

The PERAC Financial Bulletin



Financial Market Review, Fourth Quarter 2008

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2008
WAS THE YEAR
WHEN THINGS WENT
FROM **BAD** TO
WORSE



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As the US --- and most of the world--- fell deeper into recession and interest rates on short Treasury securities approached zero, a horrific fourth quarter saw stocks tumble to multi-year lows in one of the market's worst, and most volatile, years ever. Several of the nation's largest financial institutions either failed or were taken over and the government resorted to unprecedented measures in a frantic effort to forestall an even worse economic debacle.

During the tumultuous quarter, the hotly debated \$700 billion rescue plan approved by Congress was signed by the President, the market followed with its worst week ever and then its single largest daily gain ever, the jobless rate rose to a 15-year high, consumer prices saw their biggest decline in over 60 years, stocks broke through their previous bear market lows, the government pledged to pump another \$800 billion into ailing credit markets, industrial output registered its biggest decline in almost thirty years, the government stepped in to stabilize Citigroup and then to shore up General Motors and Chrysler, mortgage rates declined to their lowest levels in decades, and the Fed cut interest rates to historic lows. And to complete the nightmarish quarter, financier Bernard Madoff was arrested in December on charges of orchestrating a massive multi-billion dollar investment fraud.

Equity markets

After declining more than 20% during the fourth quarter, US stocks finished with their third worst year ever and worst since the Great Depression. The Dow Jones Industrial Average, off 33.8% for the year, had its worst year since 1931 and the S&P 500 (large cap) index, off 38.5%, had its worst year since 1937. The NASDAQ Composite fell 40.5%, registering its worst year ever, even surpassing the decline suffered after the tech stock bubble burst in 2000. The broad market Dow Jones Wilshire 5000 suffered a 37.3% decline. Scarily, these historically bad returns came even after a rebound of nearly 20% from lows reached during November.

The pain of the year's losses was sharpened by gut-wrenching volatility during the final months of the year. The Dow saw four of the largest one day losses as well as two of the biggest one day gains in its 113-year history. Average swings between intraday highs and lows on the S&P 500 were 6.9% in October and 5.4% in November, representing the two most volatile months ever. Before recovering at year end, US stocks --- at their November lows --- were down about 54% from their October 2007 record highs, representing a loss of about \$10 trillion in market value. At the November lows, stocks were at their lowest level in six years.

After the carnage of 2008, most broad stock indices show negative annualized returns of about 1% for the trailing ten year period. Equity performance lags behind most other asset classes ---including investment grade bonds, which returned an annualized 5.6%--- over this period.

Small caps outperformed large caps by about 4% in 2008 even though larger companies are typically expected to hold up better in a recession. Value held up modestly better than growth. Among the S&P 500's sectors, financials performed the worst both for the quarter (-37.64%) and for the year (-56.95%). The best performing sectors for the quarter and year were telecom services (-2.86%) and consumer staples (-17.66%), respectively.

Among notable individual stocks, troubled mortgage giants Fannie Mae and Freddie Mac both saw their stocks decline 98% while crippled insurer AIG suffered a 97% loss. General Electric fell 56%, General Motors declined 87%, and Citigroup lost 77%. Reflecting consumers penchant for belt tightening, WalMart (+18%) and McDonald's (+6%) were among the market's few gainers for the year.

One theme heard throughout the year was that was virtually no place to hide during 2008. This was certainly true of foreign stock markets as no region of the world was able to "decouple" itself from the US' problems. Europe appeared to be mired in a recession even more severe than the US, Asia's export economies were battered by evaporating demand in the West, and slumping commodity prices contributed to the woes of Latin America. The surprising strength of the dollar (up 8.6% in 2008 in the Fed's trade-weighted index) served to worsen losses for US investors. The MSCI-EAFE Index was down 20% for the fourth quarter and 43.4% for the year. MSCI's Emerging Markets index was down 27.6% for the quarter and 53.3% for the year.

Chart 1
S&P 500, 2008: A Year to Forget

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Chart 2
S&P 500, 2003 - 2008: Stocks Reach Lowest Levels in Six Years

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Fixed Income Market

The credit markets were the major drivers behind most of 2008's historic events. During a quarter when it seemed that stock prices were falling to zero, yields on short-dated Treasuries actually did approach zero as a result of the Federal Reserve's aggressive action to resuscitate the economy and many investors' willingness to accept virtually no return as long as they were assured of getting their principal back. The Fed cut the Fed Funds rate seven times during 2008, from 4.25% at the start of the year to the record low 0-0.25% range set at its December meeting. Holders of Treasury securities enjoyed capital appreciation during 2008 as the yield on the ten-year note declined from 4.033% to 2.25% and the yield on the 30-year bond

Chart 3

S&P 500, 1999 - 2008: Over Ten Years, Stocks Have Been Losers

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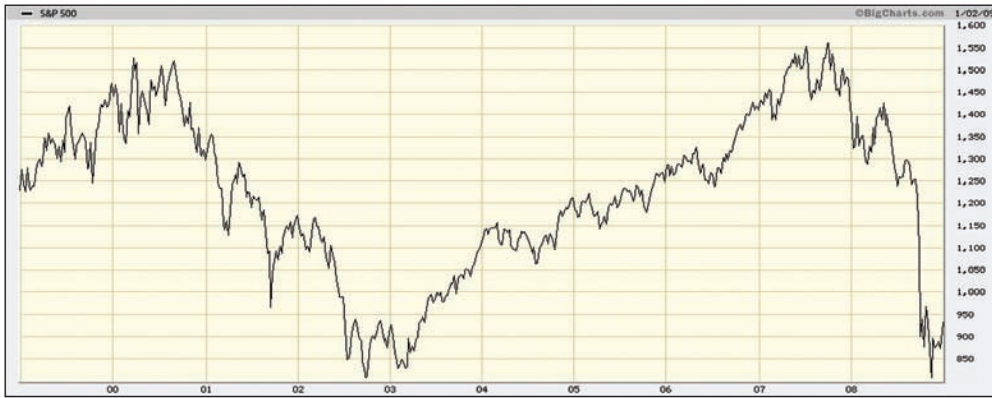
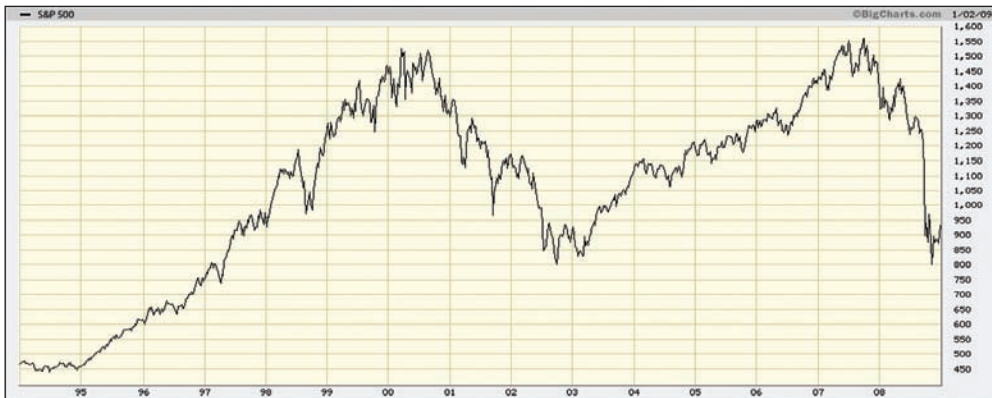


Chart 4

S&P 500: A Fifteen-Year Perspective

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dropped from 4.457% to 2.671%. Both levels represented historic lows. However, investors in investment-grade corporate bonds suffered losses as the yield differential between these bonds and Treasuries tripled from about 2% to 6% during the year. High yield "junk" bonds suffered their worst year ever as their yield spread to Treasuries generally tripled from about 6% to over 18% during the year. Performance of the Treasury's inflation-protected securities (TIPS) suffered as investors began to focus more on the threat of deflation than inflation. Investment grade bond issuance fell 35% during the year while junk bond issuance plummeted by 75%. Overall, the Barclay's (formerly Lehman Brothers) Aggregate Bond Index rose 5.2% in 2008, while indices for investment grade corporate and junk bonds showed losses of about 7% and 26%, respectively.

With the freezing of so many parts of the credit markets leading stocks and the economy on their downward path in 2008, an unprecedented and very costly many-pronged effort by the Fed and the Treasury to restore liquidity to the markets by recapitalizing institutions and hopefully stimulating new lending was undertaken and by the end of the year there was cautious optimism that some of these bold moves were beginning to have a positive effect.

Other asset classes

For real estate, 2008 was the year when things went from bad to worse, when the residential housing market had its worst year ever and when troubles began spilling over to the commercial market as a result of the weakening economy and the worsening credit crunch that ground new deals to a virtual halt. It was difficult to obtain a reliable gauge as to just how far commercial property values have fallen since there have been so few actual transactions, but the 38% drop (all of which occurred in the fourth quarter) in the NAREIT Index of publicly traded equity real estate investment trusts offered an ominous clue. Weakness in both consumer and corporate spending was having obvious effects on the valuation of shopping malls, warehouses, office buildings, and hotels. When released, the NCREIF national property index for private investment is certain to show a decline for the first time since 1992.

Reporting of composite returns for alternative investments is significantly lagged, but, with activity in the mergers and acquisitions markets as well as in the initial public offerings market grinding to an essential halt in 2008 and with the historic declines in the public equity markets, it would be unrealistic to expect favorable returns from either buyouts or venture capital, although, as always, performance will vary widely among managers in these areas.

As widely noted, there was no place to hide in 2008 and, to the dismay of many, this also applied to hedge funds, which suffered through the worst year by far in the industry's relatively short history. Hedge funds could not escape the huge decline in stock prices and the collapse of most areas of the credit markets, and when they were forced to sell assets as part of deleveraging or to meet redemptions, the fact that so many hedge funds owned the same or similar assets further aggravated the losses. Returns varied widely according to manager and strategy, but many of the industry's most highly regarded managers suffered significant losses and some of the strategies, like convertible arbitrage, that had provided some of the steadiest returns in the past posted huge losses in 2008. Hedge Fund Research's preliminary composite returns for the year were -18.3% for hedge funds overall and -20.0% for funds of funds. The fact that composite hedge fund losses were significantly less than those of stocks and several other major asset classes including publicly traded real estate and junk bonds was of little solace to investors expecting positive absolute returns. Assets under management declined (by about 25%, according to some estimates) for the first time ever and the rate of attrition among hedge funds was expected to show a sharp rise. Losses on hedge funds added further woe to those pension funds that employed portable alpha strategies and used hedge funds of funds as their alpha source. The Madoff scandal at year-end also added to hedge funds' perception problem; although the disgraced financier did not run a hedge fund, some hedge funds of funds had allocated money to him.

Oil was not the only basic commodity to suffer a drastic decline during the second half of 2008. While the stock prices were on a downward trajectory throughout 2008, commodities actually rose handsomely during the first half of the year before beginning an ugly decline at mid-year. As the financial crisis spread and tipped the world economy into recession, demand for basic materials weakened and prices were further impacted as many institutional investors were forced to liquidate positions and reduce leverage. The 37% drop in the Dow Jones-AIG Commodity Index for the year wiped out all the gains commodity investors had earned over the previous five years.

Summary

If there's any consolation to the horrors of 2008, it's that, in contrast to the situation a year ago when both stocks and bonds appeared fully priced, there appear to be bargains galore at this point. Depending on analysts' expectations for future corporate profits, price-earnings ratios on equities have declined to levels that range from historically average to well below average. As noted

above, the attractiveness of investment grade and below investment grade bonds relative to riskless Treasuries has rarely been greater. Many good values are also likely there for the taking in real estate. The timetable for these various values proving profitable will depend on the success of the government's massive effort to rekindle lending, to stabilize the housing market, and to encourage a reasonable amount of risk taking once again. Given the massive and worldwide nature of the problems, it is likely that the healing process will be an extended one.

After a year when everything other than Treasury securities (and cash) tumbled in value, this might not be the best time to repeat our usual strong encouragement for a diversified asset allocation. Nevertheless, the fact that all asset classes did not fall uniformly and that some asset classes did hold up significantly better than stocks does indicate that asset allocation certainly remains important.

After a year when the typical public retirement system is likely to have suffered a loss in the range of 25-30%, perhaps the one thing we can say with confidence is that it is finally over and we very unlikely to experience another year like 2008. Bear markets have happened before and they will occur again, but investors should not lose sight of the fact that their strategies and goals are long-term in nature.

Chart 5

Ten-Year Treasury Note: Interest Rates Plummet as Economic Concerns Mount

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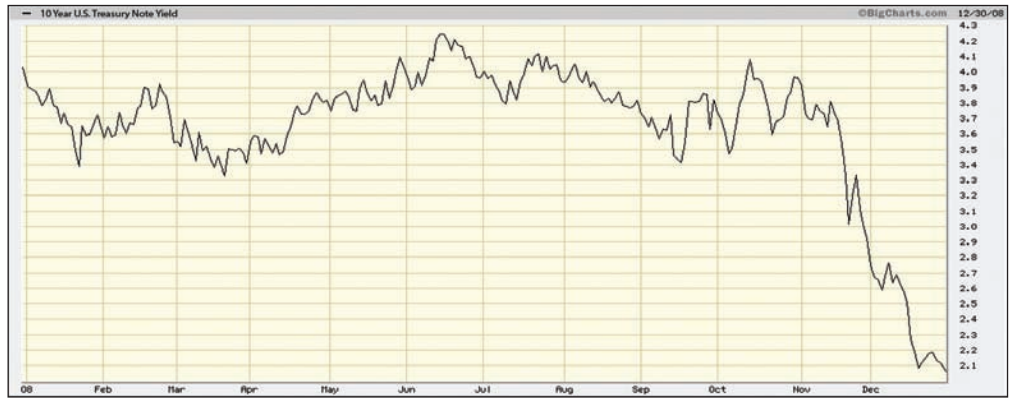
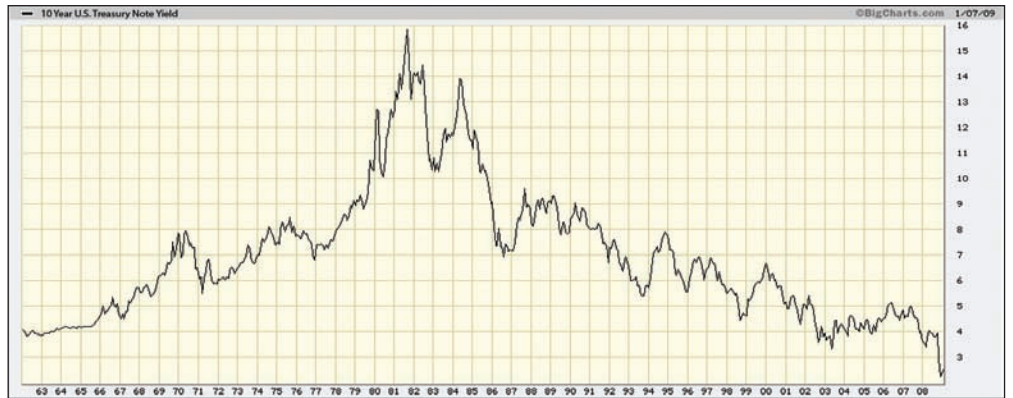


Chart 6

Ten-Year Treasury Note: Yields are Lowest in History Since 1962

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TOTAL RETURNS | FOURTH QUARTER, 2008

INDEX	FOURTH QUARTER, 2008	TWELVE MONTHS, 2008	FIVE YEARS, ANNUALIZED	TEN YEARS, ANNUALIZED
US EQUITY MARKET				
Dow Jones Industrial Avg.	- 18.40%	- 31.93%	- 1.12%	- 1.66
Standard & Poor's 500 (Large Cap)	- 21.94%	- 37.00%	- 2.19%	- 1.38
NASDAQ Composite	- 23.80%	- 39.70%	- 3.90%	- 2.30
Wilshire 5000 (Broad Market)	- 22.85%	- 37.23%	- 1.69%	- 0.64
Standard & Poor's Mid-Cap 400	- 25.55%	- 36.23%	- 0.08%	+ 4.46
Russell 2000 (Small Cap.)	- 26.12%	- 33.79%	- 0.93%	+ 3.02
GROWTH VS. VALUE				
Russell 1000 (Large Cap) Growth	- 22.79%	- 38.44%	- 3.42%	- 4.27
Russell 1000 (Large Cap) Value	- 22.18%	- 36.85%	- 0.79%	+ 1.36
Russell Midcap Growth	- 27.36%	- 44.32%	- 2.33%	- 0.19
Russell Midcap Value	- 27.19%	- 38.44%	+ 0.33%	+ 4.44
Russell 2000 Growth	- 27.45%	- 38.54%	- 2.35%	- 0.76
Russell 2000 Value	- 24.89%	- 28.92%	+ 0.27%	+ 6.11
INTERNATIONAL EQUITY				
M.S.C.I. - E.A.F.E.	- 19.95%	- 43.38%	+ 1.66%	+ 0.80
M.S.C.I. - Emerging Markets	- 27.60%	- 53.33%	+ 7.66%	NA
FIXED INCOME				
Lehman Brothers Aggregate Index	+ 4.60%	+ 5.20%	+ 4.70%	+ 5.60
Merrill Lynch High Yield Index	- 17.50%	- 26.20%	- 0.80%	+ 2.30
REAL ESTATE				
NAREIT - Equity Real Estate Investment Trusts	- 38.80%	- 37.73%	+ 0.91%	+ 7.42