

The PERAC Financial Bulletin



Financial Market Review, Third Quarter 2008

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“NO LONGER JUST A BEAR MARKET BUT A SLOW-MOTION CRASH”

Looking back at our first quarter market review that was headlined “The Worst Financial Crisis in a Generation”, it is now apparent that, after the jaw-dropping historical events of the third quarter, the substantially worsened crisis now represents the most serious upheaval since the Great Depression.

The first two months of the quarter were relatively placid, but rising concern over the solvency of the mammoth government-sponsored mortgage agencies Fannie Mae and Freddie Mac culminated in the surprising and costly federal takeover of these agencies on September 8. Then, Black Monday on September 15 saw the stock market

have its worst day since immediately after September 11, 2001, as Lehman Brothers declared bankruptcy, Merrill Lynch was forced to sell itself to Bank of America, and AIG, one of the world’s largest insurers, teetered on the brink of insolvency (largely due to their straying from their basic insurance business into massive trading of derivative instruments) before the Fed engineered an \$85 billion bailout. A large money market fund “broke the buck” as a result of impaired mortgage-related investments. As the turbulent, historic month neared an end, the era of large, lightly regulated investment banks came to an end as Goldman Sachs and Morgan Stanley became bank holding com-

panies (giving them greater access to Federal Reserve credit), the seizure of Washington Mutual represented the largest bank failure in US history, and Wachovia, the nation’s fourth largest bank, sold itself to Wells Fargo (after initially agreeing to a deal with Citigroup) as a result of mounting losses from its mortgage-lending and commercial real estate operations. After a week of tense and politically charged negotiations, Congressional leaders agreed on an historic plan for a bailout fund that would acquire about \$700 billion of troubled, illiquid loans from financial institutions in hopes that the restored capital bases of the participating institutions would help them to begin borrowing

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and lending at reasonable terms once again. However, when election-year politics and taxpayer opposition led to the House's unexpected defeat of this proposal on September 29, the stock market plummeted with the largest one day point drop ever and the largest percentage drop (the Dow off 7%, the S&P 500 off 9%) since the 1987 Crash. As the Administration, Treasury, and Congress went back to the drawing board amid serious concerns about the crisis' effect on the economy, it was no surprise that a widely followed measure of the market's volatility, sometimes referred to as the "fear index", reached its highest level in 28 years as the market fell to its lowest level in three years. The market rallied the next day, and a revised bill was approved by Congress by the end of the week, but the market remained jittery as it was apparent that the credit crisis was indeed tak-

ing its toll on the economy and that the problems were so deep that there would be no easy or quick recovery.

The quarter actually began on a positive tone as the market reacted to the significant retreat in oil prices from earlier highs, but once the above-noted credit-related calamities commenced in late summer, the market trended down with gut-wrenching volatility. For the quarter, the Dow Jones Industrial Average (which has little exposure to financials) declined only 3.7%, but the broad market DJ Wilshire 5000 Index fell 8.7% (as did the Russell 3000). The S&P 500 Index (large caps) fell 8.4%, the S&P 400 Mid Cap 400 fell 10.9%, while the Russell 2000 (small cap) Index fell only 1.1%. In each cap category, value held up much better than growth. The technology-laden NASDAQ Composite fell 9.2% for the quarter.

Through the end of the quarter, the DJ Wilshire 5000 lost 18.6% and the Russell 3000 declined 18.8%. The S&P 500 gave up 19.3%, the S&P MidCap 400 14.3%, and the Russell 2000 10.4%. The NASDAQ Composite was off 21.5%. At quarter-end, the S&P 500 was 26% below its peak of last October. As seen in the accompanying charts, the decline wiped out most of the market's gains of the past four years.

Among the S&P 500's ten sectors, financials were nearly flat for the quarter as other sectors caught up to the losses borne by financials in previous quarters. Reflecting the fall in oil prices and commodities, energy stocks were off 25.0% and materials 22.9%. Consumer staples were actually up 4.1% for the quarter. Year-to-date, financials (-31.0%) and telecom (-31.7%) were the worst perform-

Chart 1

S&P 500, Nine Months: OUCH!

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Chart 2

S&P 500, Five Years: Four Years of Gains Lost

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ers while consumer staples (-4.8%) was the only sector with a single rather than double digit decline.

Reflecting a wide dispersion of returns among individual stocks during the tumultuous quarter, there was an 83% differential between the best performing (Bank of America, up 46.6%) and the worst performing (Alcoa, down 36.6%) stocks. Year-to-date, IBM (+8.2%) and JP Morgan Chase (+7.0%) were relative winners while Merck (-45.7%) and General Motors (-62.0%) lost the most.

After several years of outperforming the US markets, foreign stocks failed to provide any diversification benefits as worldwide growth slowed, the credit crisis made its way overseas, and the dollar strengthened relative to many foreign currencies. The MSCI-EAFE Index was off 21.1% for the quarter

and 31.1% year-to-date. In local currency terms, the losses would have been 13.0% and 26.7%, respectively. Emerging markets, a star performer in recent years, were hit even harder as the big declines in commodity prices led to major selloffs in markets such as Brazil, Russia, China, and India. The MSCI-EM Index was off 27.0% and 35.5% (20.9% and 30.7% in local currencies), respectively, for the quarter and year-to-date.

Through the end of the third quarter, the stock market's losses were within the magnitude of typical bear market declines, perhaps somewhat surprising given the gravity of the quarter's events and the threat that the credit freeze was posing to the world economy. All this changed during the first seven trading days of October, which saw a shocking and relentless decline of over 20%

in the US market and even larger sell-offs in many world markets. With the market off nearly 40% from its high exactly a year earlier and \$8.4 trillion in wealth having been wiped out, stocks fell to their lowest level in five years. It was no longer just a bear market but a slow-motion crash.

The credit markets began the quarter in disarray and ended it barely functioning at all. Investors shunned almost anything that entailed risk and rates rose substantially for those able to borrow at all. In a flight to quality, rates declined on US Treasury securities, with the yield on the benchmark 10-year note falling from 3.97% to 3.83% over the quarter but they rose on everything else. The US Treasury note yield is near an historic low. The yield differential between "AA" corporate bonds and Treasuries widened from 2.4% to 4.0% and from 2.9%

Chart 3

S&P 500, Ten Years: Close to Where We Started

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Chart 4

S&P 500 vs. Broker/Dealers, Two Years: Financials Take a Beating

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to 4.9% for “A” corporate bonds. As would be expected, junk bonds fared the worst, with the yield spread to Treasuries widening from 7.5% to 11%, one of the widest differentials ever. The volume of new corporate bond issuance fell 68% from the third quarter of 2007. Overall, the Lehman Brothers Aggregate Index was off 0.5% for the quarter and up 0.6% year-to-date, while a horrible third quarter left junk bonds off more than 10% for the year.

Although office and mall vacancy rates have been rising in most markets, commercial real estate has so far continued to avoid the melt-down in residential real estate. The NCREIF Index of private property investments is not yet available but publicly-traded Real Estate Investment Trusts were up 5.6% for the quarter and have a positive return of 1.8%

year-to-date although they turned down dramatically during October. The sharp declines in IPOs and mergers and the difficulty in securing leverage are just some of the problems affecting venture capital and buyouts. As always, performance will vary widely among managers but, given the public market’s steep plunge, it is difficult to foresee any meaningful benefits from alternative investments during this period.

The SEC’s ban on short selling nearly 800 stocks (mostly financial companies) added to the travails of the hedge fund industry, which was in the midst of its most difficult year in memory. Although expected composite returns in the negative high single digits through quarter end were significantly better than those of the stock market, they were, nevertheless, very disappointing to investors seeking

absolute returns uncorrelated to the markets. It is expected that thousands of struggling smaller hedge funds will choose to shutter their operations. If market conditions continue to deteriorate, it was feared that a rash of redemptions from hedge funds could lead to forced selling of securities and further market turmoil.

A year and a half ago, few of us had even heard of subprime mortgages. Now, after nearly a trillion dollars of actual or potential losses, we all know about them—and about all the complex, wrongly rated, and now illiquid instruments into which they went. In the process, the very nature of our capitalistic system has changed drastically. A huge price has been paid for a period when greed was able to dominate fear and we lost our grasp of the basic principles of risk and return.

TOTAL RETURNS | THIRD QUARTER, 2008

INDEX	THIRD QUARTER 2008	TRAILING NINE MONTHS 2008
US EQUITY MARKET		
Dow Jones Industrial Avg.	- 3.70 %	- 16.60%
Standard & Poor’s 500 (Large Cap)	- 8.37%	- 19.29%
NASDAQ Composite	-8.67%	- 18.64%
Wilshire 5000 (Broad Market)	- 9.20%	- 21.50%
Standard & Poor’s Mid-Cap 400	- 10.87%	- 14.34%
Russell 2000 (Small Cap.)	- 1.11%	- 10.38%
GROWTH VS. VALUE		
Russell 1000 (Large Cap) Growth	- 12.33%	- 20.27%
Russell 1000 (Large Cap) Value	- 6.11%	- 18.88%
Russell Midcap Growth	- 17.75%	- 23.38%
Russell Midcap Value	- 7.52%	- 15.46%
Russell 2000 Growth	- 6.99%	- 15.29%
Russell 2000 Value	+4.96%	- 5.37%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	- 21.05%	- 31.07%
M.S.C.I. - Emerging Markets	- 26.95%	- 35.54%
FIXED INCOME		
Lehman Brothers Aggregate Index	- 0.50%	+ 0.60%
Merrill Lynch High Yield Index	- 9.50%	- 10.6%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 5.55%	- 1.76%