

# The PERAC Financial Bulletin

Financial Market Review, Third Quarter 2005

OCTOBER 2005 | NO. 27



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No. 27 October 2005

## **Public Employee Retirement Administration Commission**

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# Q3

After two quarters of flat to negative performance, the stock market registered positive returns for the third quarter. Bond prices slipped as interest rates rose slightly, leaving returns from bonds still modestly positive for the year. The economy was experiencing healthy growth and corporate profits were continuing their impressive rise, but the markets were confronting serious headwinds as Hurricanes Katrina and Rita left the prices of oil, gasoline, and natural gas at cyclical highs and the Federal Reserve appeared undeterred

in its program of raising interest rates.

## EQUITY MARKET

The broad market Wilshire 5000 Index rose 3.89% for the quarter and 3.92% for the first nine months. The S&P 500 (large cap) index rose 3.61% for the quarter and 2.77% year-to-date. Confounding many prognosticators by their continued outperformance versus large caps over almost six years, the Russell 2000 (small cap) index rose 4.69% for the quarter and 3.38% for the year. Over the trailing five-year

period, the Russell 2000 has outperformed the S&P 500 by an annualized 7.9%. The technology-laden NASDAQ Composite had a strong quarter, up 4.6%, but is still down 1.09% for the year. (See Charts 1-5.)

The S&P 500 outperformed most other broad indices because it has a higher weighting of energy companies (10.3% of total market capitalization at quarter-end) than the others. Reflecting the rise in crude oil from \$42.45 to \$66.24 through the first nine months, the S&P 500's energy

### Chart 1

S&P 500: After a Good Quarter, Up Slightly in 2005

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### Chart 2

S&P 500: Five-Year Perspective

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component rose 18% for the quarter and 40% year-to-date. Without the energy sector, the S&P 500 would have been down 2% this year. (See Chart 6 for the long-term price trend of oil.)

Gains in the equity market this year have been narrowly focused among energy companies, utilities, and certain health care stocks. Companies involved in the production of energy generally did well, while those that use a lot of energy,

such as chemical manufacturers, generally did poorly. For example, Exxon Mobil is up 24% this year while DuPont is down 20%. Other notable winners and losers so far this year have been Boeing (+31%), Hewlett Packard (+39%), and Altria (+21%) on the plus side and General Motors (-24%), Alcoa (-22%), and Verizon (-19%) on the minus side.

Among styles, growth did slightly better during the third quarter, but

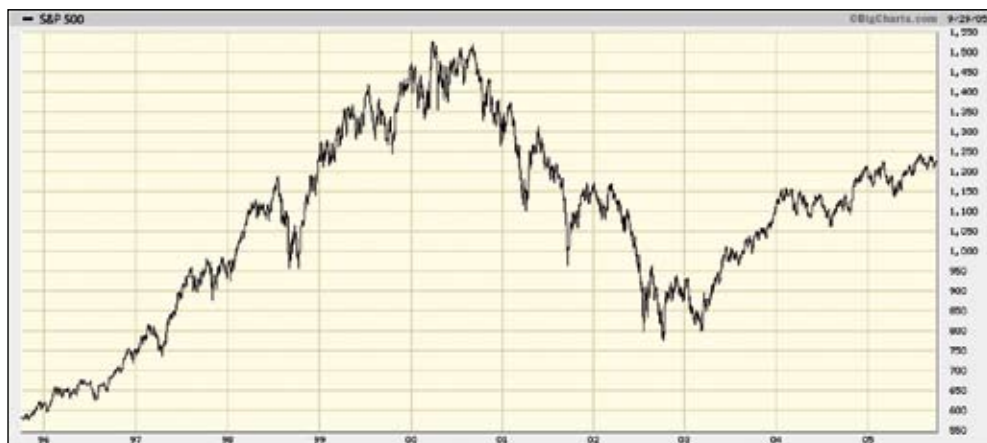
year-to-date, value has continued its decade-long trend of outperformance. According to S&P, value has outperformed growth by an annualized 7.8% among large cap stocks over the trailing five-year period.

Markets around the world managed to overcome energy and economic concerns to a greater extent than the US. Asian markets were buoyed by China's decision to revalue its currency and Latin American markets

### Chart 3

#### S&P 500: Ten-Year Perspective

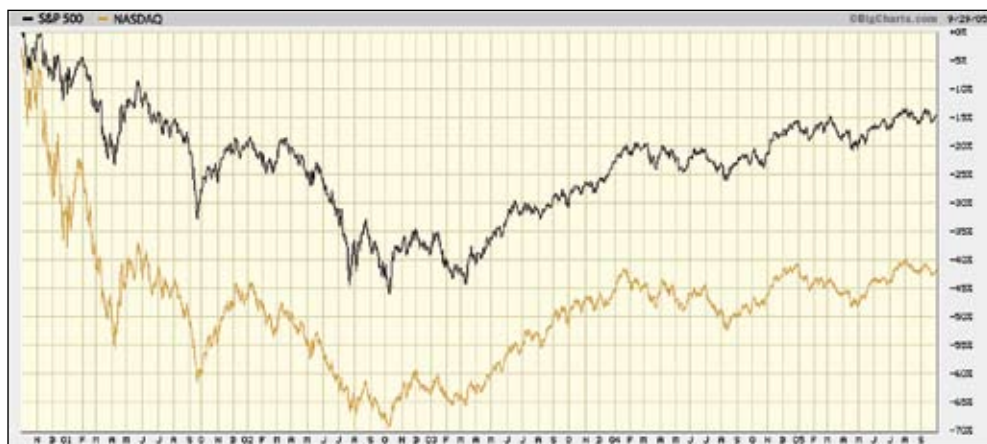
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### Chart 4

#### S&P 500 vs. NASDAQ: Over Five Years, Technology Lags

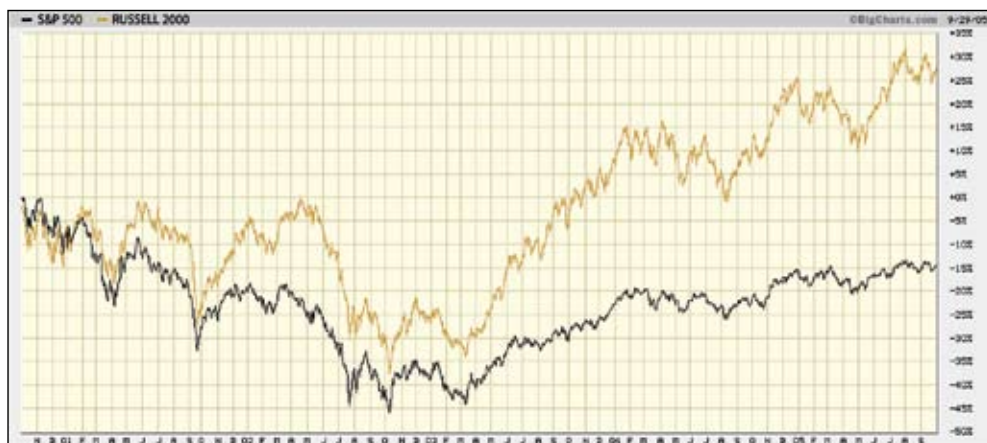
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### Chart 5

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

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reflected improved economic prospects. The MSCI-EAFE Index rose impressively by 10.4% and 9.1% for the quarter and year-to-date, respectively. Nine month returns would have been even higher were it not for the dollar's strength during the first half of the year; in local currency terms, the Index was up 20.4% year-to-date. Emerging markets, where the currency effects have been minimal, have been particularly strong this year, up 18.0% and 25.0% in dollar terms for the quarter and year-to-date.

### FIXED INCOME MARKET

The bond market confronted inflationary concerns arising from soar-

ing fuel and commodity prices as well as the prospect of massive, budget-busting governmental spending to rebuild hurricane-damaged areas. Partly in recognition of such concerns, the Federal Reserve Board—after two further tightening moves during the third quarter—indicated that its fifteen-month program of raising short-term rates would likely continue. Nevertheless, thanks in part to investors' desperate search for yield and their apparent conviction that inflation will remain under control, the bond market suffered only modest losses during the quarter. After a -0.67% return for the quarter, the Lehman

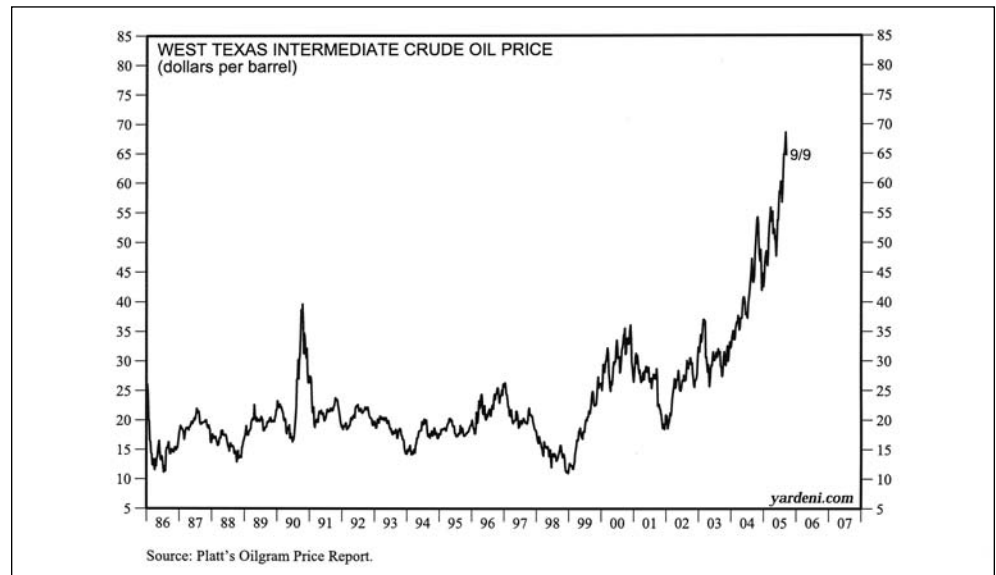
Brothers Aggregate Bond Index was still up 1.8% for the year to date.

The yield on the benchmark 10-year Treasury closed at 4.332%, up from 3.992% at the close of the second quarter but—despite continued Fed tightening of short-term rates—still below the 4.494% yield at the end of the first quarter. Perhaps the most important observation on the bond market has been the significant flattening of the yield curve. The yield differential between 2 and 10-year Treasury securities narrowed to as little as 11 basis points during September, having been as steep as 250 basis points at the

#### Chart 6

##### The Price of Oil Spikes Up

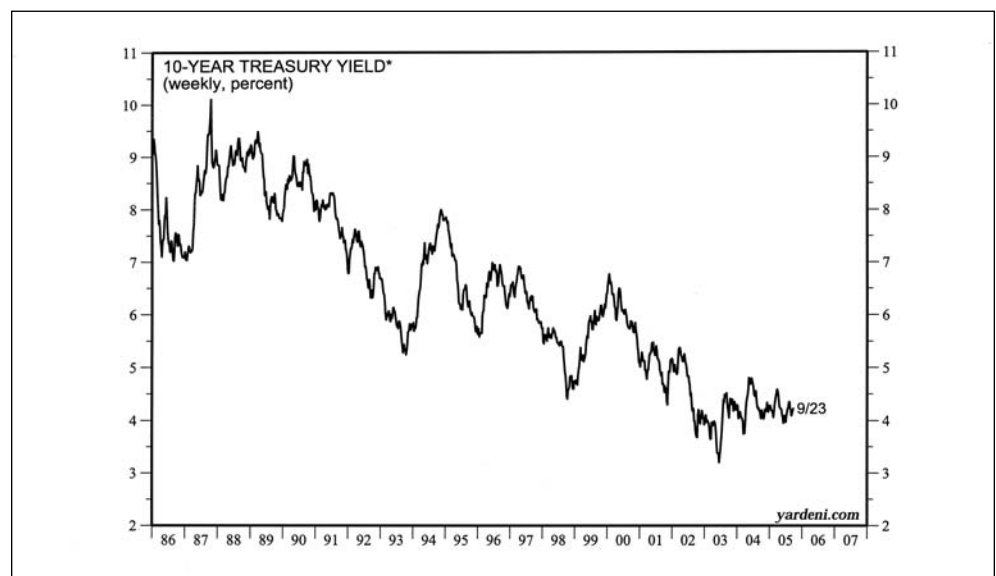
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#### Chart 7

##### 10-Year U.S. Treasury Yields: Still Low But Trending Up

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beginning of 2004. This phenomenon has negative implications for the banking industry and could be a harbinger of slower economic growth if the curve actually inverts (short-term rates yield more than long-term rates). (See Charts 7 and 8.)

In the central bank's effort to forestall inflation, it remains to be seen how long the Fed will continue to raise rates and whether it will be successful in doing so without causing undue risk to the economy. The outlook may be particularly dicey for lower quality, higher yielding segments of the market, which have enjoyed a sharp narrowing of yield spreads

versus Treasuries in recent years. (See Chart 9.) Chairman Greenspan recently addressed his concern over investors' apparent complacency about risk in their acceptance of low returns: "History has not dealt kindly with the aftermath of protracted periods of low risk premiums."

### OTHER ASSET CLASSES

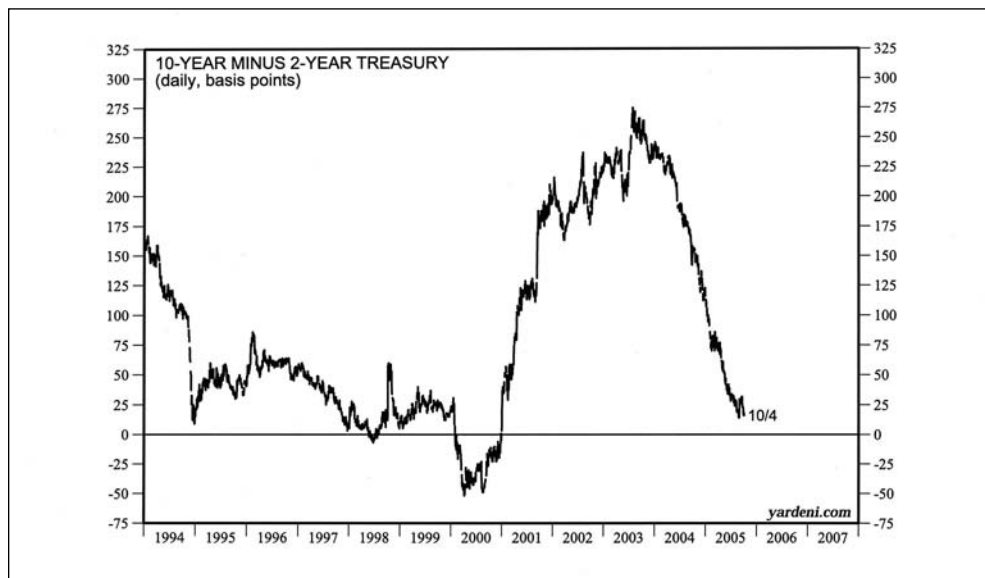
While there were signs that the residential housing market may be cooling off a bit, commercial real estate was continuing to provide strong positive returns and significant diversification benefits for institutional investors. The National Association of Real Estate Investment Trusts index of

publicly-traded REITs was up 3.8% for the quarter and 10.5% year-to-date. This index's annualized return for the trailing five years has been 19.6%, compared to -1.6% for the S&P 500 over the same period. For private property investments, the National Council of Real Estate Investment Fiduciaries national property index was rising at a rate in excess of 17% through the second quarter, with the industrial and apartment sectors doing somewhat better than retail.

Helped by the stock market's better tone during the third quarter, initial public offerings enjoyed their best summer of issuance since 2000.

**Chart 8**  
The Yield Curve Has Flattened Significantly

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**Chart 9**  
After a Big Decline, Quality Yield Spreads Are Rising

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Composite performance indices for venture capital and private equity are significantly lagged, but are likely to show impressive positive returns. Both fundraising and investing were reported to be proceeding at very healthy paces this year.

For hedge funds, it was a quarter of good and bad news. Although still only modestly positive for the year, composite performance appeared to be improving somewhat. Of the major hedge fund strategy categories, only convertible arbitrage is still significantly negative (about -6%)

for the year. However, the industry suffered another black eye when the two founders of Connecticut-based Bayou Management pleaded guilty to criminal fraud charges; at least two thirds of the \$450 million raised by this fund was apparently lost.

#### **OUTLOOK**

Whether or not the stock market will rally during the fourth quarter, as it did in 2004, will largely depend on the extent to which US consumers' purchasing patterns are impacted by higher gasoline and fuel costs. Whether or not the bond market

will continue to trend toward higher interest rates will largely depend on whether the recent hurricane-related dislocations will lead to a fundamental inflationary threat. Irrespective of whether a late market rally will allow retirement systems to meet their targeted returns this year, whether or not boards will be successful over time in their investment programs will continue to be determined by the extent of their portfolio diversification among and within asset classes as well as their skill in hiring—and their diligence in monitoring—strong investment managers.

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**TOTAL RETURNS | THIRD QUARTER, 2005**

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<b>INDEX</b>	<b>THIRD QUARTER 2005</b>	<b>NINE MONTHS 2005</b>
<b>US EQUITY MARKET</b>		
Dow Jones Industrial Avg.	+ 3.44%	- 0.34%
Standard & Poor's 500 (Large Cap)	+ 3.61%	+ 2.77%
NASDAQ Composite	+ 4.60%	- 1.09%
Wilshire 5000 (Broad Market)	+ 3.89%	+ 3.92%
Standard & Poor's Mid-Cap 400	+ 4.88%	+ 8.92%
Russell 2000 (Small Cap.)	+ 4.69%	+ 3.38%
<b>GROWTH VS. VALUE</b>		
S&P 500 Growth	+ 3.78%	+ 1.99%
S&P 500 Value	+ 3.44%	+ 3.54%
S&P Midcap 400 Growth	+ 4.38%	+ 8.10%
S&P Midcap 400 Value	+ 5.41%	+ 9.76%
Russell 2000 Growth	+ 6.32%	+ 2.51%
Russell 2000 Value	+ 3.09%	+ 4.02%
<b>INTERNATIONAL EQUITY</b>		
M.S.C.I. - E.A.F.E.	+ 10.38%	+ 9.08%
M.S.C.I. - Emerging Markets	+ 17.95%	+ 25.03%
<b>FIXED INCOME</b>		
Lehman Brothers Aggregate Index	- 0.67%	+ 1.82%
Merrill Lynch High Yield Index	+ 0.92%	+ 2.06%
<b>REAL ESTATE</b>		
NAREIT - Equity Real Estate Investment Trusts	+ 3.83%	+ 10.46%
NCREIF Property Index	+ 5.34%	+ 14.12%
	(Q2)	(Trailing 9 months)