

HAMMOND ASSOCIATES

INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

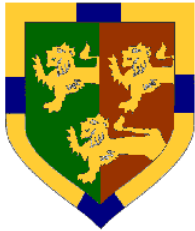
Second Quarter 2004

In this report . . .

- ✓ An Examination of Past Fed Tightening Cycles
- ✓ Storm Clouds on the Horizon?
- ✓ Is a Hedge Fund Shakeout Looming?
- ✓ Alternative Investments Update

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HAMMOND ASSOCIATES is a private investment consulting firm serving as a *fiduciary* consultant to a wide variety of clients, including university endowments, charitable and community foundations, corporate retirement plans, and family wealth. We serve clients from New York to California, and from Florida to Washington state. We are a research-based firm, providing a full range of traditional investment consulting services, and specialize in alternative investments. Our research into alternative investments includes three general areas: absolute return strategies (merger arbitrage, distressed securities, convertible arbitrage, long/short equity, market neutral equity, and event driven), real assets (timberland, oil and gas, and real estate), and private equity (venture capital and buyouts).

WE RECOGNIZE THAT NO SINGLE PORTFOLIO IS RIGHT FOR EVERYONE. Our philosophy is that the *best* portfolio for each client is the one which fulfills that client's objectives. Consequently, we provide objective, third-party consulting services that are *custom-tailored* to each client's specific requirements. Our specialty is understanding, explaining, and controlling risks. Hammond Associates is a "hard-dollar" (fee-only) consulting firm and declines "soft-dollar" (commission) arrangements. Our fee-only structure prevents the creation of conflicts of interest between our clients and ourselves.

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- National Practice
- Mid-Sized and Growing Responsibly
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 - 25 Advanced Degrees (includes 2 Ph.D.s)
 - 10 Holders, Chartered Financial Analyst (CFA) Designation
 - 1 Certified Public Accountant (CPA)
 - Over 300 Years of Combined Investment Expertise
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Contact either Dennis Hammond or Russ LaMore at 314-746-1600.

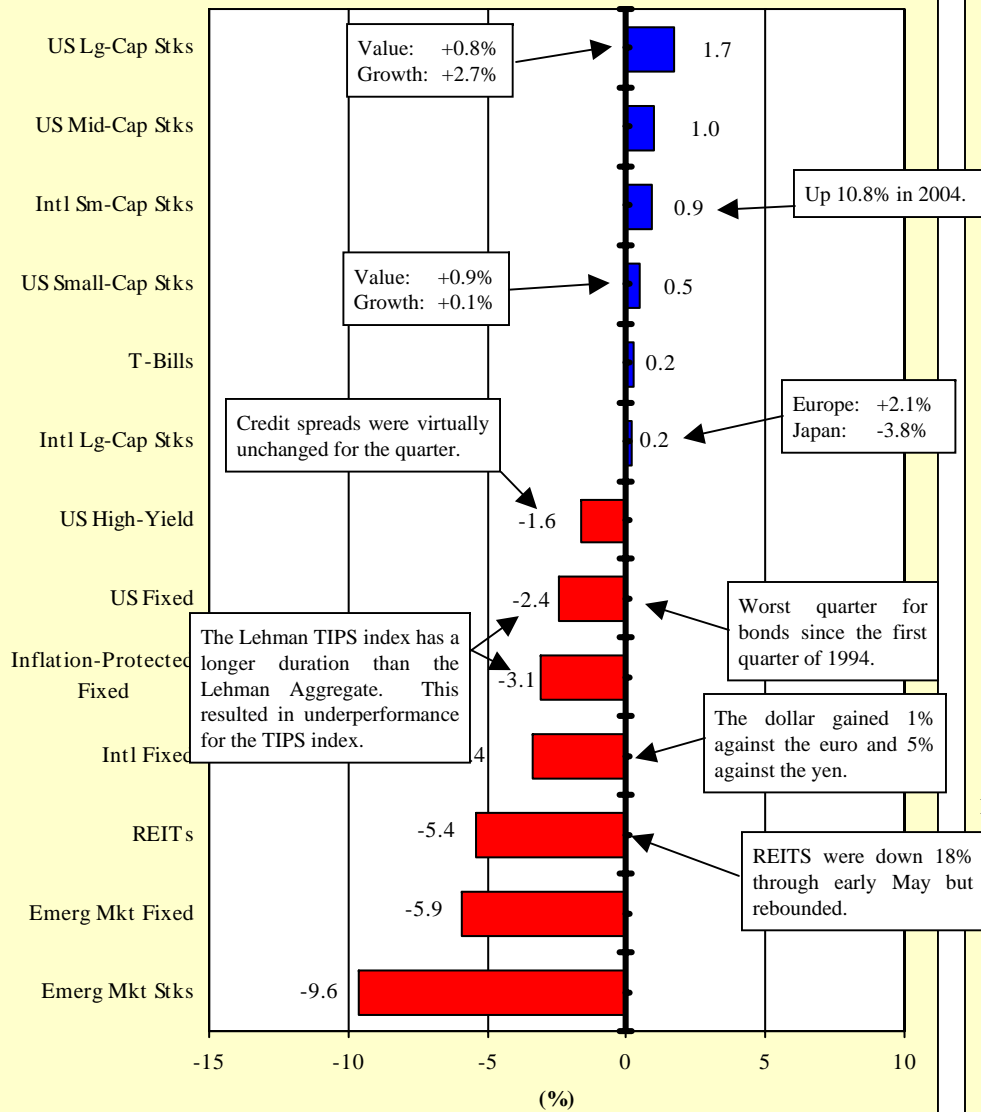
Unless otherwise noted, asset class performance throughout this report is represented by the following indices: *US Large Stocks* – S&P 500, *US Large Value Stocks* – S&P 500 / BARRA Value, *US Large Growth Stocks* – S&P 500 / BARRA Growth, *US Mid Stocks* – S&P MidCap 400, *US Small Stocks* – Russell 2000, *US Small Growth Stocks* – Russell 2000 Growth, *US Small Value Stocks* – Russell 2000 Value, *Intl Large Stocks* – MSCI EAFE, *Intl Small Stocks* – S&P/Citigroup EMI EPAC, *Intl Emerg Stocks* – Morgan Stanley Emerging Markets Free, *US Fixed Income* – Lehman Aggregate Bond, *US High Yield Fixed* – Citigroup High Yield Bond, *Inflation-Protected Bonds* – Lehman TIPS, *REITS* – Dow Jones Wilshire REIT, *Cash* – Citigroup 3-Month T-Bill

Second Quarter Executive Summary

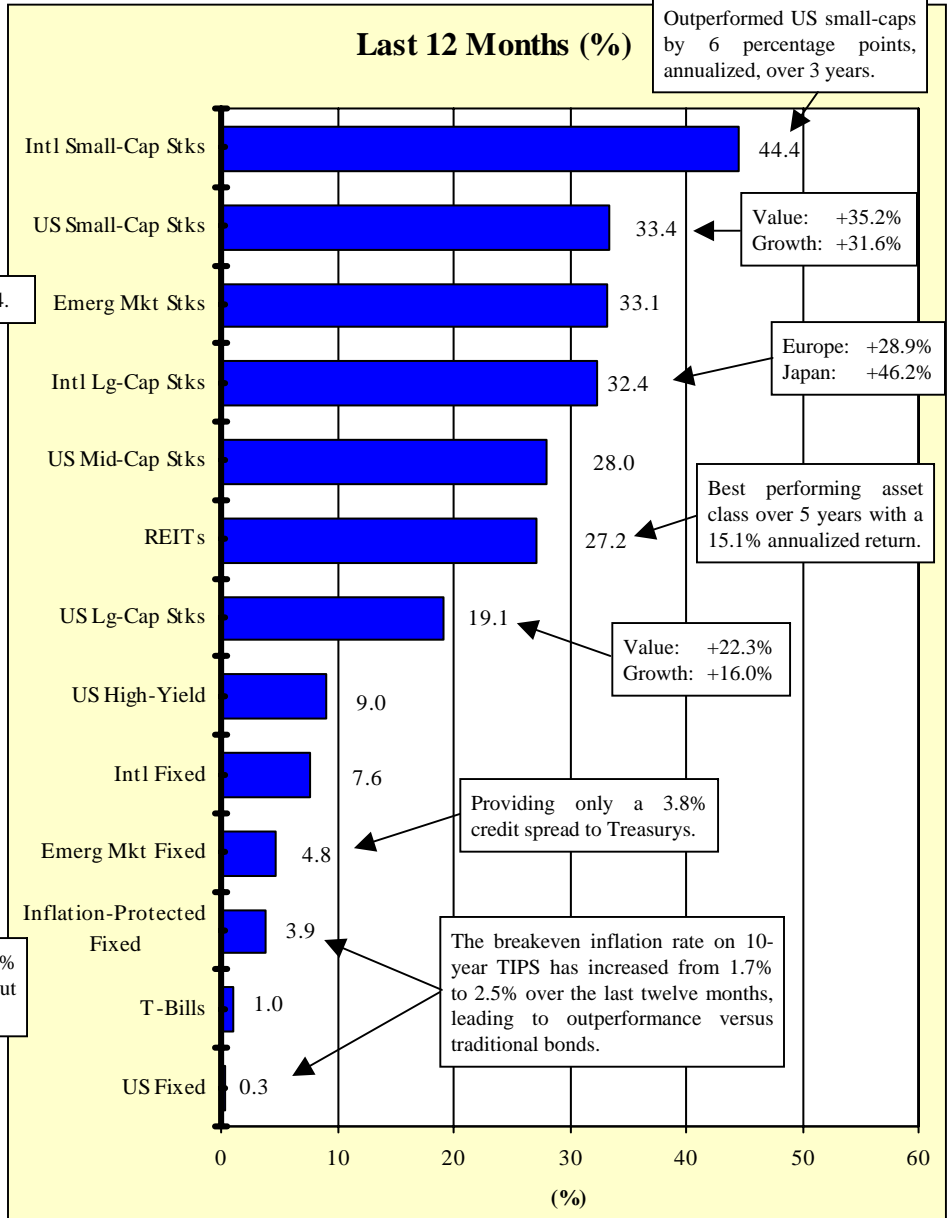
- The S&P 500 earned 1.7% in the second quarter, lifting the year-to-date return to 3.4%. Over the last twelve months, the index earned 19.1%. Two of the best performing asset classes in the first quarter, REITS and emerging market equities, were among the worst performers in the second quarter. Emerging market equities plunged 9.6% and REITS slid 5.4%. Both asset classes still show impressive twelve month returns. US fixed income had its worst quarter in 10 years, with a loss of 2.4%.
- The US economy grew at a 3.9% annualized rate in the first quarter of 2004. Data released late in the second quarter suggests that growth, particularly in consumer spending, may be subsiding. Nevertheless, forecasters polled by *The Economist* expect 4.6% growth for 2004.
- After 10 consecutive quarters of economic growth, and 4.8% average GDP growth over the last four quarters, the Federal Reserve finally raised the Fed Funds rate at their June 30 meeting from 1% to 1.25%. The Fed Funds futures market predicts that the overnight lending rate will be at least 2% by year-end. Inflation has spiked in 2004, suggesting that the Fed may have taken too long to tighten.
- We analyzed 10 major tightening cycles over the last 50 years to examine investment returns around the time of the first rate increase. Both equity and fixed income typically earned below average returns over the following 12 and 24 months. Why might this time be different? The Fed made its intentions well known in the months leading up to the rate increase, meaning that investors should have priced it into values already.
- The imbalances in the economy remain a significant concern. The Fed's accommodative interest rate policy has had the desired affect. There has been a debt feeding frenzy, which has gone a long way to support consumer spending. Despite the improving job market, consumer spending appears vulnerable. With record debt loads, US consumers are more interest rate sensitive than in past tightening cycles, and housing values seem dangerously high. As a result, it seems likely that the Fed will be cautious in raising rates. Allowing additional inflation will likely be preferable because it will have the secondary benefit of reducing the real value of debt loads. For this reason, we still prefer inflation-protected bonds to nominal bonds.
- Earnings for Corporate America remain strong. However, we fear that current profits are unsustainable. The profit margin on the S&P 500 is approaching 7.7%, which is far above the historical average of 5.5%. Earnings from financial companies appear especially susceptible to a pullback. US equity markets still appear poised to provide low returns in the future. Within the market, there are no obvious bargains. Small-caps are arguably overvalued versus large-caps, while value is trading at normal valuation multiples to growth.
- Emerging market equities, the best performing asset class in 2003, hit a rough spot in the second quarter. Anticipation of higher US interest rates and fears of a hard landing in China appear to be primary causes of the decline. Emerging markets are the most reasonably valued markets in the world.
- Despite their decline, REITS are still trading at a premium to the value of their underlying properties. In comparison to other domestic asset classes, REITS are reasonably attractive. We estimate that REITS are priced to provide a 3% risk premium to long-term TIPS.
- An absence of systematic return drivers and asset inflows have led to disappointing hedge fund returns in 2004. With the large amount of money invested in hedge funds and current market conditions, the conditions are in place for a hedge fund shakeout. What we don't know is whether there will be a catalyst to set it off. A shakeout may be beneficial for long-term investors that employ high-quality managers. It would likely result in an exit of the hot money that has flooded in over the past few years, which should make subsequent returns more attractive.

Emerging Markets and REITS Stumble

Second Quarter 2004 Performance (%)

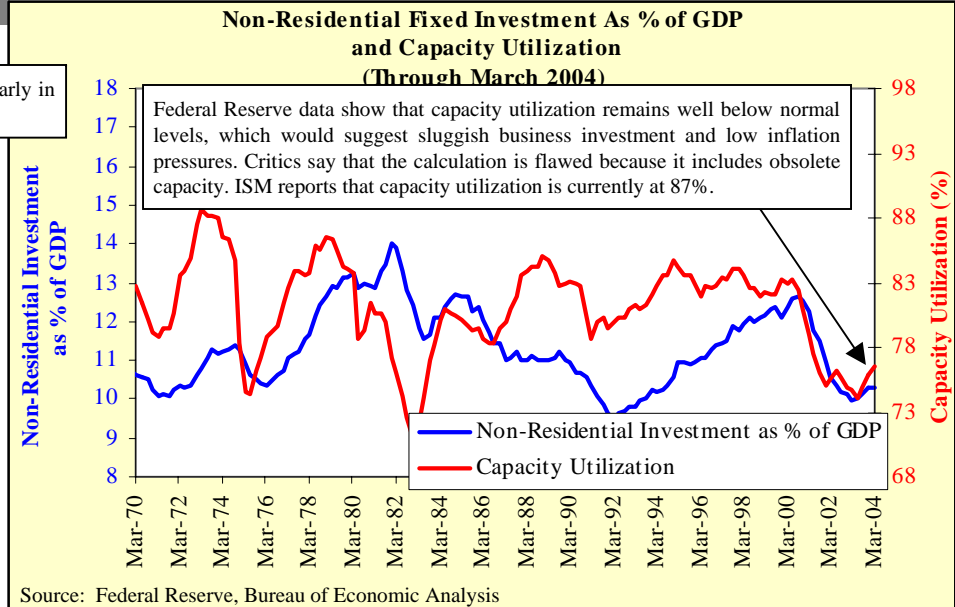
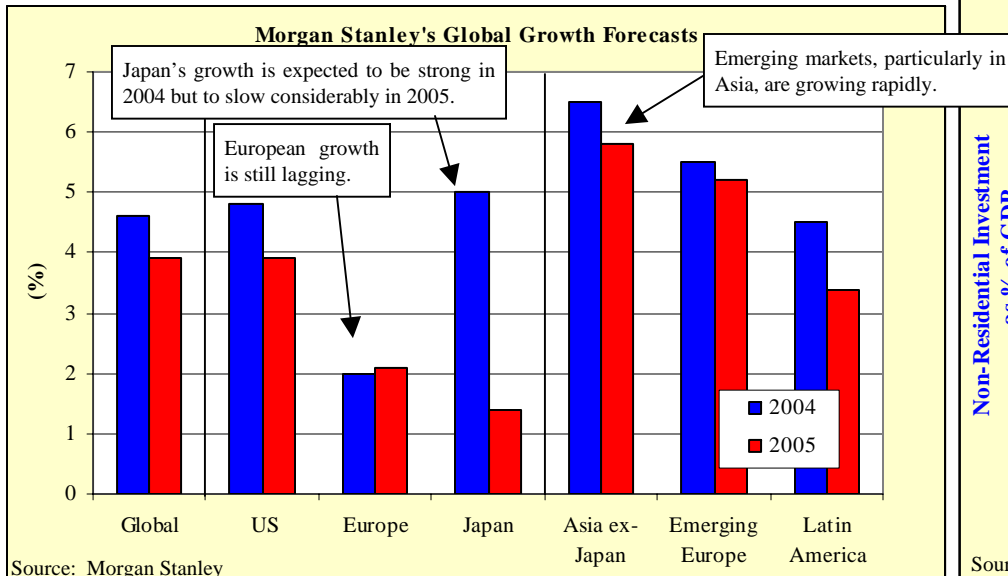
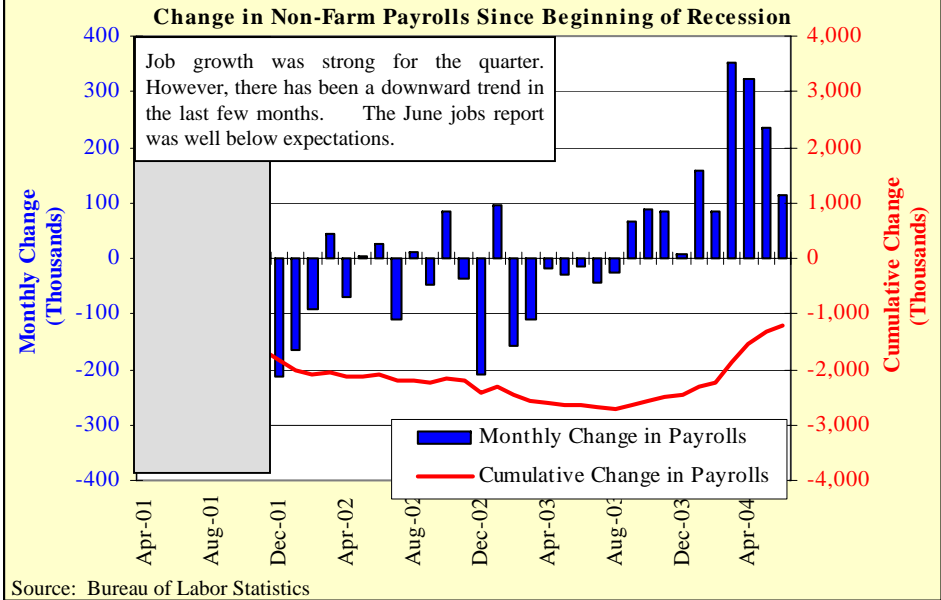


Last 12 Months (%)



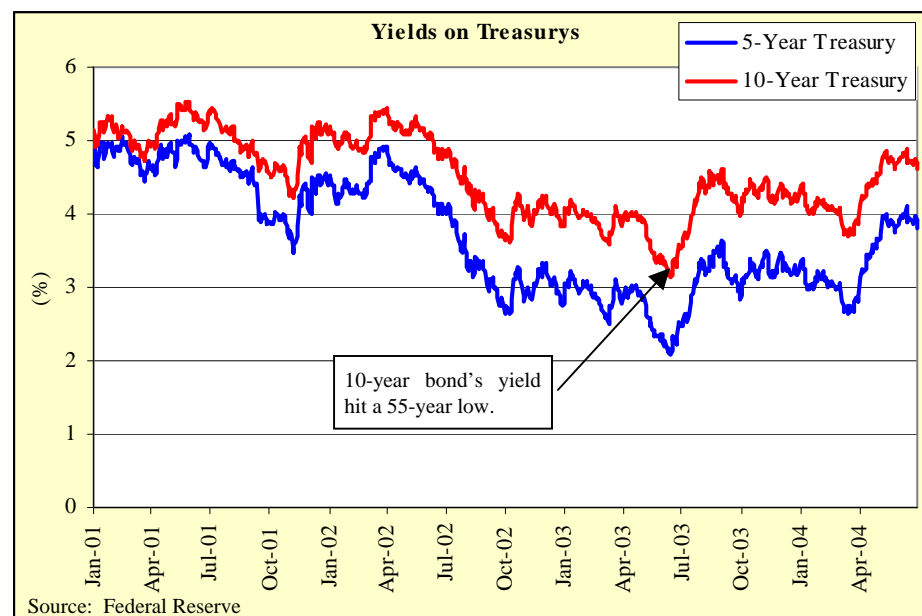
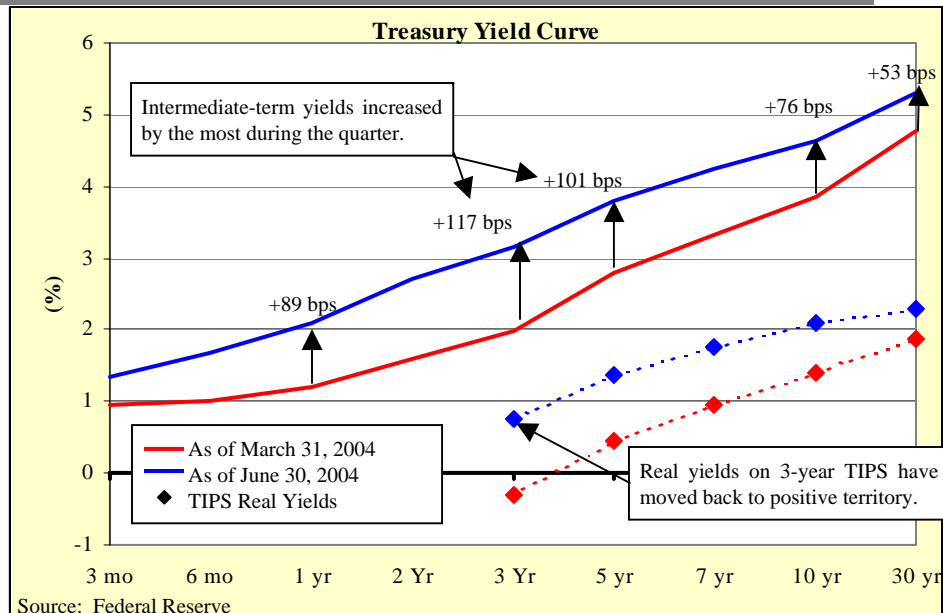
The Economy Remains Strong

- The US economy grew at a 3.9% annualized rate in the first quarter of 2004. Data released late in the second quarter suggests that growth, particularly in consumer spending, may be subsiding. Nevertheless, forecasters polled by *The Economist* expect 4.6% growth for 2004.
- The employment picture continues to improve. The economy added 671,000 jobs in the second quarter and nearly 1.3 million in the first half of 2004. The economy remains 1.2 million jobs below the peak level (March 2001).
- Business investment continues to expand, growing at a 5.3% annualized rate in the first quarter. However, as a percentage of GDP, business investment remains well below normal levels. With strong current cash flow and high cash levels, businesses should be in a position to ramp up investment and hiring, provided that demand remains strong.

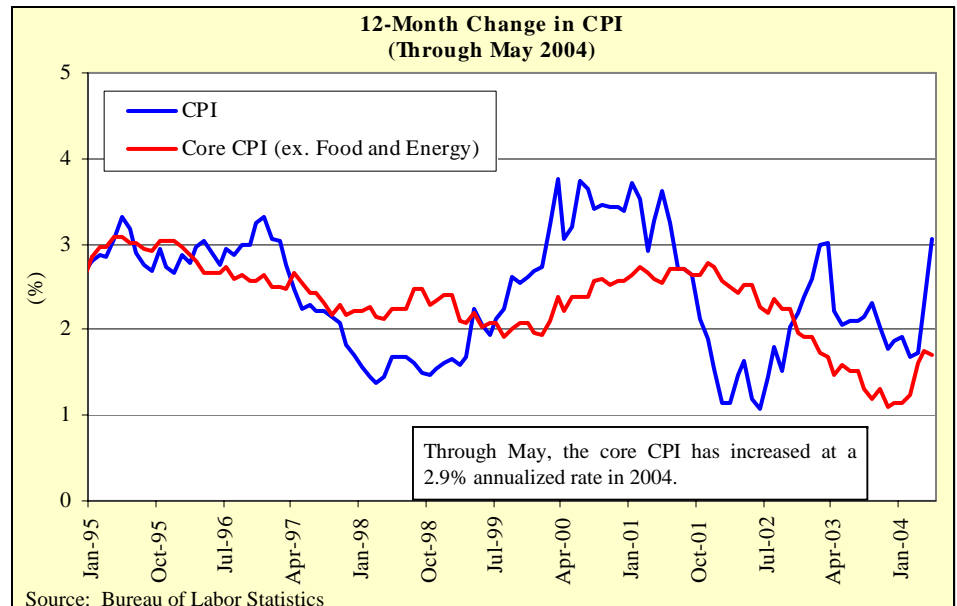
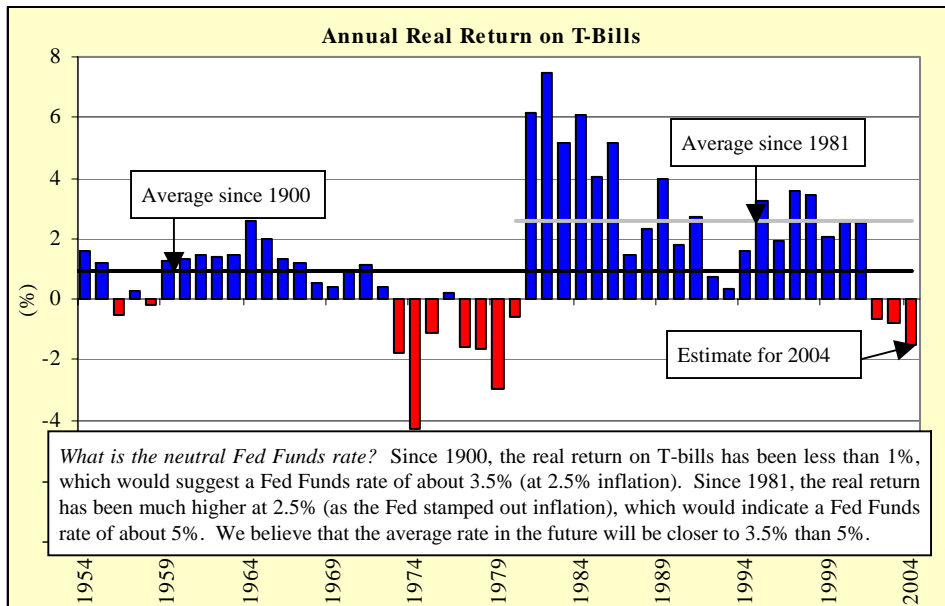
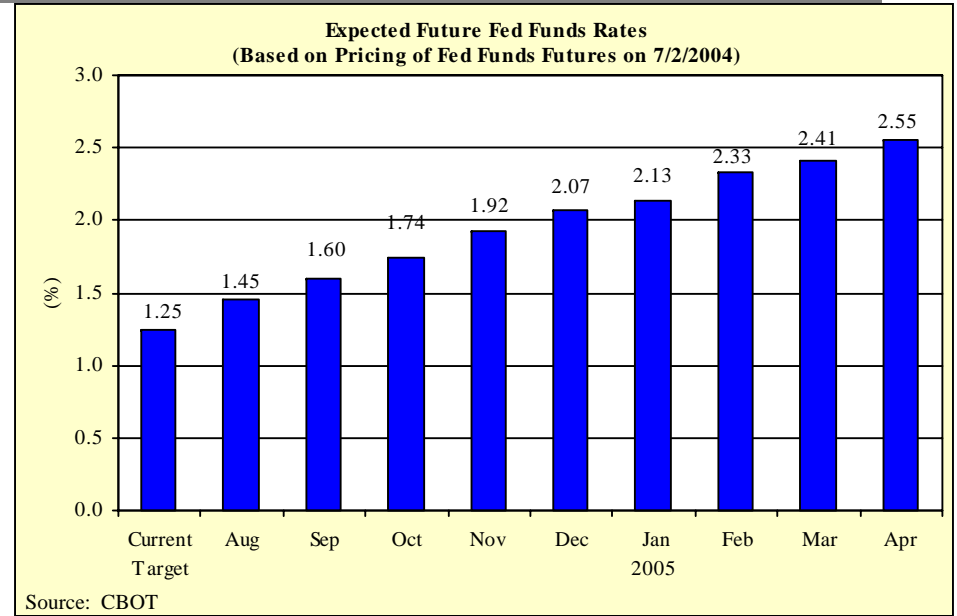
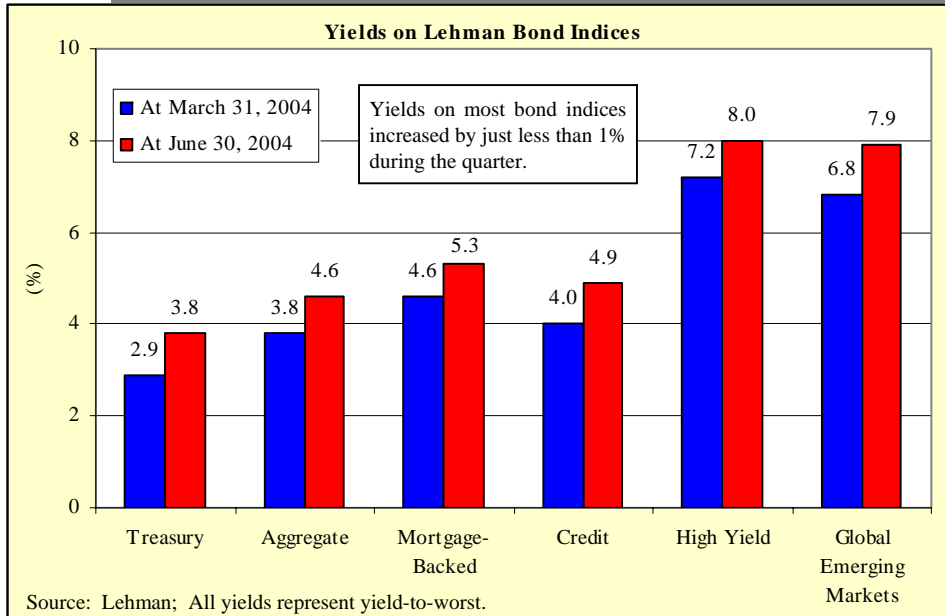


The Fed Decelerates

- After 10 consecutive quarters of economic growth, and 4.8% average GDP growth over the last 4 quarters, the Federal Reserve finally raised the Fed Funds rate at their June 30 meeting from 1% to 1.25%.
- The Fed Funds futures market predicts that the overnight lending rate will be at least 2% by year-end. Even with that increase, real interest rates will remain negative, which means that monetary policy will remain highly stimulative.
- Fixed income and other yield-oriented investments (particularly REITS) performed poorly in the second quarter. Treasury yields increased substantially in April when an unexpectedly strong jobs report and comments by Fed officials signaled that tightening would occur more rapidly than initially expected.
- Inflation has spiked in 2004, suggesting that the Fed may have taken too long to tighten. The CPI index increased 3.1% over the last 12 months versus 2.1% a year ago. That steep increase is partially due to higher energy prices. The change in the core index, which excludes food and energy, stands at 1.8% over twelve months.
- Inflation-indexed bonds are reflecting higher inflation expectations. The inflation-breakeven rate on 10-year TIPS is at 2.5% versus 1.7% one year ago. The breakeven rate on 30-year TIPS has increased from 2.2% to 3.1% over twelve months.
- If inflation matches what is implied by TIPS, Treasuries appear reasonably valued. At a 2.5% inflation expectation, the 10-year bond offers a real yield of 2.1%, which is higher than the 1.6% realized real return on long bonds since 1900. However, the threat of inflation makes that 2.1% real return uncertain. For that reason, we still favor TIPS over nominal bonds.



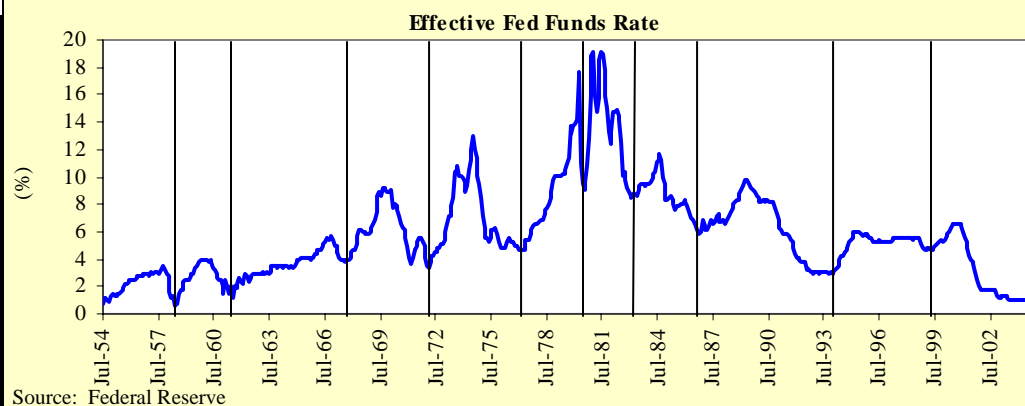
The Fed Decelerates (cont.)



An Examination of Prior Tightening Cycles

We analyzed 10 major tightening cycles over the last 50 years to examine investment returns around the first rate increase. Both equity and fixed income typically earned below average returns over the following 12 and 24 months.

Why might this time be different? The Fed made its intentions well known in the months leading up to the rate increase, meaning that investors should have priced it into values. Indeed, fixed income had a terrible quarter, implying that the aftermath should be kinder than history. Equities, on the other hand, are much more expensive than in prior periods.



Performance Around the Beginning of Tightening Cycles (%)												
Fed Funds Trough Date	US Large			Small Minus Large			Value Minus Growth			US Fixed Income		
	3 Months Prior	12 Months After	24 Months After ¹	3 Months Prior	12 Months After	24 Months After ¹	3 Months Prior	12 Months After	24 Months After ¹	3 Months Prior	12 Months After	24 Months After ¹
May 1958	9.0	37.7	16.4	3.8	10.3	5.0	4.1	22.6	2.0	1.9	(6.4)	(1.0)
July 1961	3.0	(10.0)	5.1	(4.1)	1.8	0.8	(3.5)	4.6	8.1	(0.4)	4.1	4.4
July 1967	1.6	6.5	1.6	18.0	23.1	7.5	8.3	8.5	5.9	(2.1)	4.5	0.6
February 1972	14.2	7.8	(2.0)	13.5	(27.6)	(13.9)	(1.0)	(1.7)	14.1	2.1	4.6	4.0
January 1977	0.2	(8.2)	4.1	21.4	25.9	23.1	13.7	8.2	2.7	2.3	4.8	4.2
July 1980	16.1	12.9	(1.1)	9.7	17.4	4.5	(4.1)	3.4	4.6	4.5	(5.0)	7.0
February 1983	8.0	10.9	15.7	7.8	(6.1)	(5.3)	0.2	21.0	11.7	5.1	6.8	10.2
October 1986	4.1	6.6	10.6	(3.5)	(20.2)	(5.8)	7.4	(3.1)	3.4	2.6	(2.3)	5.0
January 1994	3.6	0.6	18.0	(0.5)	(6.6)	(7.5)	0.3	(4.5)	(3.0)	1.0	(2.3)	6.9
June 1999	7.1	7.2	(4.4)	8.5	7.1	11.7	7.0	(34.3)	10.9	(0.9)	4.6	7.8
Average	6.7	7.2	6.4	7.5	2.5	2.0	3.2	2.5	6.0	1.6	1.3	4.9
<i>Std. Deviation</i>	5.3	13.2	8.3	8.7	17.8	10.8	5.8	15.9	5.2	2.3	4.8	3.3
June 2004	1.7			(1.2)			(0.9)			(2.4)		

¹Annualized

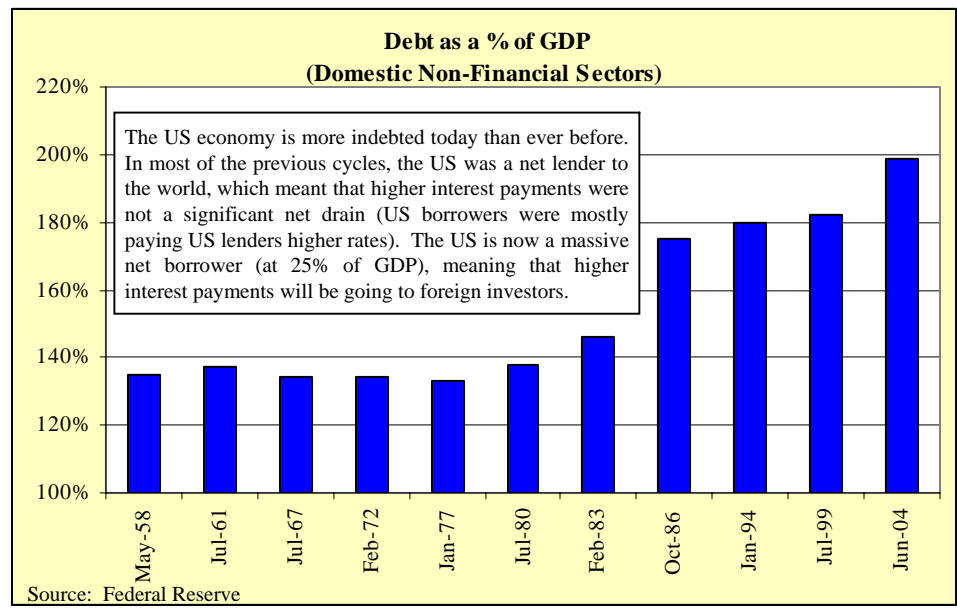
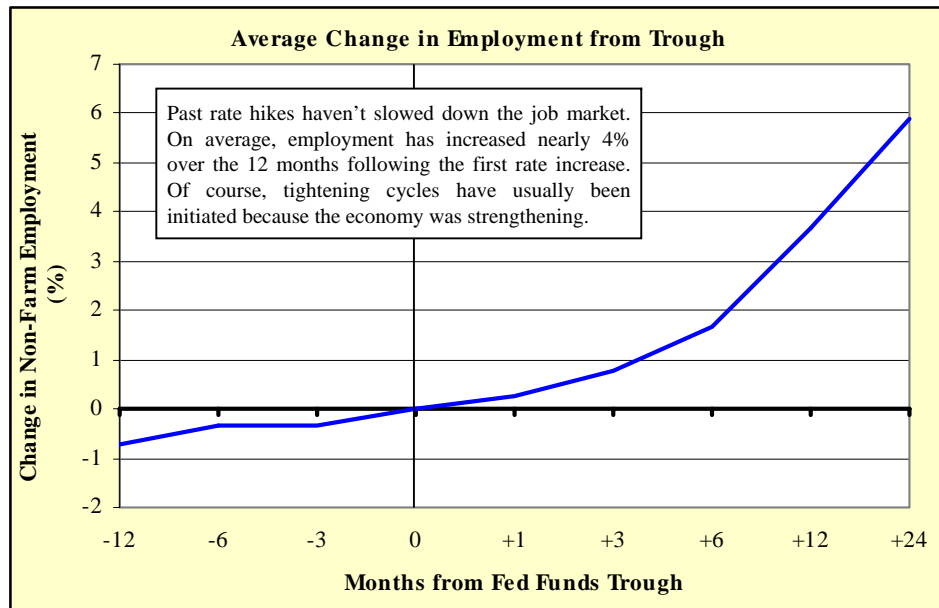
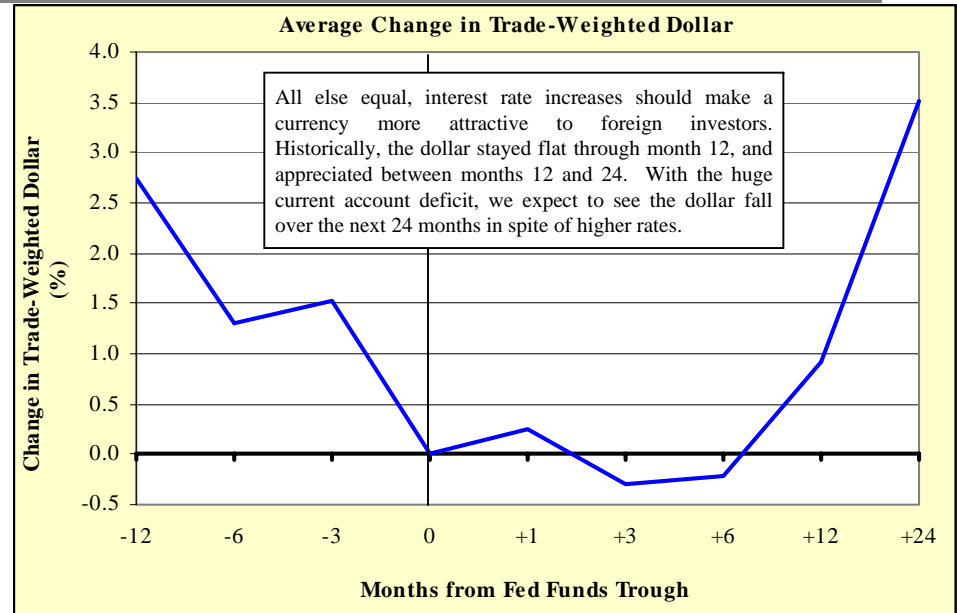
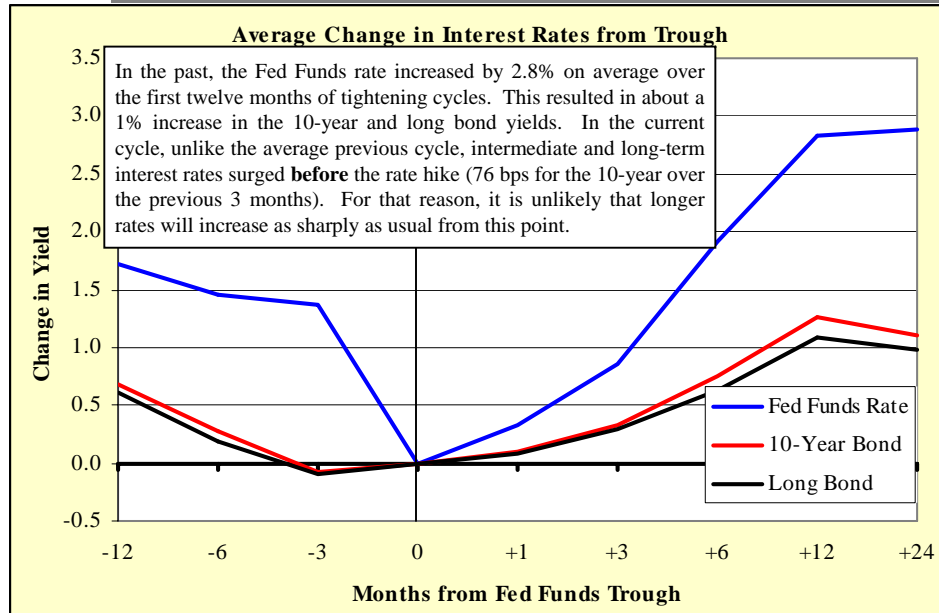
Equities have an average return of 11.3% over the past 50 years. They have significantly underperformed that average following rate increases. This cycle appears especially risky given current valuations. The P/E on trailing reported earnings stands at 20 (which is arguably understated) versus an average of 17 in the 10 prior troughs.

The small minus large returns are mixed. They are too variable to draw conclusions.

The value minus growth returns have been inconsistent over 12 months after the trough. However, over 24 month periods, value has outperformed in 9 of 10 periods by an average of 6.0%.

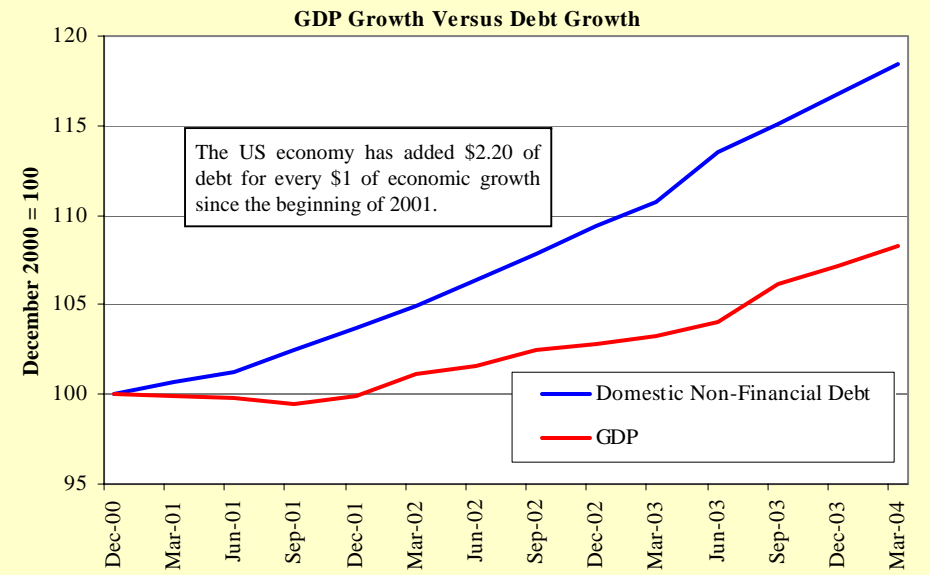
Bonds have underperformed their 50-year average return of 6.5% following rate increases.

An Examination of Prior Tightening Cycles (cont.)

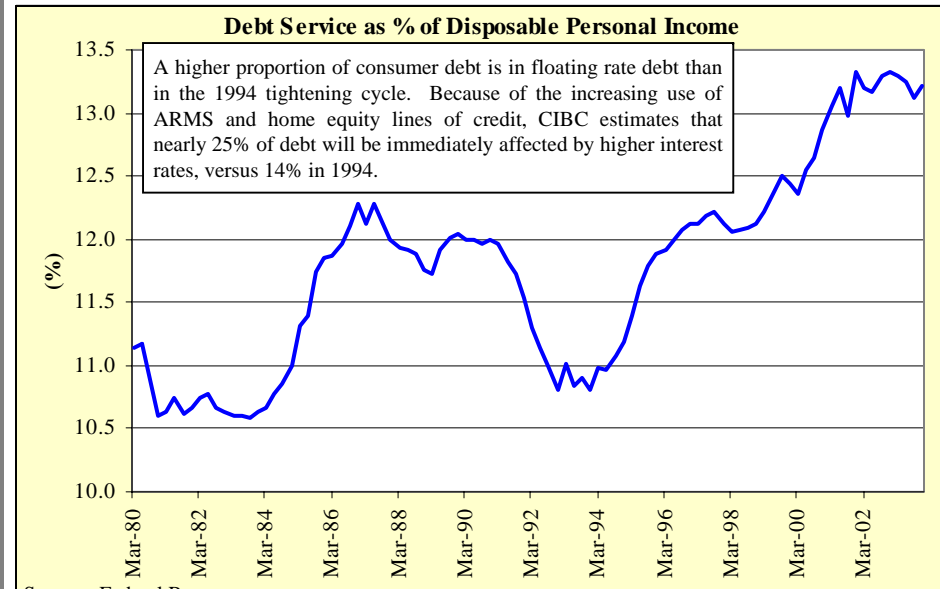


Storm Clouds on the Horizon?

- All indications are that the economy will remain strong through 2004. Looking beyond, the imbalances in the economy are a significant concern.
- The Fed's accommodative interest rate policy has had the desired effect. There has been a debt feeding frenzy, which has gone a long way to support consumer spending. Household debt has mushroomed 32% since the first rate cut at the beginning of 2001. Economy-wide debt levels are at their highest since the eve of the Great Depression.
- With consumer spending representing 70% of GDP, as go US consumers, so goes the economy. Despite the improving jobs market, consumer spending appears vulnerable.
 - ✓ With record debt loads, US consumers are more interest rate sensitive than ever before. Higher interest rates will increase already high debt service requirements. While much of household debt is fixed-rate mortgages, a sizeable portion is variable rate. CIBC estimates that a quarter of household debt will be immediately affected by higher interest rates.
 - ✓ The housing market remains a major concern. The wealth effect from the booming (debt-fueled) real estate market supported spending in the recovery. However, prices appear dangerously high. At best, the rate of growth in prices will slow considerably or stagnate. Higher mortgage rates could be a catalyst for price declines. With the value of household real estate at \$15 trillion (130% of GDP), even modest declines could have substantial effects on spending.
- The Fed has a difficult task. Increasing rates to a neutral level risks pricking the debt and housing bubbles. Keeping them too low risks inflation and larger debt and housing bubbles. Nevertheless, it seems likely that the Fed will be cautious in raising rates. Allowing additional inflation will likely be preferable because it will have the secondary benefit of reducing the real value of debt loads. But, how long would bondholders play along?

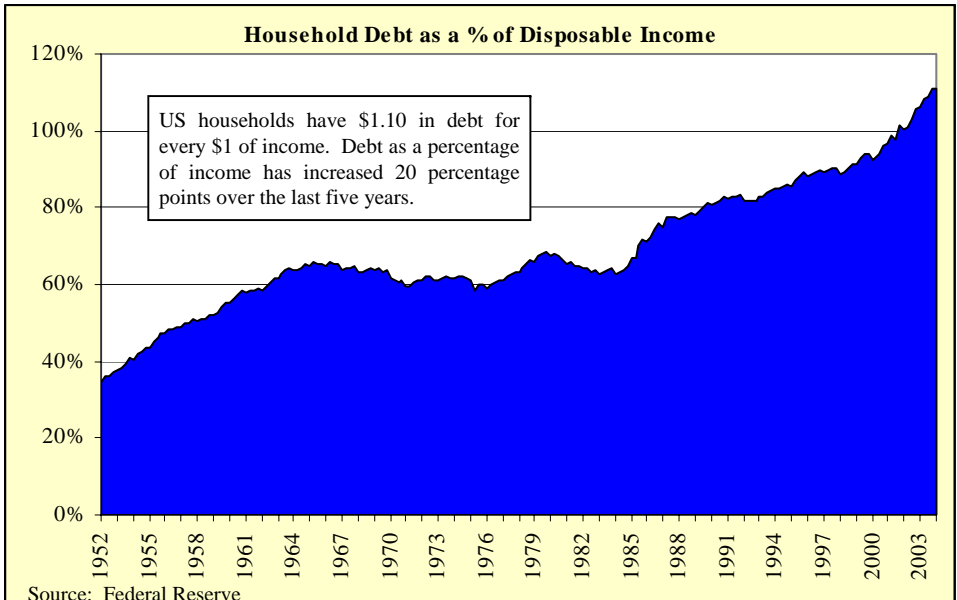
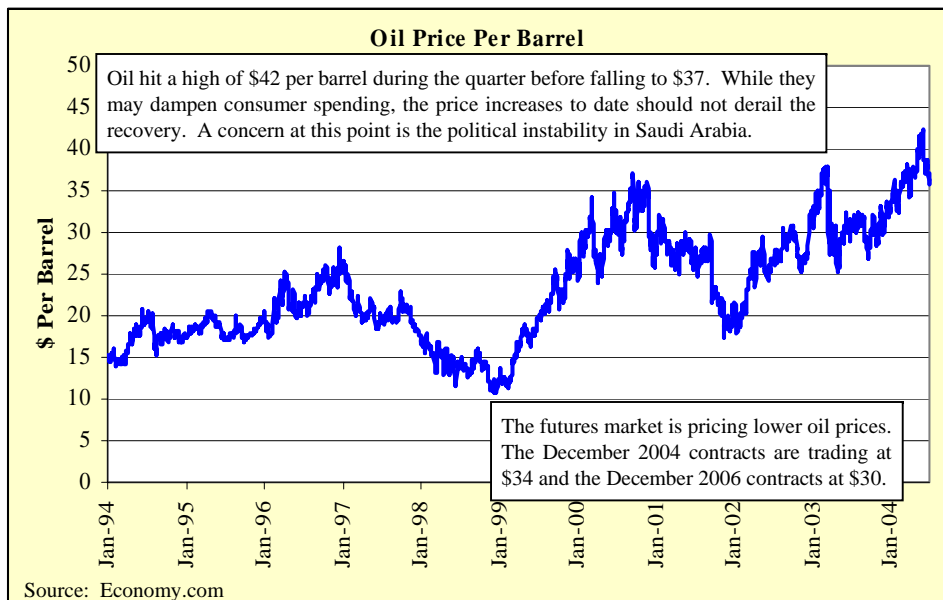
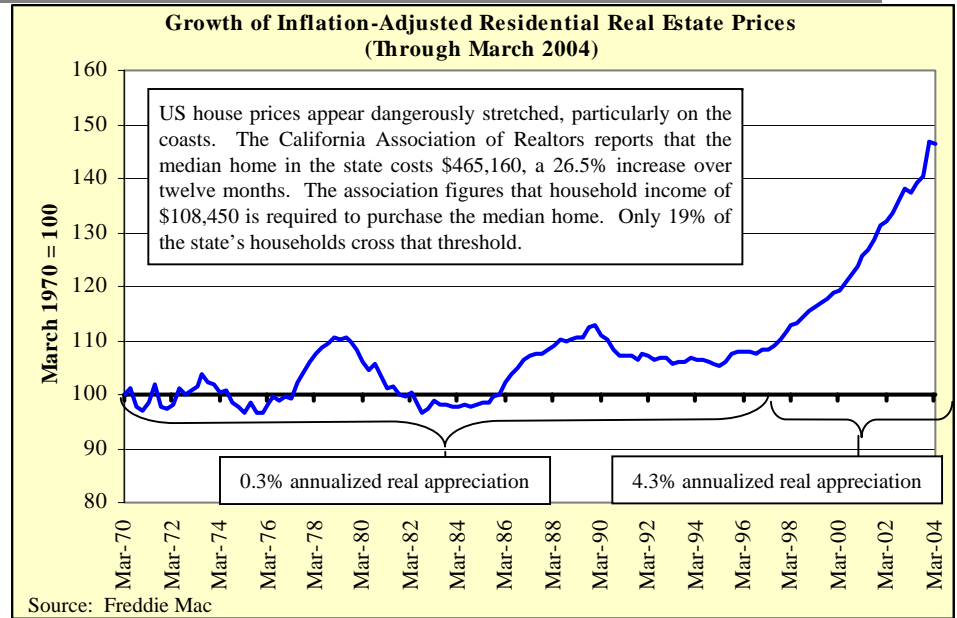
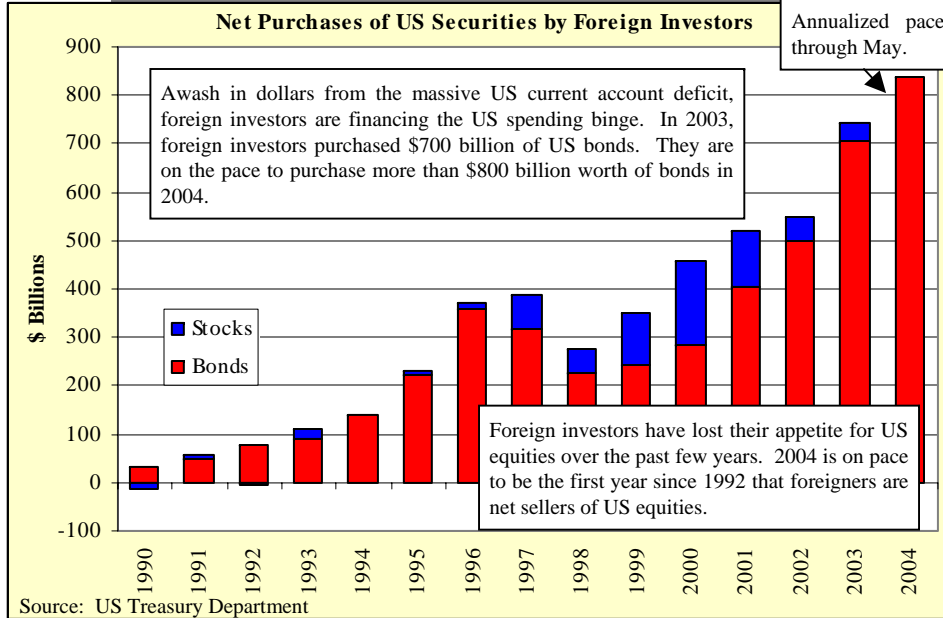


Source: Federal Reserve, Bureau of Economic Analysis



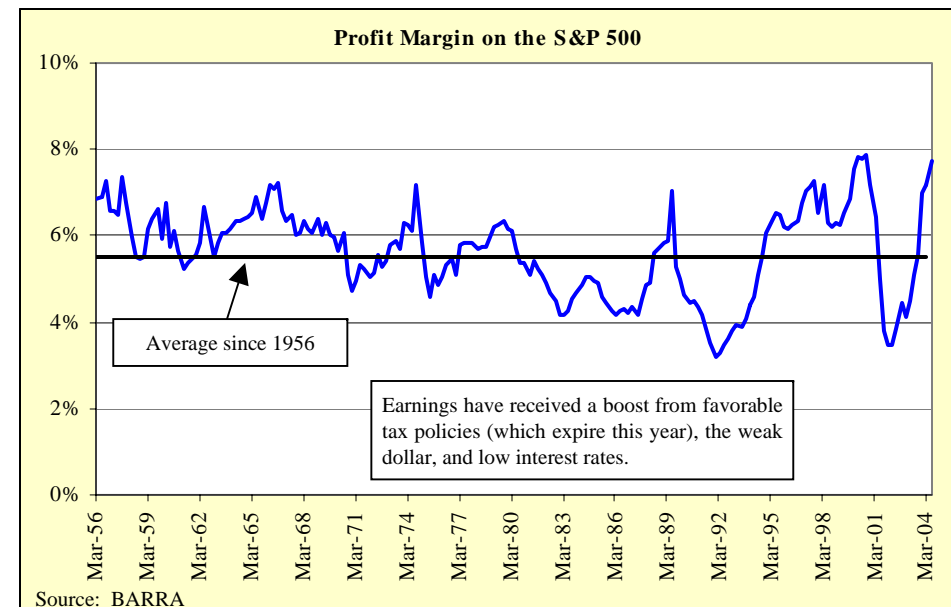
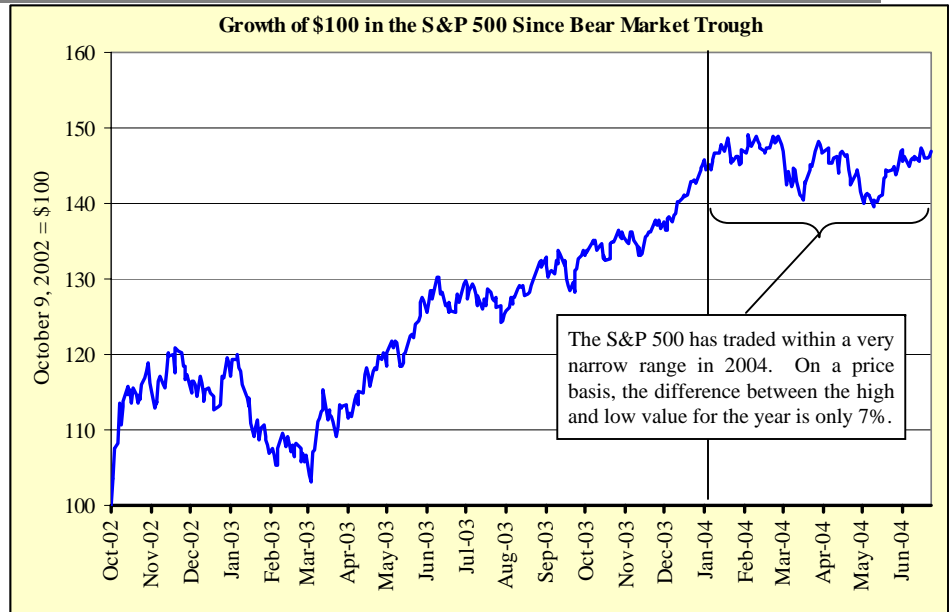
Source: Federal Reserve

Storm Clouds on the Horizon? (cont.)

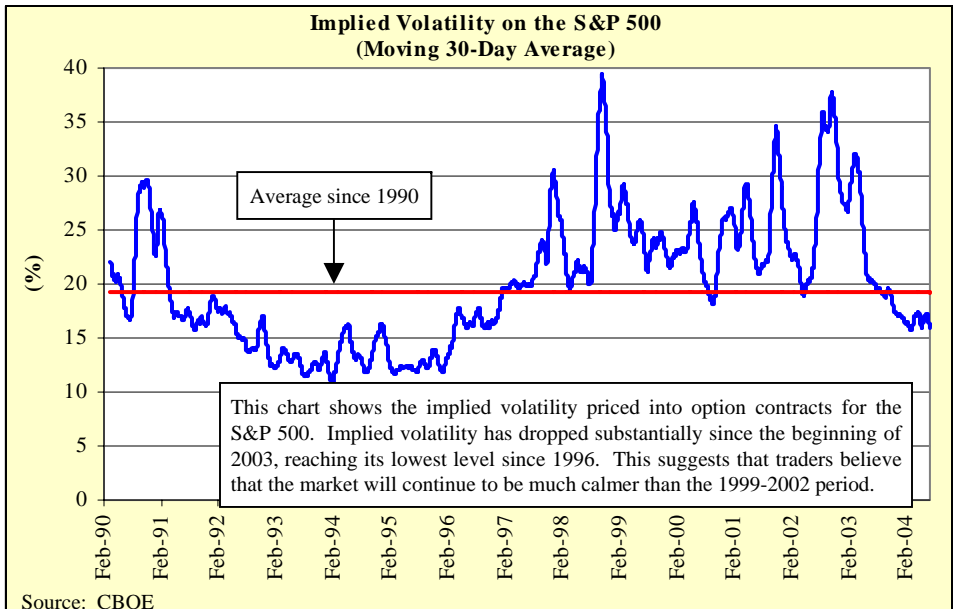
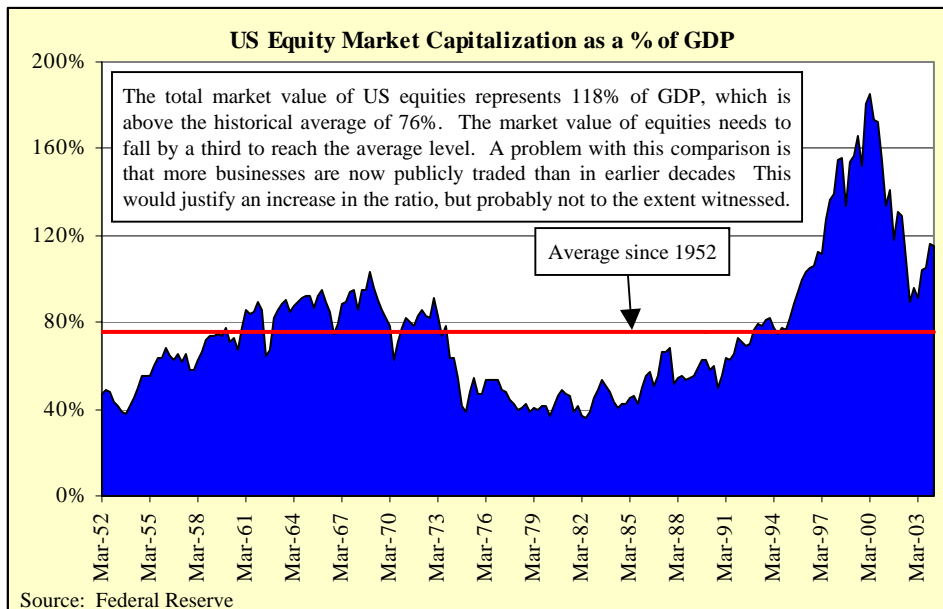
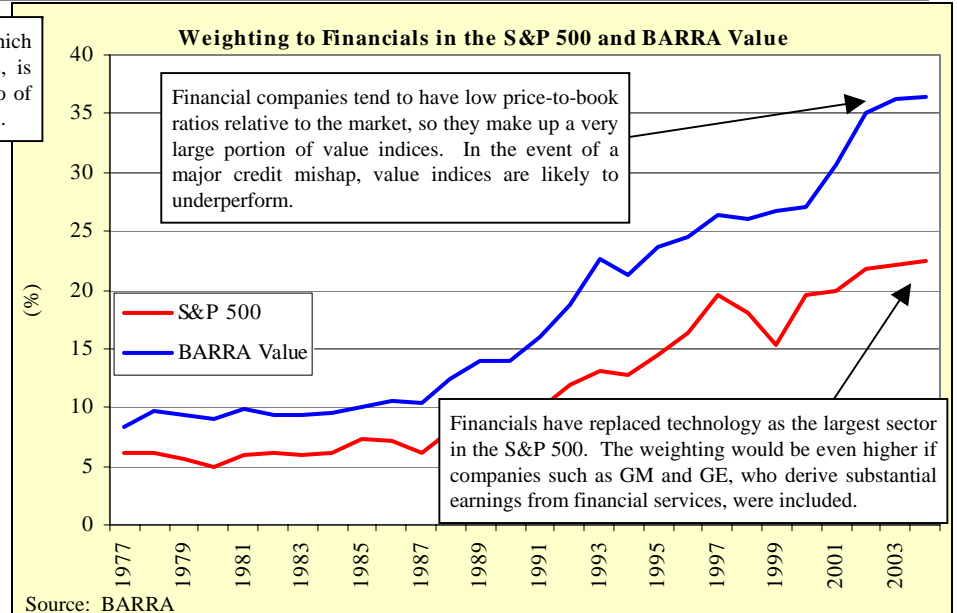
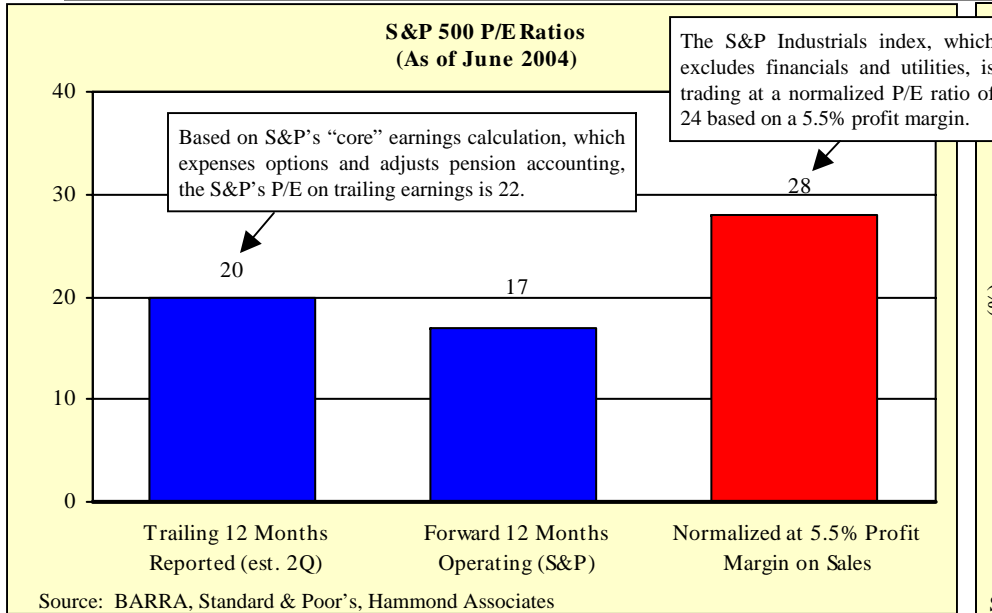


US Equities in a Holding Pattern

- Earnings for Corporate America remain strong. Based on estimated second quarter earnings, reported earnings for the S&P 500 have eclipsed the September 2000 peak. Nevertheless, the index's performance has essentially treaded water so far in 2004. It has earned 3.4% year-to-date.
- The P/E ratio on trailing 12 month earnings stands at 20. While high by historical standards, this P/E ratio may be appropriate if investors are satisfied with a lower equity risk premium.
- However, we fear that current profits are unsustainable. The profit margin on the S&P 500 is approaching 7.7%, which is far above the historical average of 5.5%. The only other time that profit margins were at this level was just before the earnings collapse in late 2000.
- Earnings from financials seem susceptible to a pullback. Over the last year, financials have contributed nearly half of the S&P 500's operating earnings versus their 23% weight in the index. Financial companies have benefited from the "carry trade" (borrowing at short-term rates and lending at higher rates). With the Fed moving interest rates higher, the trade will be less lucrative. More worrisome is the potential impact of bursting debt and housing bubbles. It's unclear to what extent financial companies have off-loaded credit risk, but there would certainly be a significant earnings hit.
- US equity markets still appear poised to provide low returns in the future. Within the market, there are no obvious bargains. Small-caps are arguably overvalued versus large-caps, while value is trading at normal multiples to growth.



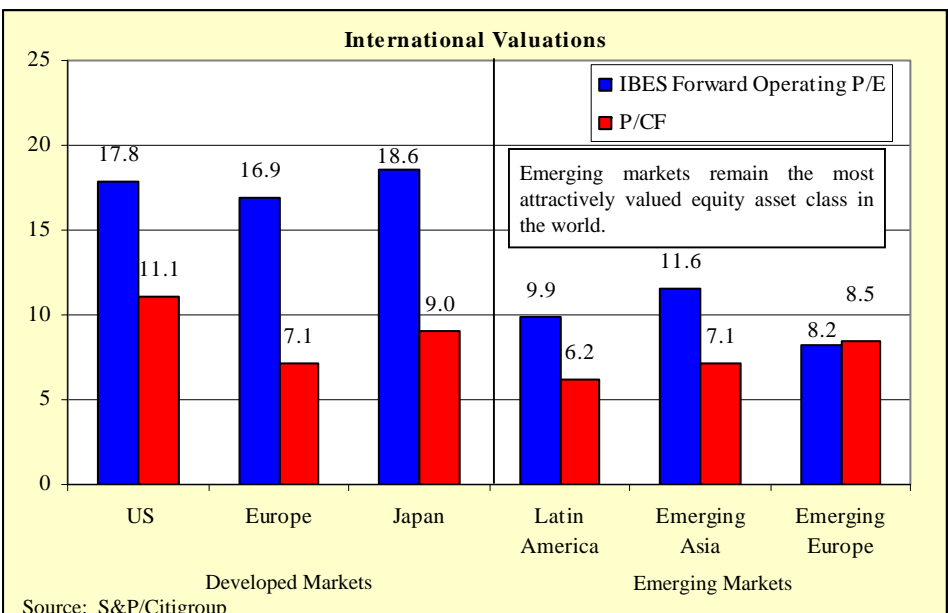
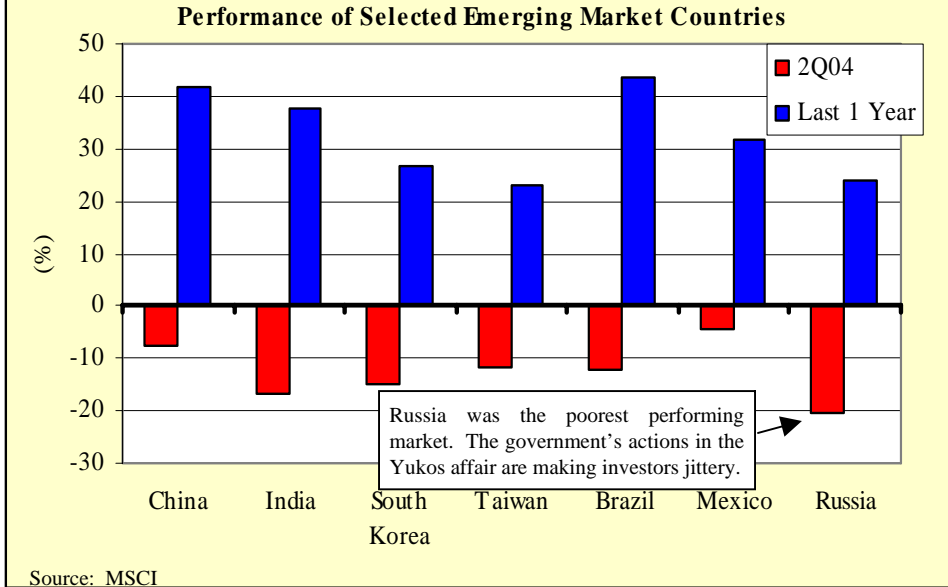
US Equities in a Holding Pattern (cont.)



China and Interest Rates Shake Emerging Markets

- Emerging market equities, the best performing asset class in 2003, hit a rough spot in the second quarter. The MSCI Emerging Markets index declined 9.6%, erasing the first quarter gain. Year-to-date, the index is down 1%.
- Anticipation of higher US interest rates was likely one factor in the decline. Heavily indebted Latin American countries, such as Brazil, tend to be sensitive to US interest rates, since much of their debt is denominated in dollars.
- Another cause of the decline appears to be China. While China is a small part of emerging market equity indices, many emerging market countries (plus Japan), rely on exports to China to fuel economic growth. There is growing concern that the Chinese government's attempt to engineer a soft landing for the economy will fail, which could risk contagion throughout emerging markets.
- Despite the risks, emerging market equities still appear to be the most reasonably valued in the world. While they are no longer the bargains that they were at the beginning of 2003, we believe that they offer a fair expected return for the inherent risk, which we cannot say for US equities. We expect that emerging markets will be the best performing equity asset class over the next decade, but there is sure to be gut wrenching volatility in the interim.

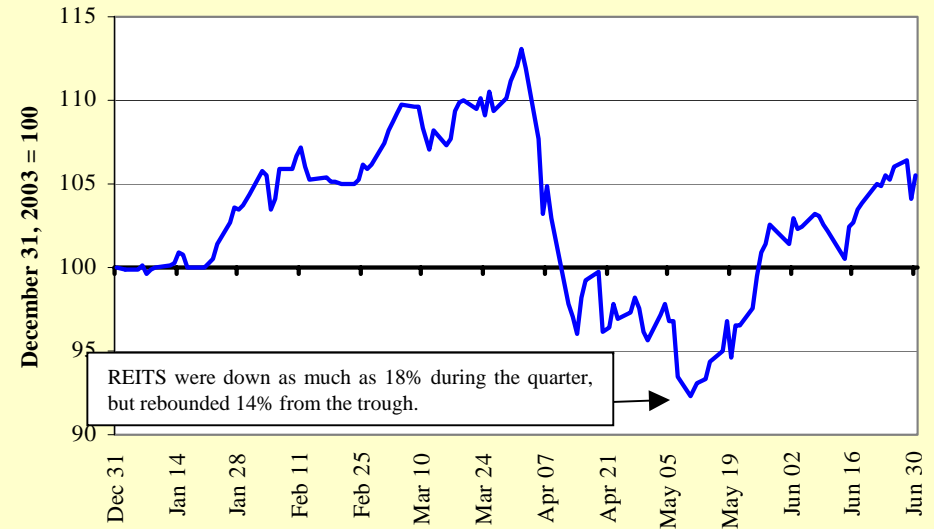
Changes to the MSCI Emerging Markets Index – Last year, Taiwan removed investment restrictions on their markets, making the equity market more investable. As a result, MSCI will raise the weighting to Taiwan in the benchmark. When the transition is complete, Taiwan's weight in the index will be 22% versus 12% at the end of 2003. With this change, the index becomes very top heavy. Taiwan and South Korea will combine to make up 39% of the index, and 60% of the index will be in Asian countries.



REITS Plunged Then Rebounded

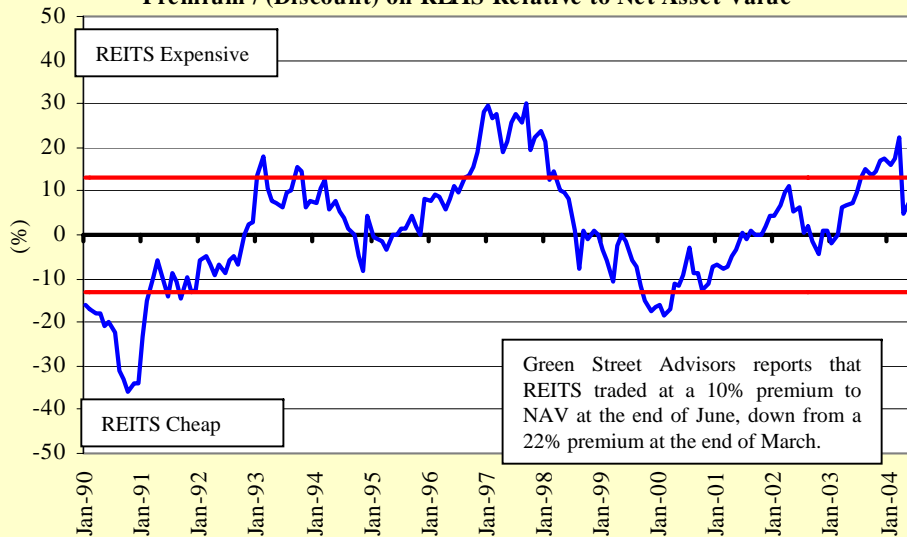
- REITS experienced a tumultuous quarter. They declined 14% in the first two weeks of the quarter, but rebounded to finish it down only 5.4%. Despite the decline, REITS are still trading at a premium to the value of their underlying properties.
- In comparison to other domestic asset classes, REITS are reasonably attractive. We estimate that REITS are priced to provide a 3% risk premium to long-term TIPS. While lower than average, it is much more attractive than our sub-2% estimate for the risk premium on US equities.
- A continuing concern for REITS is the deterioration of real estate fundamentals. Net operating income is still declining, which means that it may be difficult for the dividend yield on REITS to keep pace with inflation over the intermediate term.

Performance of REITS in 2004



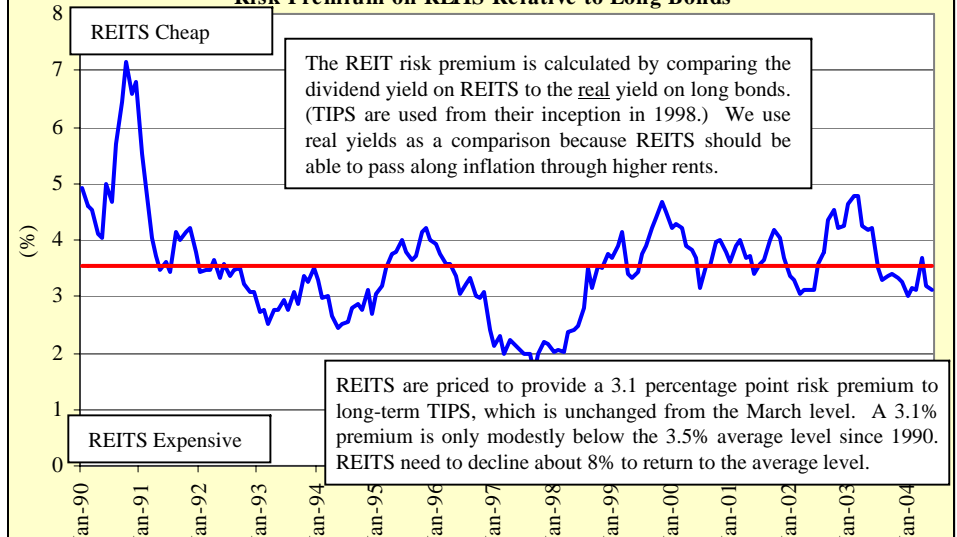
Source: NAREIT

Premium / (Discount) on REITS Relative to Net Asset Value



Source: Green Street Advisors

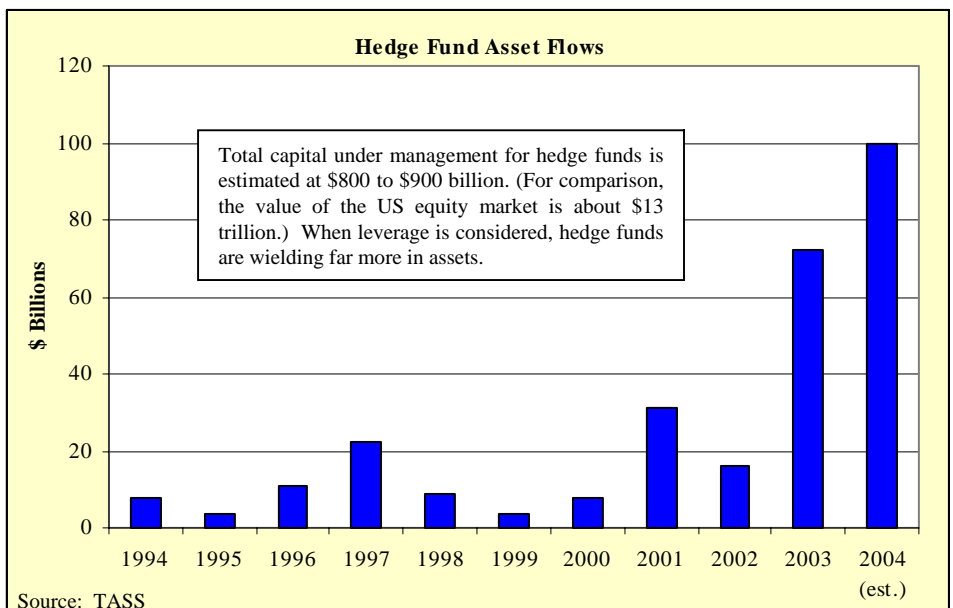
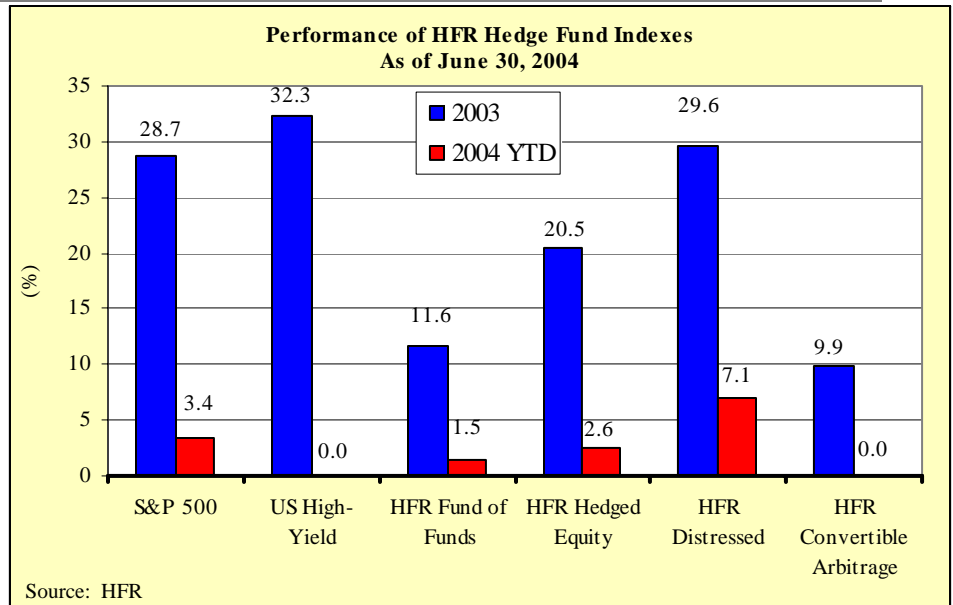
Risk Premium on REITS Relative to Long Bonds



Source: NAREIT, Hammond Associates

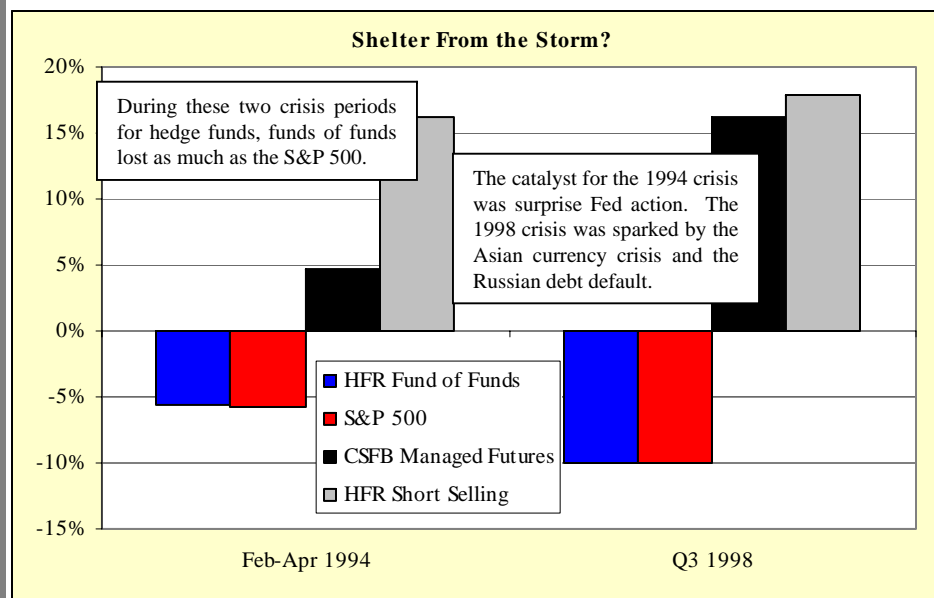
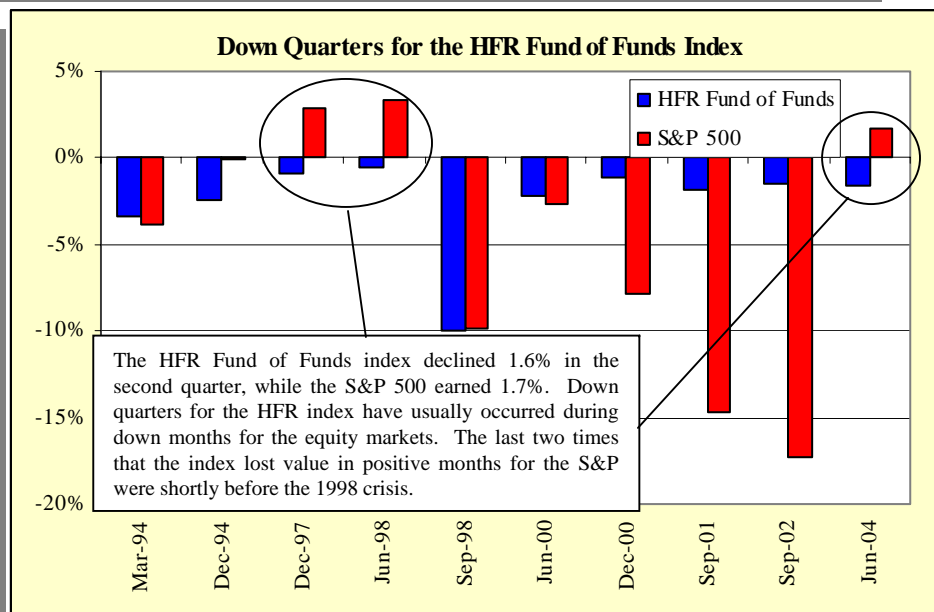
Is a Hedge Fund Shakeout Looming?

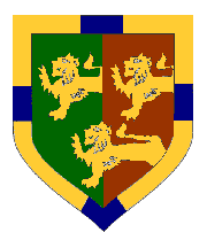
- Hedge fund returns in 2003 were impressive (albeit below equity returns). So far, however, 2004 has been disappointing. Distressed is one of the few strategies that posted solid results year-to-date, but near-term opportunities for the strategy are questionable given tight credit spreads.
- While hedge funds purport to generate absolute returns, systematic risk factors were a driver of last year's results. Now, with the S&P 500 up a meager 3.4% in 2004 and high yield bonds flat on the year, hedge funds are having a hard time finding profitable sources of systematic exposure. If the returns to risk factors like equity and credit exposure remain subdued, funds will be forced to generate alpha (as they should) in order to meet investors' expectations.
- Capital inflows to hedge funds have also contributed to this year's lackluster first half. As inflows into hedge funds surge, an increasing number of dollars pursues a static set of market opportunities. Return dilution is the likely result.
- Commonly-employed arbitrage strategies appear to be the most affected by the inflows. Significant crowding in merger arbitrage has kept deal spreads low despite rising deal volume. An abundance of operators in the statistical arbitrage field have rendered most models profitless. The crowding effect has resulted in such richly-priced convertible bonds that it's hard to imagine this strategy producing hoped-for returns in the future.
- We expect the average hedge fund experience to produce disappointing returns relative to most investors' expectations. Only the best hedge fund and fund of hedge fund managers are likely to earn their fees.



Is a Hedge Fund Shakeout Looming? (cont.)

- We've been fortunate enough to make it nearly six years without a major hedge fund incident. With the large amount of money invested in hedge funds (amplified by leverage) and current market conditions, the kindling appears to be there for another one. What we don't know is whether there will be a spark to set it off. Potential catalysts include credit problems (defaults and/or spike in spreads), surprise Fed action (causing a sudden unwinding of carry trades), or terrorist attacks.
- On a positive note, hedge fund managers in general seem to be using less leverage than in the past. However, there has been a disturbing trend among fund of funds: many are employing leverage at the fund level, thereby leveraging already levered investments. This strikes us as dangerous.
- A shock may be beneficial for long-term investors who employ high-quality managers. The likely result would be an exit of the hot money that has flooded in over the past few years, which would make subsequent returns more attractive. The HFR Fund of Funds index gained 15%, annualized, over the two years following the 1998 crisis.
- Regardless, in our opinion, a diversified investment with skilled, experienced hedge fund managers has far less downside risk than investments in equity markets, particularly at today's equity valuations.
- For investors looking to further diversify their hedge fund programs, managed futures and dedicated short sellers are worth consideration. These strategies posted impressive performance during past "crisis periods" and might provide protection for investors in the event of hard times for common hedge fund strategies.





Hammond Associates Alternative Investments Update May 2004

This is a reprint of a report published in May 2004. It is the second edition of a semi-annual report that covers the hedge fund, real asset, and private equity sectors of the alternative investment universe. We hope that you find it useful and informative. If you would like to receive forthcoming reports, please indicate on the back page. The November 2003 report is available at www.hammondassociates.com.

Alternative Investment Index Returns

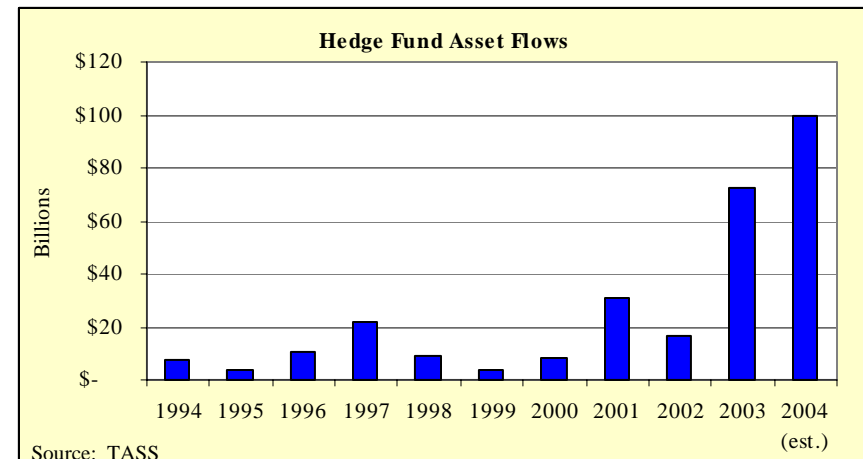
March 31, 2004	Annualized Returns				
Hedge Funds	1Q04	1 Year	3 Year	5 Year	10 Year
HFR Fund of Funds Index	3.4	14.0	5.9	8.8	8.2
HFR Convertible Arbitrage Index	1.3	6.4	9.0	11.6	11.3
HFR Market Neutral Index	2.0	4.3	3.2	7.1	8.6
HFR Distressed Securities Index	4.9	30.0	16.2	13.5	12.2
HFR Merger Arbitrage Index	1.3	8.8	3.2	8.0	10.6
HFR Equity Hedge Index	3.4	25.7	6.8	12.0	16.0
December 31, 2003					
Real Estate & Timber					
Wilshire REIT Index		34.0	16.6	15.2	12.2
NCREIF Real Estate		9.0	7.7	9.3	10.1
NCREIF Timberland Property Index		7.7	1.3	4.2	8.7
Private Equity (Venture Economics)					
	4Q03				
All Private Equity	7.0	18.3	-7.0	6.8	12.7
Buyouts	9.1	24.1	-2.1	2.2	7.8
Venture Capital	4.8	8.1	-18.9	22.8	25.5

Performance Commentary

Last year was not a period about which alternative investors could boast. The nominal returns were fine, but were generally overshadowed by traditional public market returns. In 2003, the US equity market turned in solid returns of 29% for large cap stocks and nearly twice that for small cap stocks. The US bond market returned a modest 4.1% in 2003, but has been one of the best performing major asset classes over the last three years. 2004 looks to be a different story. Private equity returns have turned positive for the first time in three years and realization activity driven by both M&A activity and IPO's has increased. So far in 2004, the public equity markets have been volatile and appear to be range-bound. Government bond yields seem to have nowhere to go but up and high yield bond spreads appear unsustainably tight. With so many parts of the public markets priced for perfection, alternative investments look especially attractive in the near-term.

Hedge Funds

Hedge funds have been increasingly popular investment vehicles over the last couple of years as the following chart demonstrates. Total hedge fund assets are now estimated to be between \$700 billion and \$800 billion, with nearly \$100 billion coming into the space since January 2003, according to figures from TASS. Hedge funds are an influential player in the equity markets representing 5% of assets and 15% of trading volume, according to a recent Forbes article.



Hedge funds, as represented by the HFR Fund of Funds index, gained a solid 3.4% during the first quarter, doubling the return of the S&P 500. A brief discussion of the return drivers and outlook in each of the major strategy categories follows.

Convertible Arbitrage – Convertible arbitrage managers endured a difficult quarter, posting a modest gain of 1.3%. The first quarter was a tale of 3 months. January was a strong month for the strategy, as credit spreads continued to tighten, while many arbitrageurs simply held their gains through the rest of the quarter, despite the volatility spike as a result of the terrorist attack in March. New issuance remains reasonable in terms of volume, but not very attractive in terms of price. We continue

to see multi-strategy managers reduce their allocations to the strategy, particularly in the US, and a growing number of participants are selectively implementing the reverse trade.

Distressed – Distressed managers continued to have the wind at their backs in Quarter 1, but the breeze may be shifting. Credit continued its torrid rally in January, but stalled and reversed late in the quarter. With credit spreads tighter than the historical averages, one has to ask what is next for the strategy? Smaller deals and greater management involvement in the workout may be primary drivers for the rest of the year and into 2005. The robust high yield issuance in 2003 is sowing the seeds for plentiful opportunities in 2006.

Equity Hedge – Long/short managers enjoyed a strong quarter, as the HFR Equity Hedge Index gained 3.4%. The “index” has now posted positive results for twelve consecutive months, earning 25.7% over the past year. It is not lost on us that the S&P 500 is up more than 35% over the same period. Considering that low quality and small cap companies were the primary drivers of market return in 2003, we have to question the quality of long/short returns at the aggregate. Are the managers simply riding the equity wave, or is stock-picking the driver of their returns? In the case of the latter, how viable is a strategy that is long low quality companies and short companies with more solid fundamentals? We find neither explanation palatable. We do take comfort in the fact that a number of outstanding stock-pickers, who stumbled in 2003, are off to solid starts in 2004. Perhaps this is a signal that fundamental stock-picking will be rewarded this year.

Market Neutral – The first quarter showed signs of revival for the strategy, as relative stock-picking may be back in vogue. While alpha should always find a home in institutional portfolios, low cash rates continue to place a ceiling on reasonable expected returns for the strategy, which likely fall short of an institution’s goal return. Statistical arbitrage is still moribund as the opportunity set appears to have been arbitrated away.

Merger Arbitrage – Deal activity has picked up; deal spreads have not. The recent bear market for the strategy has left so few pure merger arbitrage players standing, we have to question the purity of any merger arbitrage “index.” In our estimation, multi-strategy capital will continue to swamp deal spreads. Mid-single digits returns for the year are likely, assuming no major mistakes.

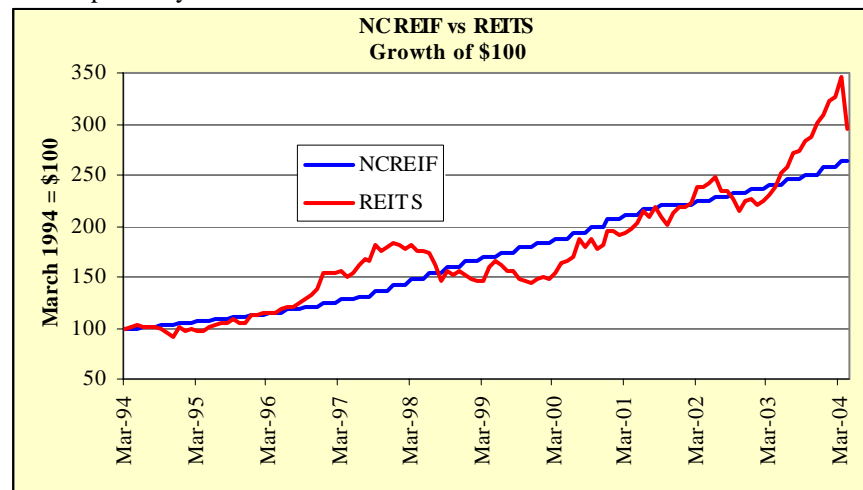
Fund of Funds – Fund of funds returns have been good, depending on the perspective. During the bear market, particularly 2003, the *relative* returns of fund of funds were highlighted, as the products didn’t lose as much as traditional investments. In 2003, traditional investments were asset classes of primary reward, and funds of funds generated strong *absolute* returns, generally in the low double-digits. A potentially troubling development is the leveraged fund of funds, which is

gaining traction in the institutional marketplace. Apparently, absolute returns aren’t good enough anymore. While some of these products may have merit, we smell a disappointment lurking in the future.

Real Assets

Real Estate

The real estate market continues to offer more attractive yields compared to fixed income, but that spread is beginning to narrow a bit. Institutional investors continue to allocate assets to new real estate investments and the demand for high quality income producing properties is especially keen. Core real estate funds that invest in fully-leased properties with little or no debt are having difficulty finding enough suitable properties, resulting in a six-month waitlist for new investors. The NCREIF Index, which measures the gross return of unleveraged institutional properties, returned 9.0% in 2003, in line with the five-year and ten-year returns of 9.3% and 10.1% respectively.



Some of the richest valuations have been for grocery store anchored retail centers, trophy office buildings, and Class A apartments. While office properties in general have been having problems with high vacancies, some submarkets like Washington DC have been continuing to appreciate. The interest rate increases in April have not impacted the institutional real estate market yet. Debt is still available at 5% or less.

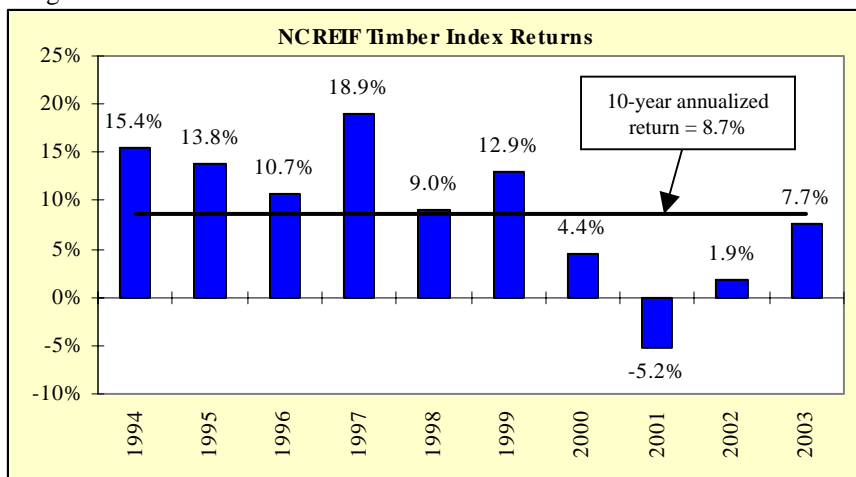
REITs returned 36% in 2003 and had another good quarter to start 2004, returning about 12%, only to see those gains reversed in April. The valuation of REITs versus private real is closer to parity after the declines in early April. In our last report we noted that the outperformance of publicly traded REITs vs. private real estate like we

saw last year tends to be cyclical and transient, so the reversion in REIT valuation was not particularly surprising.

Timber

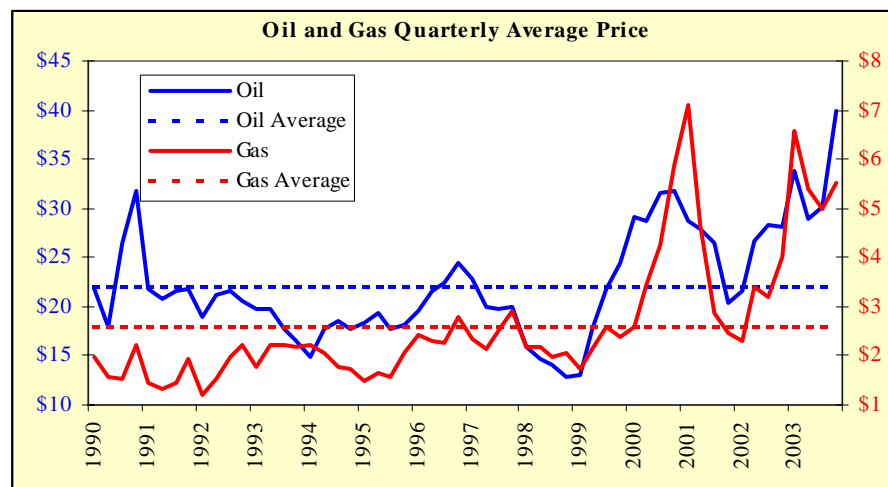
Timber investments are attracting much more attention since general return expectations have declined. Last year, the NCREIF Timber Index gained 7.7%, a rebound from the poor returns of the last three years and close to the 6% real return many investors anticipate. Trailing period returns have been fairly modest due to the drop in stumpage prices from 1999-2003. The soft economy is partly to blame for lower timber prices, and it will be interesting to see if investors cool to this area if longer term returns do not rebound.

A new twist on this market is the growth of international timber strategies focused on Latin America, Australia and New Zealand. Managers are basing the return potential of these types of timber investments on the continued demand for raw materials in China. In a low return environment, investors have been willing to bet on these markets in pursuit of target returns of 500 basis points in excess of domestic timber strategies.



Energy

In 2003 and into 2004 we have seen an increase in interest in all real asset categories, but no sector has been as hot as energy funds. The reason may have as much to do with the relative scarcity of energy fund managers as the relative amount of capital targeting these funds. The established fund managers are having no trouble raising capital, with significantly more interest from investors than they can reasonably accommodate. The prices of Oil and Natural Gas since 1990 are plotted below as of December 2003. Oil has recently hit \$40 a barrel, creating potential downside risk should prices revert to their longer term averages.



Some investors have also included funds investing in power generation assets in their real asset portfolios. While most of these funds are an imperfect fit with the general characteristics of real assets, we understand the case for using power generation as a real assets investment. The interest in this sector has allowed a few groups to raise funds as large as \$1 billion on very modest track records, a handful of transactions, and few, if any, exits. Making the competition for available assets even keener is the presence of large private equity funds pursuing transactions in both the power generation and oil and gas markets.

Private Equity

Buyout fund returns turned positive in 2003. It will surprise many investors that have been concentrating on the small end of the buyout market that the best performing sector last year was “Mega” buyouts, with a 28% return according to data from Venture Economics. Small buyouts returned 6% in 2003. The wide disparity in near-term results reflects the better access to the public markets larger buyout deals enjoy.

Distressed debt was the best performing segment of the private equity arena in 2003. The non-control funds with the wherewithal to invest in large, liquid, high-yield issues at the outset of the latest Iraq conflict have made exceptional returns and had been returning capital to investors over the latter months of 2003. The most notable control distressed fund in 2003 was Wilbur Ross’s WLR Recovery Fund II. WLR II portfolio company International Steel Group went public and is driving a large portion of the fund’s gains. Investors in the fund have been rewarded with interim returns that now stand at roughly 3 times invested capital.

Venture capital returns turned positive in 2003 as well, up 8%, with late stage funds leading the way, up 25%. Late stage funds generally benefited from an opening IPO

market. Early stage funds have continued to be negative, down 7% for 2003, but the losses are shallower than in previous periods. The trailing three-year annualized returns are still significantly negative for venture capital, down 19%.

Rising Buyout Transaction Valuations

The average buyout deal valuation is still only creeping up gradually, but there is ample anecdotal evidence that some buyout transactions are getting done at valuation levels similar to the late 1990s. We have seen numerous examples of announced deals in which companies are changing hands at over eight times cash flow. The last time prices were that high investors fared poorly. The capital provider that is enabling such rich values is, once again, the high yield debt market. Senior lenders continue to be exercising discipline, only lending less than three times cash flow. However, high yield bonds are being issued at less than 8% to companies with junk debt ratings. The distressed investors are biding their time waiting for these borrowers, especially those that have issued floating rate debt, to default in a couple of years.

We are still seeing deals getting done at reasonable valuations outside of auction situations. The challenge is to find groups with truly proprietary deal flow that avoids the type of open competition and price pressures one finds in an auction. Two areas of growing interest for us at this point are industry specific funds and smaller, regional funds. Industry specialists benefit from having established franchises within their area of expertise that makes such a group a favored investment partner for an entrepreneur. These fund managers tend to be well known within their industries and have a track record of successfully building value for similar companies.

Smaller regional funds may have a broader investment focus, but can be better networked into the intermediaries that assist small companies in raising capital or finding a buyer. The challenge to investing in these funds is that they often lack the institutional qualities of larger nationally focused funds.

Business Development Companies

Private equity firms have begun raising capital in the public markets by raising publicly traded vehicles called business development companies (BDCs). Some elements of a business development company are.

- Closed end evergreen structure
- Publicly traded
- Must invest at least 50% of capital in individual companies (not funds)
- May invest in debt or equity

These are not new. What is striking is the number of vehicles being launched. The other issue is “Why now?” Debt capital is plentiful for supporting buyout

transactions across both the senior and subordinated sectors. I guess the answer to the question is “Because they can.”

American Capital Strategies (NASDAQ: ACAS) is probably the best known BDC in the US, and it has been a public company since 1997. Similar entities called venture capital trusts have been publicly traded in the UK for well over a decade. Most of these are not actually investing in early stage companies, but are run by some of the larger UK buyout groups.

Apollo Management raised \$930 million in a public offering of Apollo Investment Corp. (NASDAQ: AINV) in April 2004 and was swiftly followed by announcements from other buyout shops that they are planning to start BDCs of their own. KKR, Blackstone, Evercore, Ares, and a handful of others have already announced their intentions to come to market this year. The most attractive feature of these vehicles for private equity managers is their evergreen structure. Raising a new private equity fund every three to five years is a hassle most general partners would rather not have to deal with. It will be interesting to see if these vehicles become a viable means for institutions to access private equity investments without the illiquidity of partnership vehicles. The biggest roadblock to these new issues coming to market is likely to be that they will typically trade at a discount to net asset value within weeks. Who will buy the new issues at par when they can expect to trade at a discount in the aftermarket?

There are concerns coming from within the private equity community that these new entities will compete aggressively against mezzanine debt funds for available deal flow and drive returns down in that sector. The mezzanine space is already quite competitive, and some recent financings have been announced where competition has reduced the prospective returns to levels we would find unattractive.

Google

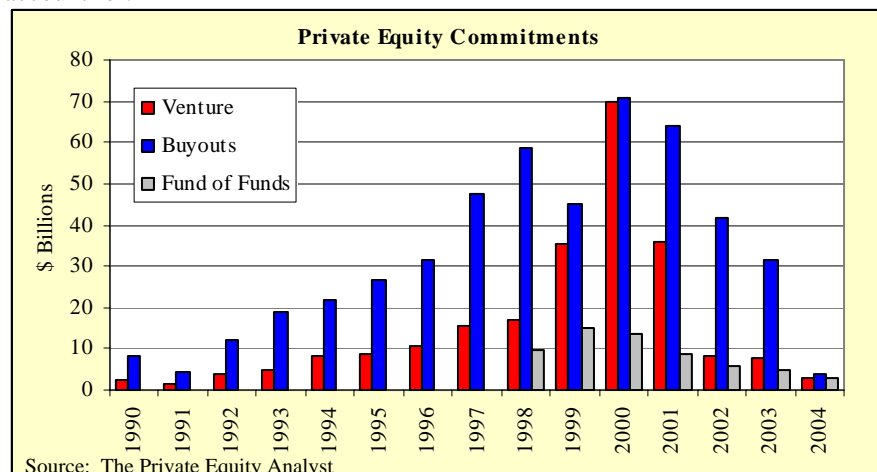
No review of the private equity environment would be complete without at least a mention of the upcoming Google IPO. It does not appear to be a watershed event like the IPO for Ciena in early 1997, which was a windfall for many venture capital funds. Nor is it being interpreted as a sign that the IPO window is open for other technology companies like the IPO for eBay was in the fall of 1998. The Google IPO looks like an isolated event that will only benefit a few VC funds and Google’s employees. It has been reported in the New York Times that Kleiner Perkins’ stake in Google is likely to be worth \$3 billion after the IPO, 240 times the amount they invested in the company in 1999. Until now, that fund, KPCB IX, has been a below median performer with an IRR of -23%. After the IPO, it will be one of the best 1999 funds.

One group of people that is being left out is the technology investment bankers, since Google is raising capital directly from the public via a Dutch auction process.

Coming on the heels of a guilty verdict in the Frank Quattrone trial for IPO related shenanigans, this seems fitting.

Private Equity Fundraising

According to The Private Equity Analyst, 2003 fundraising was roughly \$46 billion, which was nearly back to 1996 levels. Quarterly asset flows are very lumpy, so it is difficult to make meaningful comparisons for year over year statistics. However, life science venture capital funds drew in \$1.3 billion in the first quarter of 2004, versus \$750 million in the first quarter of 2003. Funds of funds attracted nearly 30% of new capital in the quarter, which is significantly higher than the 10% share they typically account for.



HarbourVest Partners raised a total of \$4 billion in 2003-2004 for its latest fund of funds, split evenly between venture capital and buyouts. It will be interesting to see how such a large venture capital allocation is deployed over the next few years. \$2 billion would represent 12% of the total venture capital commitments of the last two years.

Liquidity

IPO activity has increased lately with 13 venture backed companies raising \$2.7 billion in the first quarter of 2004. This is the most activity since the third quarter of 2000, and more than twice the \$1.1 billion raised in the fourth quarter of 2003. Semiconductor Manufacturing International Corp. raised the majority of the capital in the most recent quarter with a \$1.8 billion offering. The next largest offerings were \$136 million for EyeTech Pharmaceuticals and \$126 million for Atheros Communications. As of April 1, 2004 there were an additional 50 venture backed companies in registration for initial public offerings.

The IPO activity for the prior nine quarters is listed below. The post offering value represents the equity market capitalization as of the IPO date of the companies that premiered that quarter, and does not reflect the performance of the companies since that date.

Qtr	VC Backed IPO's	Total Raised (\$MM)	Post Offering Value (\$MM)
Q1 2002	4	376	2,398
Q2 2002	15	1,836	5,918
Q3 2002	1	30	153
Q4 2002	4	231	524
Q1 2003	1	77	148
Q2 2003	2	164	695
Q3 2003	9	733	3,065
Q4 2003	17	1,049	4,350
Q1 2004	13	2,721	10,575

Source: National Venture Capital Association and Venture Economics

Buyout funds have also been actively generating exits for investors, though the buyers of these portfolio companies are often other buyout firms. A good example of this phenomenon is Sealy Mattress, which was sold by Bain Capital to KKR in the first quarter. Strategic investors are still in the market for acquisitions as evidenced by FedEx's purchase of Kinko's from Clayton Dubillier & Rice. The overall liquidity trend has given a boost to older funds as well as secondary funds that purchase mature fund interests from limited partners.

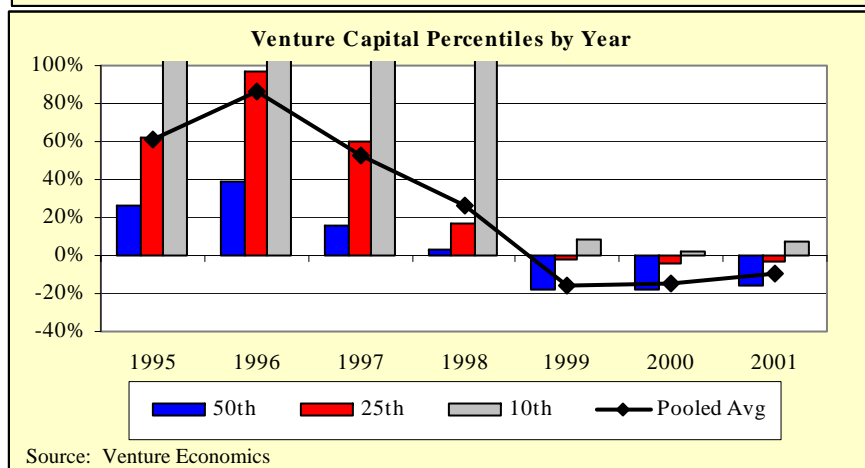
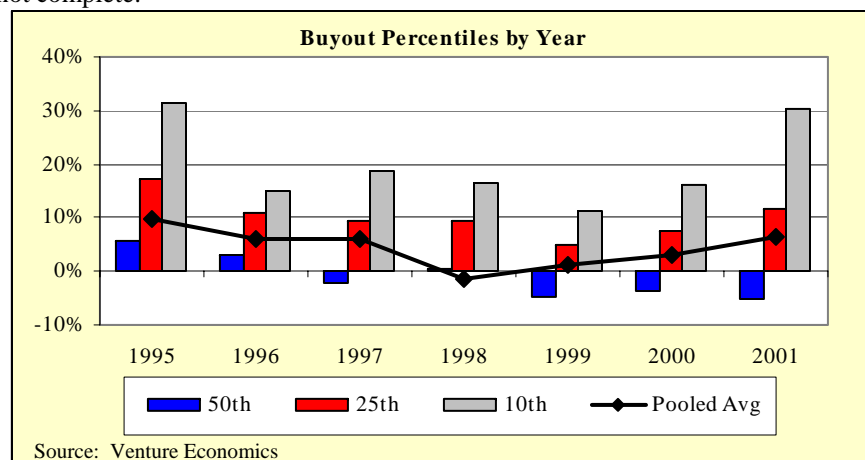
Returns

Looking at vintages of buyout funds since 1995, 1995-1998 buyout funds' returns are well below the levels anticipated at the time of investment. The median IRRs from these vintage years are 5.8%, 2.9%, minus 0.2%, and 0.6% respectively, as of 12/31/03, which is a modest improvement over the 6/30/03 numbers. Prices for companies in these funds were bid up along-side the rising stock market of the period. These deals were then structured with too much leverage provided by banks and the high-yield debt market. Many buyout investors also decided to opportunistically pursue new-economy growth investments, and some even began venture capital funds seeded with buyout fund capital. It was a bad time to lose one's value discipline. Recent increases in buyout transaction valuations have us concerned that fund managers have not learned their lessons on valuation, though we are not seeing the style drift of the earlier period.

The 12/31/03 IRRs for the median, 25th percentile and 10th percentile returning Buyout Funds (including Mezzanine) and Venture Capital funds from vintage years 1995-2001 are below. Overall, we are seeing about 2% increases in the returns at

each break point of the Venture Economics buyout fund universe. The venture capital fund median vintage year returns for the late 1990s are improving, but negative returns will generally improve as time will drive those returns closer to zero. Even though the top quartile funds had truly exceptional returns over this period, 1995 and 1996 were the only years where the median venture capital fund returned over 20%. 1998 venture capital funds were generally disappointing, though the surviving companies (such as Google) are poised to provide some lift to those funds.

Venture Economics tracks the performance of private equity funds, but does not have access to return data for all funds. Comparing fundraising data from The Private Equity Analyst and returns from Venture Economics, it appears that Venture Economics is tracking less than half of the fund universe. While the data is useful, it is not complete.



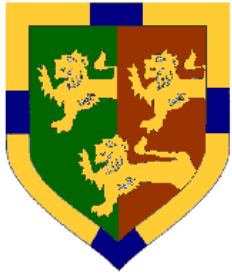
A Short Rant...

The fund of funds arena should provide the greatest level of transparency when marketing a new fund to institutional investors. After all, these are people who review other peoples' funds for a living. They should understand better than anyone the level of disclosure required to assess the quality of an investment proposal. Unfortunately, it is one of the most frustrating groups of managers with which we deal.

The most basic proof statement one can provide a potential investor is a track record demonstrating prior success. It is surprising how many fund of funds managers successfully raise capital from institutions based on broad themes, the potential high returns from the asset class, and generally good marketing.

Too many times, we are asked to review a fund of funds vehicle where the general partner has asked for the discretion to make direct investments or co-investments without presenting a viable track record to support such a proposal. Some of these direct investment allocations also lack concrete investment guidelines for diversification or other common investment limitations. If a private equity fund approached one of these fund of funds managers with a similarly vague and poorly supported investment thesis, they would be rejected outright. I do not understand how a fund of funds manager can fail to grasp the contradiction.

*Michael J. Forestner, CFA
Director of Alternative Investments*



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