

The PERAC Financial Bulletin

Financial Market Review, 3rd Quarter 2004

OCTOBER 2004 | NO. 23

Many Questions...

How badly will record high oil prices affect the economy? Will the situation in Iraq stabilize? Will the threat of terrorism continue to be a concern? Will economic expansion be strong enough to bring job growth back up to historical levels? Will the November elections bring about change in economic policies? Will the recent moderation in economic growth lead the Fed to slow the pace of its monetary tightening? Will corporate profits be able to sustain their impressive growth rate of the past year? Will businesses emerge from their current period of caution and resume capital spending at a healthy rate?

These are some of the major uncertainties overhanging the markets, causing equities to languish in a narrow range and bonds to do surprisingly well as a haven of perceived safety.



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Q3

The third quarter of 2004 was expected to be a rough one for bonds and a healthy one for stocks, but as so often happens, the markets have a way of confounding the experts. It had been anticipated that the reports of robust job growth in late spring would presage a period of strong economic growth. However, the second quarter's GDP growth rate of 3.3% was actually lower than the 4.5% pace of the first quarter and this slower rate continued into the third quarter. Job growth in the third quarter was disappointing and expectations of corporate profit growth were being lowered.

THE EQUITY MARKETS

Whether it was attributable to higher oil prices (which reached a record high of \$50 a barrel as October began), fear of terrorism, uncertainty over the election, or to the possibility that the benefits from previous fiscal (tax cuts) and monetary (lowest interest rates in over 40 years) stimulation had run their course, **there was no question that the economy had run into what Fed Chairman Greenspan termed a "soft patch"**. Accordingly, equity prices generally

fell during the quarter. The broad market Wilshire 5000 Index declined 1.8% during the quarter although it was still up 2.1% for the year.

Surprisingly, even after four years of previous outperformance,

small and midcap stocks have continued to outpace large caps so far in 2004.

Although they actually underperformed during the third quarter, small caps (Russell 2000) have outpaced large caps (S&P 500) by about 2% so far this year. (See accompanying table) Reflecting the doldrums from overcapacity and lackluster demand affecting the technology sector, the NASDAQ Composite was down 7.4% for the quarter and 5.3% year-to-date.

Also surprising to those who have predicted a reversal of another four-year trend, value stocks continued to outpace growth. In fact, after a wide performance advantage in the third quarter, value stocks have generally registered healthy positive returns for the year while growth has been flat to negative.

Overall, the market has been less volatile than in recent years but, as always, there have been wide differentials in performance among different sectors and specific stocks.

For instance, Home Depot, mirroring still healthy consumer spending, was up 11.4% for the quarter while Coca Cola, Intel, and Merck (whose popular Vioxx drug was withdrawn from the market on September 30) declined 20.7%, 27.3%, and 30.5%, respectively.

International stocks have generally reflected similar economic and monetary conditions as in the US and have also been lackluster this year. The MSCI-EAFE Index has modestly outperformed the US market while emerging markets, which include some countries (such as Russia, Indonesia, and Mexico) that are benefiting from rising oil and commodity prices, have outperformed the developed markets.

FIXED INCOME MARKET

The bond market's action during the third quarter was surprising to many. The Fed announced its second and third tightenings of the year, bringing the federal funds rate up to 1.75% (still very low by historical standards), but in a pattern that hadn't been seen in over thirty years, **bond rates did not rise in concert with short rates but actually declined** as traders noted that economic growth was moderating, not accelerating, and

Chart 1

Meandering Market:
S&P 500 in 2004

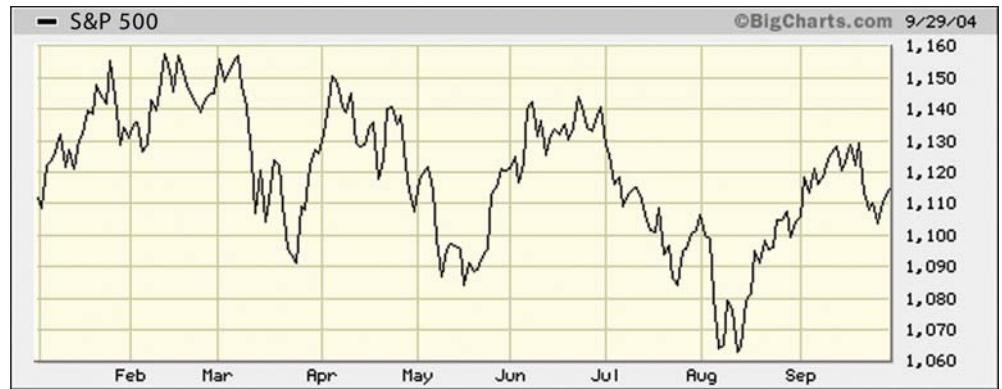


Chart 2

S&P 500: A Five-Year Perspective

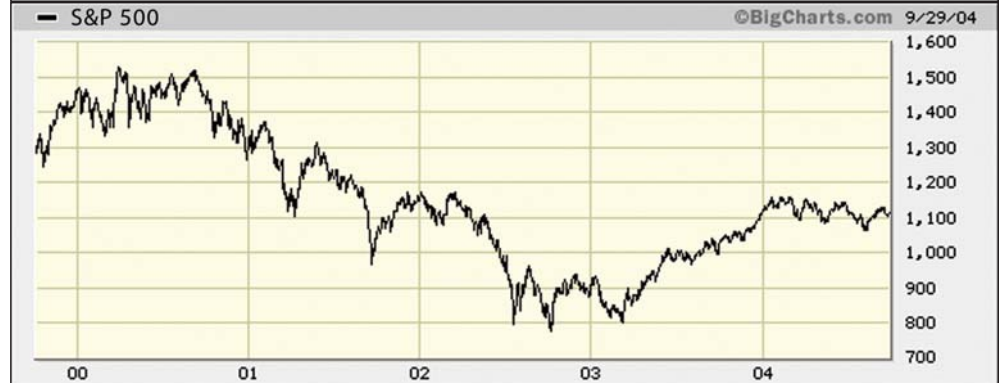


Chart 3

S&P 500: A Ten-Year Perspective

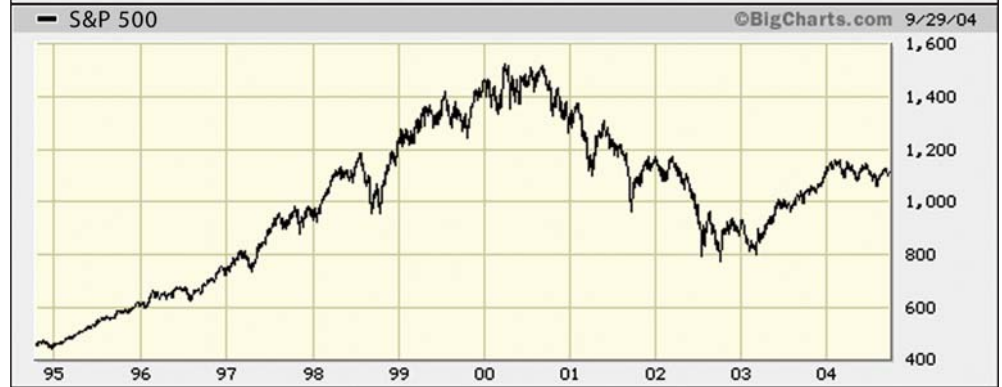


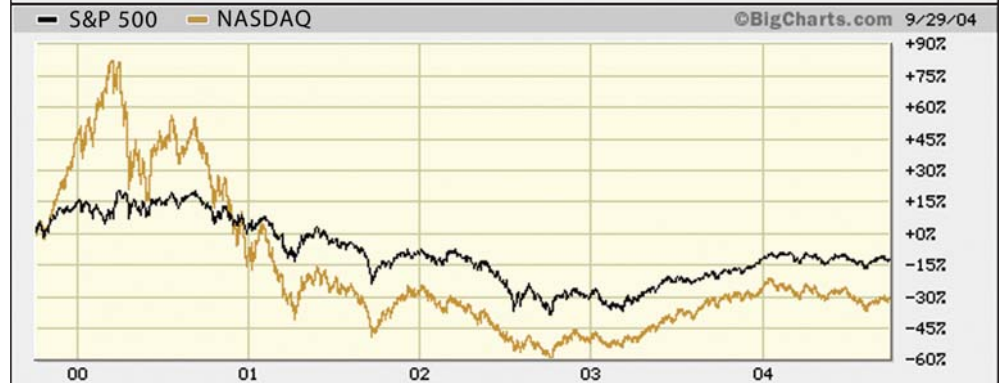
Chart 4

S&P 500 vs. Russell 2000:
Over Five Years, Small Caps Rule



Chart 5

S&P 500 vs. NASDAQ:
Since the Bubble, S&P Outperforms



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that inflationary fears were perhaps exaggerated. The benchmark ten-year Treasury bond began the quarter at 4.6% and rallied to below 4% before settling at 4.125% at quarter-end. Since bond prices rise as interest rates fall, the Lehman Brothers Aggregate Index rose 3.2% for the quarter and 3.3% year-to-date. There was a moderate flattening of the yield curve as the yield differential between two and ten-year Treasury bonds narrowed from 1.9% to 1.6%. Corporate bond yields generally declined in concert with Treasuries, maintaining the generally narrow quality yield spreads of recent months. Although their yield advantage compared to high-grade bonds has narrowed considerably after their very strong performance in recent years, high yield “junk” bonds have still registered a positive return both for the quarter and year-to-date.

ALTERNATIVE ASSET CLASSES

Real estate has continued to offer strong diversification benefits versus equities.

After a blockbuster year in 2003, publicly traded REITs have significantly outperformed the stock market again so far in 2004. Surprising even some industry professionals with performance that exceeds actual trends in most real estate markets, REITs are up over 14% so far this year. Privately held real estate has also done well, appreciating at an annualized rate of about 10%. According to NCREIF, retail space has been the best performing sector while the east and west coasts have had the best regional performance.

Actual returns are not yet available, but the private equity and venture capital markets appeared to be heading back to normalcy. Led by

the \$1.76 billion offering by Google, the IPO market has been strong. Through the end of the third quarter, both the number and market value of IPO offerings this year are double those for 2003 and they represent the most activity since 2000. Unlike in 2000, it is encouraging that this year's IPO offerings are not concentrated in technology but are well diversified by industry and are also very likely to be at or near profitability.

Hedge funds are not an asset class but a collection of strategies aimed at achieving absolute returns. Institutional investors continue to be an important component of the rapid growth in assets in hedge funds, but returns this year have been a reminder that the industry does not offer a panacea for performance-starved investors. Returns on most hedge fund strategies have been flat to only modestly positive this year. During the quarter, the SEC issued for comments its proposed regulations that would require most hedge funds to register as investment advisors.

OUTLOOK

It's possible that, with the assistance of a post-election rally and/or positive geopolitical or economic news, retirement boards may still meet their actuarial rates of return this year. But with stocks fully priced relative to earnings and bond prices having limited upside as interest rates are historically low, achieving strong returns will likely continue to be a struggle in the months ahead. Once again, there are no easy solutions to coping with flat markets other than to have portfolios that are as well diversified as possible, with reasonable allocations to small and midcaps as well as large cap stocks, growth as well as value, and international as well as domestic stocks. Systems not already involved in alternative asset classes

such as real estate should consider doing so. Finally, systems should be intolerant of consistent underperformance by their investment managers. Systems should not be averse to considering index funds as low-cost, viable alternatives to high-cost active managers who fail to even match their benchmarks over a full market cycle.

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 | *3rd Quarter, 2004*

INDEX	THIRD QUARTER, 2004	NINE MONTHS, 2004
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 3.40%	- 2.12%
Standard & Poor's 500 (Large Cap)	- 1.87%	+ 1.51%
NASDAQ Composite	- 7.40%	- 5.32%
Wilshire 5000 (Broad Market)	- 1.78%	+ 2.08%
Standard & Poor's Mid-Cap 400	- 2.10%	+ 3.86%
Russell 2000 (Small Cap.)	- 2.86%	+ 3.71%
GROWTH VS. VALUE		
S&P 500 Growth	- 4.78%	- 2.19%
S&P 500 Value	+ 1.04%	+ 5.25%
S&P Midcap 400 Growth	- 3.42%	+ 1.75%
S&P Midcap 400 Value	- 0.78%	+ 5.95%
Russell 2000 Growth	- 6.01%	- 0.67%
Russell 2000 Value	+ 0.15%	+ 7.99%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	- 0.28%	+ 4.27%
M.S.C.I. - Emerging Markets	+ 8.14%	+ 7.09%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 3.20%	+ 3.35%
Lehman Brothers High Yield Index	+ 4.85%	+ 6.27%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 8.23%	+ 14.19%
NCREIF Property Index	+ 3.13% (Q2)	+ 10.80% (Trailing 12 months)

