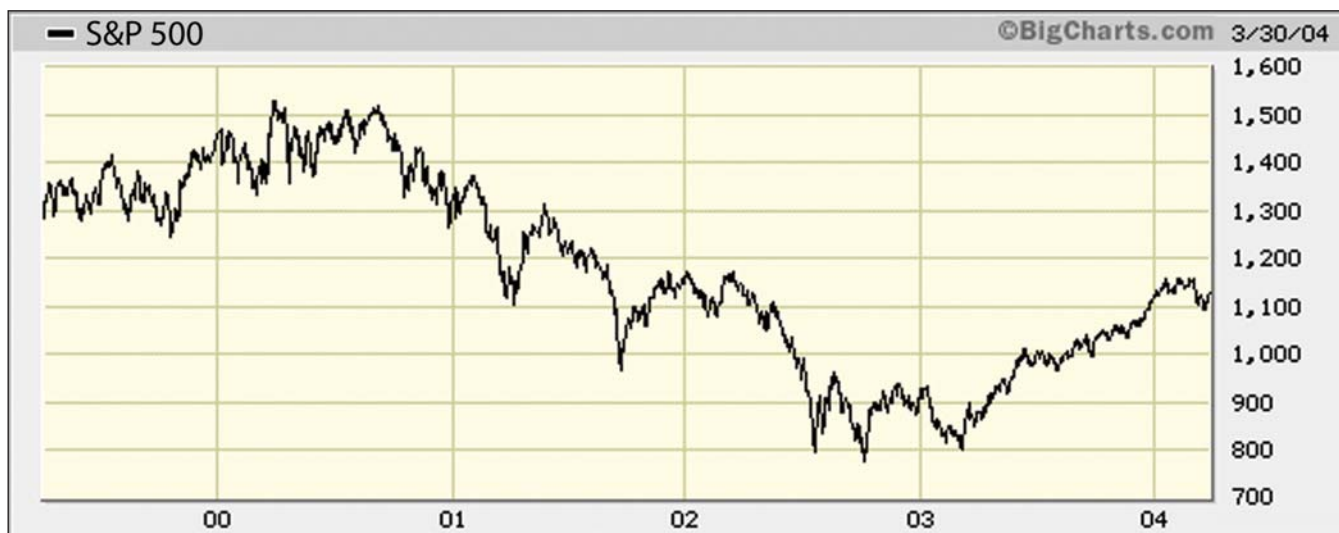


Chart 2 | S&P 500: Five-Year Perspective



Charts reprinted with the permission of www.bigcharts.com.

possible rise in interest rates, as well as the uncertainties surrounding this year's presidential election also weighed on investors.

Also somewhat surprisingly, mid-cap and small cap stocks continued to outgain large caps, even after four years of significant outperformance, and value stocks generally outperformed growth once again. (See accompanying table of returns.) As they often do during uncertain times, household product stocks held up well while restaurants and retail also did well.

Technology stocks gave back some of their gains from 2003, while airlines and auto manufacturers generally did poorly. Among the Dow Industrials, McDonald's and WalMart were up 12-15% while Microsoft, General Motors, and Intel were down 9-16%.

Foreign stocks were also mixed. China's surging economy lifted growth in Hong Kong, Singapore, and South Korea while, after several years of essentially zero interest rates, Japan's economy finally seemed to be on the mend.

Developing countries like Mexico also did well while Europe remained generally mired in stagnant economic growth and concerns over terrorism.

Despite expectations that interest rates were more likely to rise than fall from their historically low current range, the continuation of low job growth, restrained inflation, and Asian central bank purchases served to create another quarter of gains for the bond market. The market also took comfort from the Fed's signaling that no hike in rates

Chart 3 | Russell 2000 vs. S&P 500: Small Caps Still Rule

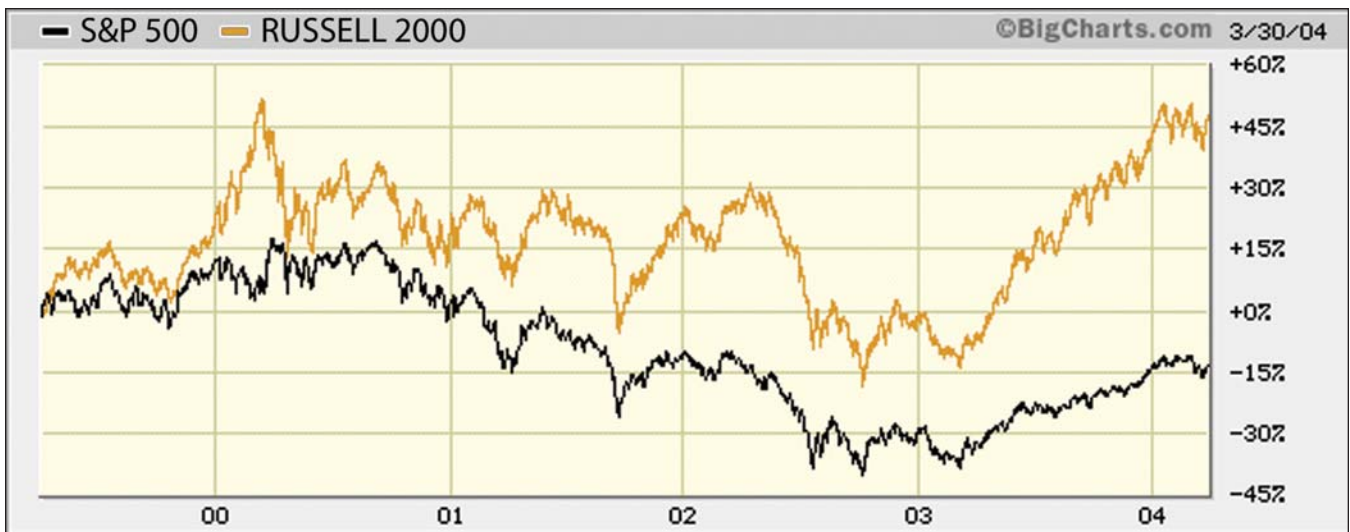
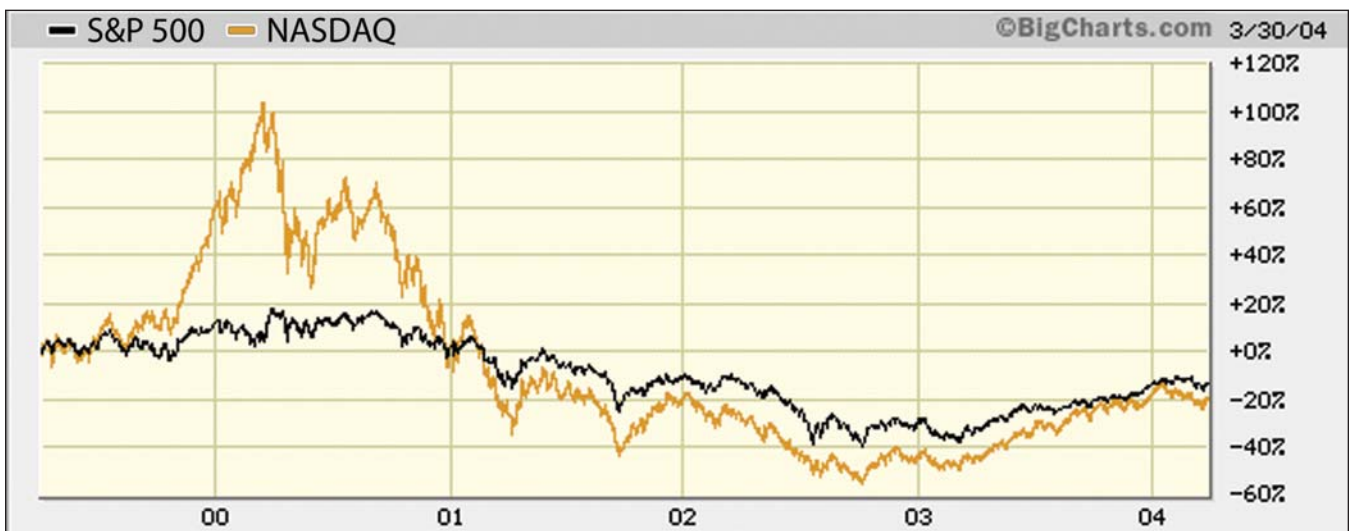


Chart 4 | NASDAQ vs. S&P 500: About Even Over Five Years



Charts reprinted with the permission of www.bigcharts.com.

was imminent. The benchmark 10-Year Treasury bond yield declined from 4.25% to 3.85% (before sharply rising back above 4% following the April 2 employment report). Corporate and “junk” bonds registered yield declines of much smaller magnitude.

After four years of positive returns, including 37% in 2003, the outlook for Real Estate Investment Trusts in 2004 was guarded. Nevertheless, REITs returned a composite 12% during the first quarter, due in part to their continuing wide yield advantage over other income producing investments. Returns on privately held property were more consistent with the actual fundamentals of the real estate industry. Overall returns have been in the range of 9% annualized, with apartments and retail performing the best and hotels and office space showing more modest gains.

Last year’s sharp recovery in the stock market in general and NASDAQ in particular has given a long-awaited bounce to the moribund venture capital industry. The first quarter was the busiest for Initial Public Offerings in four years and, despite a reported overhang of uninvested funds from previous years, fundraising has begun to pick up. General partners are confident that today’s more realistic valuations will contribute to healthy future gains for investors.

Hedge funds are not a true asset class but a collection of widely disparate strategies intended to achieve absolute returns. Following hedge funds’ positive composite performance during the three-year bear market, the industry has

Despite expectations that interest rates were more likely to rise than fall from their historically low current range, the continuation of low job growth, restrained inflation, and Asian central bank purchases served to create another quarter of gains for the bond market.

Chart 5 | Interest Rates: Still Historically Low



Chart 6 | Yield Curve: Historically Steep



Charts reprinted with the permission of www.yardeni.com.

Chart 7 | Quality Spreads: Still Attractive

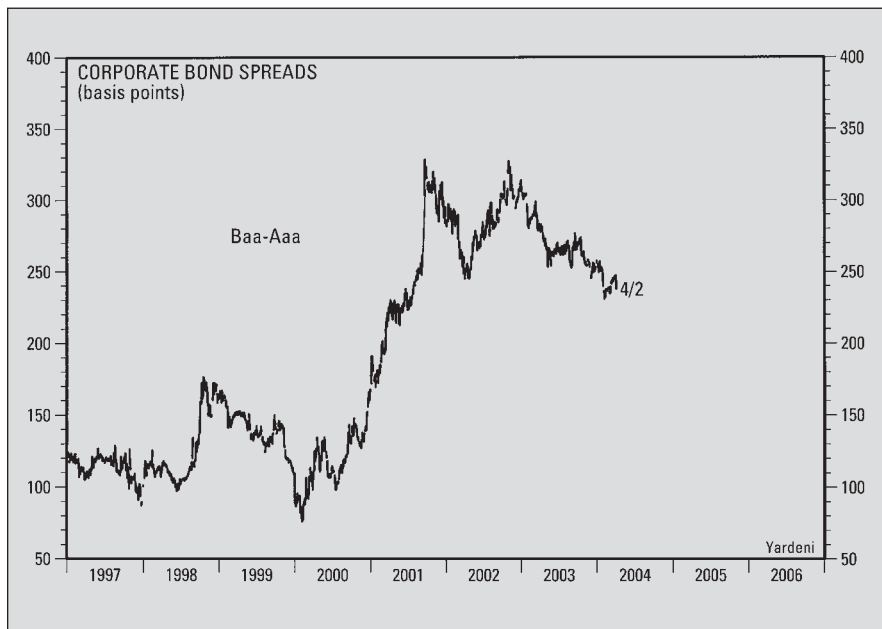


Chart reprinted with the permission of www.yardeni.com.

continued to see impressive growth in demand from sophisticated investors who are seeking greater portfolio diversification. Returns for the first quarter were modestly positive in most hedge fund strategies.

The quarter was also notable for the continuing investigation by state and federal regulators into improper practices in the mutual

fund industry. A number of high profile firms were charged with allowing improper market timing and/or illegal late trading or with failing to disclose financial arrangements with firms that sold their products. The findings have had no effect on the financial markets and very little overall impact on assets under management in the mutual fund industry but they will have

brought about a definite improvement in corporate governance within the fund industry.

While the coming months are fraught with political, economic, and investment uncertainties, there is no doubt that retirement boards must continue to be very vigilant in monitoring their portfolios. Asset allocation should be reasonably balanced between equities and fixed income, and equity holdings should themselves be well balanced between large cap and small cap and between growth and value. Boards should examine other asset classes (such as real estate and private equity) that might offer increased portfolio diversification. And just as important as asset allocation, boards must be satisfied that their investment managers are satisfactorily fulfilling their mandates.

As always, the PERAC Investment Unit welcomes the opportunity to work with retirement boards and to provide assistance in any phase of their investment program.

TOTAL RETURNS | *1st Quarter, 2004*

INDEX	FIRST QUARTER, 2004	TRAILING TWELVE MONTHS
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 0.43%	+ 32.55%
Standard & Poor's 500 (Large Cap)	+ 1.69%	+ 35.12%
NASDAQ Composite	- 0.46%	+ 48.70%
Wilshire 5000 (Broad Market)	+ 2.60%	+ 39.37%
Standard & Poor's Mid-Cap 400	+ 5.06%	+ 49.10%
Russell 2000 (Small Cap.)	+ 6.26%	+ 63.83%
GROWTH VS. VALUE		
S&P 500 Growth	+ 0.02%	+ 26.74%
S&P 500 Value	+ 3.35%	+ 44.14%
S&P Midcap 400 Growth	+ 4.56%	+ 41.18%
S&P Midcap 400 Value	+ 5.53%	+ 57.05%
Russell 2000 Growth	+ 5.58%	+ 63.16%
Russell 2000 Value	+ 6.92%	+ 64.49%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 4.34%	+ 57.53%
M.S.C.I. - Emerging Markets	+ 9.59%	+ 81.66%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 2.66%	+ 5.40%
First Boston High Yield Index	+ 2.66%	+ 22.85%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 12.02%	+ 52.58%
NCREIF Property Index	+ 2.76% (Q4)	+ 8.99% (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