

HAMMOND ASSOCIATES

INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

First Quarter 2004

In this report . . .

- ✓ The Impact of an Aging Population
- ✓ A Bubble-Blowing Fed?
- ✓ Is the Party Over for Small-Caps?
- ✓ Conditions in Private Equity Improving

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- Independent Fiduciary - Free of Conflicts of Interest
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- 24 Foundations
- 16 Pension Plans
- Wealthy Families

•Staff

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- 9 Holders, Chartered Financial Analyst (CFA) Designation
- 1 Certified Public Accountant (CPA)
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The Impact of an Aging Population

Research Note

March 2004

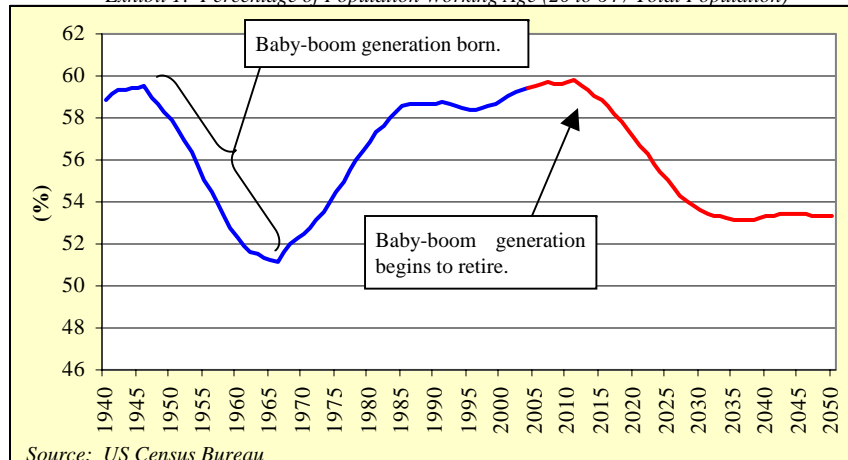
The aging of the US population represents a financial challenge for the coming decades. The effects of longer life spans, the demographic spike from the baby-boom generation, and falling fertility rates, will combine to produce a decline in the working age population percentage and an increase in the dependency ratio (retirees per worker). As this transition takes place, it will test the flexibility of the economy and financial markets.

To compound the issue, the Federal government has established entitlement programs whose commitments to future retirees are far more than current tax policies can bear. It seems unavoidable that major changes are in store. Fed Chairman Alan Greenspan stirred up the hornet's nest in Congressional testimony in February. He testified that entitlement growth (Social Security and Medicare) and current tax policies are incongruent. In an election year, the Chairman's remarks were not well received. This intersection of politics and economics will bedevil us for decades to come.

The Pyramid Scheme

The core of the demography problem is that dependency ratios will be on the rise over the next few decades, meaning that there will be fewer working age persons to support each retiree. With the general expectation of retiring at age 65, the percentage of the population in the US of working age will decline from 59% to 53% over the next 30 years, as shown in Exhibit 1. The challenges we face in the future are best illustrated by examining entitlement programs.

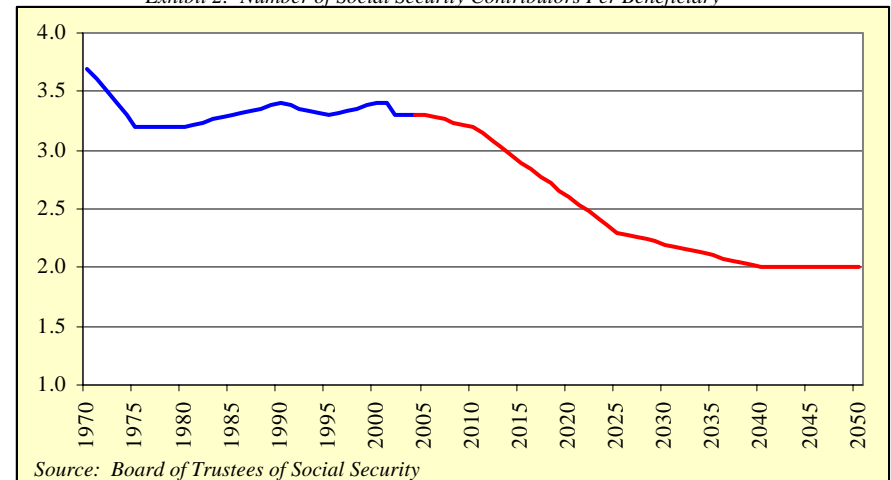
Exhibit 1: Percentage of Population Working Age (20 to 64 / Total Population)



Social Security was started in the 1930s as a safety net for retirees. It is a pay-as-you-go system, meaning that current workers pay current retirees' benefits. The problem for the program is that benefits have become more generous through time, largely because life expectancies have lengthened. At the program's creation, the retirement age for full benefits was 65.¹ The average person then wasn't expected to live long enough to receive full benefits (life expectancy was 63). The typical worker who survived to 65 could expect to live another 12 years. Today, life expectancy is 73 years. A person who reaches 65 should live another 18 years. This means that a typical beneficiary will receive benefits 50% longer than at the program's inception.

Social Security is similar to a pyramid scheme in significant ways. The system is sound so long as the number of people contributing to it is growing faster than the number drawing from it. This has been the case since the creation of the program. High population growth from the baby-boom and the increasing participation of women in the workforce led to rapid workforce expansion. However, the tide is about to turn as baby-boomers approach retirement. Within 10 years, the number of retirees receiving benefits will be growing faster than the workforce—and then the problems begin. As a result, there will be a considerable decline in the number of workers paying into Social Security per beneficiary. As shown in Exhibit 2, currently there are roughly 3.4 workers per beneficiary. That will decline to 2.6 by 2020 and to 2.0 by 2040.

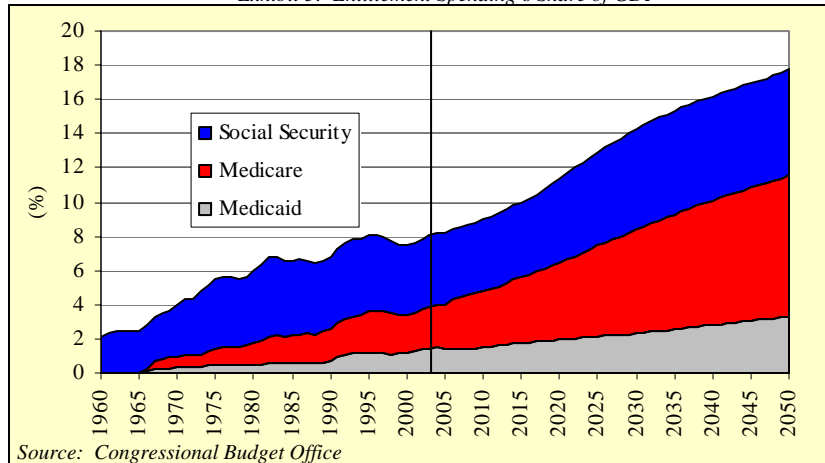
Exhibit 2: Number of Social Security Contributors Per Beneficiary



¹ Workers can draw actuarially-reduced benefits beginning at age 62.

Medicare and Medicaid programs also represent staggering future liabilities. Medicare expenditures are currently about a third of Social Security expenditures, but with healthcare inflation and the prescription drug benefit, growth in Medicare will be rapid. The Congressional Budget Office (under their intermediate cost case) forecasts that Medicare will absorb 5.3% of the economy by 2025 and Medicaid will cost an additional 2.1%. By 2050, Medicare and Medicaid will comprise nearly 12% of the economy.

Exhibit 3: Entitlement Spending's Share of GDP



In 1983 Congress took steps to address weaknesses in the system. They enacted legislation to gradually increase the retirement age from 65 to 67 beginning in 2003 through 2022 (although still allowing actuarially-reduced benefits at 62). While this was a step in the right direction, by the time it is fully enacted, life expectancies will have increased by more than four years. Congress also increased FICA payroll taxes (Social Security and Medicare) as a way to save and partially “fund” the system. In reality, nothing was saved. The Treasury essentially treated excess FICA taxes as general revenue.² The excess contributions were supposedly set aside in the Social Security Trust Fund. However, the trust fund is merely an accounting gimmick. The \$1 trillion purported to be in the fund is “invested” in US Treasury bonds, which means that the government is writing IOUs to itself that will have to be paid by future generations.

The effect is clear—to fund promised benefits given current tax policies, the budget deficit is likely to balloon in the coming decades. Otherwise, taxes must increase. In their 2004 annual report, Social Security’s trustees estimated that FICA taxes must increase from their current level of 15.3% (including employer contributions)

to 20.4% in 2025 and 26.3% in 2050 to keep the system in balance. If tax burdens are increased on workers to support retirees to the extent that will be necessary, it would threaten to reduce the incentive to work, and could lead to a stagnating economy (and to intergenerational conflicts).

A perplexing issue is the low savings rate for US households. The facts that baby-boomers comprise such a large percentage of the population and are in their prime savings years suggest that savings rates should be higher than normal. In fact, the opposite is true. The aggregate savings rate is less than 2%, versus a post-WWII average of 8%. In addition, debt loads are ballooning. There is good news. The net worth of US households is more than five times income, which is healthy by historical standards. A concern is that much of that net worth is in residential housing and equities, both of which are arguably overvalued. A substantial increase in the savings rate poses a risk for the economy over the next decade, especially if investments do not provide hoped-for returns. An increase in the savings rate is prudent for individual households, but if everybody becomes prudent at the same time, the economy could be sent into a major recession.

As distressing as the picture looks in the US, the problem is even worse in many other industrialized nations. Continental European countries have retirement and medical programs that are more generous than the US. In addition, because of below-replacement-level fertility rates, and restrictive immigration policies, the working-age population in some countries will decline, exacerbating the global aging problem. In Japan for instance, the population aged 20 to 64 is expected to *decline* by 15% through 2025, while the 65-plus population is expected to *increase* 42%. France and Germany will also see declines in the working age population.

The Solution

What can be done to avoid increasing the tax burden on working-age persons? The government could finance the cost by borrowing for a while. However, that obviously isn’t sustainable over the long-term. Eventually, interest costs would become a crushing weight on the economy, and private investments would be “crowded-out,” due to higher interest rates. The clear, albeit politically painful, solution to the problem is to begin reforming entitlement programs to encourage later retirement ages. Indexing the Social Security retirement age and Medicare eligibility age to life expectancy seems the most prudent course. In an article published in 2003, Rob Arnott and Anne Casscells suggest that the retirement age needs to increase to 73 over the next thirty years to keep dependency ratios at today’s level.³ The fact is that even without an adjustment in the Social Security retirement age, many baby-boomers will have to work beyond 65 to maintain their standard of living.

² The reported Federal budget balance includes excess FICA revenue. If not, deficits would have been worse over the past two decades.

³ Arnott, Robert D., Casscells, Anne. “Demographics and Capital Market Returns.” *Financial Analysts Journal*, March/April 2003

Some, including the current Administration, propose transitioning Social Security to a system of private accounts. While this wouldn't address the Medicare and Medicaid problem, private accounts have considerable appeal because it would mean moving from a pay-as-you-go system to a funded system. Some part of FICA taxes would go to private accounts, similar to a 401k. The downside is that the transition to private accounts would be costly. Social Security has a several trillion-dollar liability, which would still have to be paid by future workers. A second concern is that most private account proposals would give contributors the opportunity to invest in equities. The thought of US households heavily investing in equities in a program meant to be a "safety net" is unsettling (especially with the transition from defined benefit plans to defined contribution plans in the private sector). Stocks are not a guaranteed winner, even over the long run. In the event of a market crash, there would be significant pressure on the government to bail-out the accounts. This would be at a time when tax receipts are down. It's not good policy for the government to give away put options on equity markets.⁴

From a demographic standpoint, a source of relief would be to enact policies that will increase the size of the workforce. The simplest way is to liberalize immigration policies to attract more young, foreign-born workers. Increasing the size of the labor force through immigration will improve the dependency ratio and relieve some of the stresses on the Social Security and Medicare systems. A larger immigrant workforce wouldn't solve the problem of people living too long into retirement, but it could help to offset the effects of the baby-boomers' bulge. Arnott and Casscells estimate that we will need an additional 4 million immigrants per year through 2030 (beyond the 1 million a year already assumed) to keep the dependency ratio at average levels. This level of population growth and the concomitant demand for goods and services could have other positive economic effects, as well.

Another factor that could improve the situation is higher than expected wage growth due to high productivity gains. If the US can continue to achieve the 3% plus productivity gains attained since the mid-90s, real wages will grow strongly. As a result, a lower than expected FICA tax rate would be required to service future commitments.

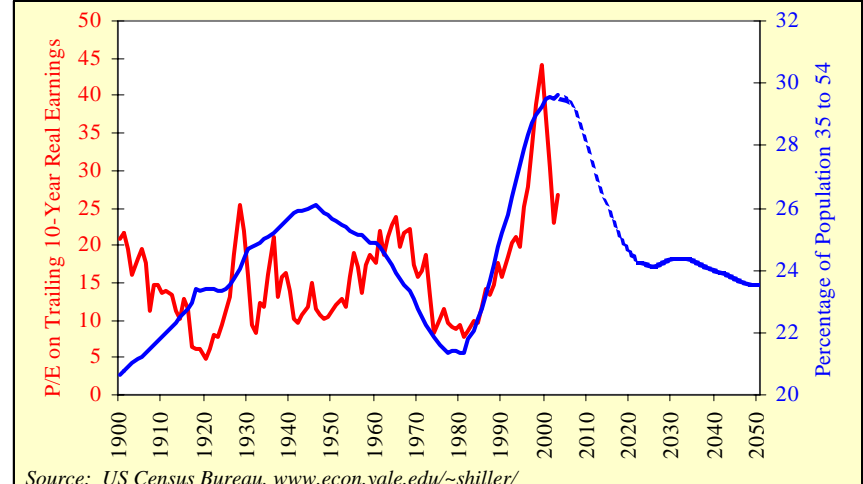
⁴ Along the same lines, some propose investing part of the Social Security Trust fund in equities to increase the expected return. Since the Social Security Trust fund doesn't really exist, the government would have to sell additional bonds to the public (or foreign national banks) to raise the money. The idea of the government issuing debt to invest in the stock market is disturbing. Not only are tax revenues positively correlated to the equity market, there would also be a temptation to use investments for political agendas. If the US did move to a funded system, the most prudent course would be to invest in assets largely outside the US to provide better diversification to tax revenues. Of course, such an approach would not be politically feasible.

Effect of Demographics on Asset Performance

It's difficult to predict what effects the aging population will have on asset performance. The shift in demographics should not have a material effect on the Federal budget until after 2010, and it will be much longer before the effects are serious. As such, it is foolhardy to make dramatic changes to a portfolio at this time based on these factors. There is, of course, still time for the situation to be corrected or to take an unexpected turn. When dealing with the complex and chaotic nature of the economy and capital markets, problems and their apparent solutions will have unforeseen effects. Nevertheless, some broad themes can be drawn.

The shift in demographics appears to present downside risk for equity markets. A concern is that baby-boomers approaching retirement will reduce equity allocations to reduce risk exposure. In the 1990s, a number of observers suggested that baby-boomers were driving the stock market higher as they prepared for retirement, ultimately leading to the bubble (see Exhibit 4). However, over the next couple of decades, baby-boomers, along with the defined benefit pension plans supporting them, may look to reduce risk exposure by cutting stock holdings. Consequently, there could be a shortage of capital available for risk taking. This, in turn, would mean a higher cost-of-capital for equities and lower P/E ratios. A counterargument made by Professor Jeremy Siegel is that foreign investors, especially those in emerging market countries who will be awash in dollars because of a continued trade surplus versus the US, will step in to provide capital.

Exhibit 4: Percentage of Population 35 to 54 Versus Shiller's Normalized P/E Ratio on the S&P 500



Source: US Census Bureau, www.econ.yale.edu/~shiller/

There may be opportunities within equity markets to capitalize on the demographic shift. Healthcare is the most obvious area, given the expected increase in medical spending over the next few decades. However, healthcare companies already trade at a premium to the S&P 500, which means that some part of this may already be priced into the market. Another risk for healthcare is government tampering. Since a substantial part of healthcare expenditures will be paid through Medicare and Medicaid, the government will have an incentive to increase regulation of the industry.

Since many other industrialized countries are experiencing even worse demographic issues than the US, investments in these countries will be facing even stronger headwinds. A positive aspect of developed international markets is that they are trading at more attractive valuations than the US market. Emerging market countries offer more promise, since their populations are younger and their fertility rates are higher. Of course, emerging market investing means far more exposure to other risks.

The implications are unclear for fixed income markets. One line of reasoning is that high budget deficits in the future will drive real interest rates up, leading to poor fixed income returns. In addition, the government may have an incentive to print money to cause inflation, thus lowering the real value of outstanding debt. A counterargument is that baby-boomers will favor fixed income over equities and will bid up fixed income prices, leading to lower real interest rates. Regardless, the risk of inflation argues for overweighting inflation-protected fixed income securities and other inflation-hedging real assets (e.g., oil & gas). Given current interest rates, investors in nominal bonds are not well compensated for taking inflation risk.

The demographic shift also appears to present downside risk for both residential and commercial real estate (particularly office buildings). Residential real estate prices have exploded over the past decade as mortgage interest rates have declined. Now that nearly 70% of households own homes and the prime home-buying demographic cohort (30 to 39) is reaching a trough, there may be fewer net new buyers. Furthermore, some baby-boomers may look to trade-down their homes in retirement and tap some of their home equity. For commercial real estate, the slow expected growth in the workforce will present challenges. AEW, a real estate advisor, estimates that current office space vacancies could take more than 10 years to absorb given workforce expansion estimates.

Conclusions

The demographic shift occurring in the US and other developed markets presents a significant challenge. The ramifications of this are difficult to forecast. If we take a proactive approach to the problem by extending retirement ages, the issue may be diffused. On the other hand, if we ignore the problem, solutions will be even more painful down the road. To some extent, the difficulty may be partially self-correcting—people will be forced to work longer because of insufficient savings to support longer life spans. That should keep the dependency ratio from becoming as dire as the projections suggest.

The US appears to be in the best position of the industrialized countries to handle the coming problems. US retirement benefits and other social programs are much less generous than their European counterparts. Furthermore, the US should continue to experience a growing working age population (albeit slower than in the past). Conversely, Japan and many European countries will experience declines in the working age population. In addition, the US economy tends to be far more flexible than other industrialized nations. During major structural shifts, flexibility is key to emerging stronger. A final advantage is the US will have an opportunity to learn from Continental Europe and Japan, since they will be facing the problem earlier.

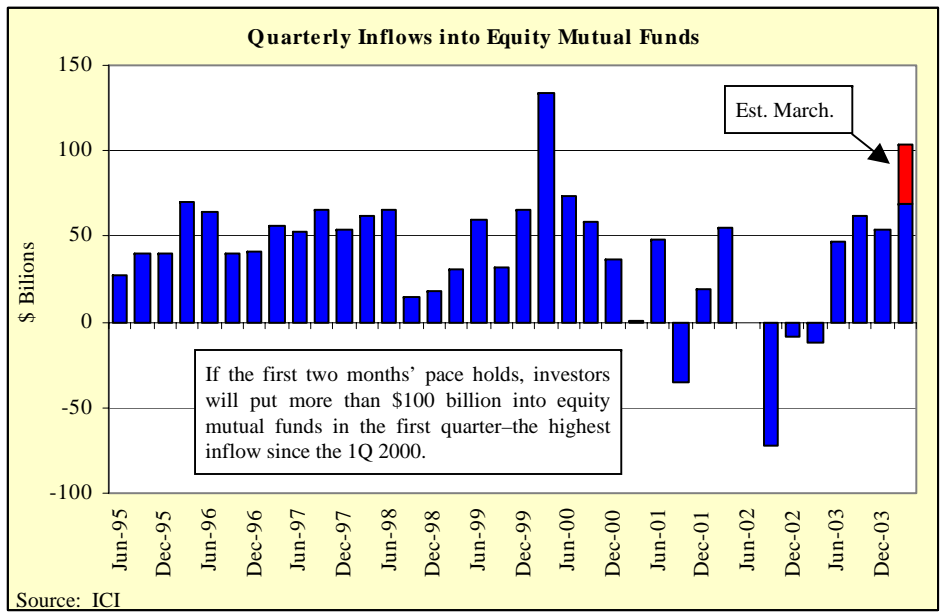
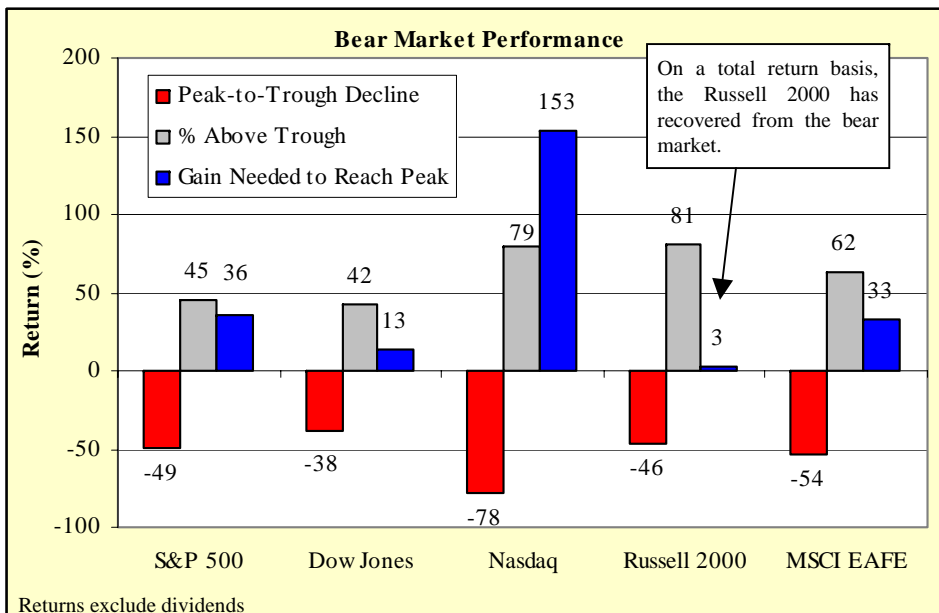
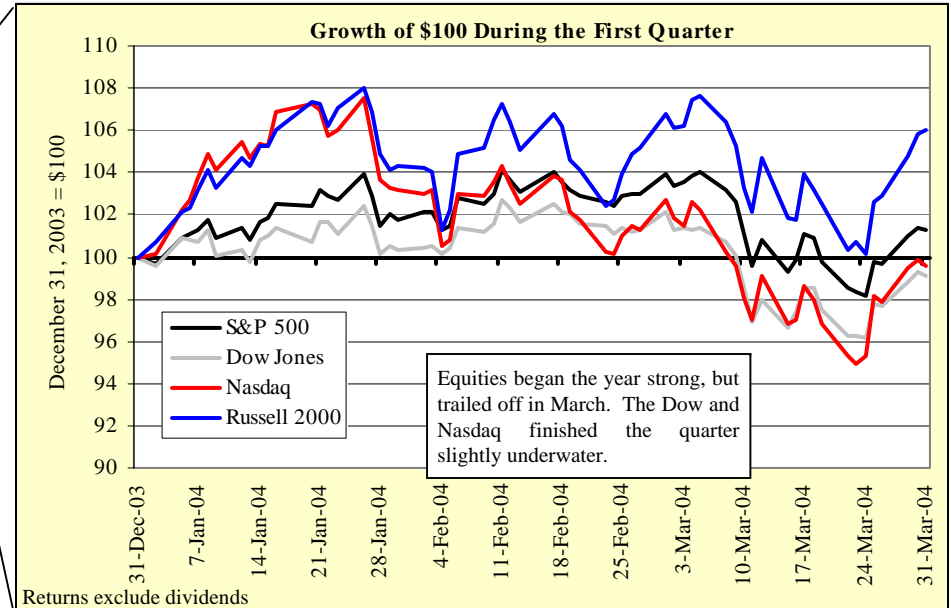
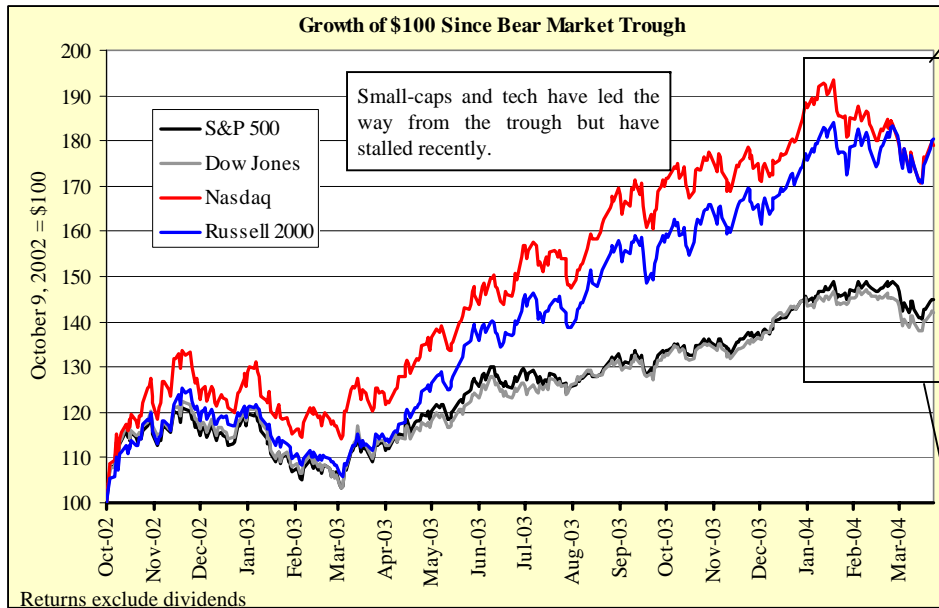
As for investment implications, given the complexity and time frame of the issue, it's hard to predict the effects on specific asset class returns. The demographic problem may have solutions, opportunities, and consequences that we cannot envision at this time. Nevertheless, with valuations already in the stratosphere, there appears to be further downside risk for equities. Retiring baby-boomers may look to reduce their equity allocations in favor of bonds, which could push P/E multiples down. Nominal bonds also seem to be at risk. Given high projected Federal and household debt loads, inflation may be an irresistible policy to reduce the real value of outstanding debt. We continue to recommend that clients diversify and reduce the reliance on public equities and standard fixed income investments.

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First Quarter Executive Summary

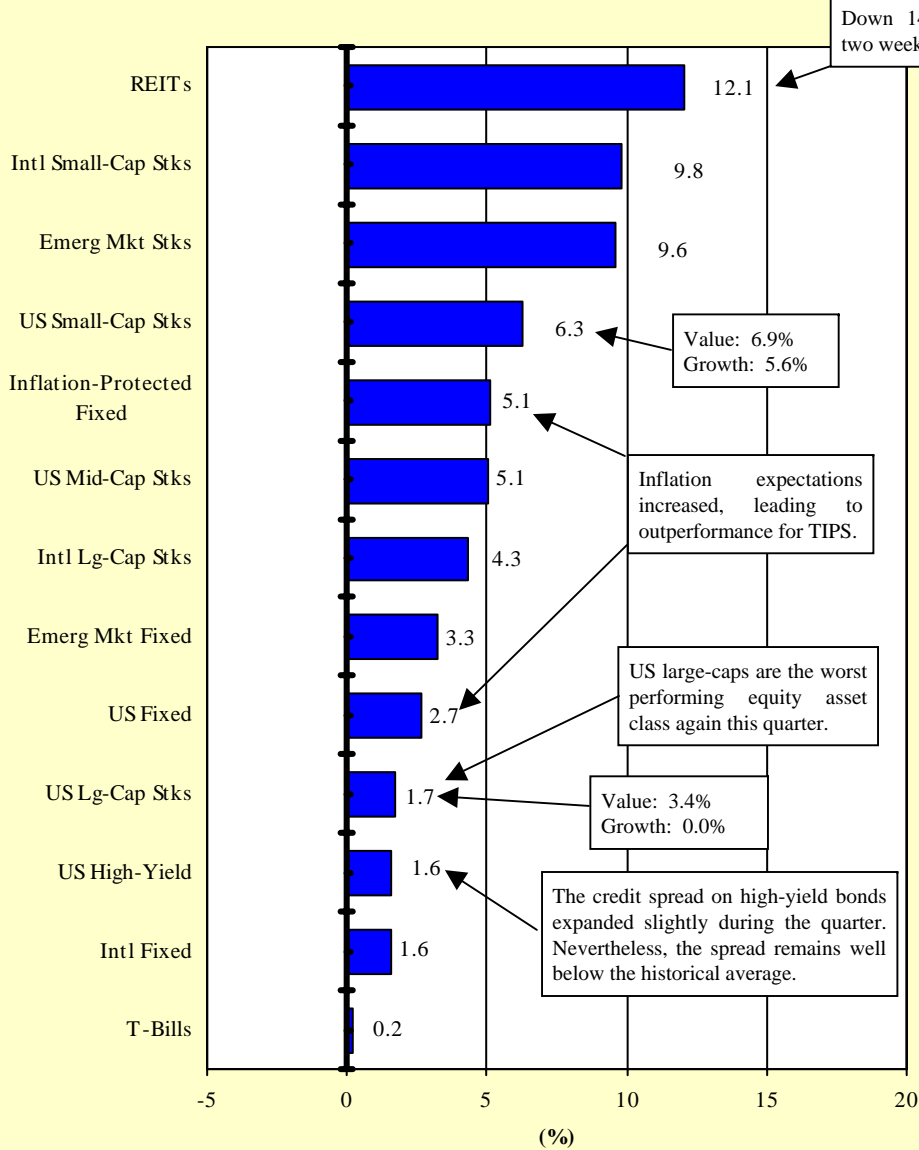
- The S&P 500 earned 1.7% during the first quarter, lifting the twelve-month return to 35.1%. Other equity asset classes performed even better. The MSCI EAFE index earned 4.3% during the quarter and emerging markets surged 9.6%. REITS were the best performing asset class, gaining 12.1% in the quarter.
- The economy grew 3.1% during the 2003 calendar year. Forecasters polled by *The Economist* expect growth of 4.7% for 2004. The 2003 tax cuts should have a positive impact on consumer spending through the second quarter. The March employment report showed an improving job market. Continued strong job growth will be necessary to support spending in the second half of the year. Looking beyond 2004, the imbalances in the economy remain a dark cloud.
- The Fed's aggressive easing of interest rates has helped to mute the effects of the bursting equity bubble on the economy. However, with the economy now enjoying strong growth, the Fed has a delicate balancing act. The pace of economic growth argues for higher rates, but the debt-fueled economy may now be addicted to low rates. Critics suggest that the Fed is creating new bubbles (in debt and housing) in an attempt to dampen the effects of the equity and business investment bubbles. This may be delaying an inevitable correction in the economic imbalances and could make any eventual correction even more painful.
- Real estate prices continued to surge in 2003. The average house appreciated by 8% in 2003 and by 35% since the beginning of 2000. The wealth effect from these gains have provided support to consumer spending. A retrenchment in real estate prices poses a significant risk to the economy.
- The dollar recovered some lost ground against the euro in the first quarter, appreciating 2.5%, but reached a four year low against the yen. With the current account deficit at 5% of GDP, the trade-weighted dollar needs to fall further.
- Reported earnings on the S&P 500 surged 78% during 2003, allowing the P/E on trailing reported earnings to contract from 41 to 23. With the surge in earnings, profit margins are well above historical average levels. As a result, we are concerned about their sustainability. Subdued earnings growth seems likely over the next few years as profit margins revert to the norm. Based on historical average profit margins, the S&P 500 is trading at a normalized P/E ratio of 29.
- Small-caps have outperformed large-caps by 8.3 percentage points annualized since the beginning of 1999. Based on fundamentals, they do not appear to have much bang left. While momentum may continue to drive small-caps higher, for those with heavy small-cap biases, it may be a good time to trim the bet.
- On a valuation basis, international equities still appear to offer more promise than US equities. Despite recent gains, emerging markets offer the best value among world equity markets. A concern over the short- to intermediate-term is their reliance on exports to the US.
- The environment for private equity appears to be improving. It may be worthwhile considering selective investments. Still, the sector faces headwinds given the remaining overhang.
- During the first quarter, hedge funds, as represented by the HFR Fund of Funds index, gained 3.1%, lifting the one year return to 13.8%. Investors continue to pour money into hedge funds, seeking uncorrelated, absolute returns. However, traditional measures of risk may fail to capture the peril in hedge funds that arises from leverage, both obvious and not so obvious, and option-like payoffs.

2004 Starts Off On Right Foot

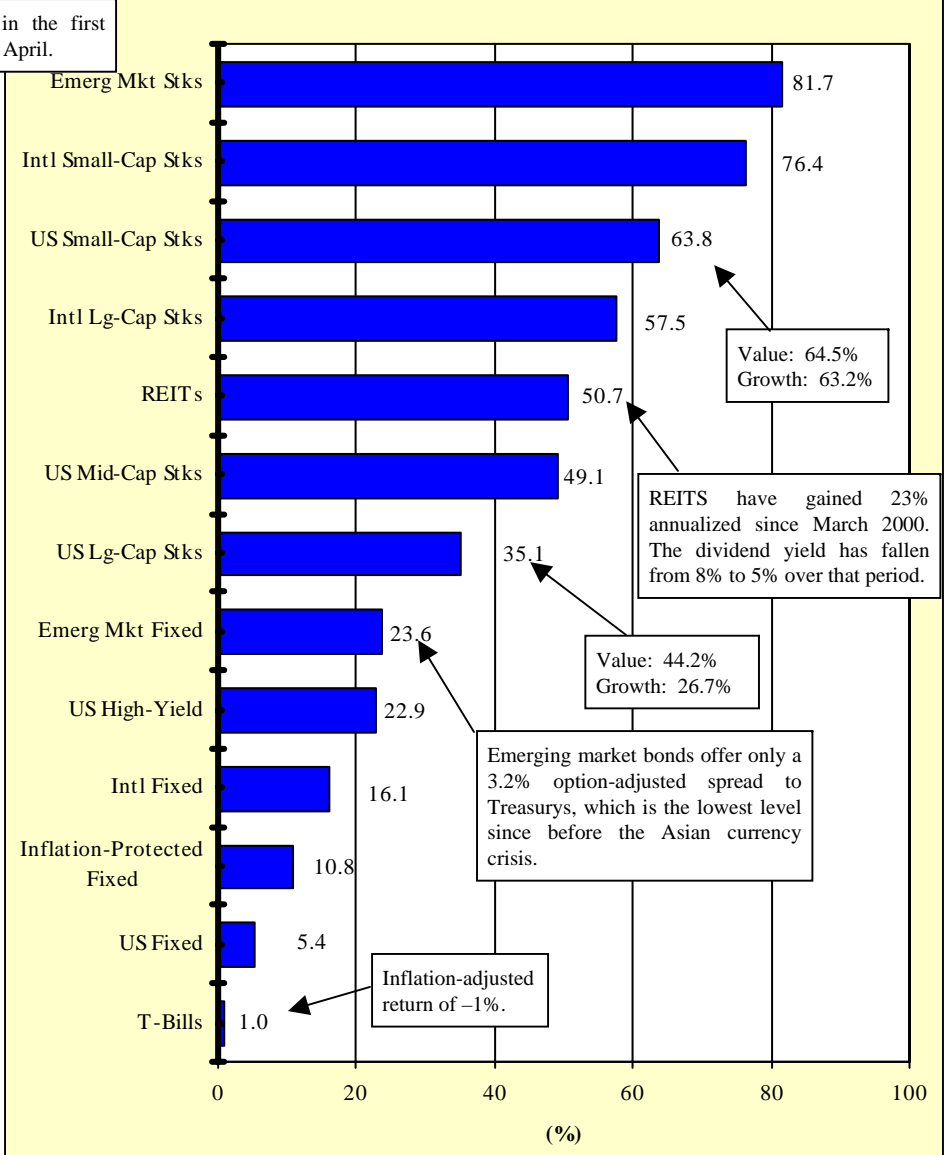


REITs Finish the Quarter on Top

First Quarter 2004 Performance (%)



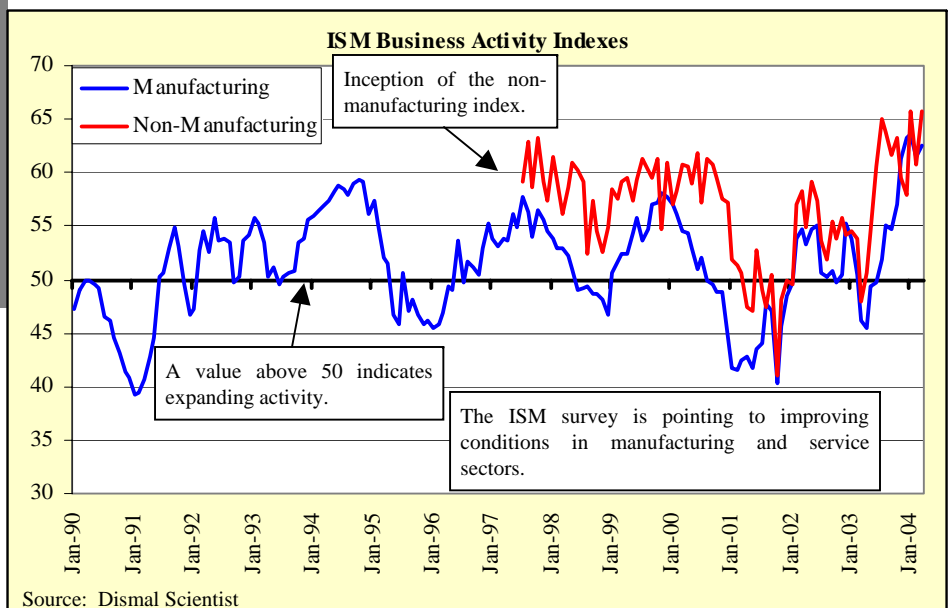
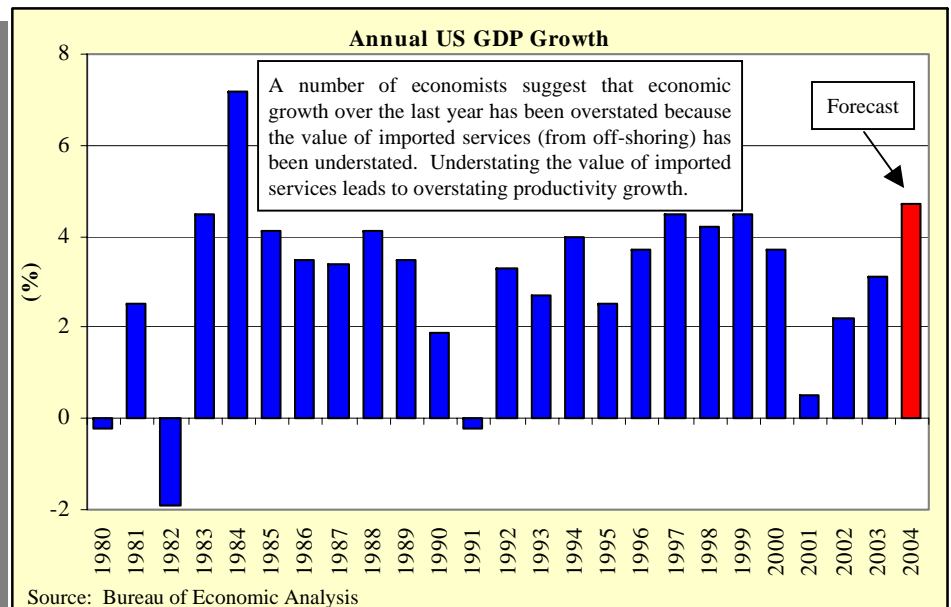
Last 12 Months (%)



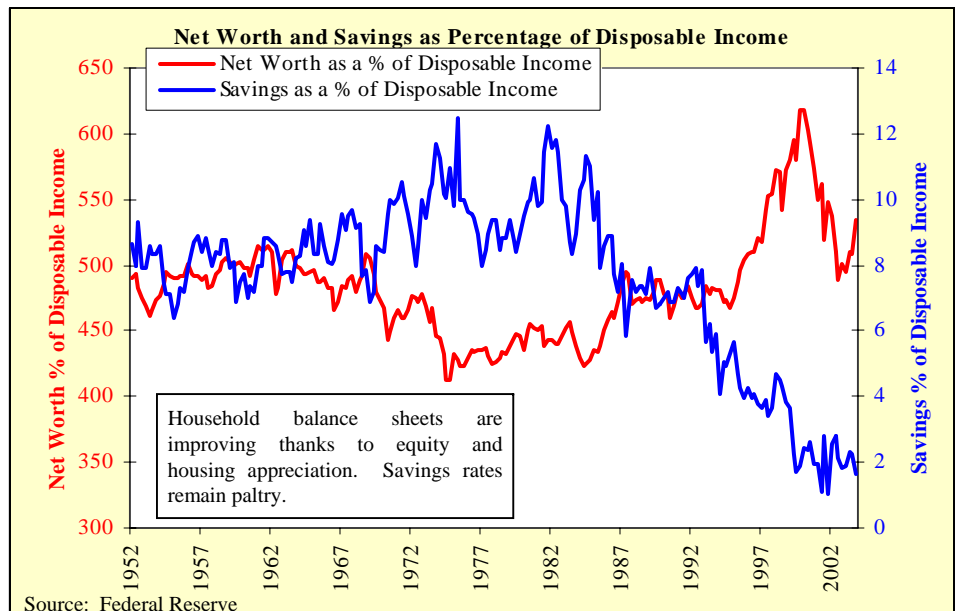
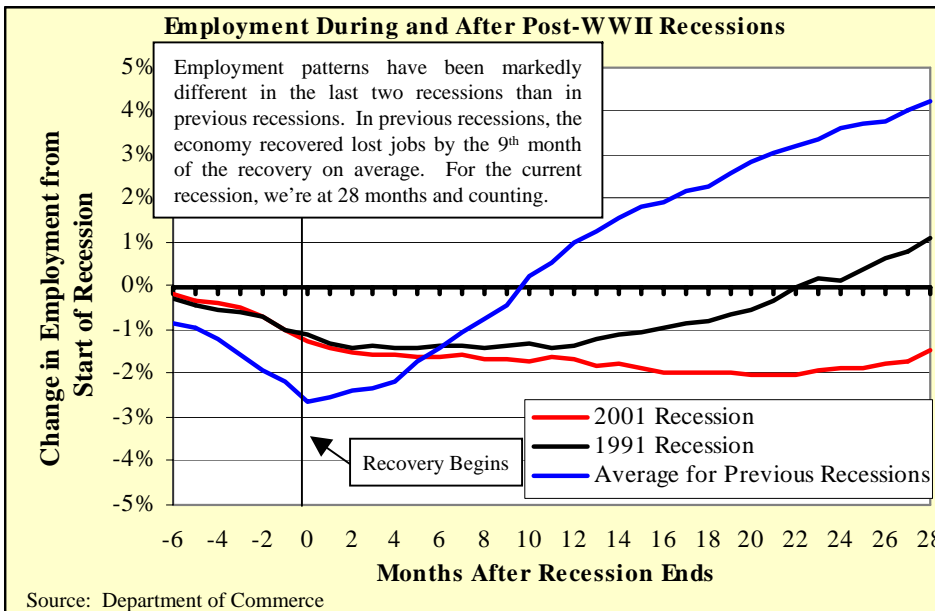
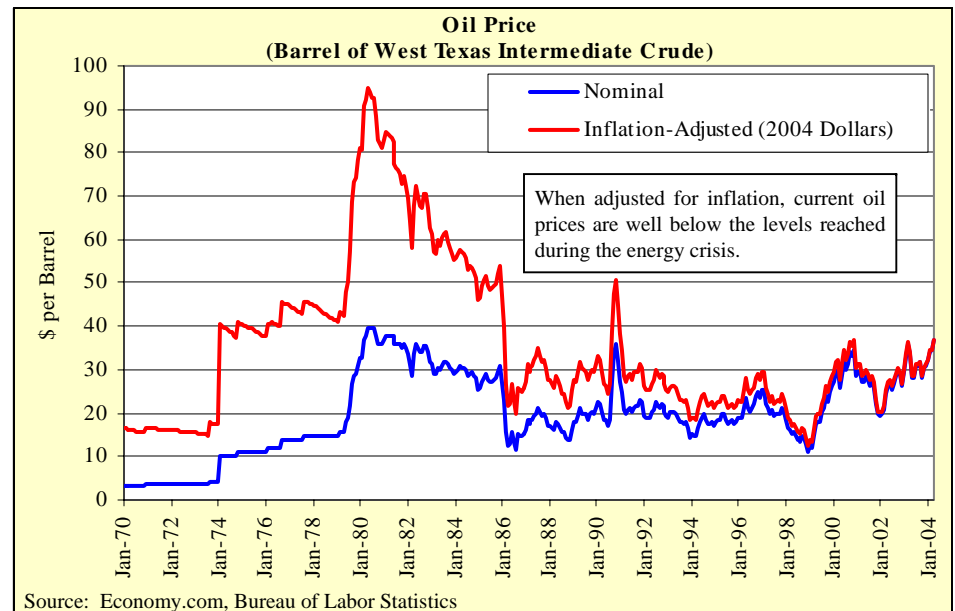
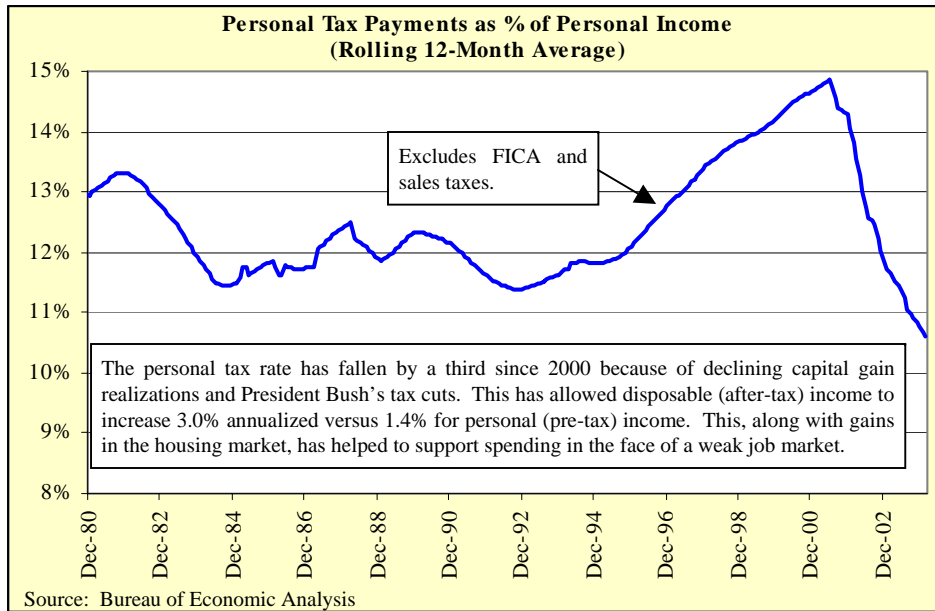
Job Market Improving, Economy Growing

- After growing at a 4.1% annualized pace in the fourth quarter, the economy expanded 3.1% for the 2003 calendar year. Most economists expect strong growth in 2004. Forecasters polled by *The Economist* expect growth of 4.7% for the year.
- The 2003 tax cuts should have a positive impact on consumer spending through the second quarter. Because the cuts were made retroactive to the beginning of 2003, tax refunds are running 10% above last year's level.
- With the March report, the employment situation appears to be improving. The economy added 308,000 jobs in March. For the quarter, 513,000 jobs were created, the highest since the second quarter of 2000. However, the pace of job creation remains far behind that of the typical recovery. Continued strong job growth will be necessary to support spending in the second half of the year.
- Rising energy prices are a source of concern; however, it's unlikely that the increases experienced so far will derail the recovery. The economy has become less sensitive to energy prices since the crisis in the 1970s.
- The economy is poised to have a strong 2004. Looking beyond, the imbalances in the economy remain a dark cloud (trade deficit, low savings, budget situation, and debt loads).

	2003 Growth (%)	Contribution to 2003 Growth (%)
Personal Consumption Expenditures	3.1	2.2
Non-Residential Fixed Investment	3.0	0.3
Residential Fixed Investment	7.5	0.4
Change in Inventories	—	(0.0)
Government Consumption	3.3	0.6
Trade Balance	—	(0.4)
GDP Growth	3.1	3.1

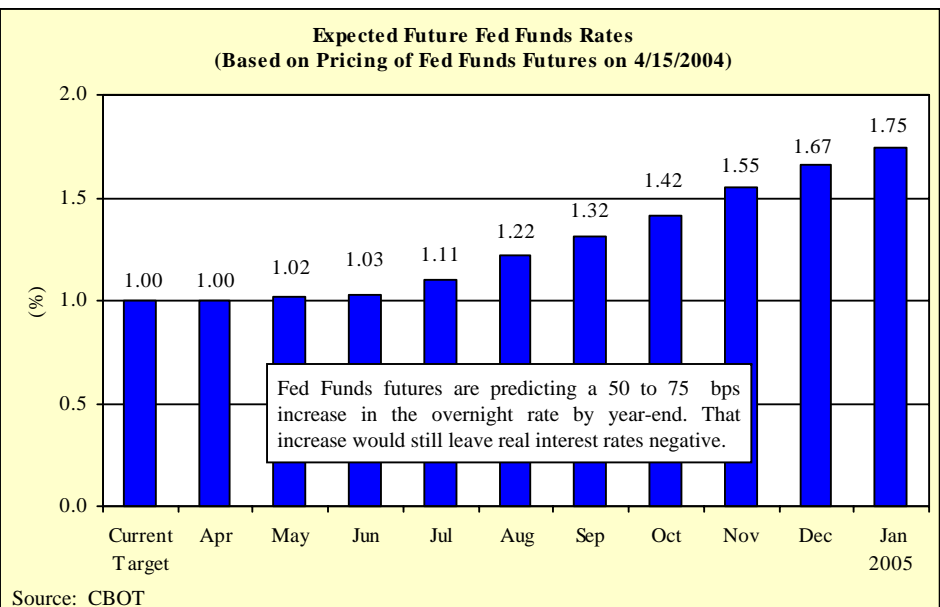
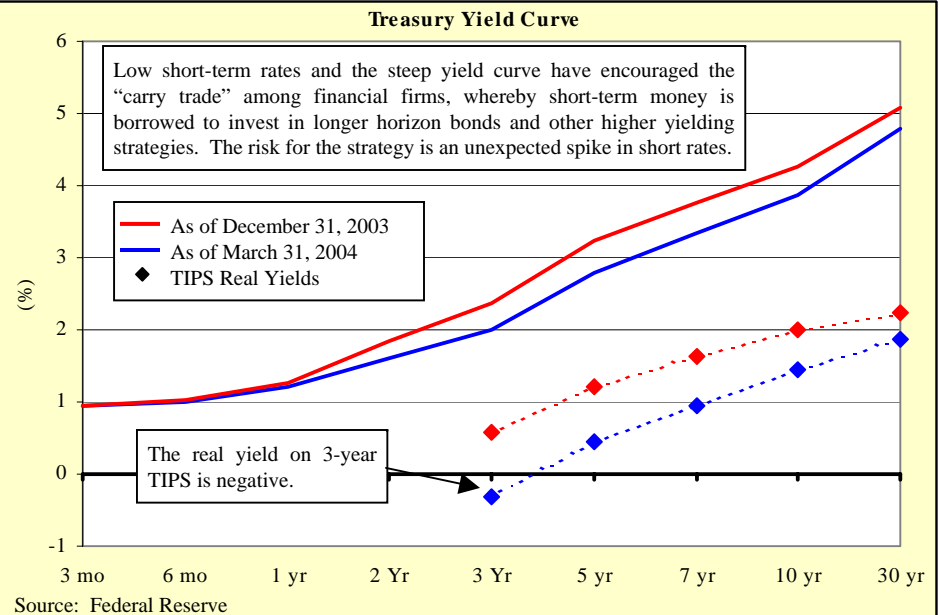


Job Market Improving, Economy Growing (cont.)

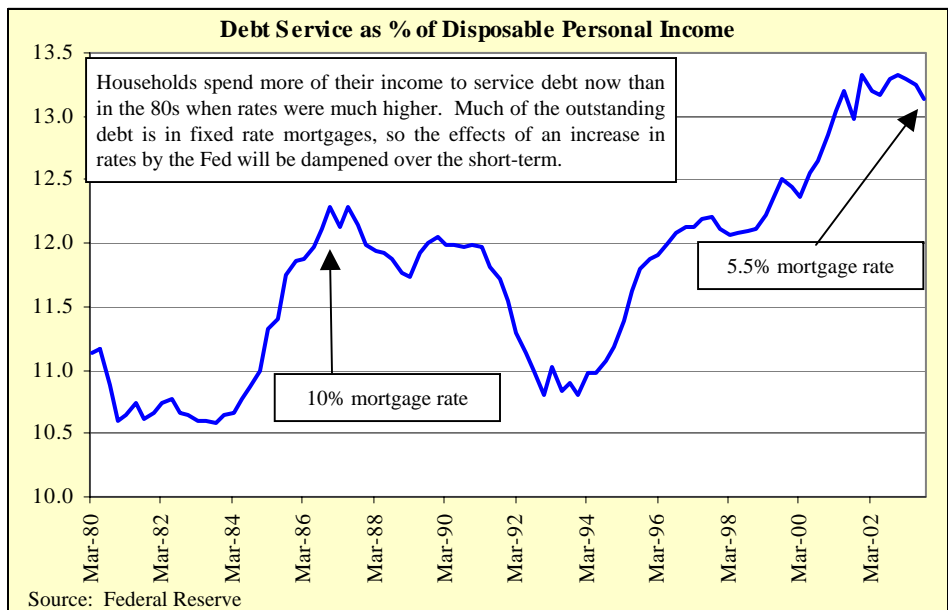
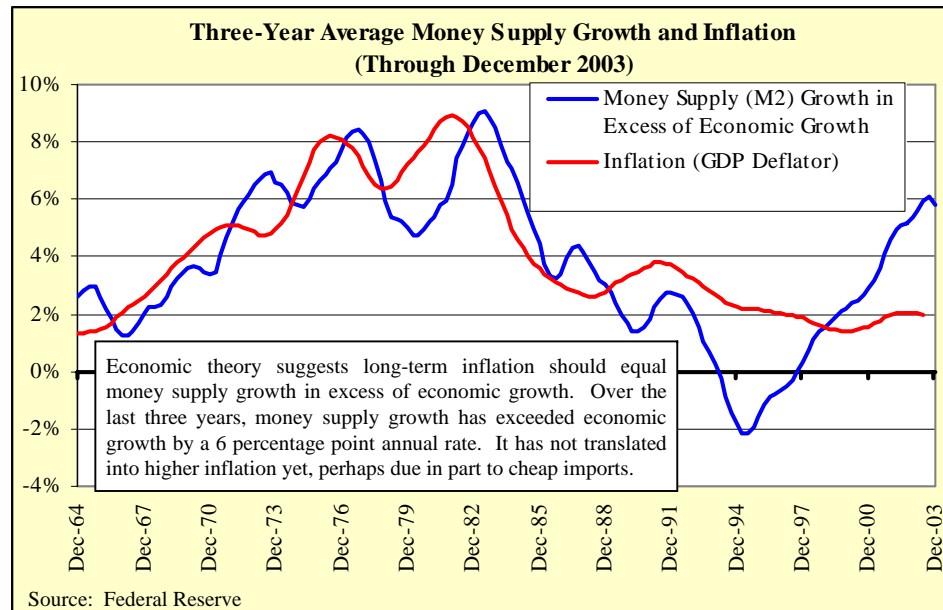
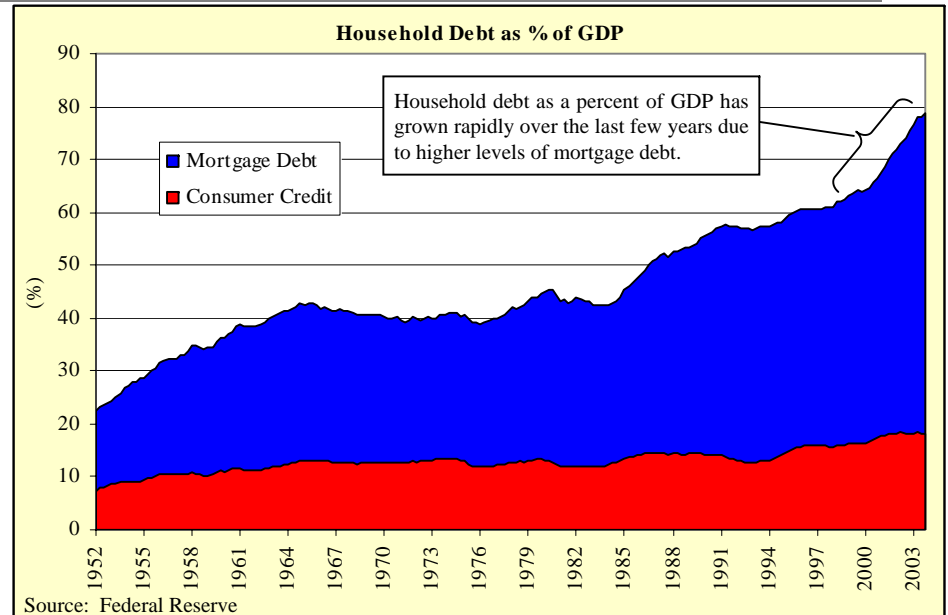
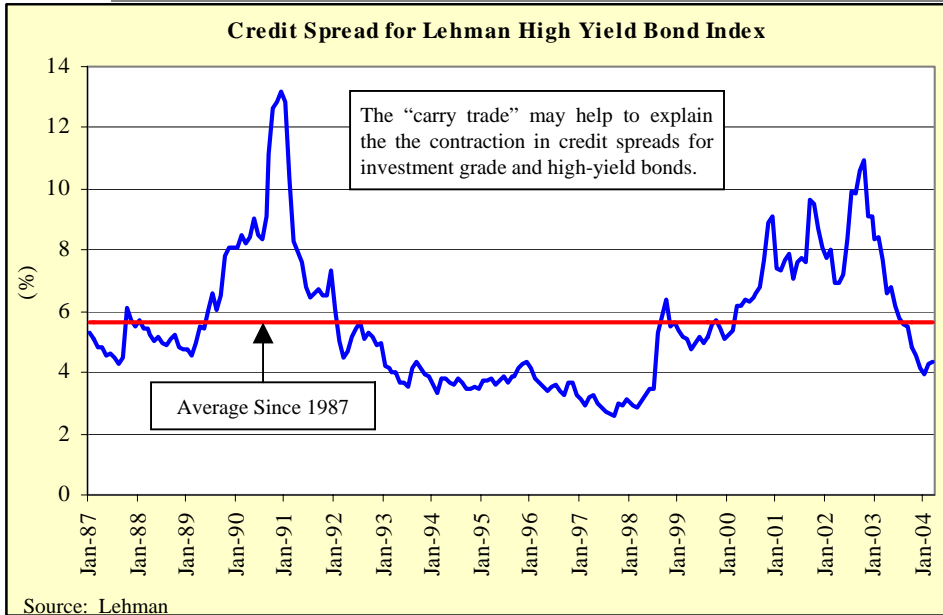


A Bubble-Blowing Fed?

- The Fed's aggressive easing of interest rates in the face of bursting bubbles in the equity market and in business investment has helped to mute the effects of these shocks on the economy. The recent recession was the mildest on record. It's clear that the Fed is applying lessons learned from Japan's experience.
- The bi-product of the Fed's easy money policy has been an increase in debt levels, especially for financial firms and households. Low mortgage interest rates have encouraged new buyers to enter the housing market and existing buyers to trade up. All the while, homeowners have been tapping their home equity to support spending. (See page 14.)
- With the economy now enjoying strong growth, the Fed has a delicate balancing act. The pace of economic growth suggests that negative *real* interest rates will be inflationary. However, the debt-fueled economy may now be addicted to low rates. A return to normal rates could take a toll on household spending, corporate profits (particularly for financial firms employing the "carry trade"), and asset valuations.
- Critics suggest that the Fed is creating new bubbles (in debt and housing) in an attempt to dampen the effects of the bursting bubbles. This is delaying an inevitable correction in the economic imbalances (trade deficit and low national savings) and will make the eventual correction even more painful.
- To avoid the risk of pricking bubbles, it seems likely that the Fed will be very slow to raise interest rates to normal levels.
- So far, it appears the Fed has been successful in cushioning the economy against the shocks, but it's just hard to believe the effects of the bursting equity bubble can be sidestepped with so little pain.



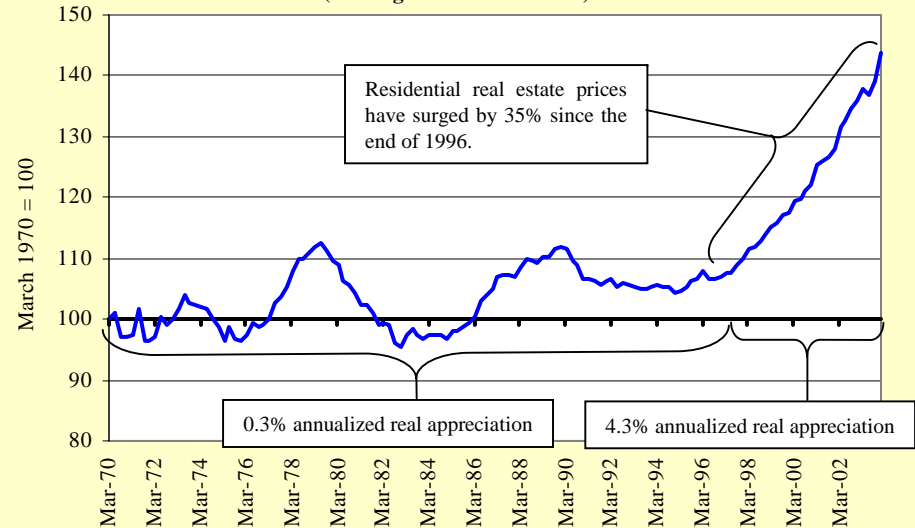
A Bubble-Blowing Fed? (cont.)



Residential Real Estate Continues to Soar

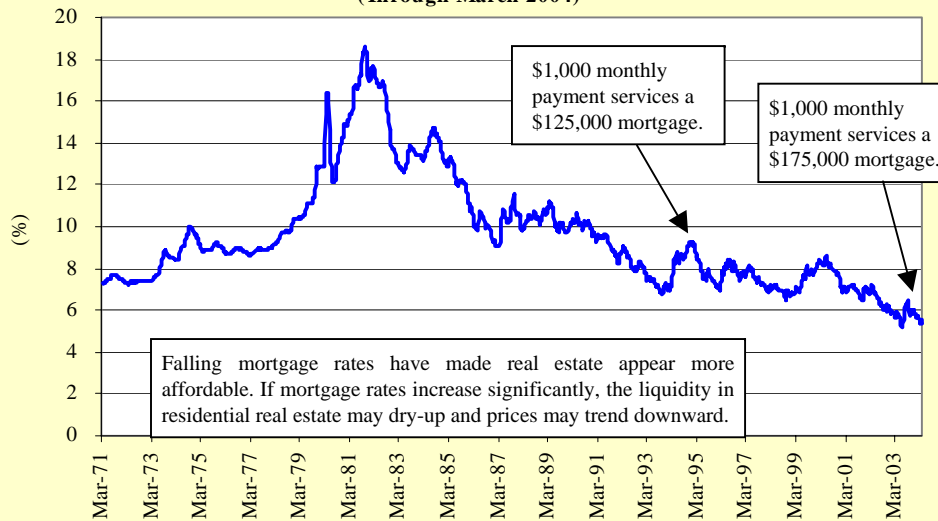
- Boosted by the Fed's accommodative interest rate policy, real estate prices continued to surge in 2003. Freddie Mac reports that the average house appreciated by 8% in 2003 and by 35% since the beginning of 2000. Gains on the coasts are even more obscene. Average prices in the New England and Pacific regions are up more than 55% since 2000. Personal income, in contrast, has increased only 9% over this period.
- The wealth effect from these gains has provided support to consumer spending. Consumers removed \$490 billion of home equity over the past three years through refinancings, home equity lines, and second mortgages.
- A retrenchment in real estate prices poses a risk to the economy. With the value of residential real estate at \$15 trillion, even modest declines could significantly impact consumer spending.

Growth of Inflation-Adjusted Residential Real Estate Prices (Through December 2003)



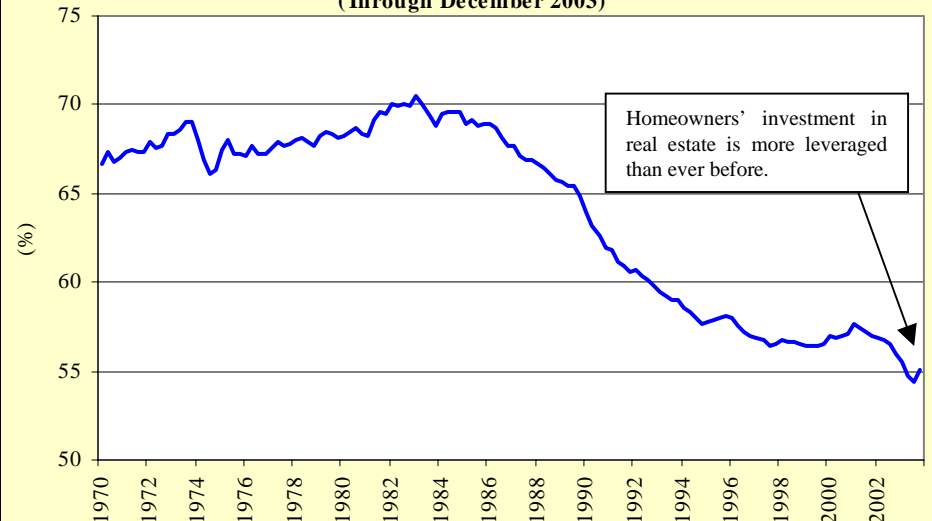
Source: Freddie Mac

30-Year Mortgage Rate (Through March 2004)



Source: Freddie Mac

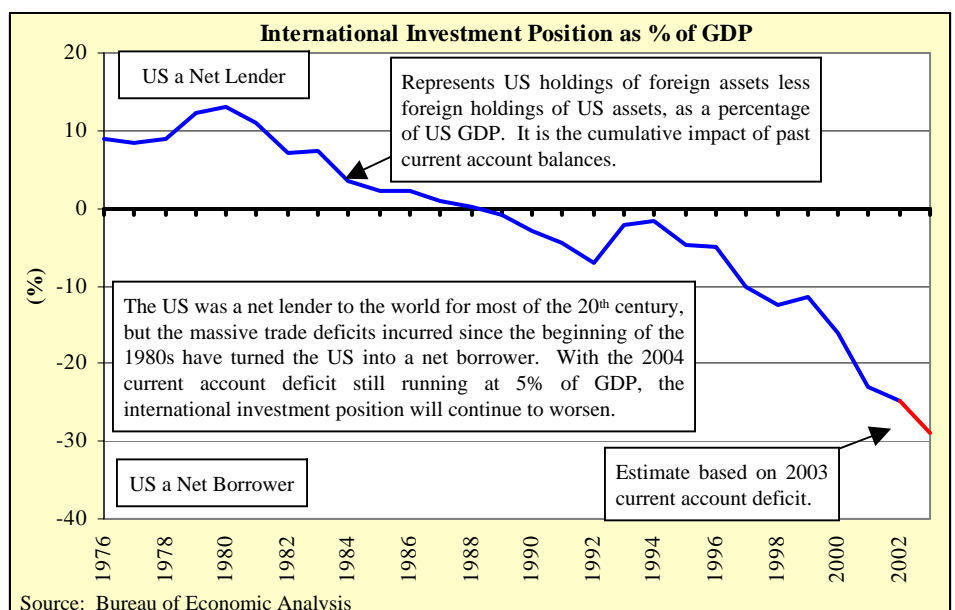
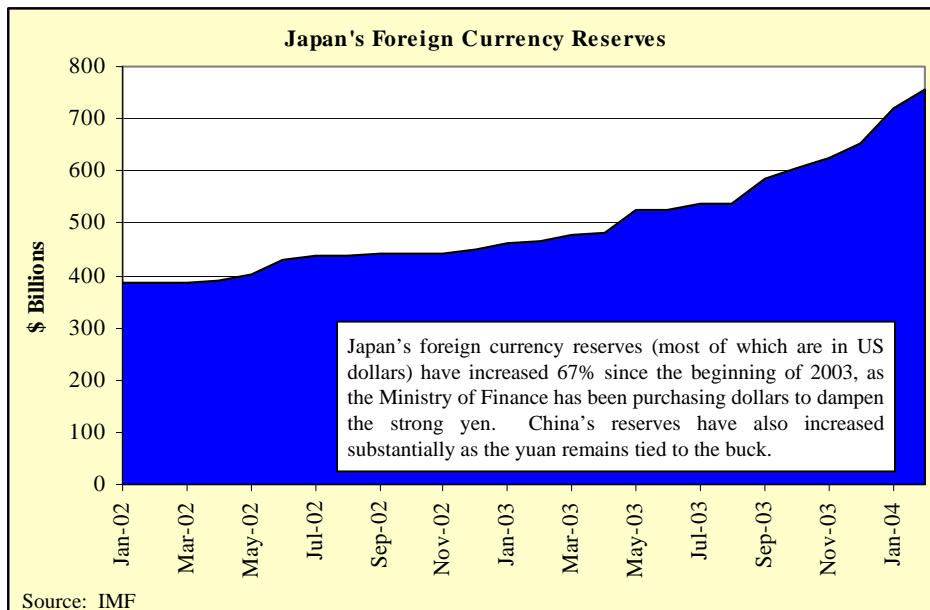
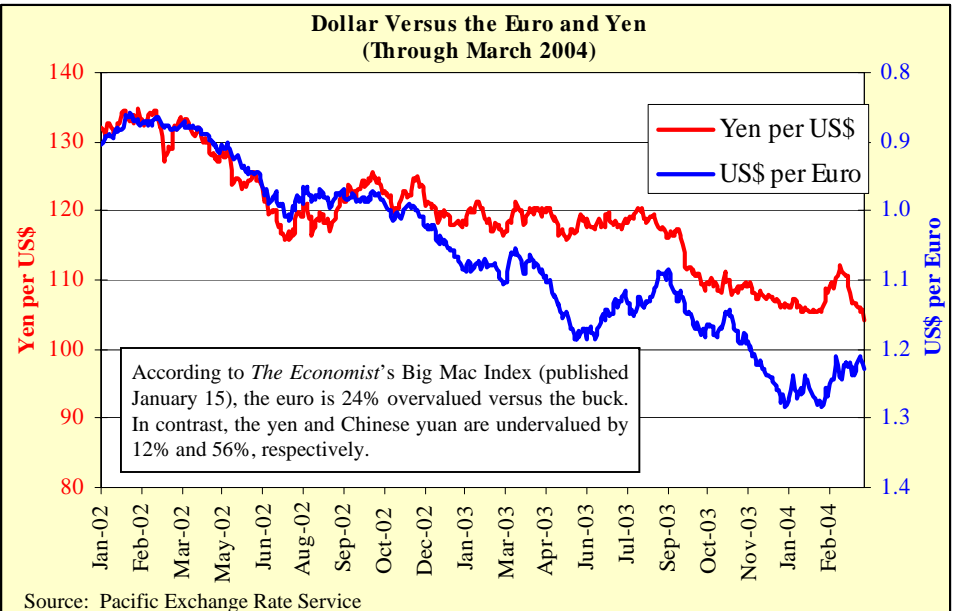
US Households' Equity in Real Estate as % of Market Value (Through December 2003)



Source: Federal Reserve

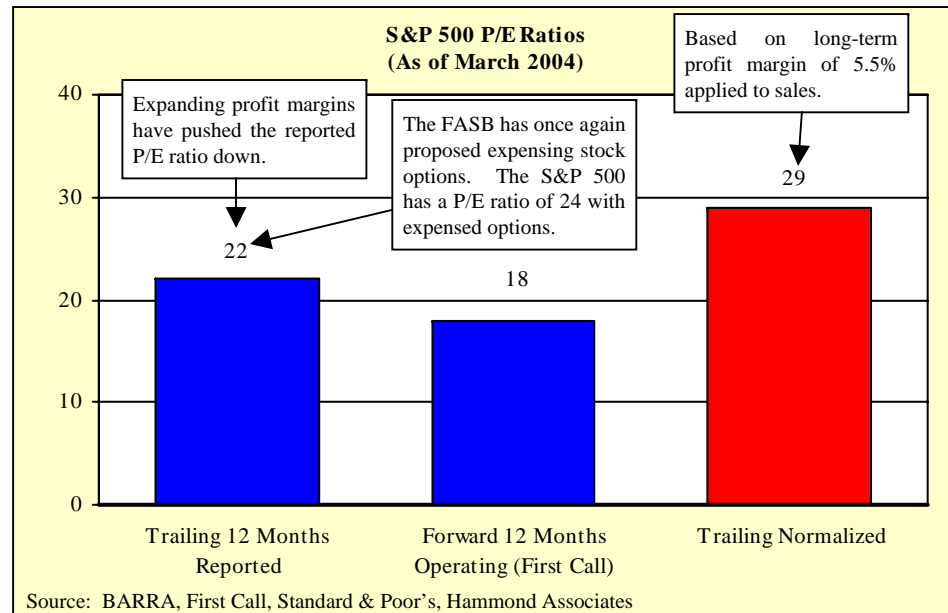
The Dollar's Performance Mixed in the First Quarter

- The dollar recovered some lost ground against the euro in the first quarter, appreciating 2.5%. Since the beginning of 2002, the dollar has fallen 27.5% against the euro.
- The dollar reached a four year low against the yen during the first quarter after Japan's Minister of Finance suggested that they may reduce currency intervention in support of the dollar. The dollar lost 2.8% against the yen during the quarter.
- The broad trade-weighted dollar was virtually unchanged for the quarter.
- The current account deficit, which essentially represents the trade deficit, still stands at 5% of GDP. It seems likely that the trade-weighted dollar has much further to fall.



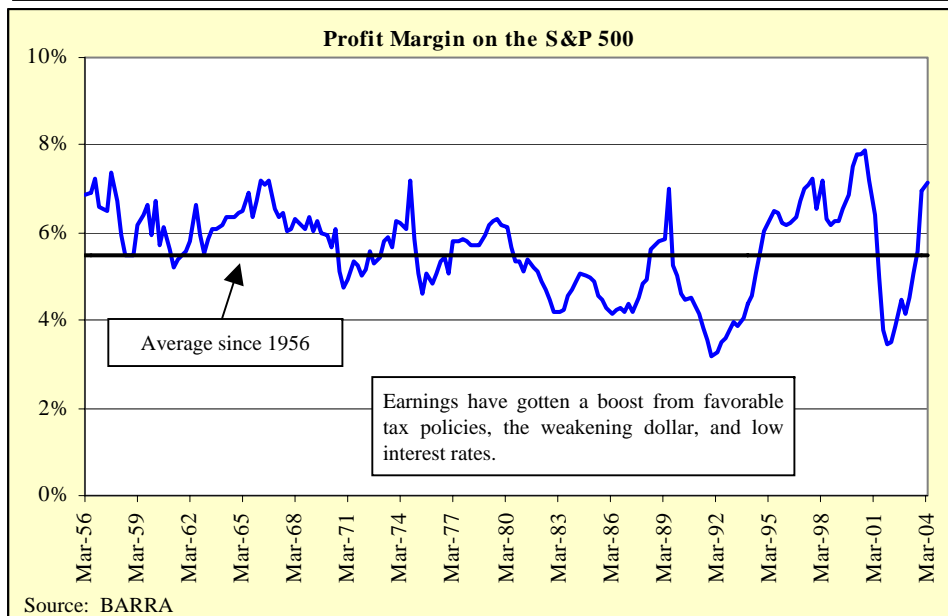
Corporate Profits Surge, But Stocks are Still Expensive

- Reported earnings on the S&P 500 surged 78% during 2003, allowing the P/E on trailing reported earnings to contract from 41 to 23 in spite of a 29% gain for the index. Based on estimated first quarter earnings, the trailing P/E stands at 22. S&P forecasts reported earnings growth of 6.6% for 2004.
- With the surge in earnings, profit margins (earnings as a percentage of sales) are well above historical average levels. The profit margin for the S&P 500 was 7.0% in 2003, 20% above the historical average of 5.5%.
- As a result, we are concerned about the sustainability of current profits. We may be approaching a cyclical peak in earnings, aided by writeoffs, cost cutting, and low interest rates. Subdued earnings growth seems likely over the next few years as profit margins revert to the norm.
- Based on the historical average profit margin of 5.5%, the S&P 500 is trading at a normalized P/E ratio of 29.

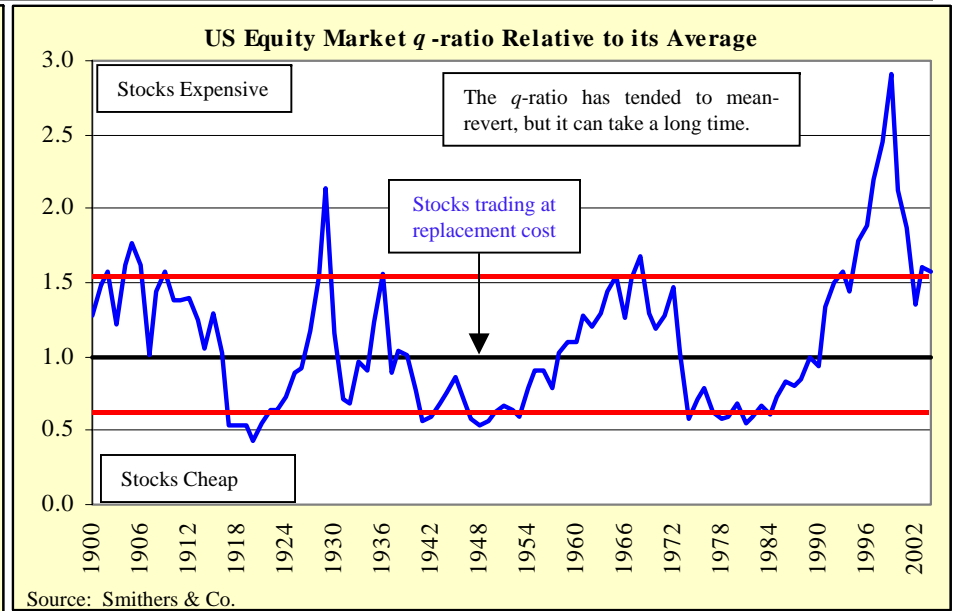
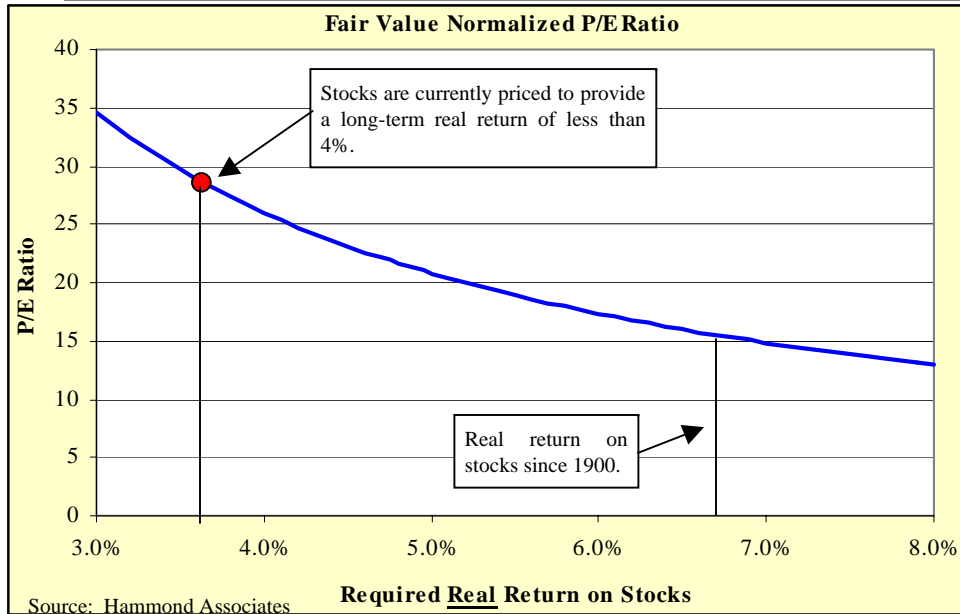


Price Change Required for the S&P 500 to Reach Fair Value							
Expected Long-Term Profit Margin	Required Equity Risk Premium Over TIPS (Based on 2.0% Long-Term Real Yield on TIPS)						
	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%
4.5%	0%	(14%)	(25%)	(33%)	(40%)	(45%)	(50%)
5.0%	11%	(5%)	(17%)	(26%)	(33%)	(39%)	(44%)
5.5%	22%	5%	(8%)	(18%)	(27%)	(33%)	(39%)
6.0%	33%	14%	0%	(11%)	(20%)	(27%)	(33%)
7.0%	56%	33%	17%	4%	(7%)	(15%)	(22%)
8.0%	78%	52%	33%	19%	7%	(3%)	(11%)

If investors are satisfied with a 2% equity risk premium over TIPS, the S&P 500 is close to fair value.



Corporate Profits Surge, But Stocks are Still Expensive (cont.)



Expected Annualized <u>Real</u> 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%	(5.7%)	(2.2%)	0.4%	2.5%	4.2%	7.1%
2.5%	(5.2%)	(1.7%)	0.9%	3.0%	4.8%	7.6%
3.0%	(4.8%)	(1.2%)	1.4%	3.5%	5.3%	8.1%
3.5%	(4.3%)	(0.7%)	1.9%	4.0%	6.3%	8.7%
4.0%	(3.8%)	(0.2%)	2.4%	4.6%	6.8%	9.2%

This model assumes that earnings grow at the same rate as GDP. Historically, earnings growth has trailed GDP growth by about 1% annualized.

Predictive Ability of the q -ratio

(1900 – 2002)

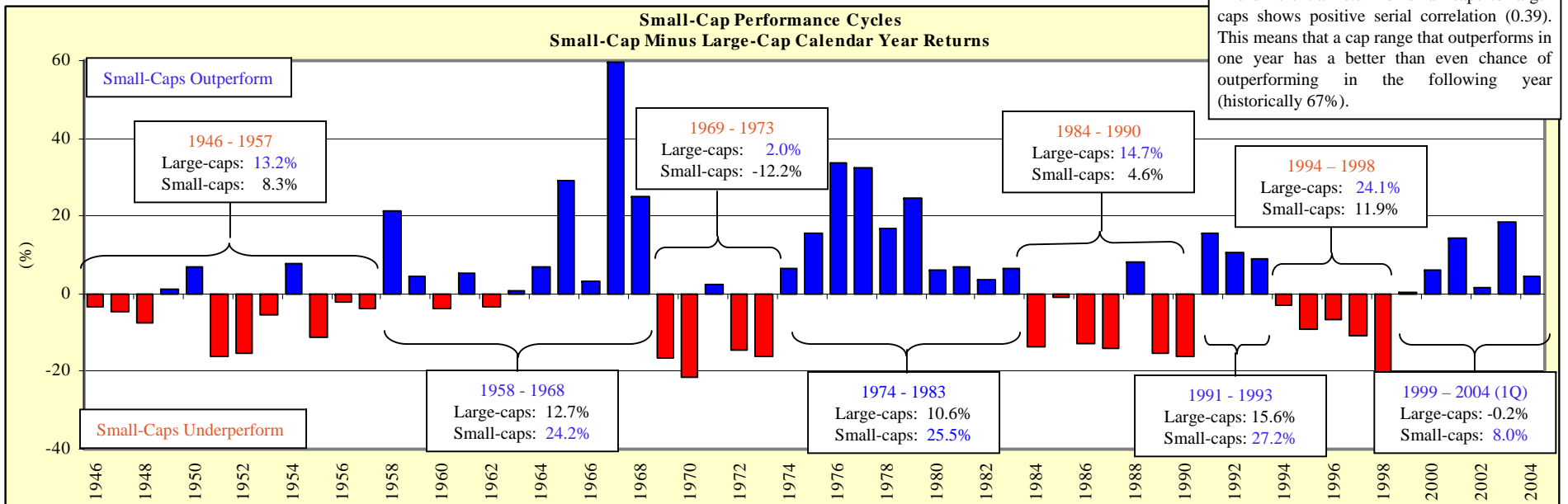
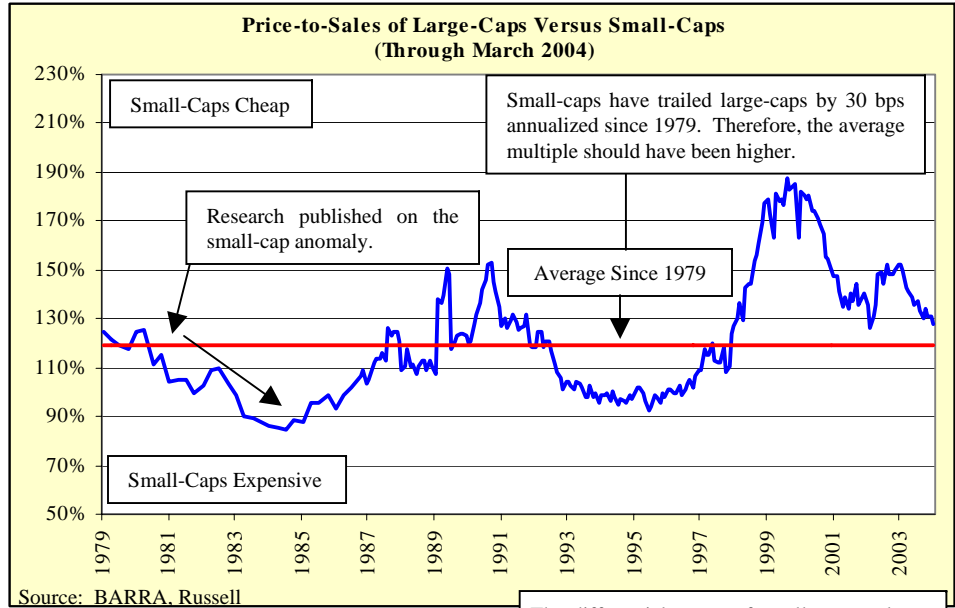
q -ratio at Beginning of Period		Subsequent Annualized <u>Real</u> Return (%)			
		3 Years	5 Years	10 Years	20 Years
>1.55	Average	0.6	0.9	1.1	4.0
	Range	-28.4 to 23.7	-11.1 to 19.4	-3.1 to 4.2	1.8 to 10.4
1.20 to 1.55	Average	1.6	2.4	1.3	2.8
	Range	-29.4 to 25.9	-13.3 to 23.8	-4.5 to 8.5	0.3 to 11.8
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 1.57 has been associated with future real equity returns in the low single digits (1.1% average annualized real return over a 10-year horizon).

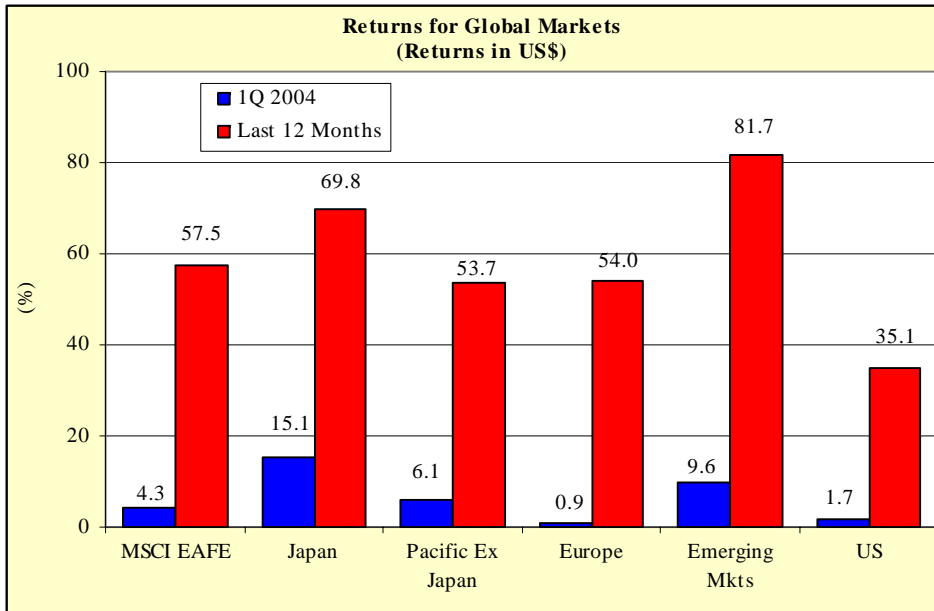
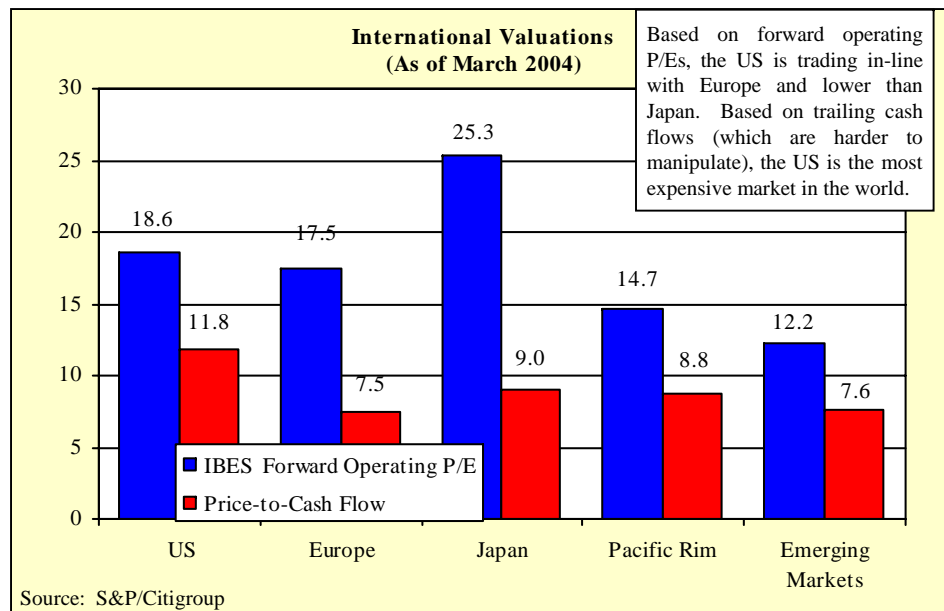
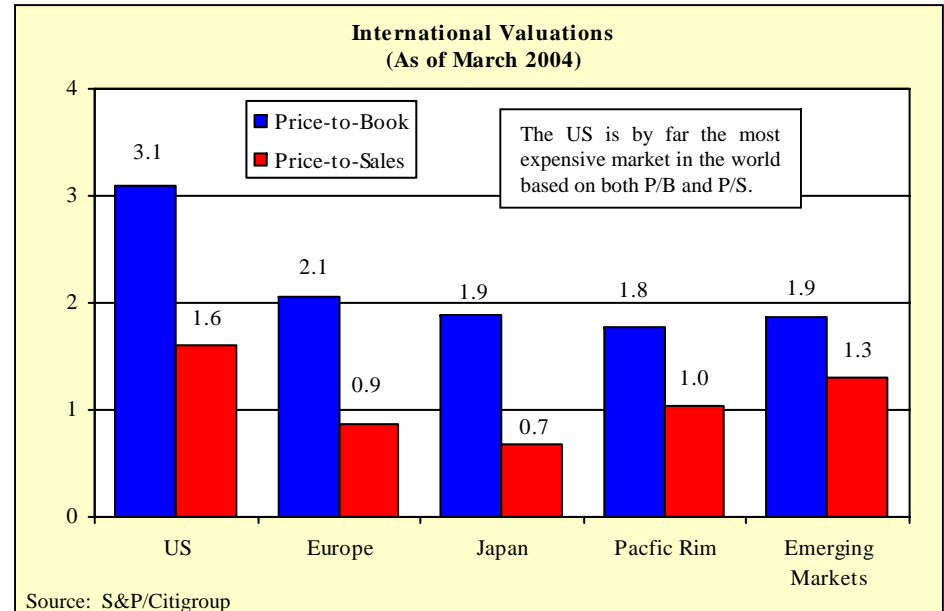
Is the Party Over for Small-Caps?

- Small-caps have performed extremely well versus large-caps recently. Since the beginning of 1999, small-caps have produced an annualized return of 8.0% versus a decline of 0.2% for the S&P 500.
- Today, small-caps appear fairly to slightly overvalued relative to large-caps. That, however, doesn't mean that their rally is over. Small-caps have had a tendency to become very overvalued relative to large-caps after prior runs.
- Based on fundamentals, small-caps do not appear to have much bang left. Given current valuations, we estimate that small-caps are priced to provide less than a 0.5% premium to large-caps over the next 10 years. While momentum may continue to drive small-caps higher, for those with heavy small-cap biases, it may be a good time to trim the bet.



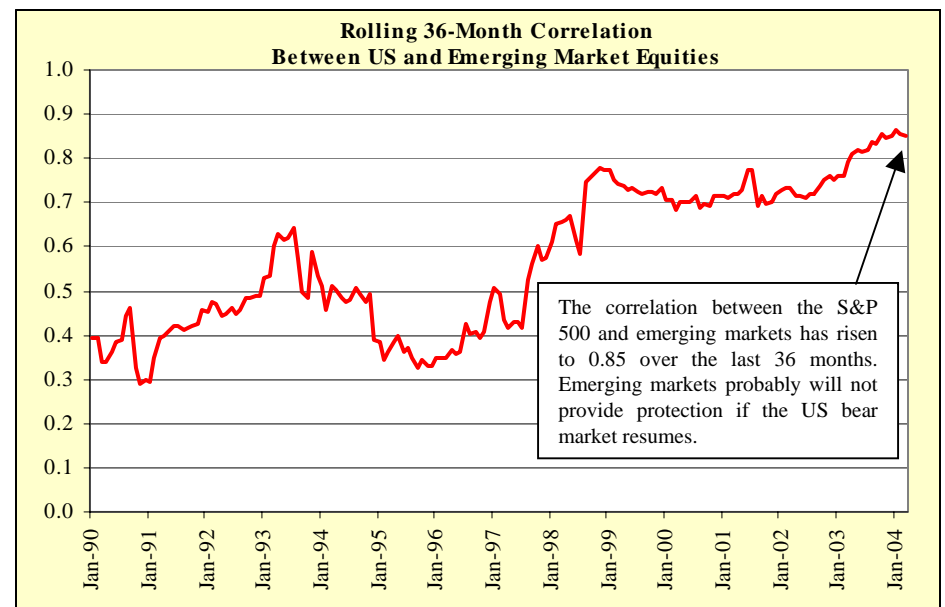
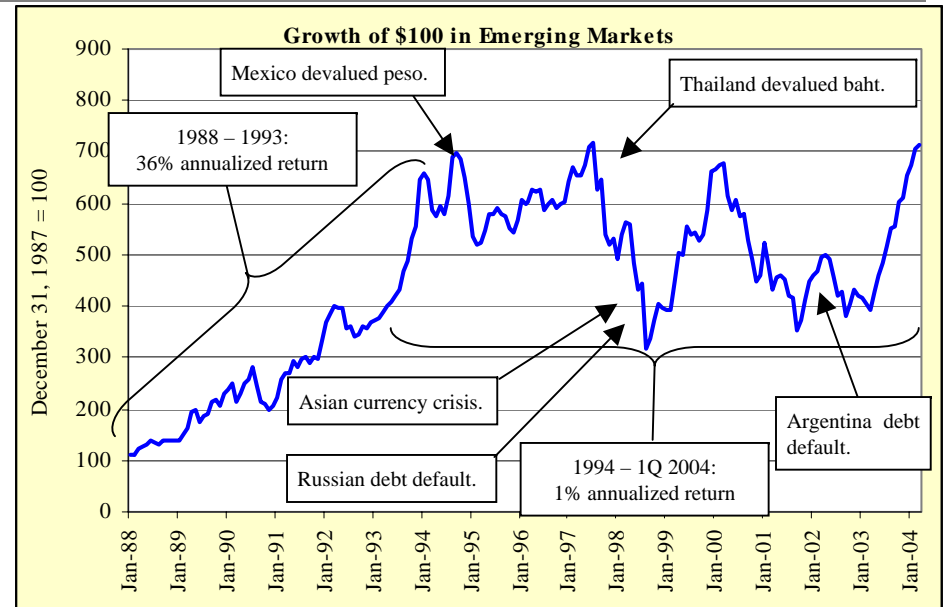
International Equities Outperformed US Equities

- International equities continue to perform well. The MSCI EAFE index earned 4.3% during the quarter versus 1.7% for the S&P 500. Over the last 12 months, MSCI EAFE has outperformed the S&P 500 by 22 percentage points.
- The outperformance during the first quarter was mostly due to local country returns, rather than a weakening dollar (which was the case in 2003). Japan was the among the best performers of the developed markets, posting a return of 15.1%. Positive economic data hints that the Japanese economy might finally be emerging from its long slump.
- On a valuation basis, international equities still appear to offer more promise than US equities.



Emerging Markets: A Play on the US?

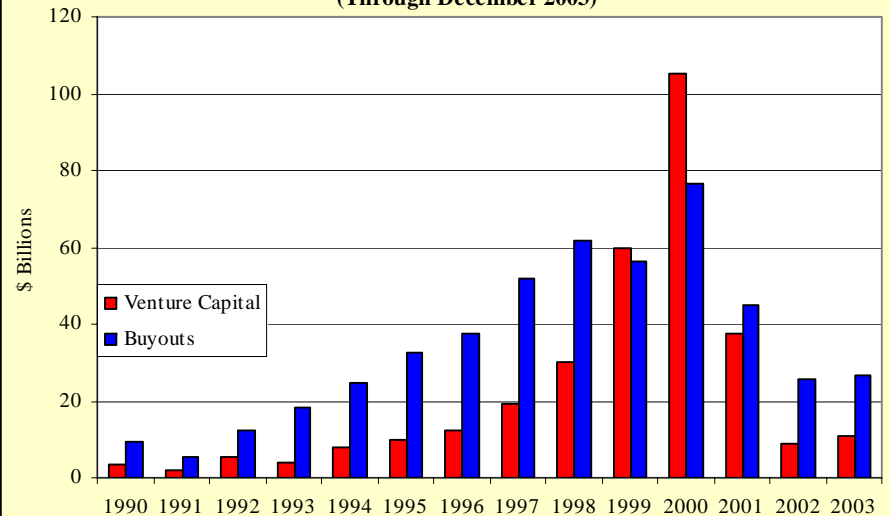
- The 82% return for emerging market equities over the last twelve months has made an asset class that was a bargain far less attractive. Nevertheless, emerging markets still appear to offer the best value among world equity markets.
- A concern over the short- to intermediate-term is their reliance on exports to the US. If US households de-lever and increase savings, emerging market economies may descend into a recession.
- A second area of concern is China. China's efforts to keep the yuan pegged to the dollar is causing the economy to overheat. To absorb all the dollars flowing into the economy, the Chinese have been forced to increase their money supply. While China remains a modest allocation in emerging market indices, a collapse could lead to contagion throughout the Asian region, and perhaps to all emerging markets (such as in 1998).
- Still, the long-term prospects for emerging markets are promising. They contain 85% of the world's population, but produce less than a fifth of world output. This provides tremendous growth opportunities as these populations become more productive and standards of living increase. As this occurs, they should be able to generate more of their growth internally, rather than relying on exports.
- Another advantage of emerging markets is that most will not have the demographic and pension problem that many developed markets must face over the coming decades.



Conditions in Private Equity Improving

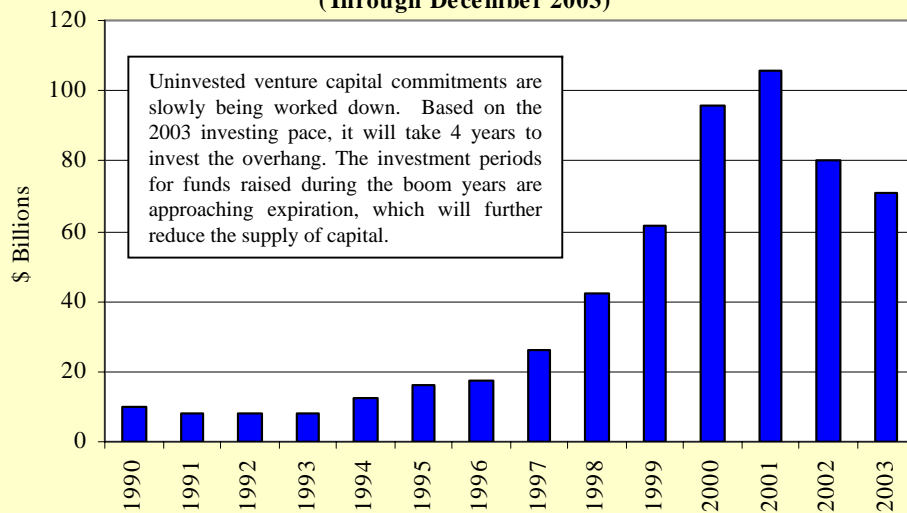
- 2003 was another slow year for private equity fundraising, particularly venture capital, but exit opportunities are becoming easier to find. The venture-backed IPO market is improving. The first quarter saw \$2.7 billion in new issues, which was the highest level for a quarter since the third quarter of 2000. The IPO market should be even stronger in the remainder of 2004. For buyouts the primary exit appears to be selling to other buyout funds at ever higher multiples. Anyone for musical chairs?
- Private capital investing still faces challenges given the remaining overhang. Perhaps more worrisome is the “secondary overhang”—the money that institutions are earmarking for private equity investments but have yet to commit.
- Nevertheless, it may be worthwhile considering some selective investments in private equity.

Private Equity Commitments by Year
(Through December 2003)



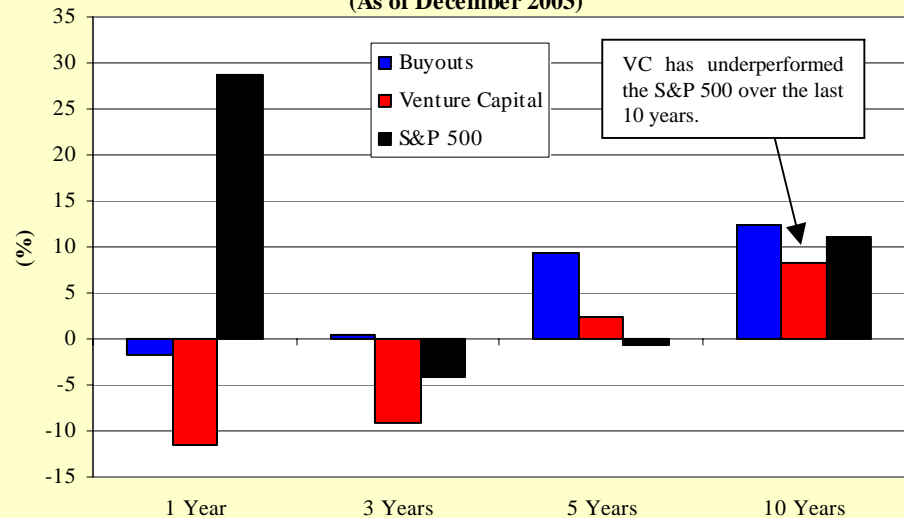
Source: Venture Economics

Uninvested Venture Capital Commitments
(Through December 2003)



Source: Venture Economics, Hammond Associates

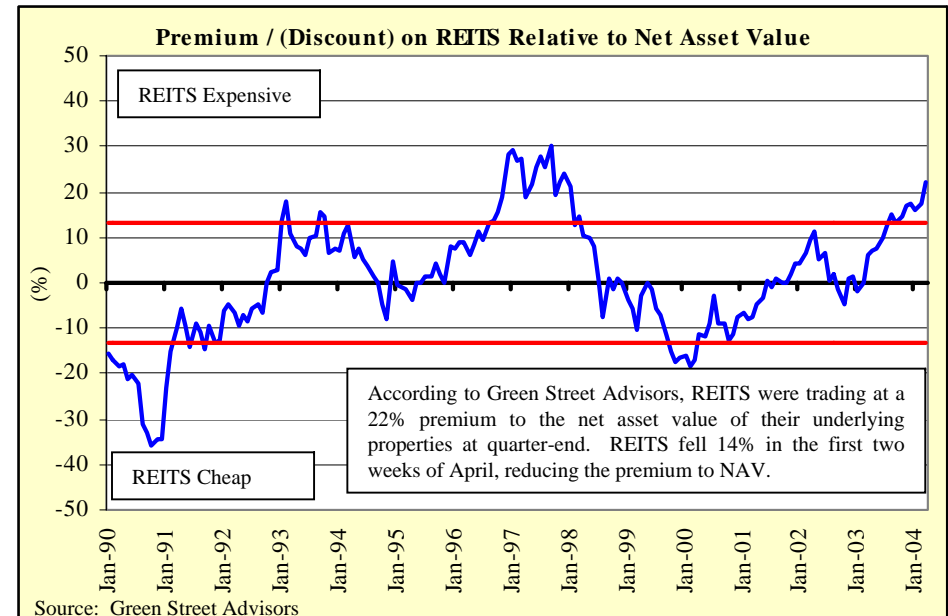
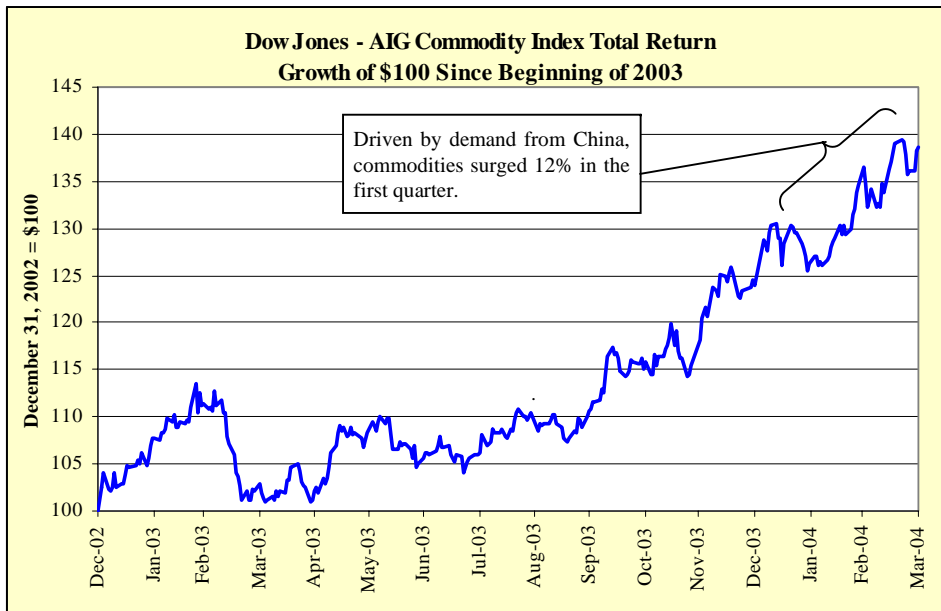
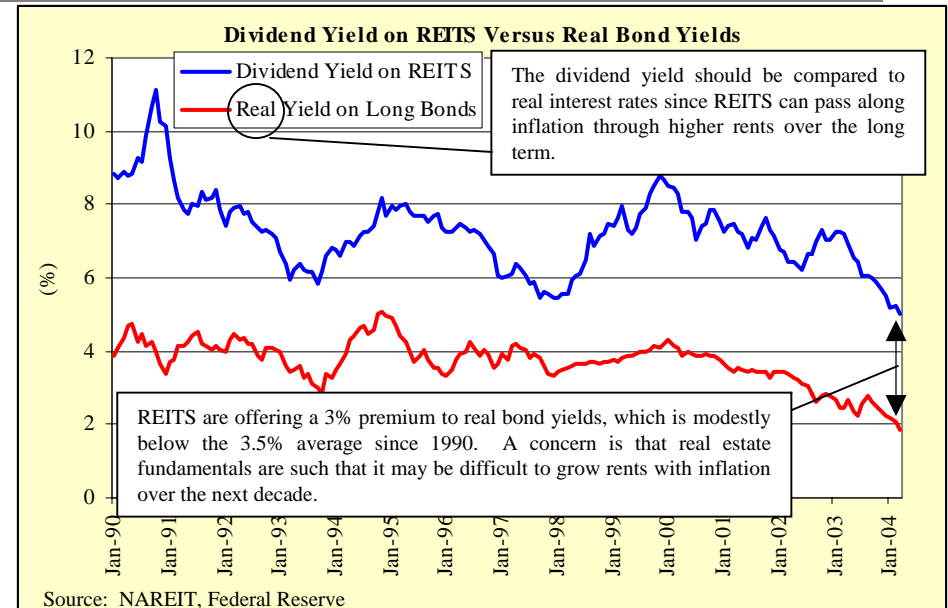
Private Equity Performance
(As of December 2003)



Source: Venture Economics

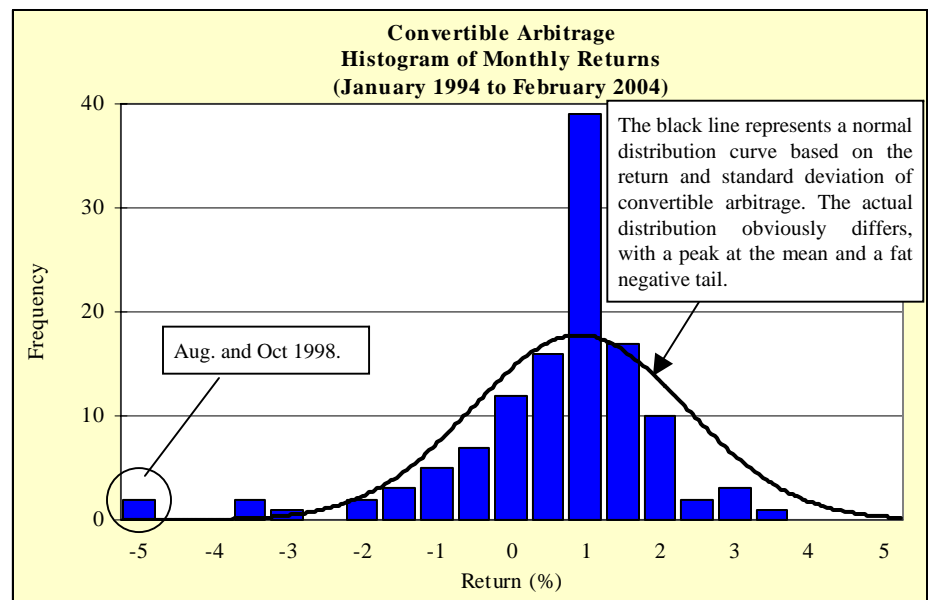
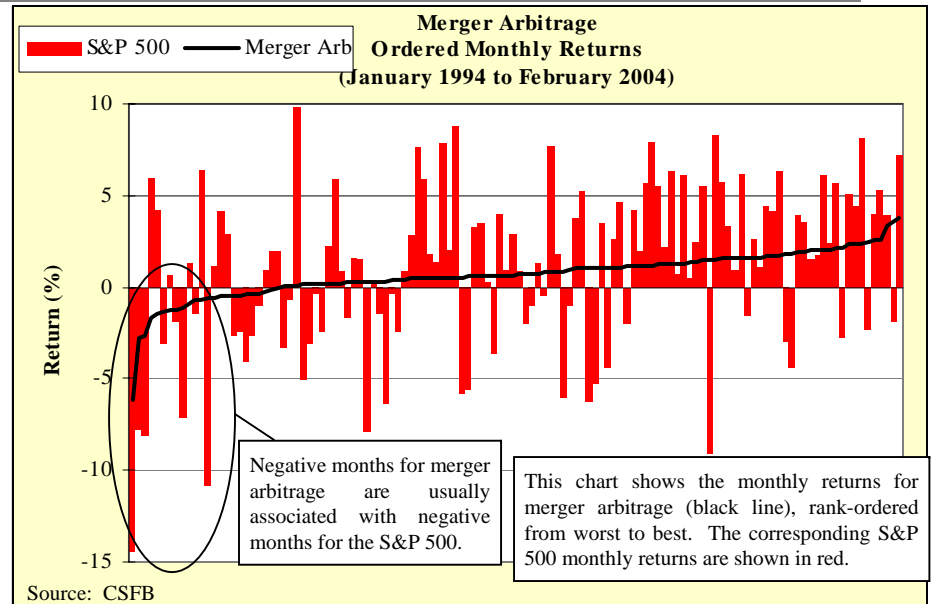
Real Assets: REITS and Commodities Advance

- Real estate investment trusts were the best performing asset class during the first quarter, gaining 12.1%. Investors continue to be attracted by the high dividend yield (another “carry trade”). However, property fundamentals continue to weaken and net operating income is declining. Furthermore, REITS are trading at a substantial premium to net asset value.
- While REITS appear expensive on an absolute basis, they still represent a better value than US equities.
- Commodity-based investments performed well during the quarter and still offer promise. Commodities should act as a hedge against a continued weakening of the dollar. Furthermore, demand from China should continue to drive prices higher.



Hedge Funds: Hidden Risks?

- During the first quarter, hedge funds, as represented by the HFR Fund of Funds index, gained 3.1%, bringing the one year return to 13.8%. Investors continue to pour money into hedge funds, seeking uncorrelated, absolute returns. However, traditional measures of risk may fail to capture the risks in hedge funds.
- The CSFB/Tremont Risk Arbitrage index shows only modest sensitivity to the equity markets. During positive months for the S&P 500, the strategy is essentially uncorrelated. However, during negative months for the S&P 500, the sensitivity in merger arbitrage returns increases considerably. In fact, the worst months for the strategy coincide with extremely difficult periods for traditional equities. In other words, the strategy may fail to provide diversification benefits when they are needed most.
- The CSFB/Tremont Convertible Arbitrage index has generated “low risk” returns, as indicated by the standard deviation of returns ($\pm 5.2\%$ annualized). However, the distribution of returns demonstrates the dreaded “fat left tail.” We can expect more negative outliers for the strategy than is suggested by the volatility of returns. For example, given the mean and standard deviation for the convertible arbitrage index, if returns were normally distributed, we could expect a loss of 4.5% or more to occur roughly once every 1,750 years. Since 1994, it happened twice in a span of three months in the fall of 1998.
- Hedge fund returns must be interpreted with caution, as traditional measures of risk often understate the risks that may be present in the strategies. They often expose an investor to a different set of risks than those present in the traditional portfolio. Diversifying risk exposures can reduce the risk of the overall portfolio, but evaluating those risks requires an understanding of their true return distributions.



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