
RESEARCH REPORT

Second Quarter 2003

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The Triumph of Liquidity Over Reason



Market Summary

June 2003

Assets seeking return can create their own return. Since the bear market began in March 2000, the volume of assets in short-term investments has grown by more than 30% (see chart below), and these funds are returning less than zero after inflation. We believe growing liquidity, in combination with the prospect of an economic recovery, has prompted investors to embrace a lower

equity risk premium, fueling the recent stock rally and, in fact, driving the risk premium even lower. We agree with most economists that an economic rebound is forthcoming, but are less sanguine than most regarding the degree and scope of the recovery. Furthermore, we remain concerned that equity valuations are too high relative to current earnings and historical standards, and that earnings expectations are likely overstated. Therefore, we believe the recent run in stock prices is being propelled more by hope than by a rational reassessment of the risks and rewards for holding equities.

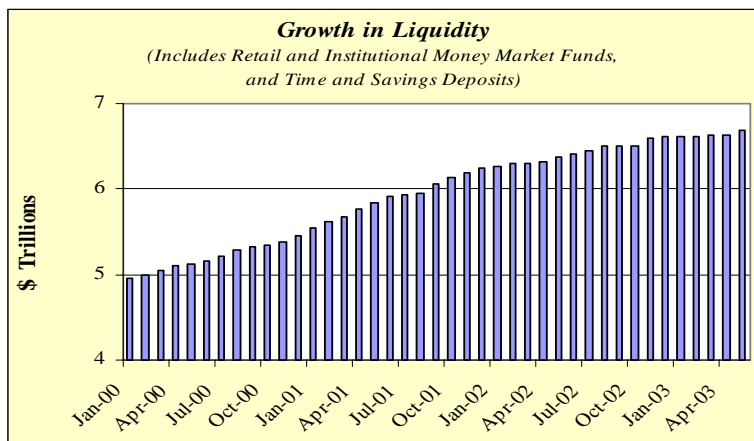
10.9% for the quarter, illustrating resurging confidence in US corporations. (More detailed return data can be found on page 7 of this report.)

While considering these gains, keep in mind that since the bear market began, the S&P 500 has experienced five prior double-digit rallies, each of which fizzled out, leaving stock prices as low as, or lower than, when the rally began. (See page 6.) Is the sixth rally any different than the previous five? Is the S&P 500 fairly valued, or even overvalued? Has the economy reached a turning point in this recession? Although we are as hopeful as any, we find scant support for this rally, and are left with the belief that US equities remain positioned to provide low returns in the coming years relative to historical averages.

At quarter's end, the S&P 500's price to earnings ratio (P/E ratio) was in the *low thirties*, based on the trailing twelve months' reported earnings. Hammond Associates' "normalized" P/E ratio, which is based on a 5.5% profit margin applied to sales, is in the *mid twenties*. On the other hand, First Call consensus estimates put the forward-looking P/E ratio (based on operating earnings) in the *high teens*, which is not far from the historical average for the S&P 500. Therefore, using First Call consensus estimates, some analysts argue the S&P 500 is fairly valued.

Given the implications of accepting consensus earnings expectations, a critical examination of this forecast is warranted. Unfortunately, industry analysts' expectations of future earnings appear to be systemically upwardly biased. A study completed by Morgan Stanley indicated that from 1986-2002 the average overestimation of annual earnings was about *6 percentage points*. Our analysis of quarterly earnings expectations from 2000-2002 demonstrates a similarly consistent upward bias, in that expectations have been overestimated in nine of the last twelve quarters, sometimes with margins of error in the low to mid teens. Moreover, consensus estimates are based on operating earnings (not reported earnings). The validity of operating earnings has come under increasing scrutiny over the misclassification of recurring operational costs as one-time events, the expensing of stock options, and questionably optimistic pension fund assumptions.

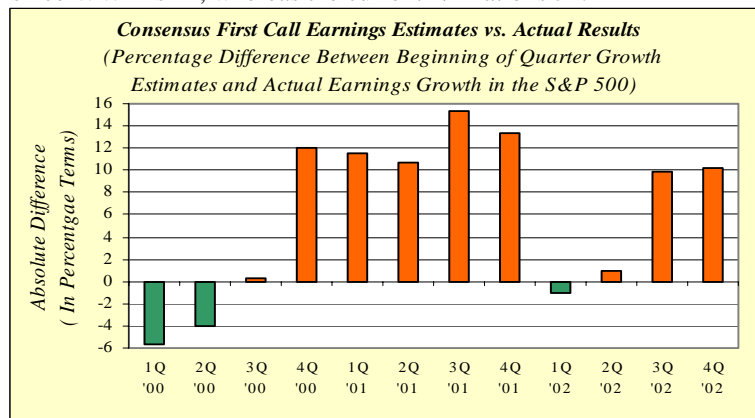
Given these factors, we believe the use of consensus estimates of operating earnings as a basis for determining the S&P 500's P/E is inappropriate. The actual, trailing P/E ratio (based on reported earnings) remains significantly above



Source: Federal Reserve

During the second quarter, domestic and international large-, mid-, and small-cap stocks all achieved double-digit returns, including a gain in excess of 20% for emerging market stocks. US fixed income (Lehman Aggregate Bond index) posted a meager, but welcome, gain of 2.5% and US high yield bonds gained

the historical average, and colossally above average for the close of a bear market. Specifically, the average P/E ratio for the S&P 500 (based on trailing twelve-month reporting earnings) at the troughs of bear markets since WWII is 11, whereas the current P/E ratio is 32.



Source: First Call, Hammond Associates

According to a recent Wall Street Journal (WSJ) article which surveyed 54 economists, GDP growth is expected to rebound within the next six months, and post an annualized growth rate of 3.8% by the fourth quarter of 2003. However, the WSJ also noted the forecasts of these economists, for the last three years at least, turned out to be excessively high.

While we believe the economy may be poised for a modest recovery, an expectation of 3.8% GDP growth by the end of the year seems too optimistic. The source of such a large amount of expected growth, to us, is elusive. We base our concerns primarily on the diminishing capacity of US consumers to spend. Over the past three years, consumer spending was responsible for all GDP growth, whereas it only constituted two-thirds of the economy; all other economic sectors netted out to less than zero growth. In other words, consumer spending has buoyed the economy in the midst of lay-offs, sharp reductions in capital expenditures, and numerous economic shocks. This is the first recession since 1949 to escape without even a single quarter's decline in consumer spending! How did this happen?

Homeowner equity (market value less mortgage) is at its lowest levels in fifty years and consumer debt as a percent of disposable income is near an all-time high. This is in spite of the Fed Funds rate being at its lowest

level since 1958 and mortgage rates being at their lowest levels in more than three decades. Simply put, consumer spending has been supported by an unprecedented run in real estate and the leveraging and re-leveraging of ever-higher residential values. Leveraging a productive asset is common, and offers potential economic dividends. However, leveraging homes adds little, if anything, to the long-term productive and competitive prowess of the US economy, which leads us to question whether or not the short-term fix of low interest rates will cost the economy down the road.

Nevertheless, even though consumer spending has grown, productivity has grown even faster, precluding the need for business investment (capital equipment and labor) to accommodate growth. Monetary policy (i.e., lowering interest rates) has been successful in sustaining the economy, but has little left to offer. In lieu of continued growth in consumer spending, we look to our government (i.e., fiscal policy) and our trading partners (i.e., exports) to initiate a recovery, but are led to several concerns. Is the recent tax cut (about 1%-2% of the GDP over the next 12 months) sufficient to stimulate the economy in the face of a likely increase in the savings rate? (See page 10.) And will our trading partners accommodate our desire to export our way to fiscal health in the face of a declining dollar? (See page 14.) Again, we remain cautiously optimistic, but are unable to identify whether these catalysts will pick up where consumer spending left off.

So where does all of this leave us? Well...frankly, it leaves us with mixed thoughts. We are fortunate to be living and working in the strongest economy in the world. Nonetheless, we are concerned about the near-term strength of the economy, and are particularly apprehensive about valuations in the equity market. Over the intermediate-term of five to seven years, equities are likely to produce mid-single digit returns. Over the short term? Over the short term, we're headed to the beach. Enjoy your summer.

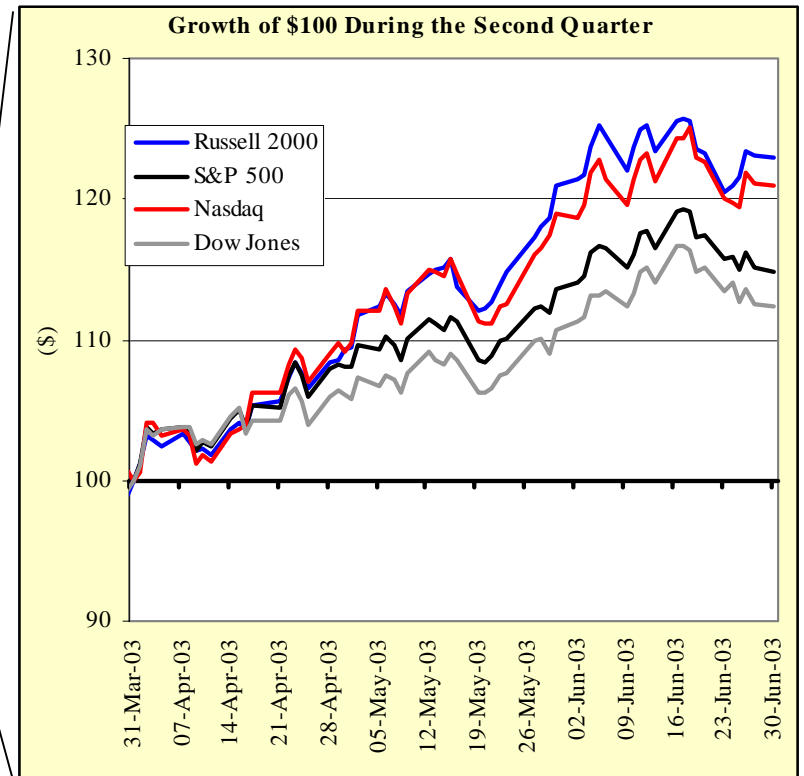
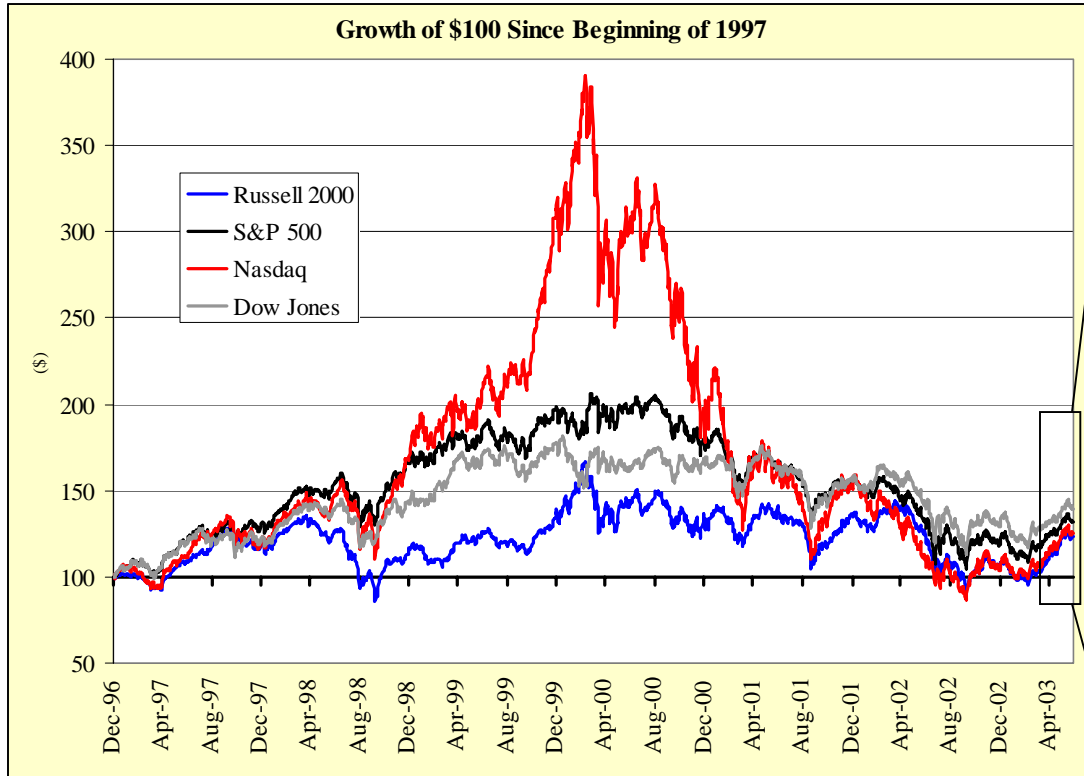


Eric J. Petroff, CFA
 Consultant

Second Quarter Executive Summary

- The S&P 500 had its best quarter in nearly five years with a gain of 15.4% for the period ended June 30, 2003. Other equity asset classes performed even better. Small-cap stocks (Russell 2000) gained 23.4%, international large stocks (MSCI EAFE) gained 19.3%, and emerging market stocks (MSCI EMF index) gained 23.3%. Over the last twelve months, most equity asset classes have posted flat to negative returns. Aggressive fixed income strategies (high-yield bonds and emerging market debt) have been the top performers over twelve months.
- There was some cause for optimism during the second quarter. The apparent conclusion of the war with Iraq reduced uncertainty substantially, and the reduction of dividend taxes made stocks worth a little more to taxable investors. Nevertheless, fundamentals do not appear to justify the significant increase in stock prices. The US equity market is still trading at stretched valuations relative to historical norms. This portends below-average long-term returns.
- The US economy grew at a 1.4% annualized rate during the first quarter. Economists expect second quarter growth to be below 2%. Business investment is still decelerating, but should begin to pick up as companies replace depreciating equipment. However, a sharp rebound to levels seen during the investment binge in the late 1990's is unlikely. The job market is still in the doldrums, as the unemployment rate rose to 6.4%. We expect depressed consumer spending growth over the next few years as households repair their balance sheets and baby boomers save for retirement. With consumer spending representing two-thirds of economic activity, such a scenario could lead to below-average overall economic growth.
- The residential housing market, boosted by falling interest rates, has provided support to consumer spending during the bear market. Since the beginning of 1997, residential real estate prices have surged a cumulative 27% *after* inflation. With the value of residential real estate approaching \$14 trillion, even modest declines could have a significant impact on consumer spending.
- The FOMC cut the Fed Funds rate to 1% during June. The futures market predicts that the Fed is likely to sit tight for the remainder of this year. Intermediate and long-term interest rates also declined during the quarter. The yield on the last issued 30-year bond, which began the quarter at 4.84%, plummeted to 4.17% by mid-June, before rebounding to 4.57% by month-end. The 10-year bond yield declined from 3.83% to 3.54% during the quarter. Credit spreads continued to contract, suggesting that bond investors believe that the worst is behind us in the corporate sector.
- The dollar continued to weaken against the euro during the second quarter, shedding 5%. With the current account deficit running at \$540 billion per year, or 5% of GDP, the trade-weighted dollar will likely need to fall much further. The next round of dollar depreciation needs to occur against Asian currencies.
- International equities, despite their strong returns in the second quarter, appear cheap relative to US equities. Emerging markets still appear to represent the best value. Emerging market economies (particularly in Asia) are growing rapidly and their stocks are trading at compelling valuations. With the dollar likely to continue weakening, international equities are well positioned to provide attractive future returns relative to US equities.

Happy Days are Here Again...



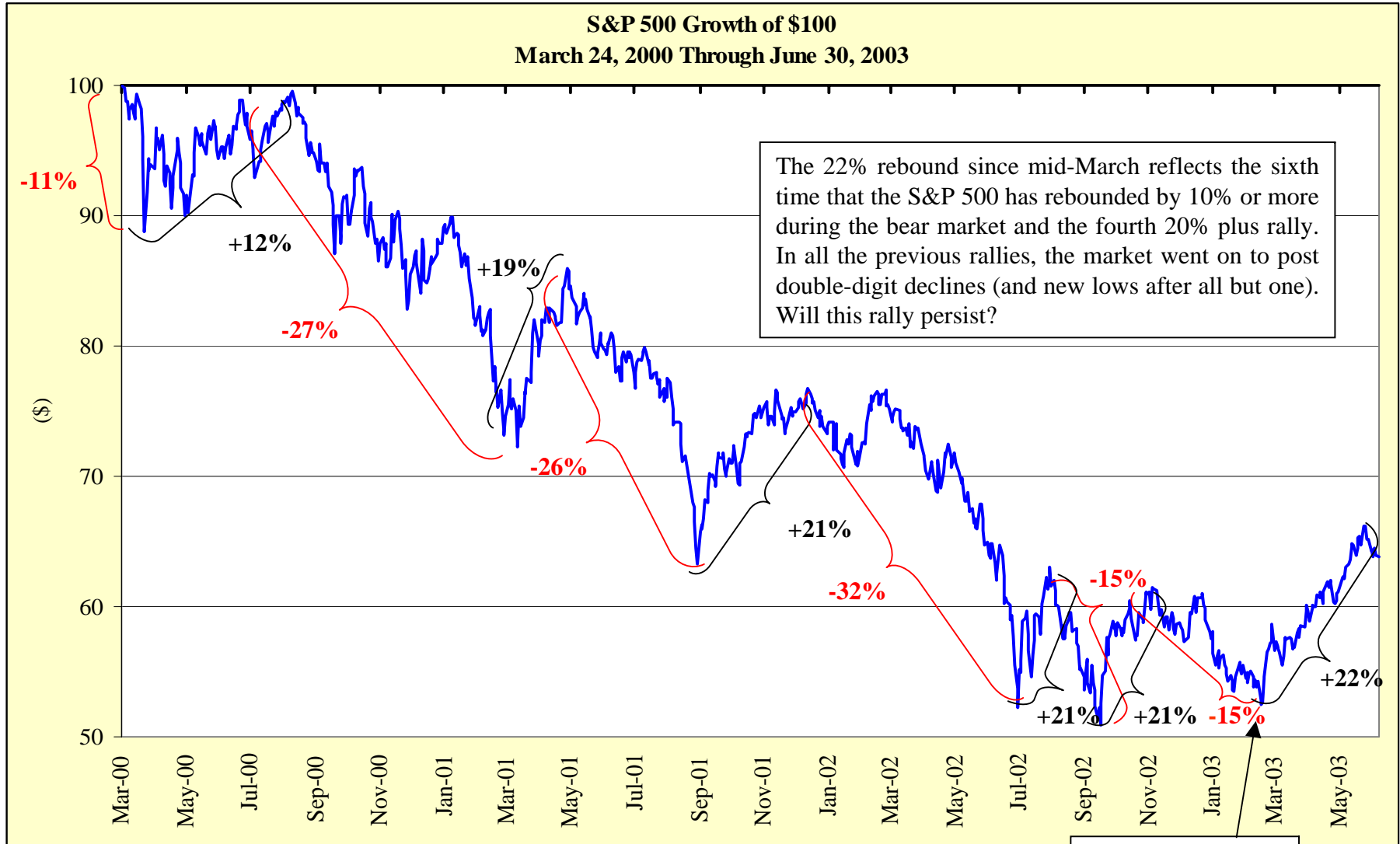
	<i>June 30 2003 Close</i>	<i>Date June 30 Level First Reached</i>	<i>Date Peak Reached</i>	<i>Date Peak Reached</i>	<i>Date Trough Reached</i>	<i>Date Trough Reached</i>	<i>Peak-to- Trough</i>	<i>% Below Peak</i>	<i>% Above Trough</i>	<i>2003 YTD</i>	<i>2Q 2003</i>
Dow	8985	4/2/98	11723	1/14/00	7286	10/9/02	(37.8)	(23.4)	23.3	7.7	12.4
Nasdaq	1623	8/6/97	5049	3/10/00	1114	10/9/02	(77.9)	(67.9)	45.7	21.5	21.0
S&P 500	975	10/7/97	1527	3/24/00	777	10/9/02	(49.1)	(36.2)	25.5	10.8	14.9
Russell 2000	448	9/22/97	606	3/9/00	327	10/9/02	(46.0)	(26.0)	37.1	17.0	23.0
MSCIEAFE	1026	12/89	1774	1/3/00	824	3/12/03	(53.6)	(42.2)	24.5	7.7	18.1

All returns exclude dividends.

Most indices are still at 1997 levels.

The Nasdaq has enjoyed the strongest gains since the October trough.

Or Are They?

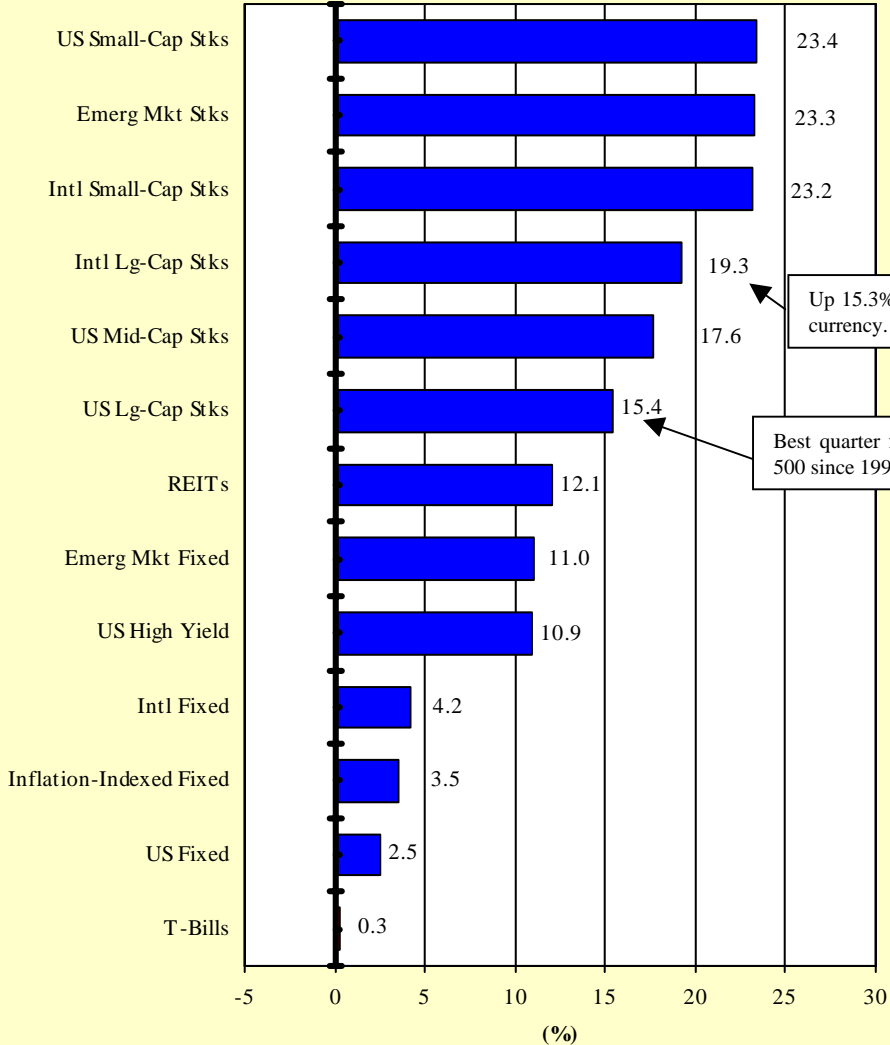


The 22% rebound since mid-March reflects the sixth time that the S&P 500 has rebounded by 10% or more during the bear market and the fourth 20% plus rally. In all the previous rallies, the market went on to post double-digit declines (and new lows after all but one). Will this rally persist?

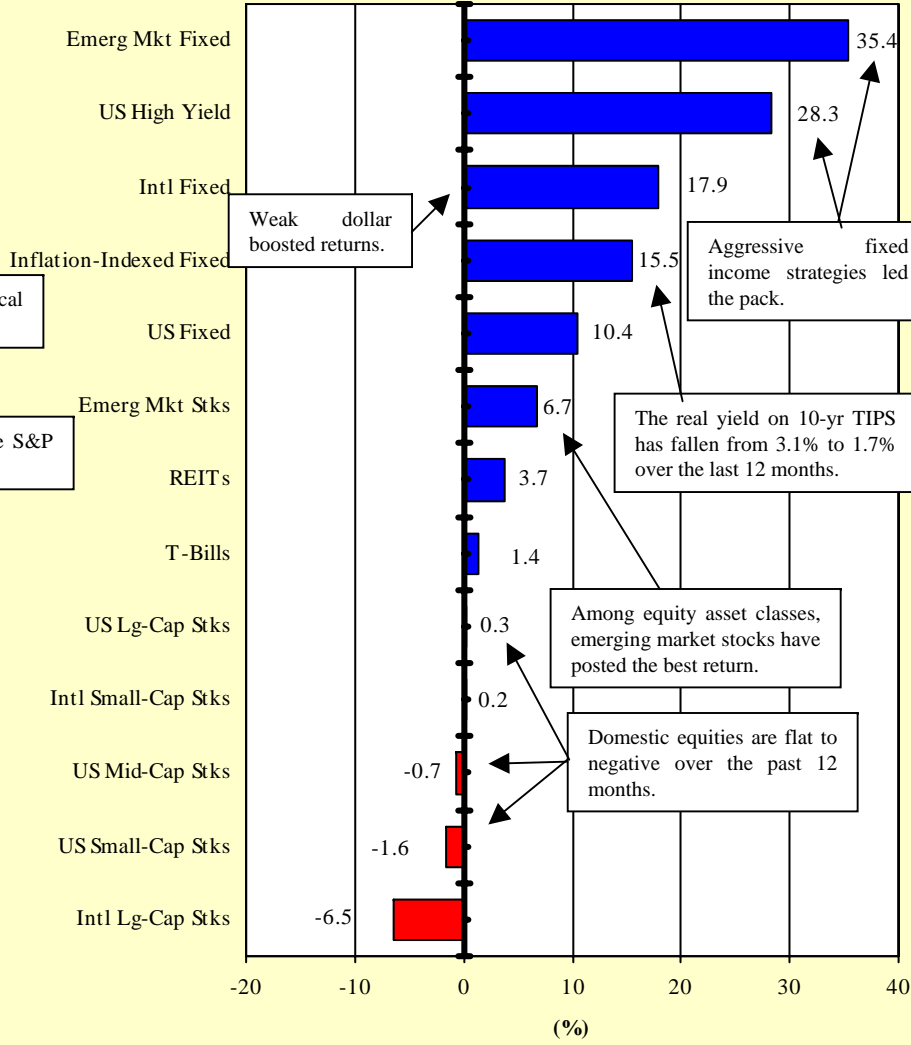
The S&P 500 barely avoided setting a new bear market low during this drawdown.

A Reversal of Fortunes

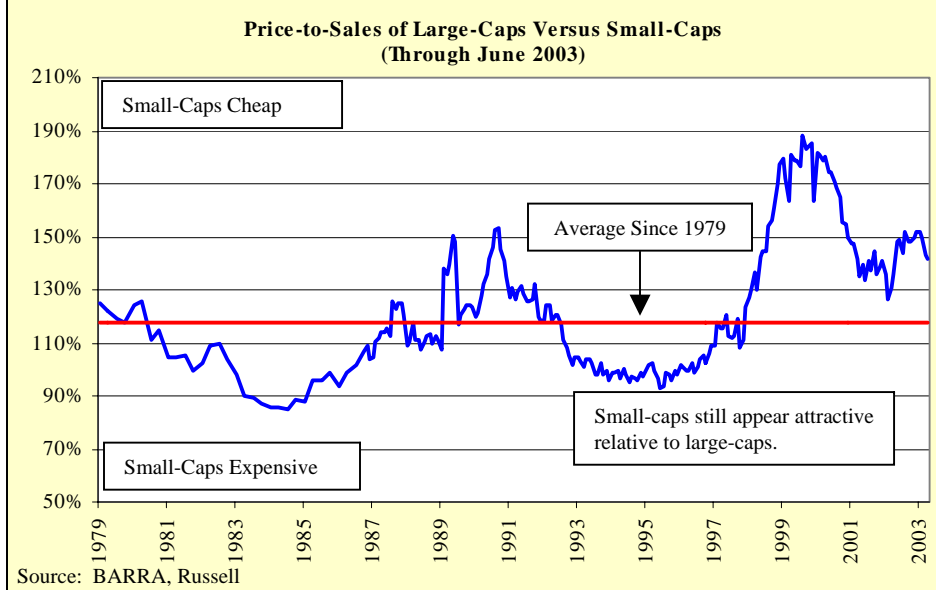
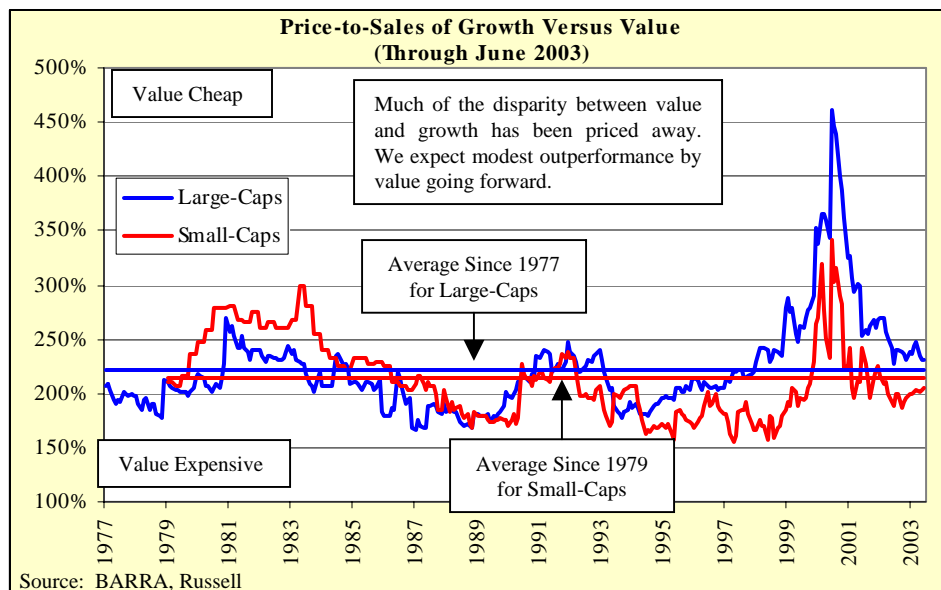
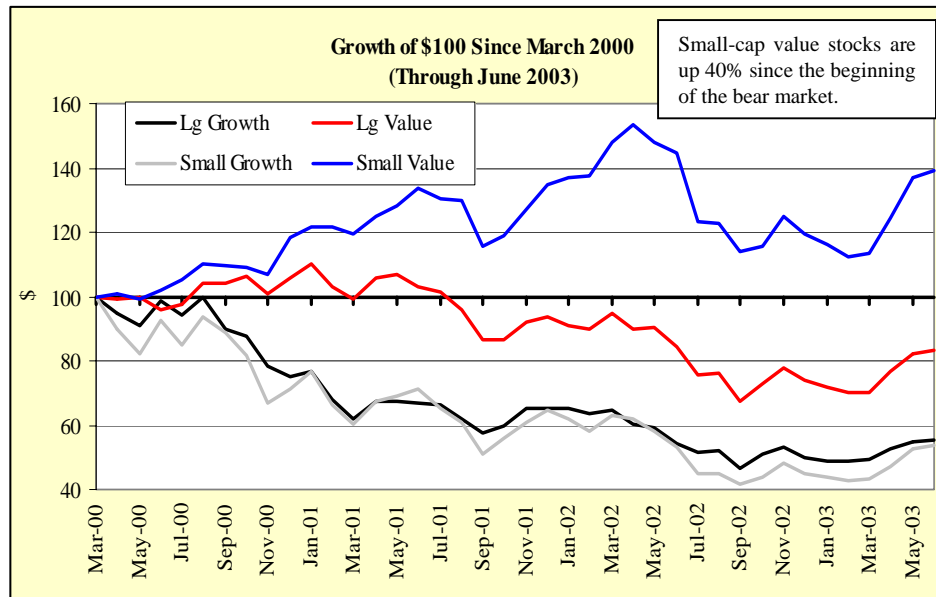
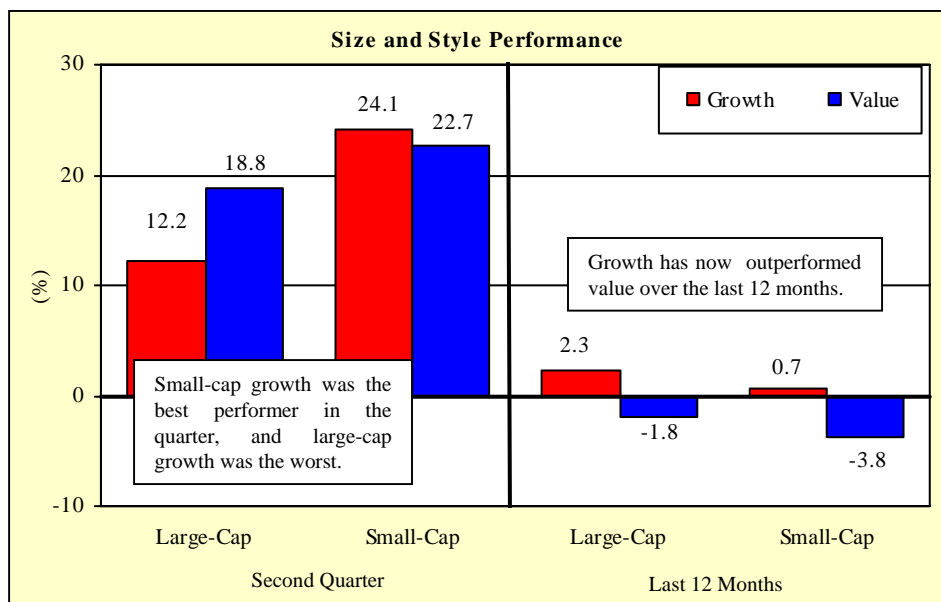
Second Quarter 2003 Performance (%)



Last 12 Months (%)

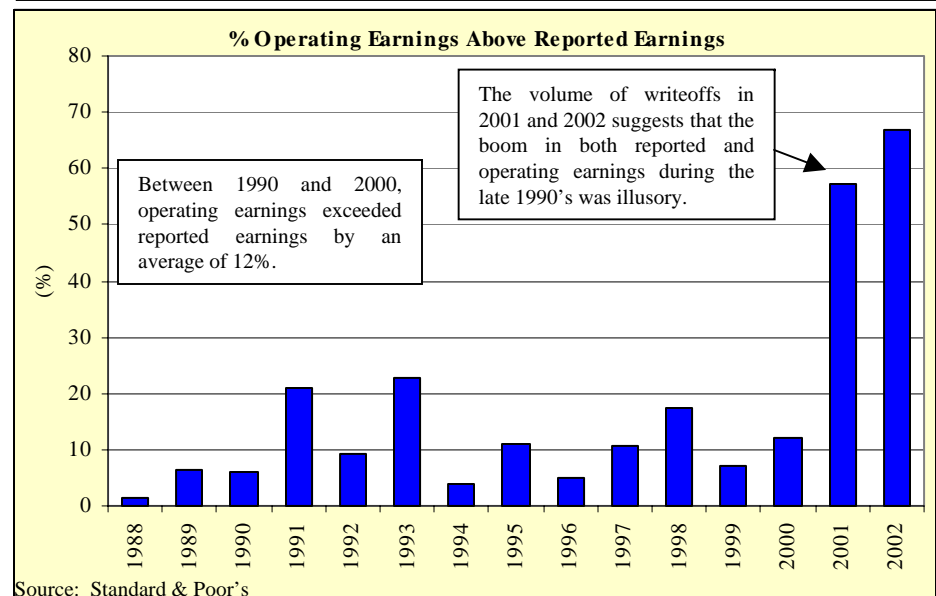
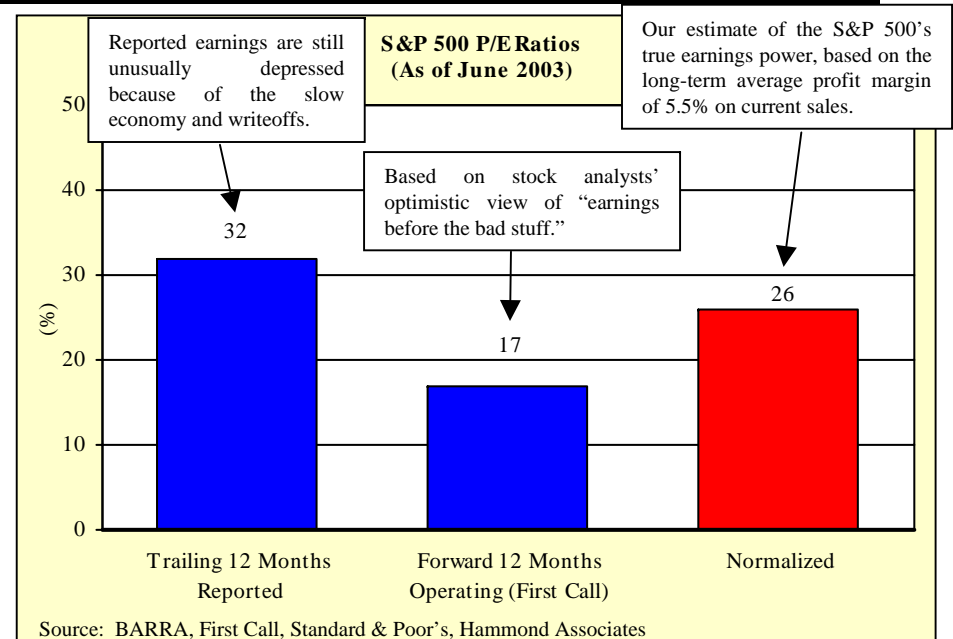


Style Returns Mixed During the Quarter



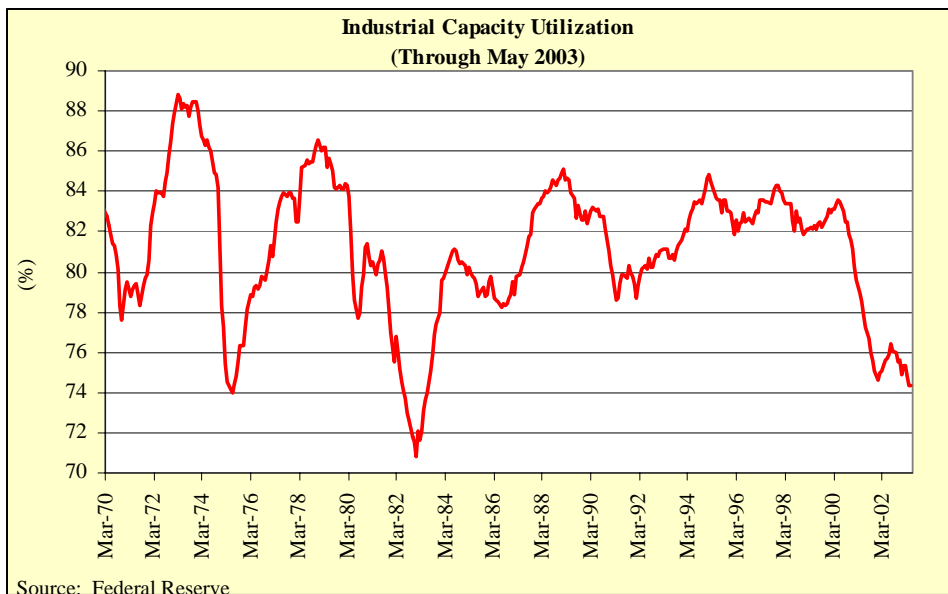
The View Through Rose-Tinted Glasses

- The S&P 500 had its best quarter in nearly five years. There was some cause for optimism during the second quarter.
 - The apparent conclusion of the war with Iraq reduced uncertainty. The implied volatility on S&P 500 options declined by a third during the quarter, meaning that investors expect equities to exhibit less risk.
 - The reduction of dividend taxes justifies higher prices. A long-term tax cut of this magnitude could justify a 10% or better rise in the S&P 500. However, absent Congressional action, the tax cut is set to expire in 2007, in which case it's worth only 2% or 3% to taxable investors.
- News on the economy remains uninspiring. While the stock market has tended to be a good leading indicator of economic performance, we are skeptical of the return of strong economic growth over the short-term. (See pages 10-11.)
- Bulls cite the market's attractive valuation as cause for optimism. Based on twelve-month *forward operating* earnings, the P/E ratio was 16 at the beginning of the second quarter, close to historical norms (with the historical norms, incidentally, based on *reported* earnings).
- However, operating earnings have little basis as a measure of aggregate corporate profits. They exclude "unusual" and "one-time" expenses. The fact that operating earnings have exceeded reported earnings (calculated based on GAAP) fifteen years in a row suggests that these unusual items aren't so unusual. The peculiarities of pension accounting and most companies' refusal to expense options further distorts earnings.
- The fact is that the market is still trading at rich valuations by historical standards (a P/E of 26 based on our normalized earnings relative to a historical average of 16). This portends below average long-term returns. (See page 17.)

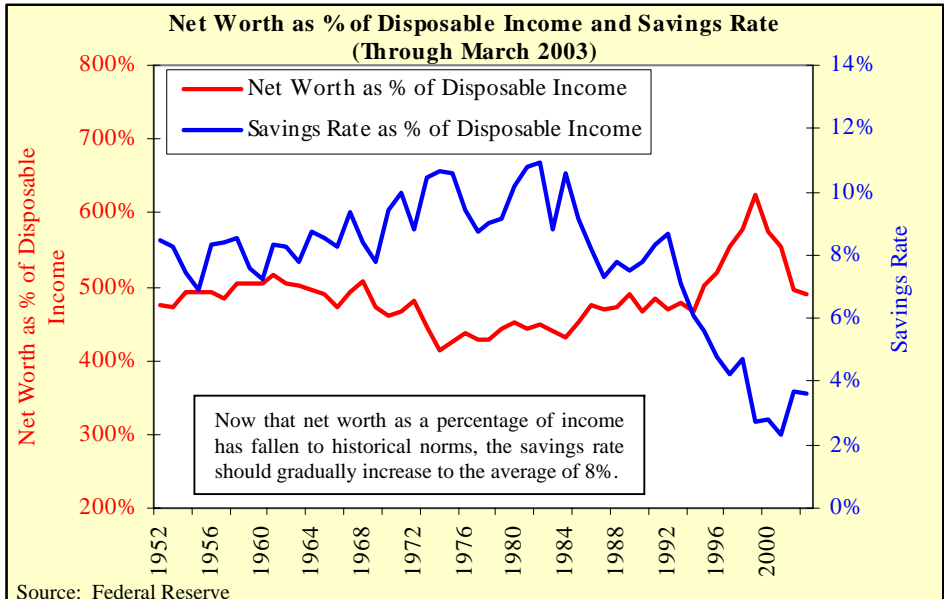
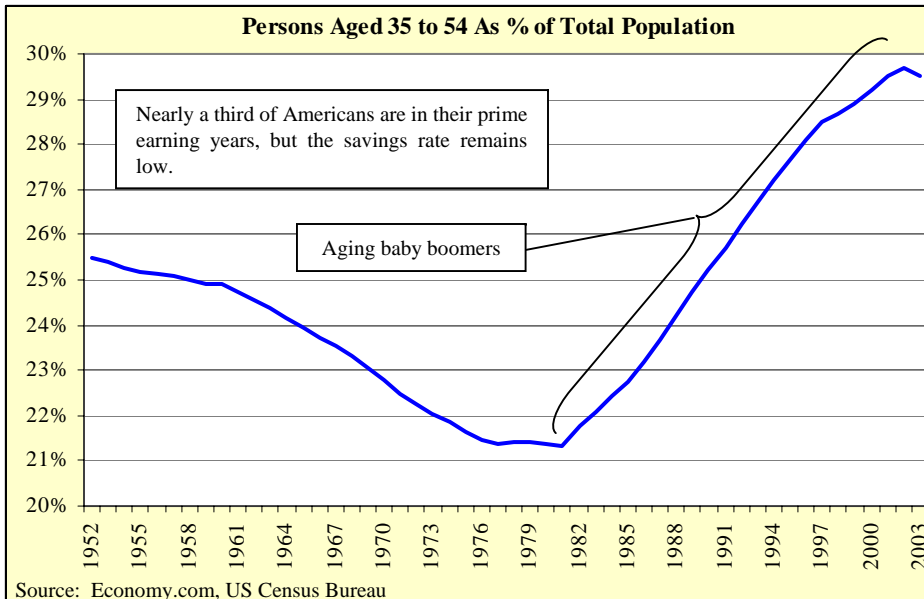
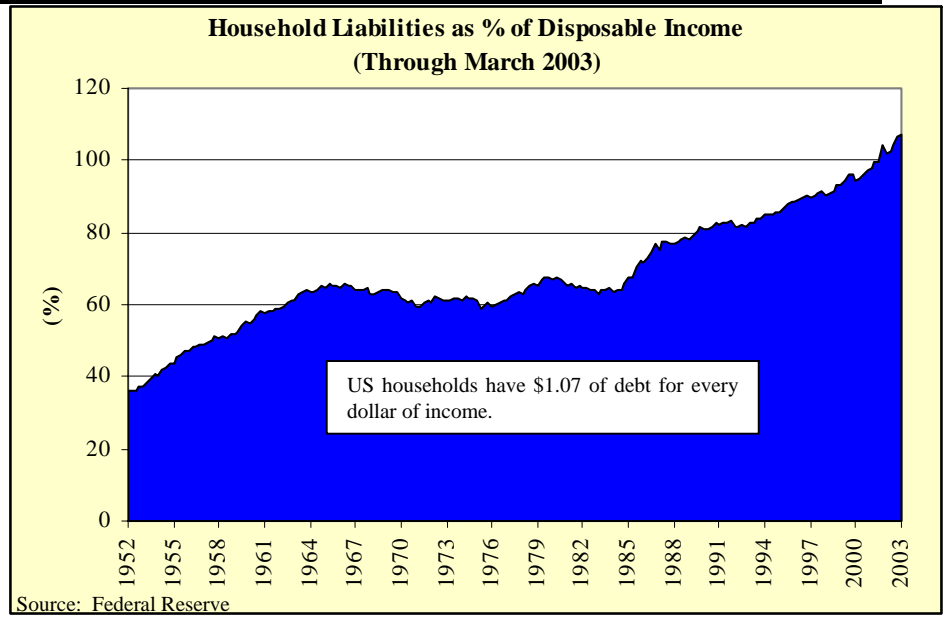
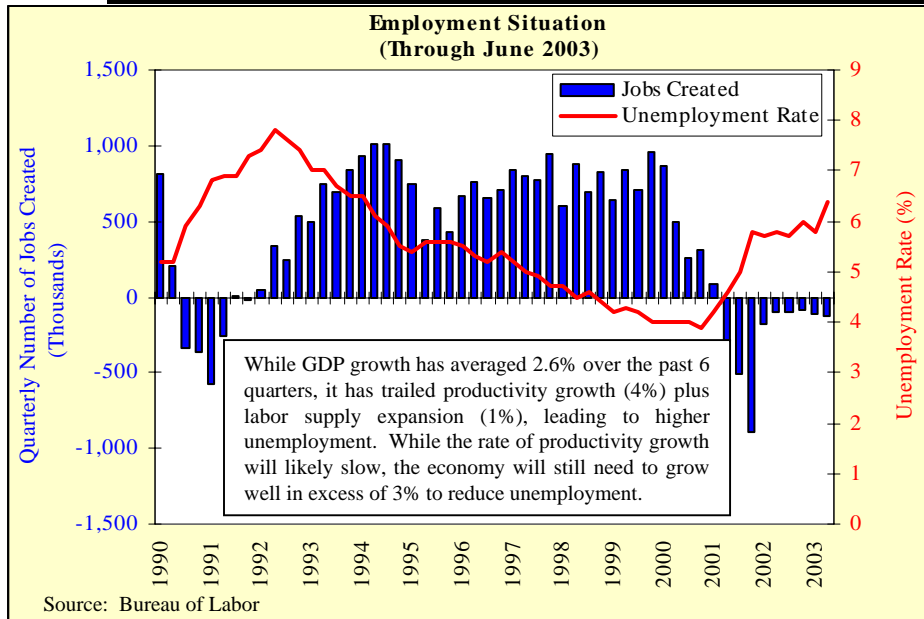


Not Much Good News on the Economic Front

- The US economy grew at a 1.4% annualized rate during the first quarter. Growth was 2.0% for the year that ended March 2003. Economists expect second quarter growth to be below 2%.
- Economists expect growth to accelerate in the second half of 2003 and into 2004. Those polled by *The Economist* project growth of 3.4% in 2004. These forecasts appear overly optimistic to us.
- Business investment is still decelerating. During the first quarter, it contracted at a 4.4% annualized rate. Business investment should begin to pick up as companies replace depreciated equipment. However, a sharp rebound to levels seen during the investment binge of the late 1990's is unlikely. Excess capacity remains in the economy and debt loads are high. As a result, business investment probably will not be a major contributor to economic growth over the next few years.
- The job market is still in the doldrums. The unemployment rate rose to 6.4%, the highest rate since 1994, as productivity increases have allowed businesses to cut payroll. Over the last two years, 2.1 million jobs have been lost.
- We expect anemic consumer spending growth over the next few years as households repair their balance sheets and baby boomers save for retirement. Thanks in large part to the booming housing market, consumer spending growth has muted this recession, but residential real estate prices likely have limited upside at this point. With consumer spending representing two-thirds of economic activity, we expect below-average economic growth over the next few years.



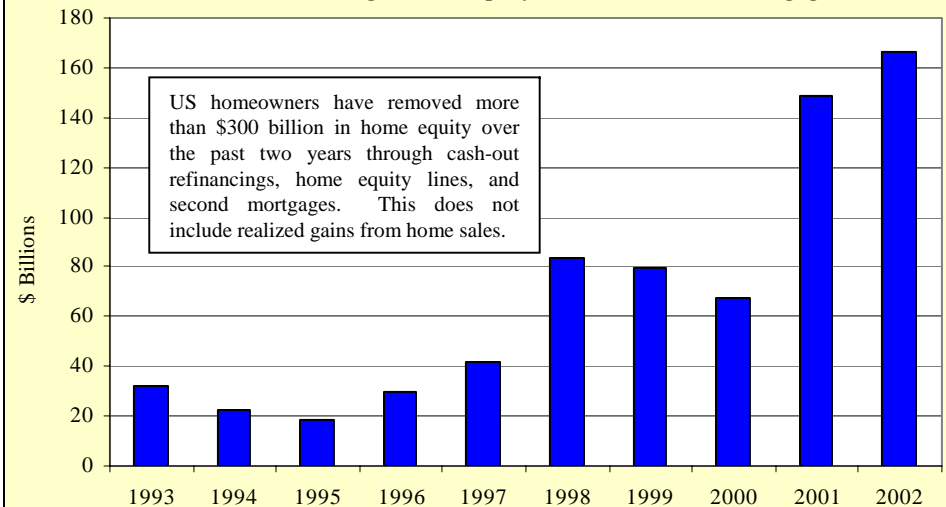
Not Much Good News on the Economic Front (cont.)



Residential Real Estate: Another Bubble?

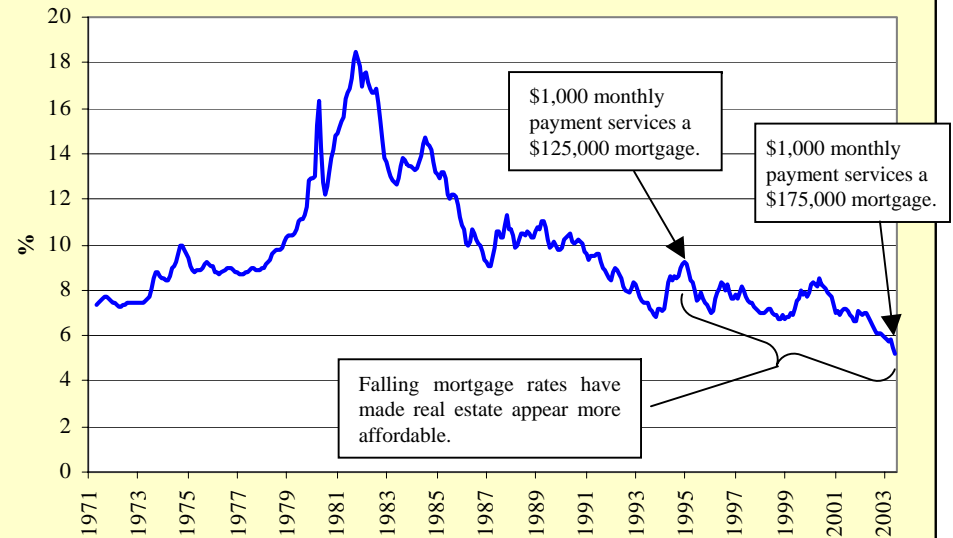
- The residential housing market, boosted by falling interest rates, has provided support to consumer spending during the recession.
- Since the beginning of 1997 residential real estate prices have surged a cumulative 27% *after* inflation. For the prior 26 years, inflation-adjusted residential real estate appreciated only 8% (cumulative).
- Studies have shown that the wealth effect from housing is much stronger than the wealth effect from stocks. The typical US household has a substantial amount of its net worth in real estate, while equity holdings are concentrated in wealthier households.
- The wealth effect of real estate has been exhibited during the bear market for equities. While the stock market has crumbled, consumer spending has remained strong, likely due, at least in part, to residential real estate.
- The economy probably will not receive much of a boost from the real estate market going forward. It's hard to imagine that real estate prices have much further to run, and most households probably have already refinanced their mortgages.
- A significant risk to the economy's health is a retrenchment in real estate prices. US homeowners' investment in their homes is more leveraged today than ever before. If mortgage rates increase significantly, the liquidity in residential real estate may dry-up and prices trend downward. With the value of residential real estate approaching \$14 trillion, even modest declines could have a significant impact on consumer spending.

Dollar Volume of Home Equity Tapped
(Cash-Out Refinancings, Home Equity Lines, and Second Mortgages)



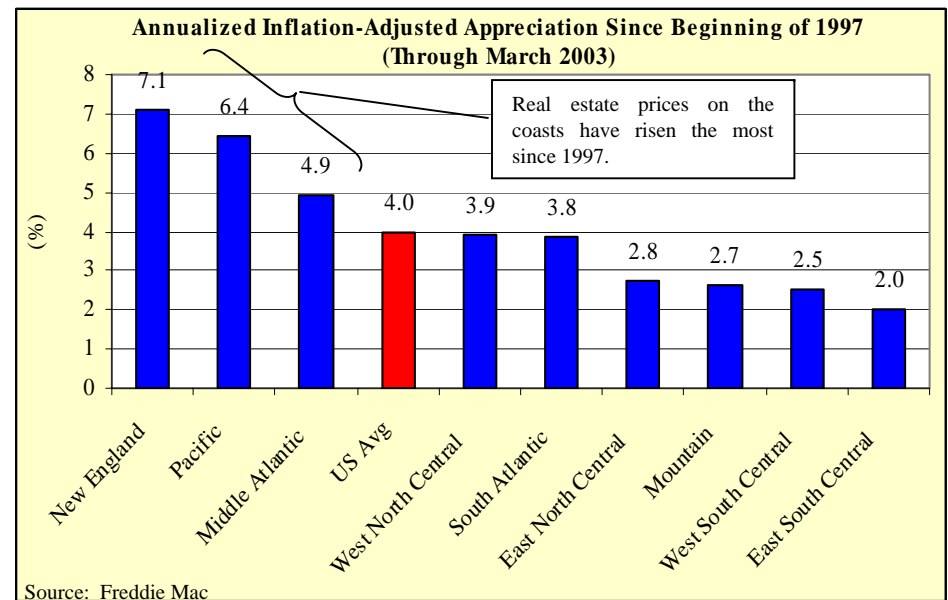
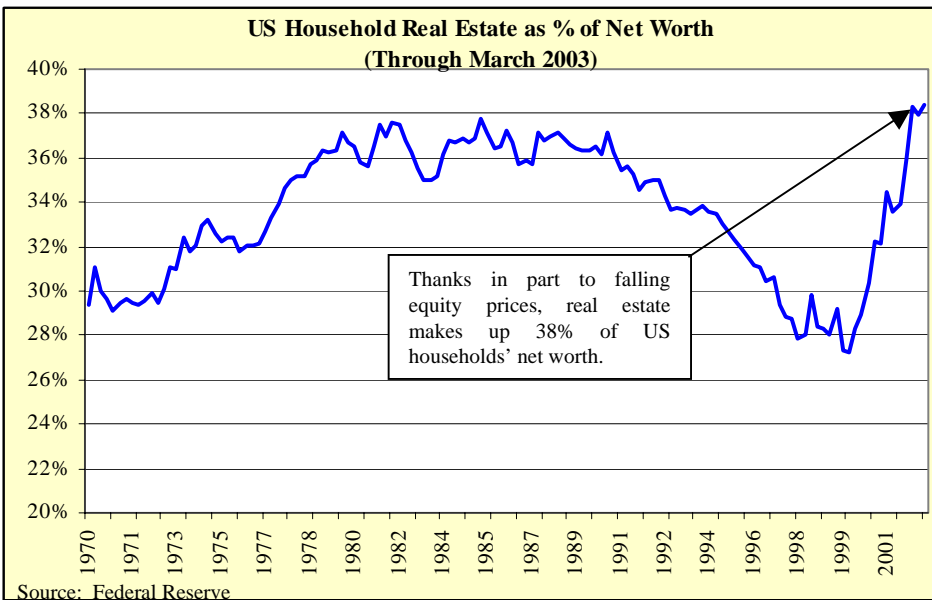
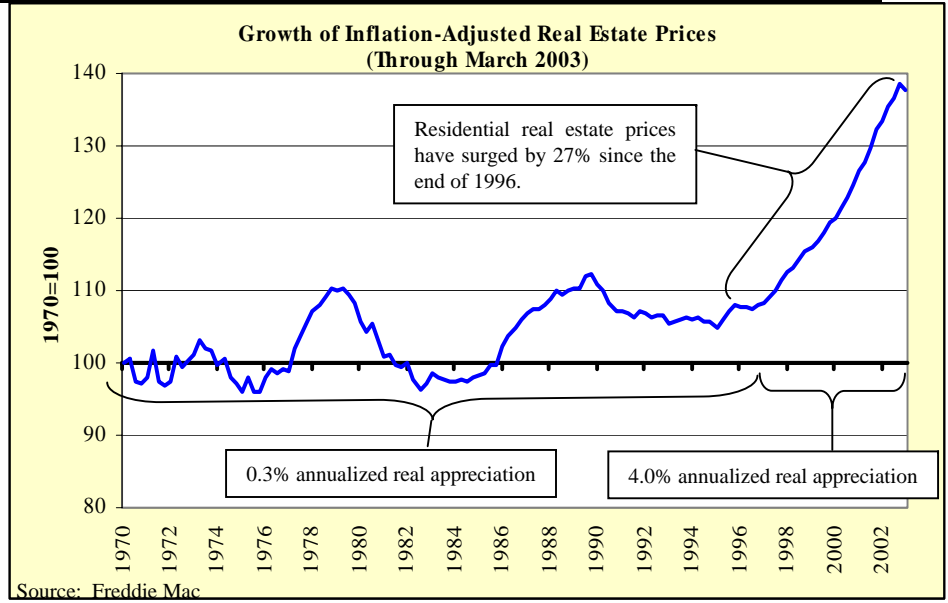
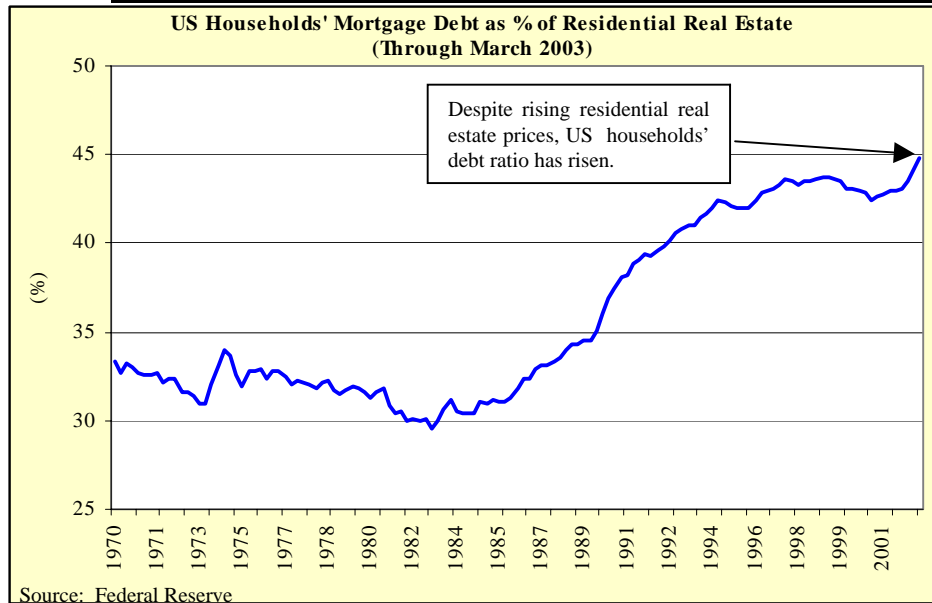
Source: Freddie Mac

30-Year Mortgage Rate



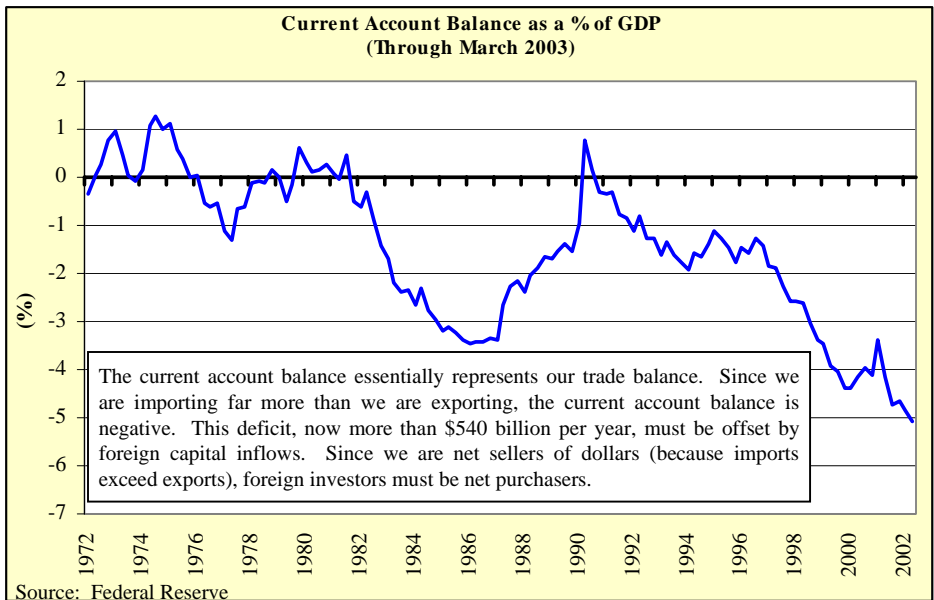
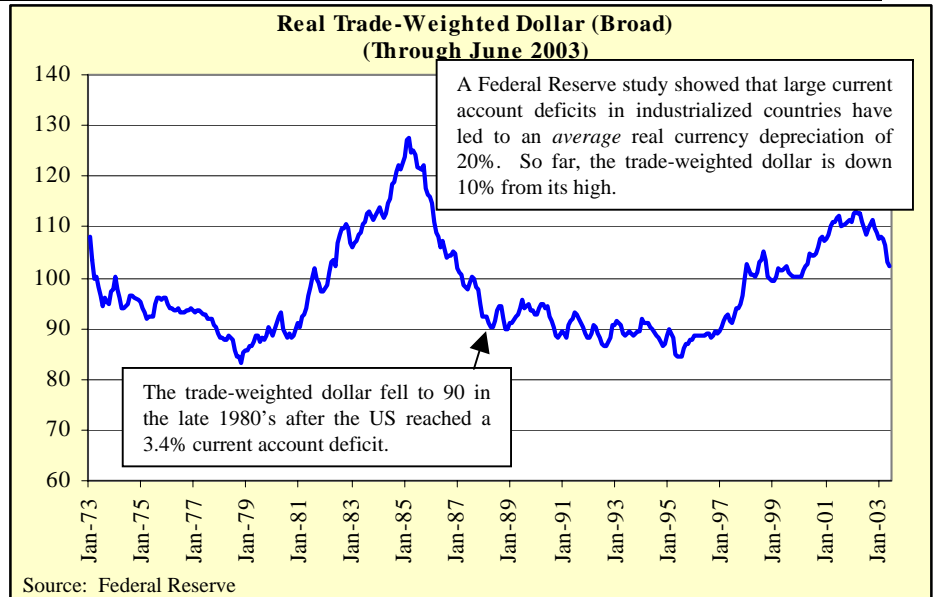
Source: Freddie Mac

Residential Real Estate: Another Bubble? (cont.)



The Dollar Continues its Descent

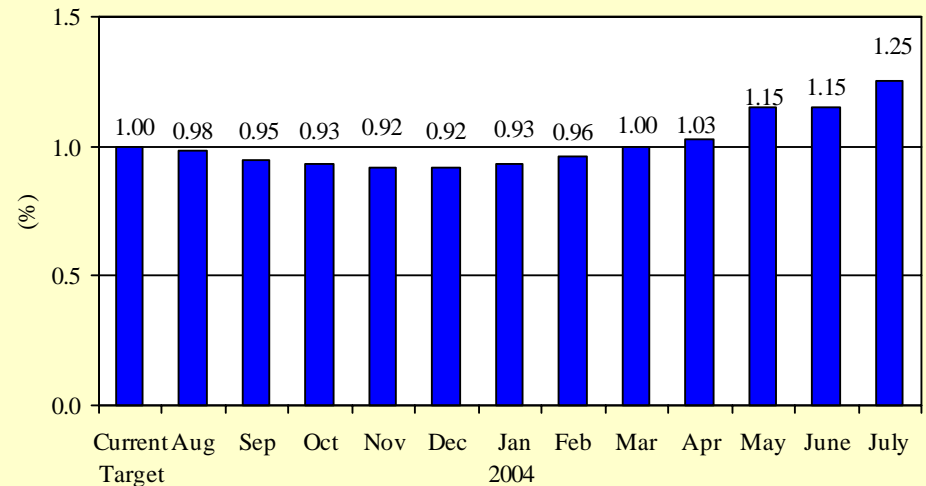
- The dollar continued to weaken against the euro during the second quarter, shedding 5%. However, the dollar showed signs of strength towards the end of the quarter, rebounding by 3% against the euro in the last two weeks of June.
- While the dollar has lost more than 20% of its value versus the euro, the real trade-weighted dollar is down only 10% from its high.
- With the current account deficit running at \$540 billion per year, or 5% of GDP, the trade-weighted dollar will likely need to fall further.
- The next round of dollar depreciation needs to occur against Asian currencies. Roughly half the US trade deficit is with Asian countries. China alone accounts for \$103 billion of the trade deficit, but the Chinese yuan has not budged because it is fixed to the dollar. The yen has appreciated by only 9% versus the dollar since the beginning of 2002.
- For fear of losing export volume and increasing unemployment, China, Japan, and other Asian governments have been accumulating dollar reserves to minimize their currencies' appreciation relative to the dollar. According to *The Economist*, Asian central banks hold \$1.5 trillion in reserves, two-thirds of the world total.
- With Asia's reluctance to allow their currencies to appreciate, the euro is bearing the brunt of the dollar correction. The dollar needs to fall more. The question now is whether Asia (particularly China) will play their role in the dollar devaluation or if Europe will continue to bear the pain.



The Final Cut?

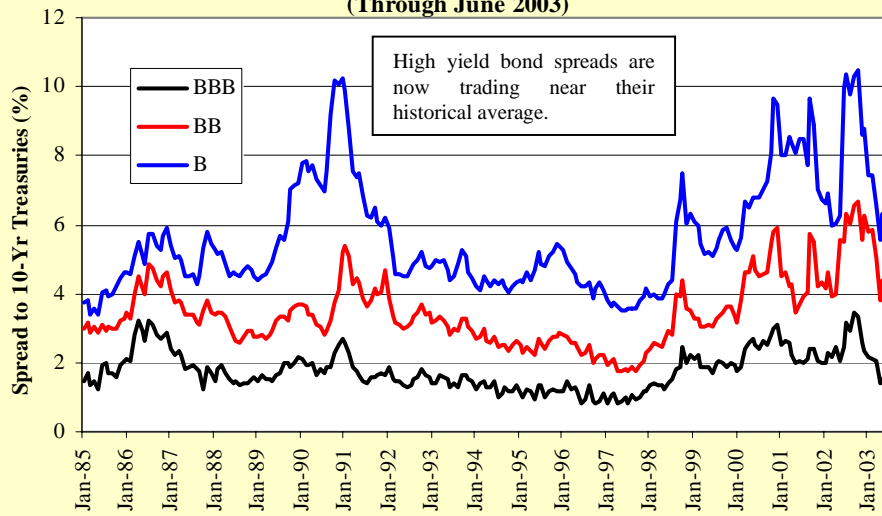
- The FOMC cut the Fed Funds rate to 1% at their June meeting. The futures market is predicting that there is a one-in-three chance that the Fed will cut another quarter-point by year-end. The futures market also predicts it is unlikely that the Fed will begin tightening until spring or summer 2004.
- Intermediate and long-term interest rates also declined during the quarter. The yield on the last issued 30-year Treasury bond, which began the quarter at 4.84%, plummeted to 4.17% by mid-June, before rebounding to 4.57% by month-end. The 10-year bond yield declined from 3.83% to 3.54% during the quarter.
- Credit spreads tightened during the second quarter, suggesting that bond investors believe that the worst is behind us in the corporate sector.

Expected Future Fed Funds Rates
(Based on Pricing of Fed Funds Futures At 7/11/2003)



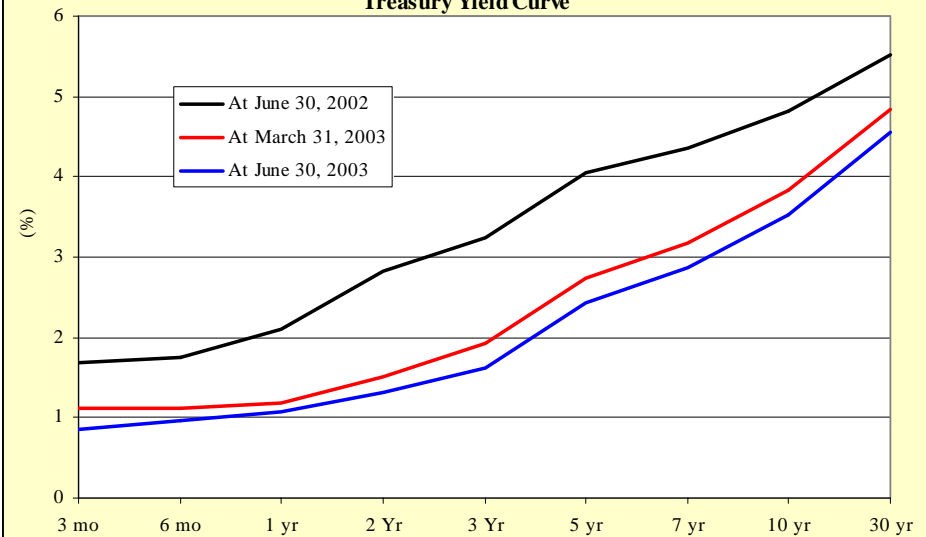
Source: Chicago Board of Trade

High-Yield Corporate Bond Yield Spreads
(Through June 2003)



Source: Salomon Smith Barney

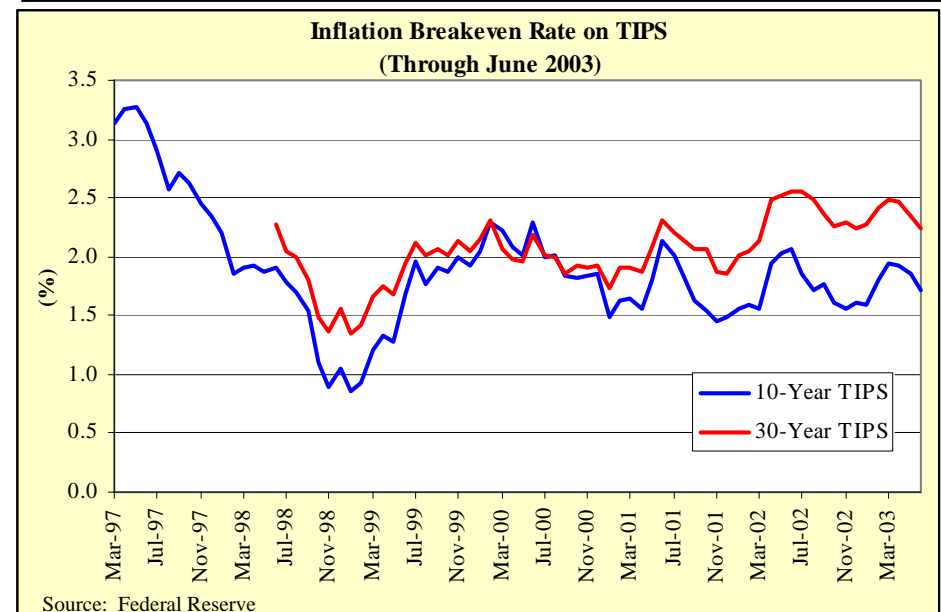
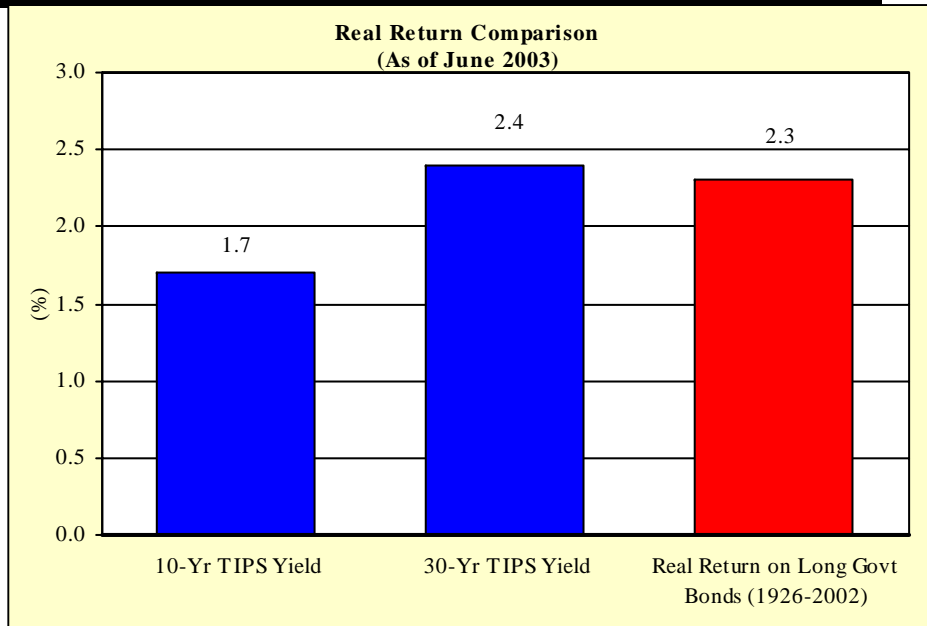
Treasury Yield Curve



Source: Salomon Smith Barney

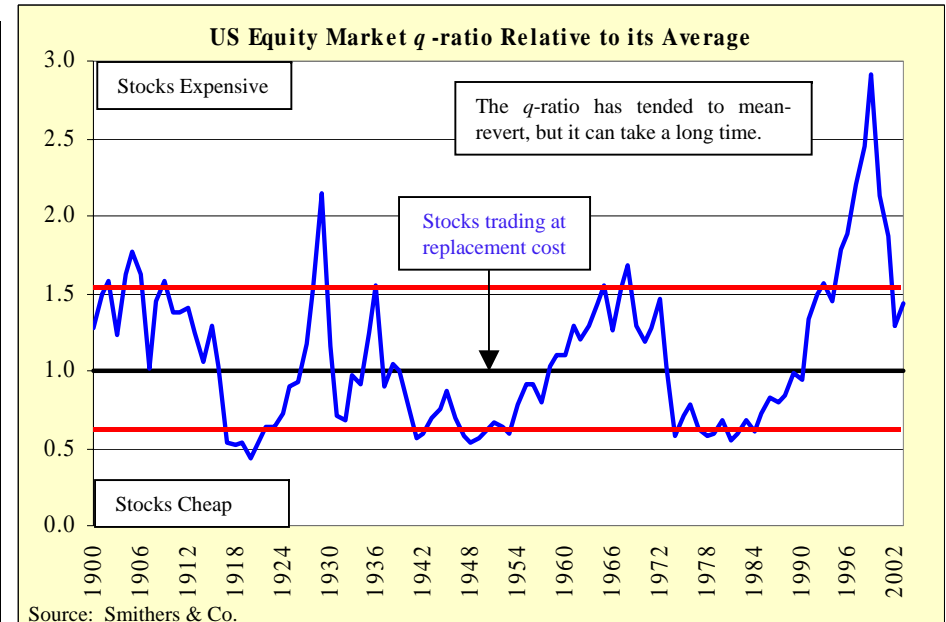
Are Bonds Overvalued?

- Long-term *real* interest rates are in-line with historical norms. The real yield on 30-year Treasury Inflation Protected Securities (TIPS) stands at 2.4%, which is approximately the real return provided by long government bonds since 1926. Therefore, *real* interest rates do not appear to be unreasonably low.
- Traditional bonds are overvalued if the embedded inflation premium is too low.
- The inflation breakeven rates priced into 10-year and 30-year Treasury bonds (relative to TIPS) are only 1.8% and 2.2%, respectively. The last ten-year period that inflation was below 2% was for the period-ended 1968.
- Over the next several years, inflation seems likely to reemerge as an issue. With the Federal government returning to deficit spending, the Fed's preference to err on the side of inflation over deflation, and the weakening dollar, we expect inflation to surpass the levels implied on TIPS. As a result, TIPS appear to represent a better value than traditional Treasury bonds.
- Nevertheless, interest rates may not increase significantly over the short-term. The Fed has a strong incentive to *attempt* to keep long-term interest rates low to spur business investment and to avoid deflating the housing market. (Even so, the Fed may not be able to keep long-term interest rates in check if the bond market gets spooked over expectations for future inflation.)



US Equities Priced to Provide Low Absolute Returns...

- James Tobin introduced the idea of q , which posited that stocks should trade at the replacement cost of their assets less liabilities. When stocks trade significantly above replacement cost, business investment should rise, leading to competition and lower profit margins, driving stock prices down. When stocks are trading below replacement cost, there is little incentive to invest, so competition declines and profit margins increase, resulting in higher stock prices.
- Andrew Smithers and Steven Wright calculate an estimated q using Federal Reserve data. Based on their measure, the q -ratio (the market value of stocks divided by the replacement cost of the underlying assets less liabilities) was 1.43 as of quarter-end, meaning that stocks need to fall by a third to reach fair value.
- The q -ratio has been a good predictor of long-term equity returns over the last 100 years.



Predictive Ability of the q -ratio
(1900 – 2002)

Expected Annualized Real Return on S&P 500 Over Next 10 Years						
Annualized GDP Growth	Normalized P/E Ratio at Year 10					
	10x	15x	20x	25x	30x	40x
2.0%	-4.7%	-1.1%	1.6%	3.7%	5.5%	8.4%
2.5%	-4.2%	-0.6%	2.1%	4.2%	6.0%	8.9%
3.0%	-3.7%	-0.1%	2.6%	4.8%	6.6%	9.5%
3.5%	-3.2%	0.4%	3.1%	5.3%	7.1%	10.0%
4.0%	-2.8%	0.9%	3.6%	5.8%	7.6%	10.6%

Source: Hammond Associates

This model assumes that S&P 500 earnings grow at the same rate as GDP. Historically, S&P 500 earnings have grown about one-third less than GDP.

q -ratio at Beginning of Period		Subsequent Annualized Real Return (%)			
		3 Years	5 Years	10 Years	20 Years
>1.55	Average	0.6	0.9	1.1	4.0
	Range	-28.4 to 23.7	-11.1 to 19.4	-3.1 to 4.2	1.8 to 10.4
1.20 to 1.55	Average	1.6	2.4	1.3	2.8
	Range	-29.4 to 25.9	-13.3 to 23.8	-4.5 to 8.5	0.3 to 11.8
0.85 to 1.20	Average	6.0	4.3	6.2	6.5
	Range	-8.1 to 26.9	-14.8 to 12.4	-1.4 to 15.6	1.5 to 13.0
0.60 to 0.85	Average	11.7	12.1	9.3	8.6
	Range	-2.0 to 30.7	-1.7 to 25.4	-0.1 to 17.0	2.6 to 13.4
<0.6	Average	12.1	11.7	11.5	8.7
	Range	-2.6 to 27.1	2.4 to 22.4	2.9 to 18.2	4.5 to 15.4

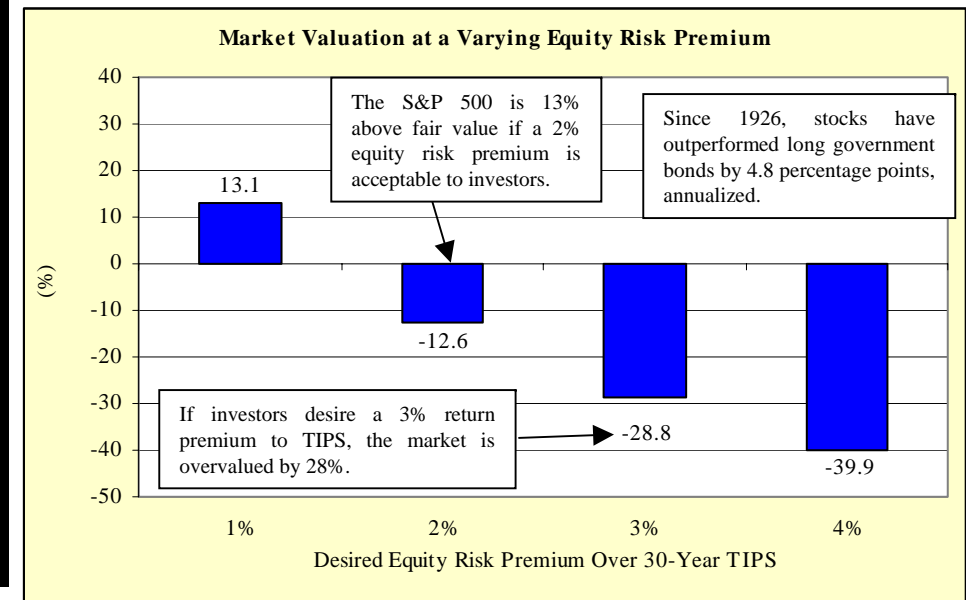
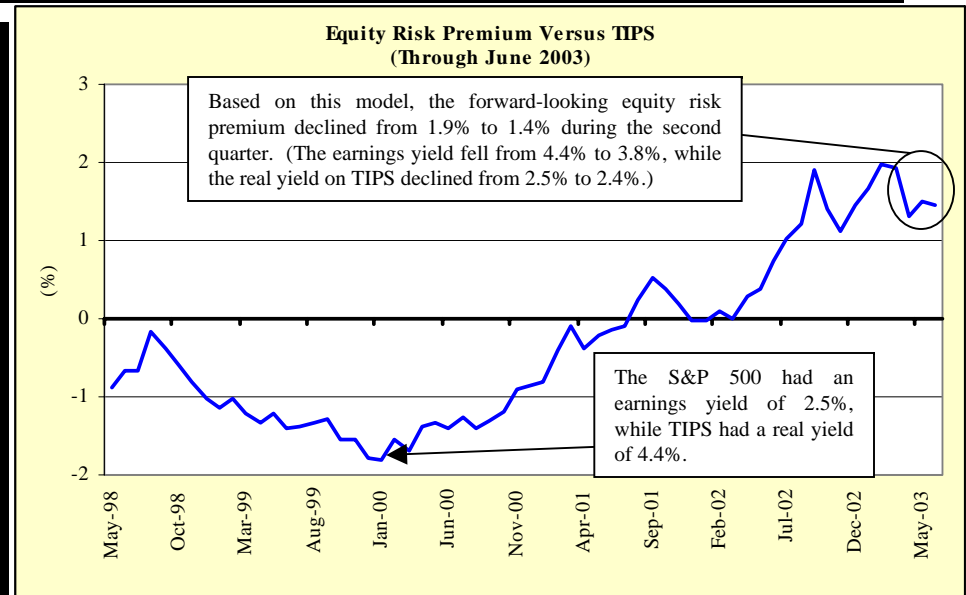
Source: Smithers & Co., Hammond Associates

Historically, the q -ratio has been a good predictor of future returns. Today's q -ratio of 1.43 has been associated with future real equity returns in the low single digits (1.3% average annualized real return over a 10-year horizon).

And Low Relative Returns

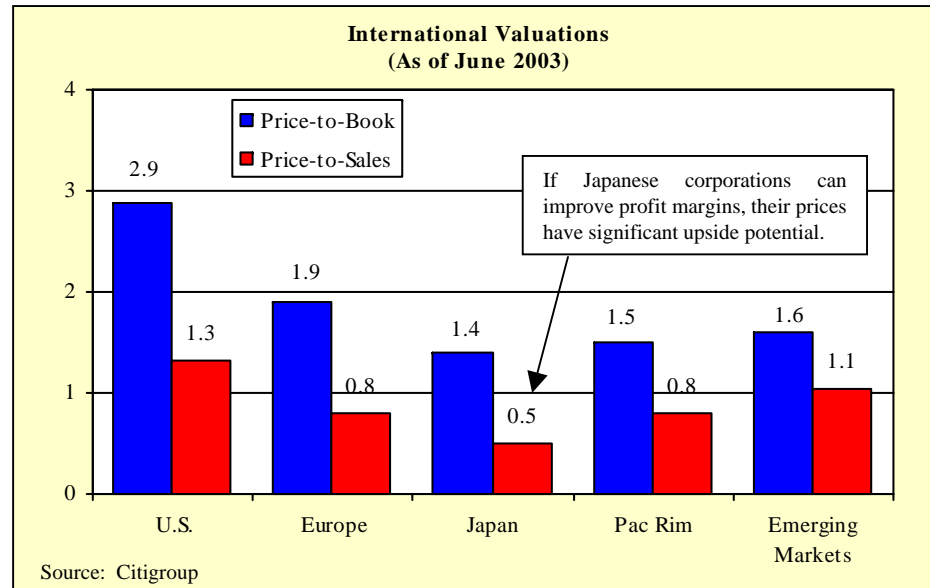
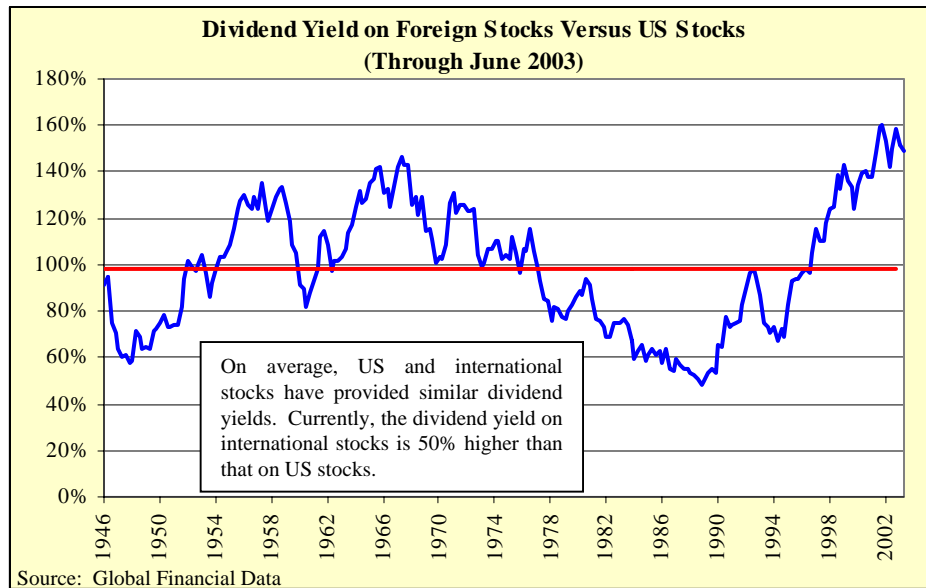
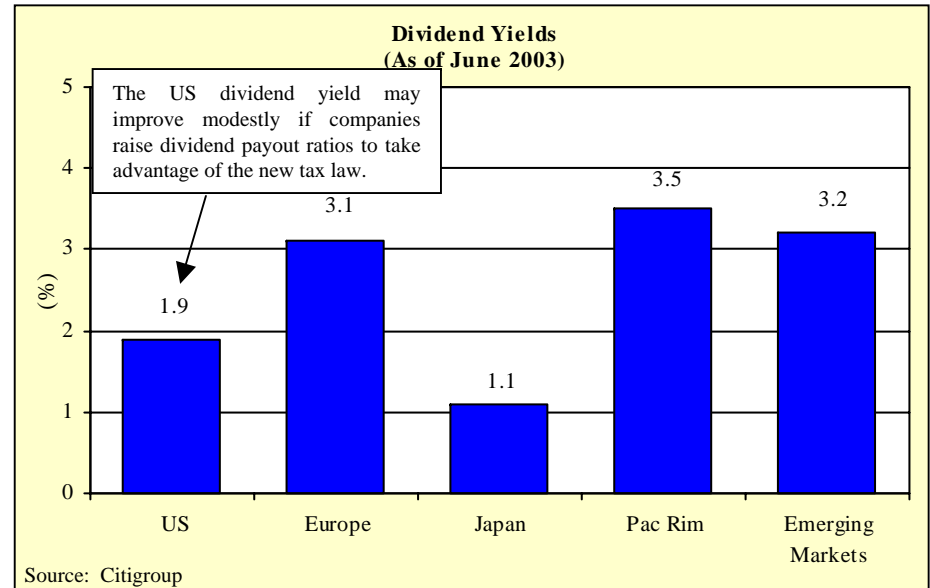
- Some argue that higher than normal valuations are justified by abnormally low interest rates. The “Fed Model”, which compares the S&P 500 to the 10-year Treasury bond yield, suggests that the index is significantly *undervalued*.
- Using nominal interest rates to value stocks is not appropriate because of inflation.¹ Over the long-term, corporations have been effective at passing inflation on to consumers. Therefore, to the extent that declining nominal interest rates are caused by declining inflation expectations, they should not benefit stocks because *lower inflation* results in *lower earnings growth*.
- A better way to measure the attractiveness of stocks relative to bonds is to use expected real interest rates. TIPS, because they are inflation-adjusted, offer an estimate of the markets’ expectation of the long-term, risk-free rate of return. For example, 30-year TIPS pay an increment to inflation of 2.4%, suggesting market participants demand a return of 2.4% over inflation free of risk.
- Jeremy Siegel, among others, has noted that the earnings yield on stocks, which is simply the inverse of the P/E ratio, has been a good predictor of long-term *real* returns.
- As the normalized P/E ratio is currently 26, the earnings yield on the S&P 500 is 3.8%. The yield on 30-year TIPS finished the second quarter at 2.4%. Therefore, the risk premium priced into stocks by this measure is 1.4% (3.8% - 2.4%). If investors are willing to settle for only a 1.4 percentage point return premium from stocks over bonds (a third of the long-term realized premium), stocks are fairly priced. If more is expected, they are overvalued; if less, undervalued.

¹There are a number of other problems with the Fed Model that are beyond the scope of this report. Cliff Asness of AQR Capital Management wrote an excellent critique of the Fed Model called “Fight the Fed Model.” It is available for download at www.aqrcapital.com.



International Equities Appear More Reasonably Valued

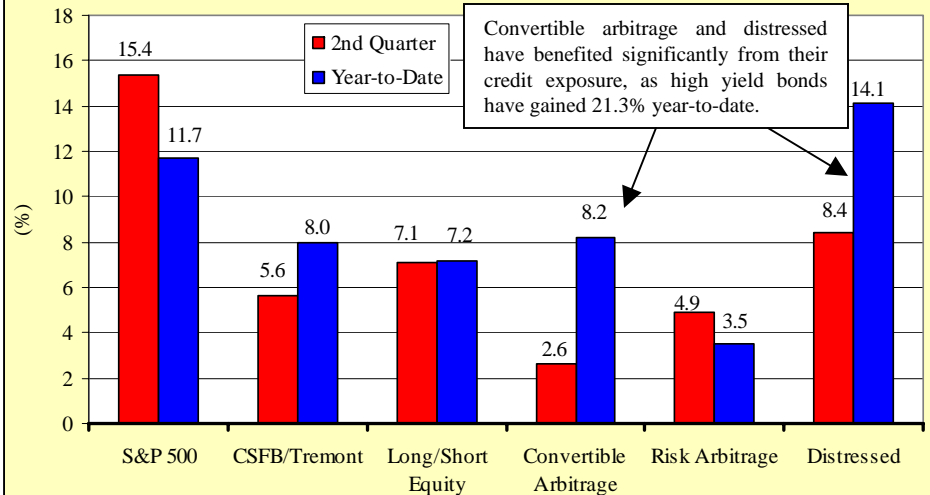
- International equities, despite their strong returns in the second quarter, appear cheap relative to US equities.
- The MSCI EAFE index has a dividend yield of 2.8%, much higher than the 1.9% yield on the S&P 500. On other measures of value, international stocks also appear relatively attractive.
- Emerging markets still represent the best value. Emerging market economies (particularly in Asia) are growing rapidly and their stocks are trading at compelling valuations.
- With the dollar likely to continue weakening, international equities are well positioned to provide attractive future returns relative to US equities.



Hedge Funds: Diversification is a Double-Edged Sword

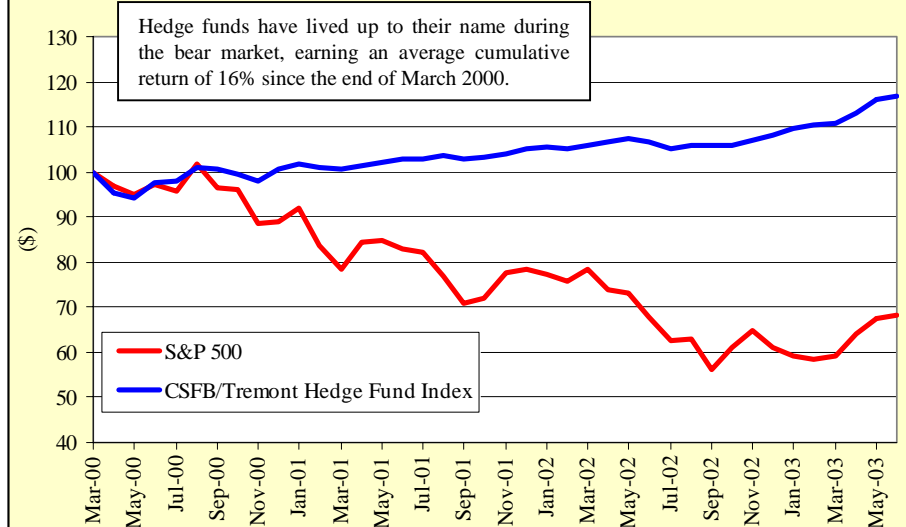
- Relative to the S&P 500, hedge funds experienced a disappointing quarter, as the CSFB/Tremont Hedge Fund Index gained only 5.6%. Given their hedged nature, these results are not surprising. We would expect most hedge funds to trail traditional equities during strong market rallies. Since the bear market began, however, hedge funds have generally preserved (and in many cases, grown) capital—a welcome relief to investors.
- The CSFB/Tremont Long/Short Equity index gained 7.1% during the quarter, bringing the year-to-date return to 7.2%. Many managers remain reluctant to dial up net exposure, suggesting that they are not fully convinced that the bull is back.
- Convertible arbitrage experienced a difficult June (-0.6%), as volatility approached one-year lows and new dividend legislation motivated many issuers to declare (or consider declaring) dividends, which diminishes the value of a convertible bond's imbedded option. The strategy is still up strongly year-to-date (8.2%, as measured by the CSFB/Tremont Convertible Arbitrage index), benefiting considerably from credit exposure.
- Merger arbitrageurs are finally seeing light at the end of the bear market tunnel, as M&A activity has picked up. The CSFB/Tremont Risk Arbitrage index gained 4.9% for the quarter, the best calendar quarter return since 1999.
- Finally, distressed securities has been the top performing strategy year-to-date (the CSFB/Tremont Distressed index is up 14.1%), as credit spreads have tightened considerably this year.
- One has to wonder if the current credit and equity market rallies have priced in an economic recovery that is unattainable. If so, the critical question will be, "Is your hedge fund hedged?"

Performance of S&P 500 and CSFB/Tremont Hedge Fund Indexes (%)



Source: CSFB/Tremont

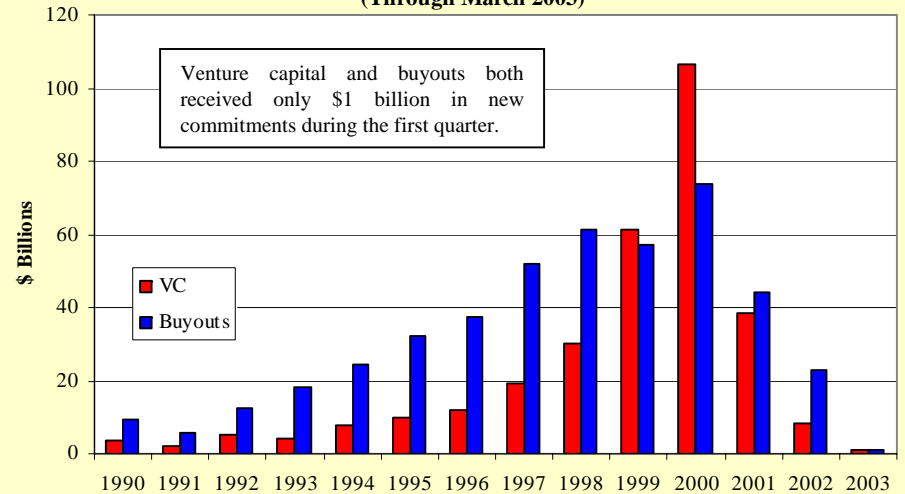
Growth of \$100 Since March 31, 2000



Private Equity: Another Quiet Year

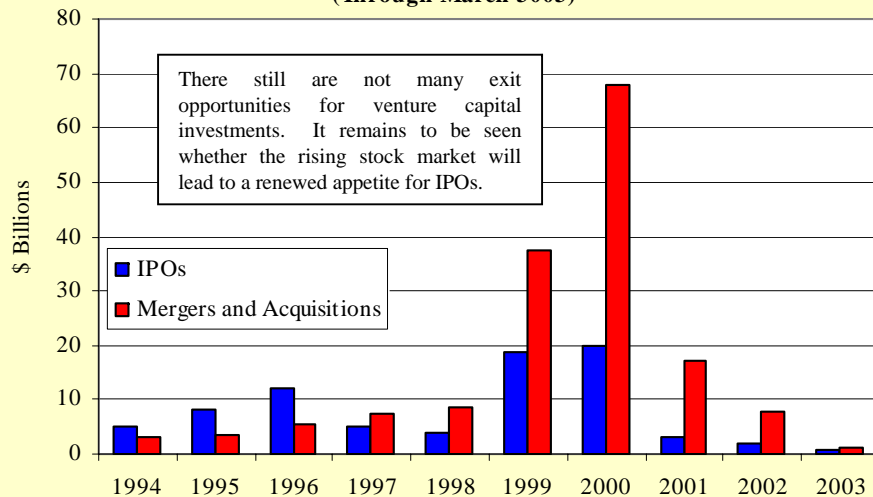
- 2003 is shaping up to be a slow year for most areas of private equity. Commitments to new funds were almost non-existent during the first quarter. Fundraising is expected to pick-up in the second half of the year, but will likely be concentrated among firms with the best track records.
- The good news is that the capital “overhang” is slowly being drawn down, as the pace of investing (albeit very slow) is greater than the pace of fundraising.
- Private distressed investing is not as attractive as it was just a couple of quarters ago. Contracting credit spreads have reduced the opportunities for trading strategies tremendously (greatly benefiting those who were already invested). Opportunities remain for control-oriented distressed investments.

**Private Equity Commitments by Year
(Through March 2003)**



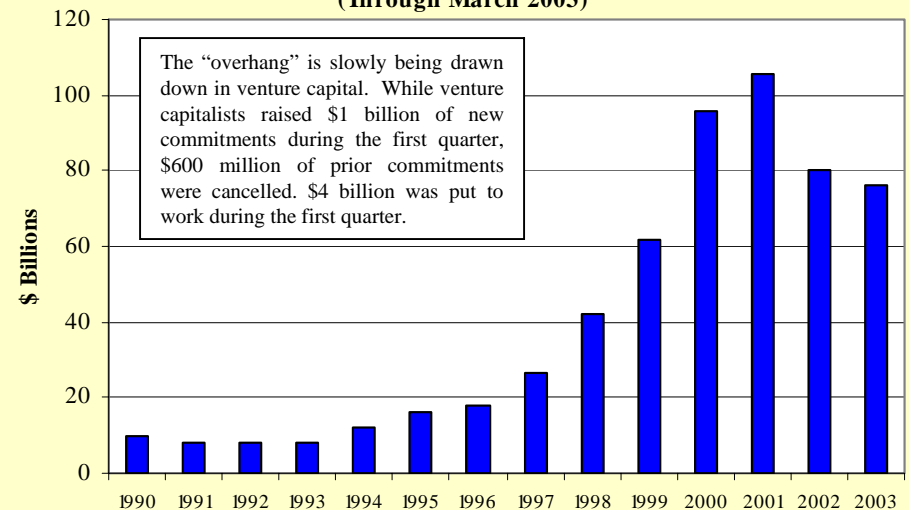
Source: Venture Economics

**Venture Exits
(Through March 2003)**



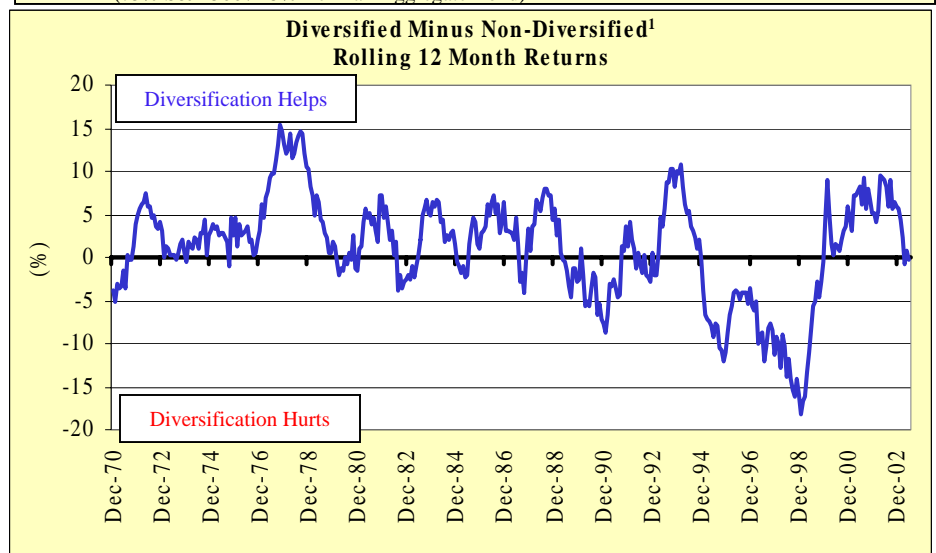
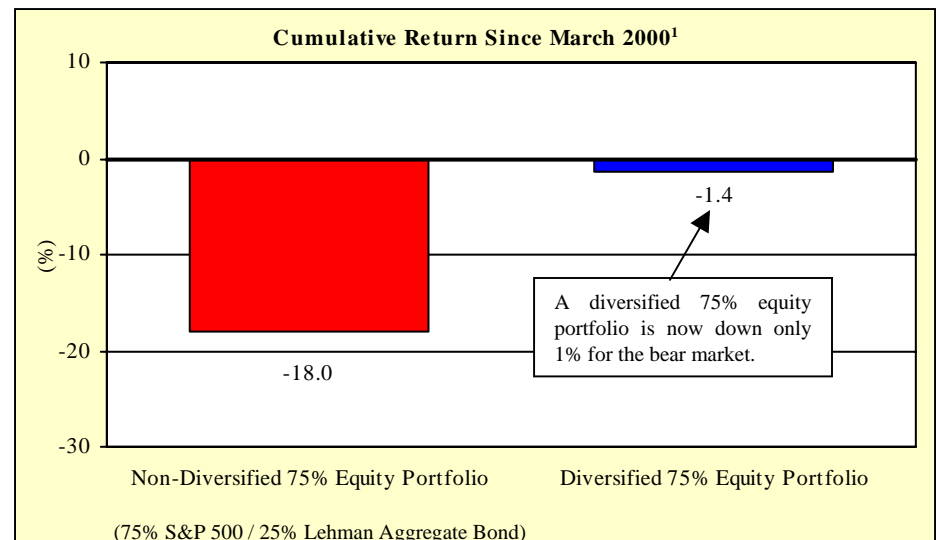
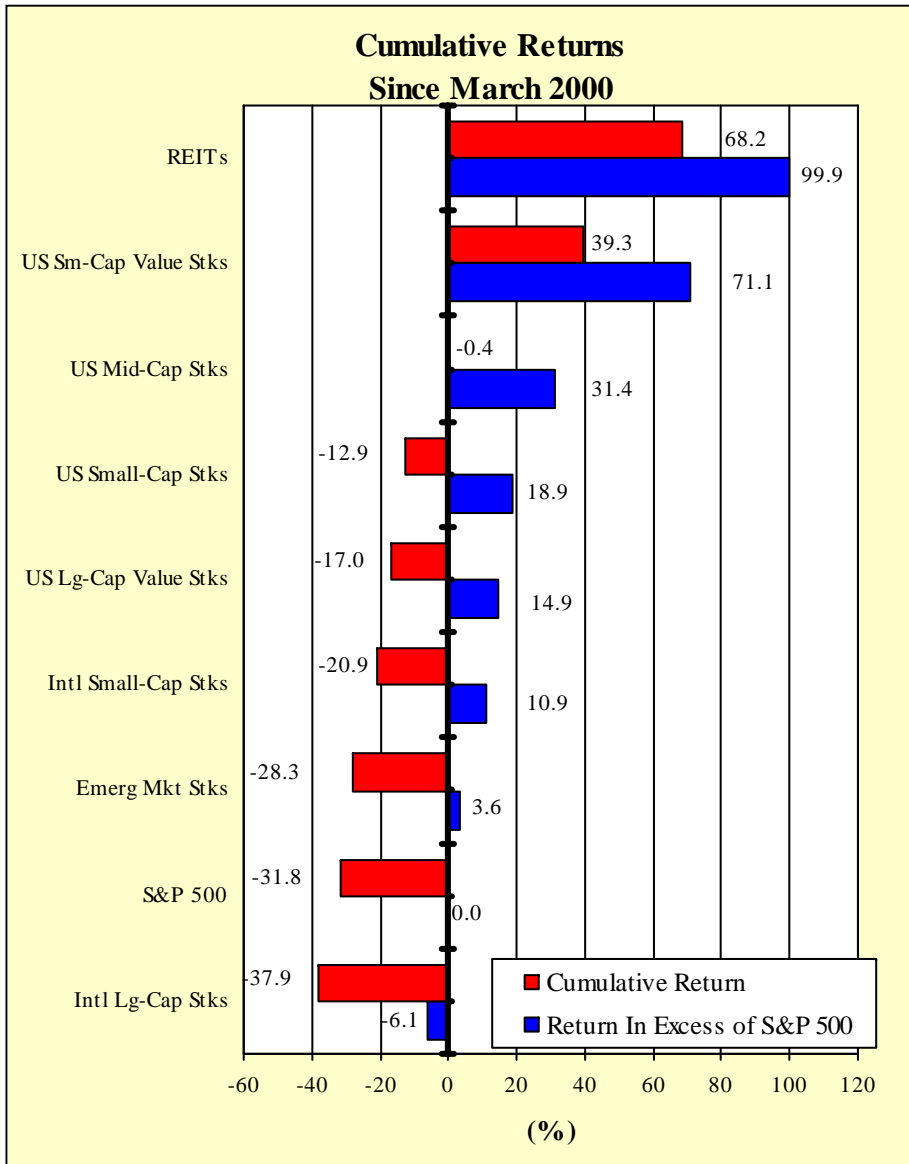
Source: Venture Economics

**Uninvested Venture Capital Commitments
(Through March 2003)**



Source: Venture Economics, Hammond Associates estimates

The Value of Diversification



¹The results of the diversified and non-diversified portfolios are shown for informational purposes only. The portfolios do not represent advice given to Hammond Associates' clients. The non-diversified portfolio is comprised of 75% S&P 500 and 25% Lehman Aggregate Bond. The diversified portfolio is comprised of 16% S&P 500, 8% S&P 500 / BARRA Value, 7% S&P MidCap 400, 11% Russell 2000, 5% Russell 2000 Value, 7% Wilshire REIT, 7% MSCI EAFE, 7% Citigroup EMI EPAC, 7% MSCI EMF, and 25% Lehman Aggregate Bond.

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WELCOME to Michael J. Forestner, MBA, CFA, *Director of Alternative Investments*

Michael is the *Director of Alternative Investments* for Hammond Associates. He earned both his BBA and MBA degrees from the University of Georgia, with an emphasis in finance. He has received his Chartered Financial Analyst (CFA) designation, and is a member of the Association for Investment Management and Research and the Atlanta Society of Financial Analysts. Prior to joining Hammond Associates, Michael worked for Alliance Technology Ventures, a venture capital firm investing in early stage enterprises in several technology-related industries. He also spent two years as Managing Director of EndPoint Capital, LLC, an SEC-registered investment advisor managing in-kind stock distributions from venture capital partnerships for private equity investors. In addition to managing the day-to-day operations of the firm, he was the lead portfolio manager, and prepared extensively for the development of a private equity fund of funds the firm planned to raise. Prior to EndPoint, Michael worked for four years as a Principal Trust Analyst at Southern Company Services, where he was responsible for managing the \$800 Million Private Equity component of the company's \$6 Billion dollar pension plan, 401(k) plan, and foundation. Among numerous investment-related duties over the years, Michael refined and implemented the private equity portfolio strategy including, but not limited to, conducting due diligence on, selecting, and monitoring private equity partnership investments, managing in-kind distributions through to liquidation, and serving on the advisory committees of eleven limited partnerships. Prior his positions at Southern Company Services, he was an Equity Analyst/Trader for Equity Investment Corporation, a mid-cap value equity money manager. Michael managed portfolios, performed equity analysis, financial modeling, securities trading, portfolio administration, and systems management.

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