

HAMMOND ASSOCIATES

INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

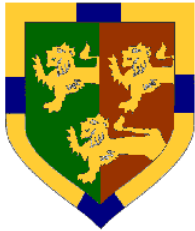
Third Quarter 2004

In this report . . .

- ✓ The Implications of \$50 Oil
- ✓ Headwinds for Consumer Spending
- ✓ Value Stocks Aren't Such a Good Value, and Neither Are Small-Caps
- ✓ Are Investor Expectations for Hedge Funds Reasonable?

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-

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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* – S&P/Citigroup High Yield Bond, *Inflation-Protected Bonds* – Lehman TIPS, *REITS* – Dow Jones Wilshire REIT, *Cash* – Citigroup 3-Month T-Bill



Hammond Associates Research Note

Liabilities and Endowment Management

September 2004

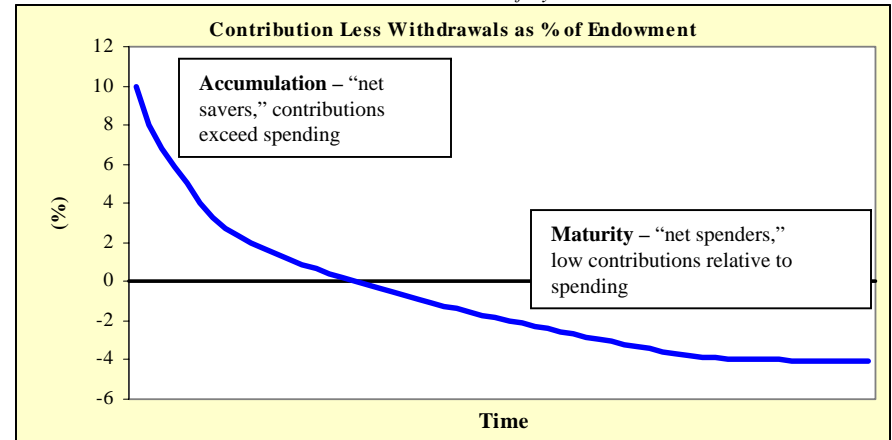
The damage done to pension plans' funding levels due to the bear market incurred for equities and lower interest rates has raised plan sponsors' awareness of liability management over the past few years. There has been far less attention given to this issue by endowment and other not-for-profit fund managers. Indeed, liability management is usually less important for such plans because future liabilities are amorphous. Pension plans are obligated to pay promised benefits and those benefits are measurable. Conversely, endowment funds can alter spending based on future circumstances. This flexibility of future spending makes it difficult to evaluate liabilities. Nevertheless, considering liabilities is a constructive exercise. It can help fund officers gain insight into risk tolerance for an institution, which ultimately could affect the asset allocation decision.

Investment Horizon for Endowments

Most endowments are expected to exist in perpetuity, and, therefore, can be thought to have an infinite time horizon. However, they should not necessarily invest that way because of spending. The fact that an endowment is a net withdrawer of capital (or will be at some point in the future) means that the investment horizon for an endowment is *not* infinite. For example, barring new gifts, an institution with a \$100MM endowment that spends \$5MM per year that *must* increase with inflation, will spend the average dollar of current market value within 15 years in present value terms. Considering the investment horizon may help to understand an institution's risk tolerance. The investment horizon for an endowment will vary based on a number of underlying factors.

One factor in the investment horizon for an endowment is its lifecycle position. As with individual investors, endowments have a lifecycle and where they are in the lifecycle should affect the risk tolerance. Like a young worker, an institution with a small endowment that is aggressively raising money is a "net saver." The money currently in the endowment is less important because future expected contributions are high. For such funds, the investment horizon is very long. It may be several years before the expected contributions fall below the spending level. Therefore, risk tolerance could be higher. A significant decline in the market is a lesser risk because on a net basis, money is not withdrawn at distressed prices. In fact, a market decline could be viewed as a positive because future contributions will be invested at more attractive prices.

Exhibit 1: Endowment Lifecycle



As a fund's balance grows, it becomes more difficult to continue to raise contributions at the same percentage rate, so eventually the spending rate will exceed the endowment contribution rate. When contributions become a fraction of annual spending, the endowment enters its mature phase. In the mature phase, year-to-year market volatility is more important than before since the endowment is a "net spender." If the market falls, securities must be sold to meet spending needs. Since market risk has a greater affect on mature endowments, they have a shorter investment horizon and should have lower risk tolerance.

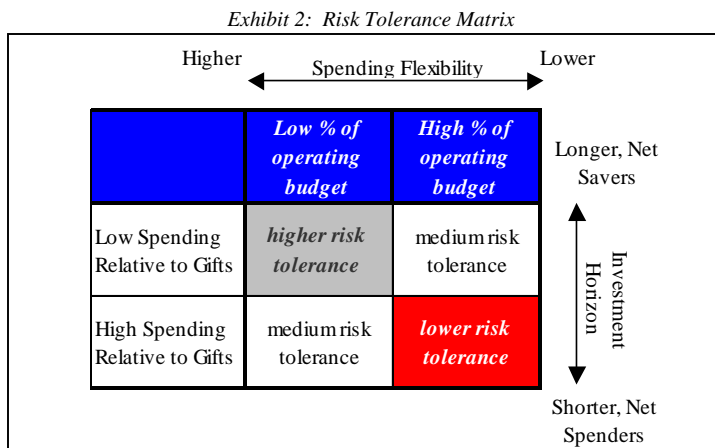
A second factor that should be considered when establishing risk tolerance is spending flexibility. If there is a significant decline in the endowment's value because of market losses, to what extent can dollar spending be cut? The ideal spending flexibility would be an endowment that could choose not to spend during periods of poor market performance so securities never have to be sold at distressed prices. Of course, this goes against the purpose of endowments—to provide a fairly predictable stream of income to the supported institution.

Spending flexibility will depend on each institution's specific situation. One way to assess spending flexibility is the annual contribution of the endowment to the operating budget. An endowment that contributes a small percentage to the operating budget is probably better able to reduce dollar spending (to keep the spending rate level) during severe market environments. Therefore, they could have higher risk tolerance. An endowment that contributes 20% or more to the operating budget (such as for several large, independent universities) would probably find it difficult to materially lower dollar spending during adverse market environments, which means that spending rates must increase at the worst time. Such institutions should have lower risk tolerance.

The spending rate should also affect risk tolerance, especially for institutions that have low spending flexibility. For instance, given a 25% decline in an endowment's

value due to market losses, an institution with an initial 3% spending rate would have to increase the spending rate to 4% to keep dollar spending constant. A 4% spending rate is still very reasonable. An institution with a 5% initial spending rate, however, would have to increase the spending rate to 6.7% to keep dollar spending constant. At a 6.7% spending rate, purchasing power becomes difficult to maintain.

Exhibit 2 integrates these ideas in a grid. An institution with high spending flexibility (low contribution to operating budget) and a low spending rate relative to gifts should be more willing to take investment risk than an institution with low spending flexibility (high contribution to operating budget) and a high spending rate relative to gifts.



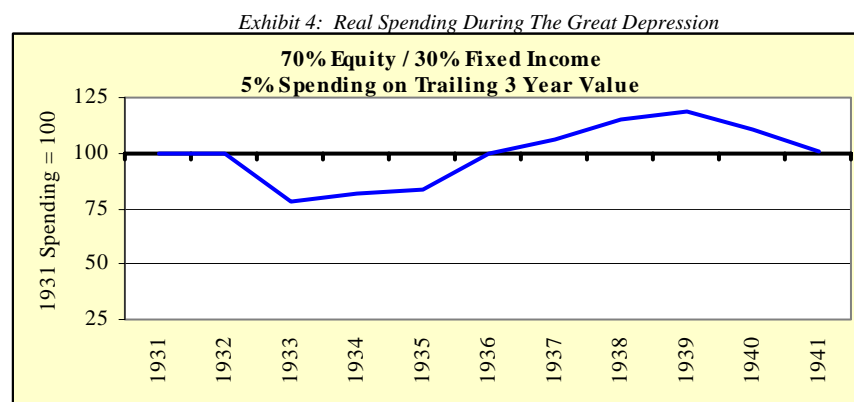
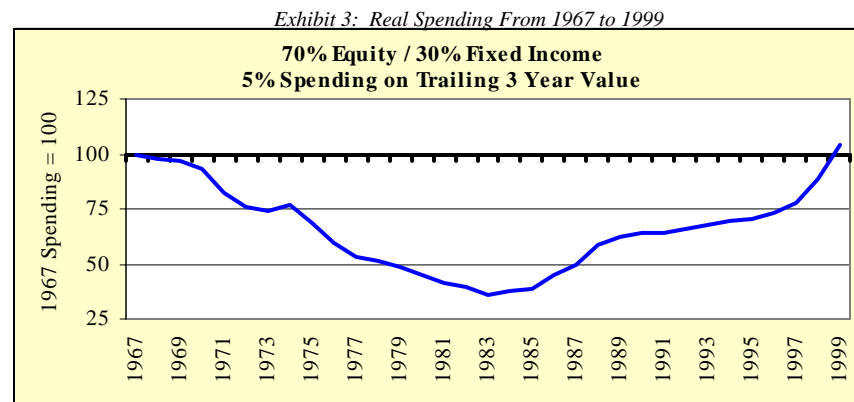
Considering liabilities poses a “Catch-22” for institutions. **As the spending rate increases, the need to take risk increases, while the ability to take risk declines.** Institutions with a low spending rate relative to gifts are in the position to take greater risk, but may not have a compelling reason to do so. Institutions with a high spending rate and low contribution rate may feel the pressure to take on additional risk to maintain purchasing power. However, they are often in the worst position to take risk, especially if they have low spending flexibility. If market returns meet expectations, everything works out, but a brutal bear market can raise the spending rate to an unmanageable level.

Liability Risk: Inflation Versus Deflation

Liabilities, and the ease by which they are met, are largely affected by future price levels. For pension plans, inflation can be positive (provided there is no cost of living adjustment). Future fixed obligations will be easier to meet because money is worth less. (Of course, inflation is bad for the plan beneficiaries.) Deflation can be debilitating for pension plans, because it becomes harder to meet nominal obligations (future money is worth more).

For endowments, the situation is opposite. Inflation is a significant risk for endowments because costs for the institution will increase, requiring ever larger distributions from the endowment to keep services the same. Deflation is positive in some ways, because it reduces cost pressures on the budget, and distributions from the endowment go further. Admittedly, this view is too simplistic in many respects. However, we believe it is reasonable to assume that inflation is a larger risk for most endowments than deflation when liabilities are considered. For this reason, endowment investments should be tilted towards assets that protect against inflation.

Comparing real spending in the 1930s to the 1970s illustrates the impact of deflation versus inflation. As shown Exhibit 3, an institution with a 70% equity and 30% fixed income portfolio with a 5% spending rate (on a trailing 3 year market value) would have seen the real value of its endowment spending drop by 65% from 1967 through 1983. The institution had to wait until 1999 to reach the real value of 1967 spending again. The Great Depression was comparatively mild because of deflation. The real value of spending declined by only 21% from 1931 through 1933 and completely recovered by 1936, as shown in Exhibit 4.



Investment Implications

Considering liabilities when constructing the asset allocation could lead to a more appropriate portfolio for an institution. We outlined two themes to bear in mind when constructing an asset allocation—(1) investment horizon and (2) inflation protection.

For the investment horizon, institutions with a short investment horizon (high spending rate relative to gifts and low flexibility) should have lower exposure to equities because they exhibit greater risk and favor assets that dampen volatility of the portfolio. Of course illiquid alternative investments pose even more risk. Because the investments are locked in, a decline in traditional assets would put added pressure on spending maintenance, since a portion of the portfolio is off limits (beyond what is received in distributions). Institutions with a longer investment horizon (low spending relative to gifts and high flexibility) are better able to withstand the volatility inherent in equity investing.

With respect to inflation protection, unexpected inflation is likely to be more damaging to endowments than unexpected deflation. For this reason, portfolios should be constructed to provide inflation protection, regardless of the investment horizon. Inflation-protected bonds are more attractive than nominal bonds for this reason. Exposure to other real assets, such as real estate and natural resources (oil & gas and timber), is beneficial for inflation protection. Equity investments also offer good protection against inflation over the long-term because earnings power increases with inflation, but they are a poor short-term hedge against inflation (witness the 1970s).

In Exhibit 5, we show three sample portfolios for institutions with different investment horizons, plus the average NACUBO portfolio. Asset classes are divided into three broad categories—(1) growth assets, (2) risk reduction assets, and (3) inflation protection assets. Growth assets include public and private global equities, which we expect to provide high total returns over the long-term. These assets should also provide inflation protection over the long-term. The risk reduction assets include absolute return strategies and nominal bonds. Their purpose is to reduce the standard deviation of the portfolio, thereby reducing the year-to-year spending volatility. The inflation-protection assets include inflation-protected bonds and real assets (real estate, natural resources, etc.). They are meant to provide protection against secular inflationary environments, such as experienced in the 1970s.

As expected, of the three portfolios shown, the lower risk tolerance portfolio has the lowest standard deviation, the lowest probability of a substantial loss year (greater than a 10%), and a better lowest likely return than the higher risk tolerance portfolio. Of course, the lower risk tolerance portfolio gives up nearly 1% in expected return over the long-term versus the higher risk tolerance portfolio.

Exhibit 5: Asset Allocation Expectations

	Lower Risk Tolerance	Medium Risk Tolerance	Higher Risk Tolerance	NACUBO Average
	A	B	C	D
Growth Assets				
Public Equity	25%	33%	40%	58%
Private Equity	10%	12%	15%	2%
Total Growth Assets	35%	45%	55%	60%
Risk Reduction Assets				
Cash				6%
US Fixed Income	15%	10%	5%	26%
Absolute Return	15%	15%	15%	6%
Total Risk Reduction Assets	30%	25%	20%	38%
Inflation Protection Assets				
US Inflation Protected Fixed	15%	10%	5%	2%
Real Assets	20%	20%	20%	
Total Inflation Protection Assets	35%	30%	25%	2%
Total	100%	100%	100%	100%
Return				
Real Long-Term Expected Return	6.2%	6.6%	7.1%	5.2%
Real 10 Yr. Horizon Return (Mean Reversion)	5.1%	5.4%	5.8%	3.0%
Risk (L/T Expectations)				
Standard Deviation (1 Yr.)	±9.1%	±10.5%	±12.2%	±11.0%
Probability of Loss Year	23.5%	24.9%	26.1%	30.0%
Probability of 10% or Worse Loss	3.4%	5.2%	7.2%	7.5%
Lowest Likely Return (1 Yr.)	-14.5%	-17.3%	-20.5%	-19.8%
Sharpe Ratio	0.46	0.44	0.42	0.29
Downside Probability at 5.0% Goal Return				
Based on L/T Compound Return (10 Yr.)	34.0%	31.2%	28.9%	47.7%
Based on 10 Yr. Horizon Return (10 Yr.)	49.0%	45.6%	42.1%	71.3%

Conclusion

We have outlined a framework for endowments and other not-for-profit institutions to consider liabilities when constructing their asset allocation. When considering liabilities, investments in inflation-sensitive assets become more important. Furthermore, institutions with high spending rates relative to gifts and low spending flexibility should be more cautious about taking risk in their asset allocation. This leads to a conundrum for such institutions—unless they take risk, they will be unable to meet their goal returns. For those institutions, the problems are better addressed on the spending side, rather than gambling on the investment side.

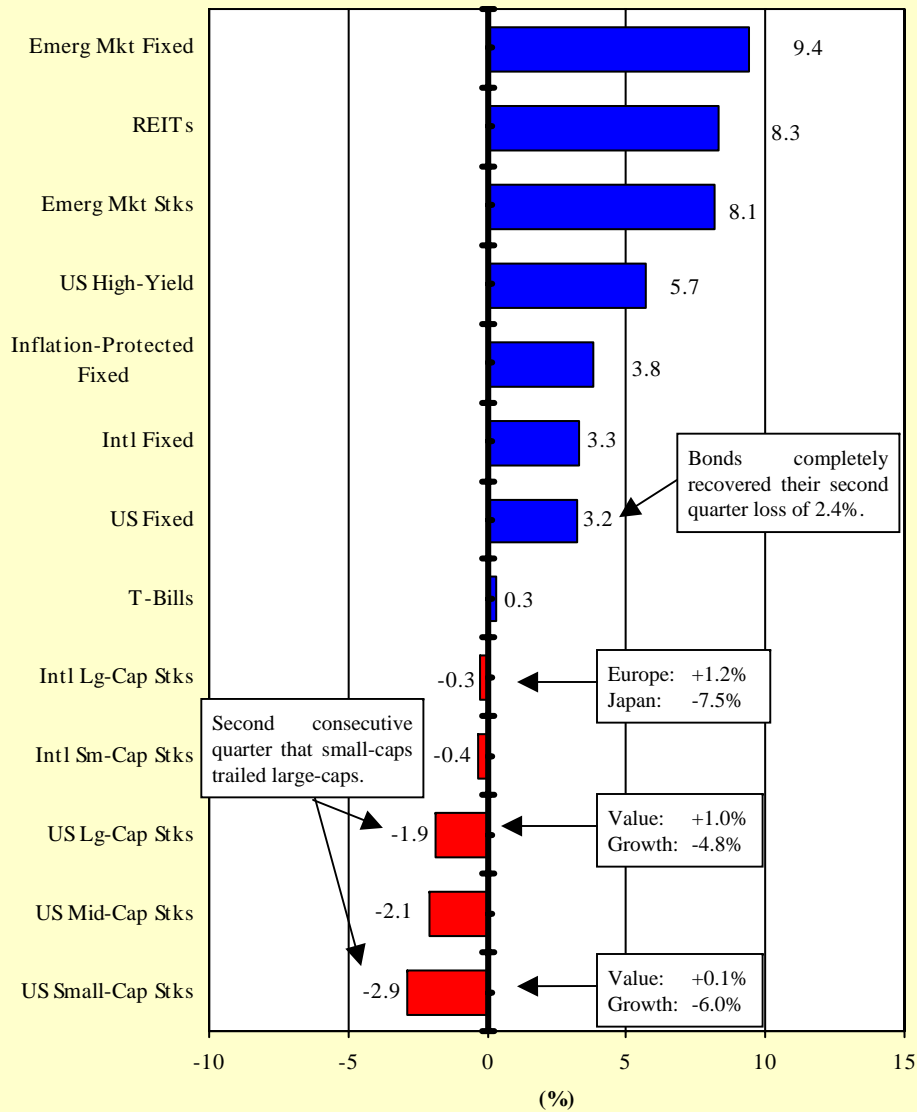
Anthony Brown, CFA
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Third Quarter Executive Summary

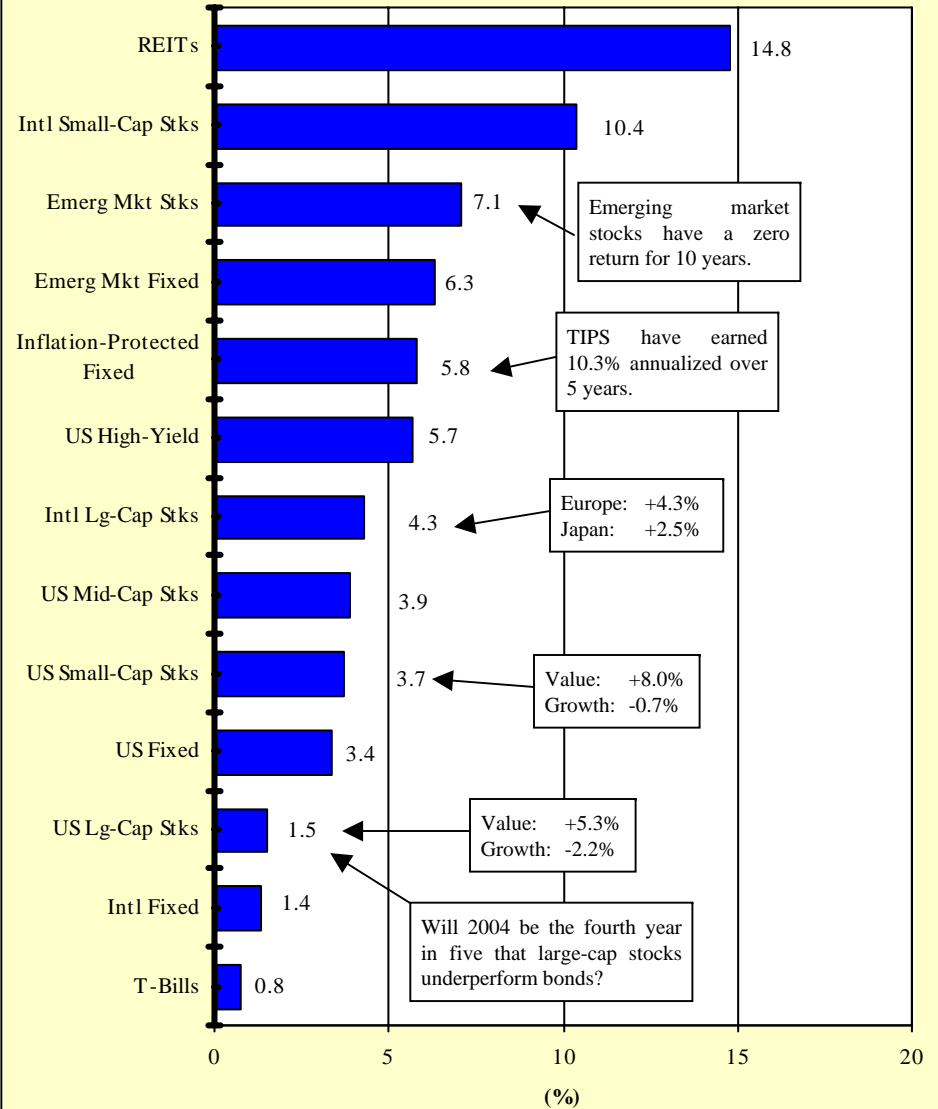
- The S&P 500 declined 1.9% in the third quarter, reducing the year-to-date return to 1.5%. Emerging market bonds, REITS, and emerging market stocks were the best performing asset classes during this three month period, gaining 9.4%, 8.3%, and 8.1%, respectively. Despite a tightening Fed, US fixed income gained 3.2%.
- The economy grew at a slower than expected 3.3% annualized rate during the second quarter. The job market was soft in the third quarter, as the economy added an average of only 103,000 jobs per month. Economists polled by *The Economist* expect 2005 growth of 3.4%.
- Oil prices surged from \$37 to nearly \$50 per barrel during the third quarter. If the price stays high, energy costs are sure to weigh on the economy as consumers will have less for discretionary spending and business costs will increase. On the surface, however, it does not appear that high oil prices will send the economy into a recession. Energy consumption's share of GDP is considerably lower today than at the time of prior shocks. However, with the imbalances in the global economy, there remains potential for unanticipated consequences.
- Growth in consumer spending was unexpectedly weak in the second quarter. The tailwinds of tax cuts and cheap money are fading. In the coming years, households will have to face headwinds from the economic imbalances that have been exacerbated by the Fed's ultra-accommodative policy. With consumer spending representing 70% of the economy, slow consumer spending growth will mean slow economic growth.
- The third quarter brought surprises from the bond market. As expected, the FOMC raised the Fed Funds rate by 0.25% at both meetings in the third quarter. Contrary to expectations, intermediate and long-term interest rates declined. In a long-term historical context, current yields on bonds appear reasonable. Bond markets still don't seem particularly concerned about inflation as evidenced by the modest breakeven rate priced into TIPS. We still prefer TIPS relative to nominal bonds.
- Despite the dollar correction over the past three years, the current account deficit continues to worsen. High oil prices are likely to help push the current account deficit to more than 6% of GDP in 2005. The dollar needs to fall substantially further to reduce this imbalance. The question now is whether Asian countries (particularly China) will play their role in dollar devaluation or if Europe will continue to bear the pain.
- Stocks are still priced at lofty levels. Based on our normalized P/E ratio, stocks are trading at a multiple of 24, which is 50% above the historical average. They are priced to provide about a 2% risk premium versus long-term TIPS. The Presidential election cycle suggests that 2005 may be a difficult year for the market.
- Value stocks continue to outperform growth stocks. The heavy weight to financials makes value indexes appear vulnerable, especially if there is a major credit mishap. Current valuations suggest that small-caps offer only a modest return premium to large-caps. We estimate that the advantage for small-caps will be less than 0.5% over the next ten years.
- International stocks, particularly in emerging markets, still offer more attractive valuations than US stocks. Coupled with our expectations of a weaker dollar, we expect international stocks to continue to outperform stocks.
- Hedge fund returns were flat to slightly positive in the third quarter, with the HFR Fund of Funds index gaining 0.3%. Despite tepid performance in many strategies year-to-date, money continued to pour into hedge funds. With an estimated \$250 billion of institutional money flowing into hedge funds over the next 5 years, it is unlikely that average future returns from hedge funds will meet investor demands.

Emerging Markets and REITS Return to Favor

Third Quarter 2004 Performance (%)

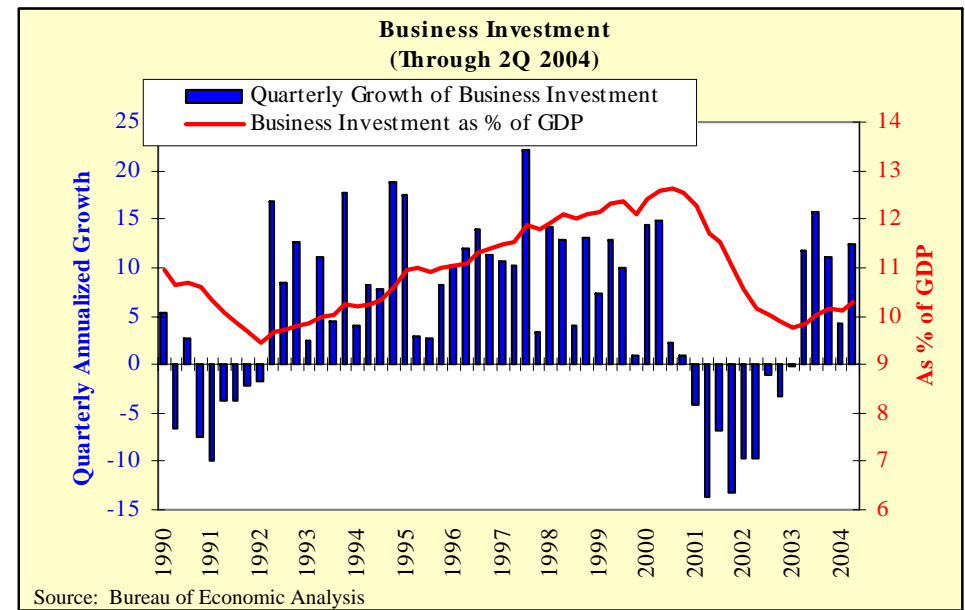
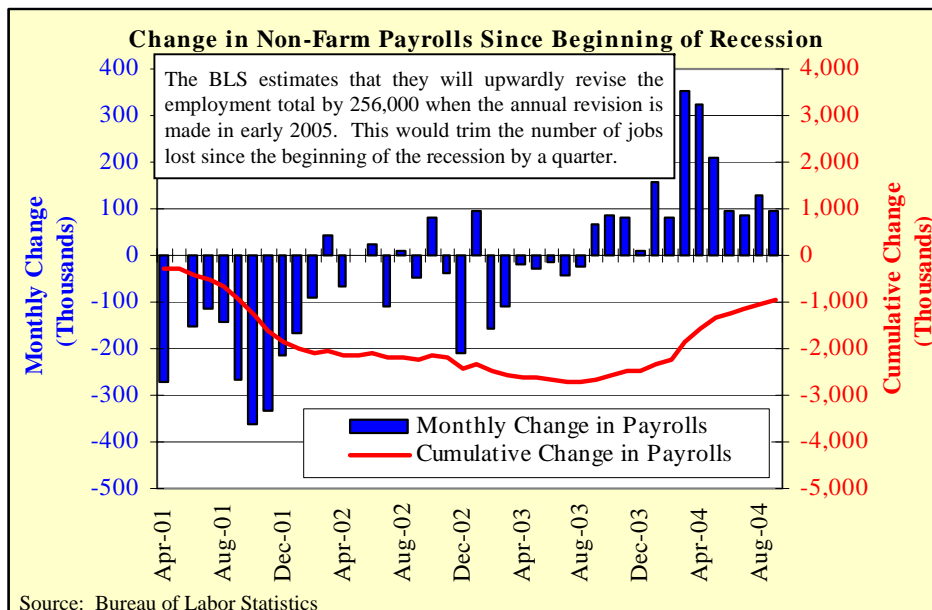
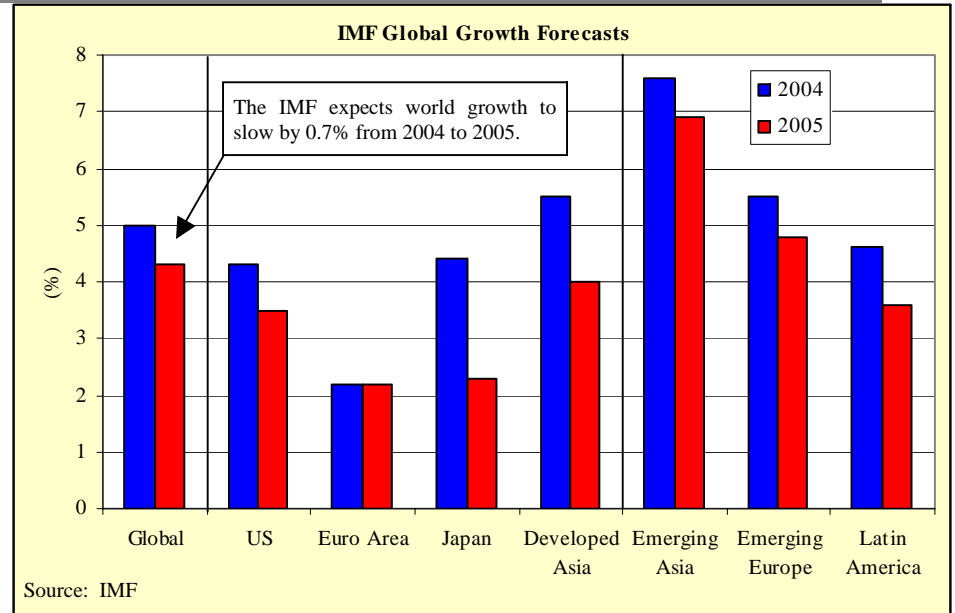


Year-to-Date 2004 (%)



The Economy Hits a “Soft Patch”

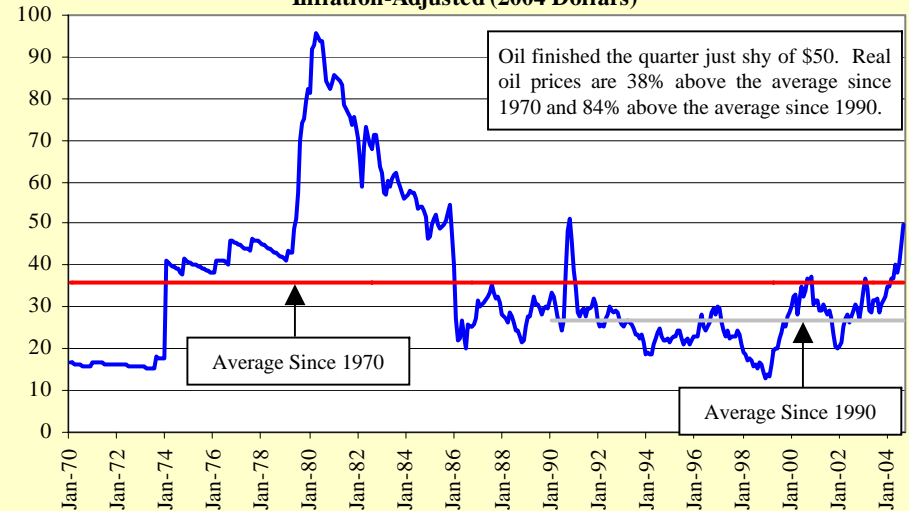
- The economy grew at a slower than expected 3.3% annualized rate during the second quarter. Slow growth in consumer spending was the leading cause of the disappointment. However, growth likely improved in the third quarter. Economists expect the third quarter GDP data release to show 4% growth.
- Businesses still seem very cautious in this recovery. The job market was soft in the July to September period, as the economy added an average of only 103,000 jobs per month. This is less than the 150,000 jobs economists say are necessary to absorb new entrants. Business investment continues to improve, but the absolute level is still depressed.
- Economists polled by *The Economist* expect 2005 growth of 3.4%. In our view, there is downside risk to this forecast because of the precarious state of US household finances and oil prices.



The Implications of \$50 Oil

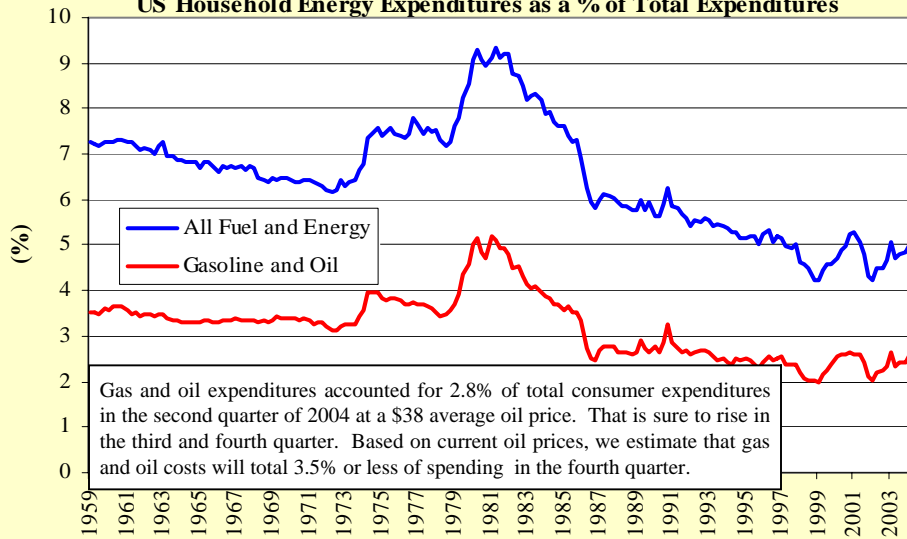
- The price of oil surged from \$37 to nearly \$50 a barrel between July 1 and September 30. One reason is that China's and other Asian countries' imports continue to rise. Other contributors include terror worries, the Russian Yukos affair, supply concerns in Nigeria, and disruption from numerous hurricanes. Demand and supply are nearly balanced, so small changes on either side will continue to cause price volatility.
- If the price stays high, it's sure to weigh on the economy because consumers will have less for discretionary spending and business costs will increase, perhaps curbing hiring and investment. Morgan Stanley cut its 2005 US growth estimate by 0.3% (from 3.8% to 3.5%) because of oil prices (which assumes prices fall to \$35 over the next year).
- On the surface, it does not appear that \$50 oil will send the economy into a recession. Energy consumption's share of GDP is much lower today than at the time of prior shocks. However, with the imbalances in the global economy, there remains potential for unanticipated consequences.

**Price per Barrel of West Texas Intermediate Crude
Inflation-Adjusted (2004 Dollars)**



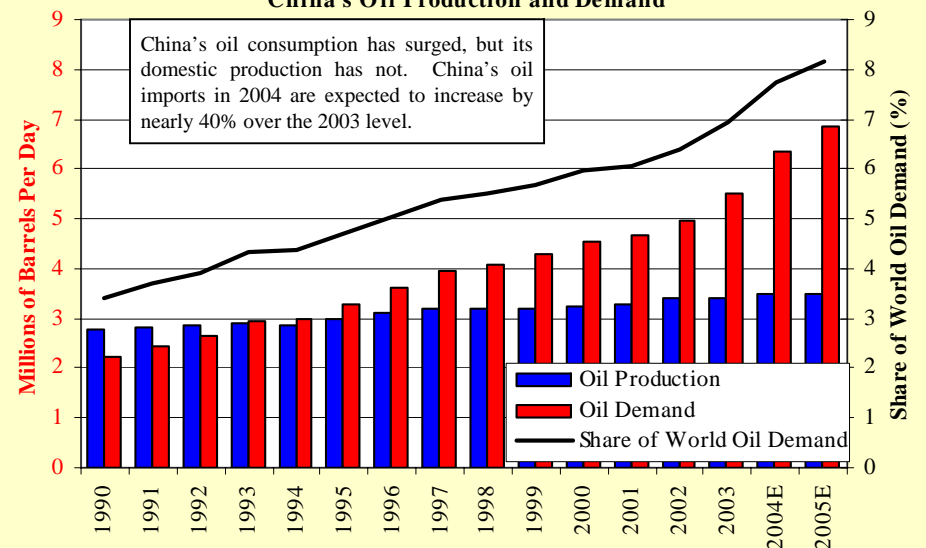
Source: Federal Reserve, Bureau of Economic Analysis

US Household Energy Expenditures as a % of Total Expenditures



Source: Bureau of Economic Analysis

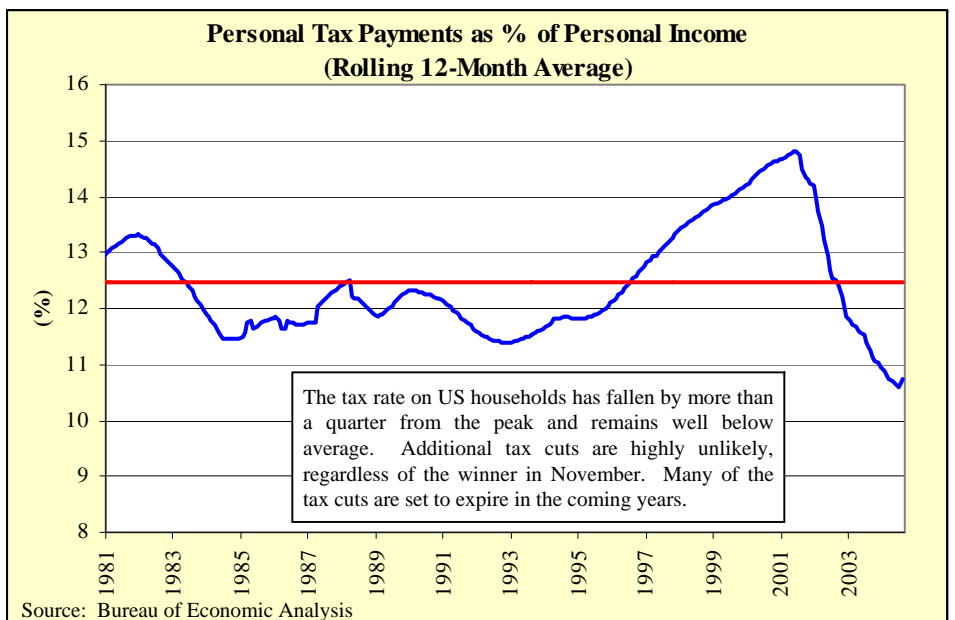
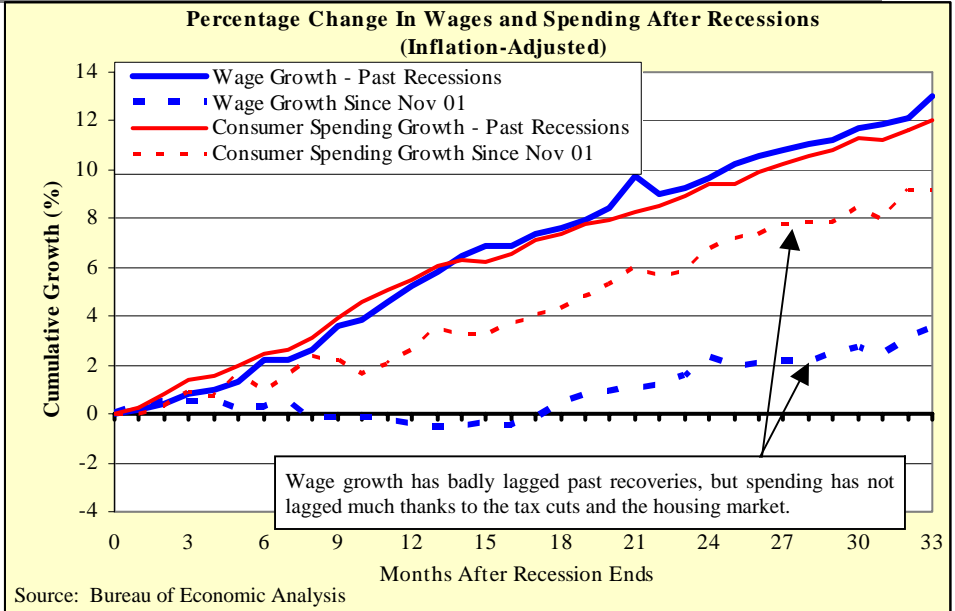
China's Oil Production and Demand



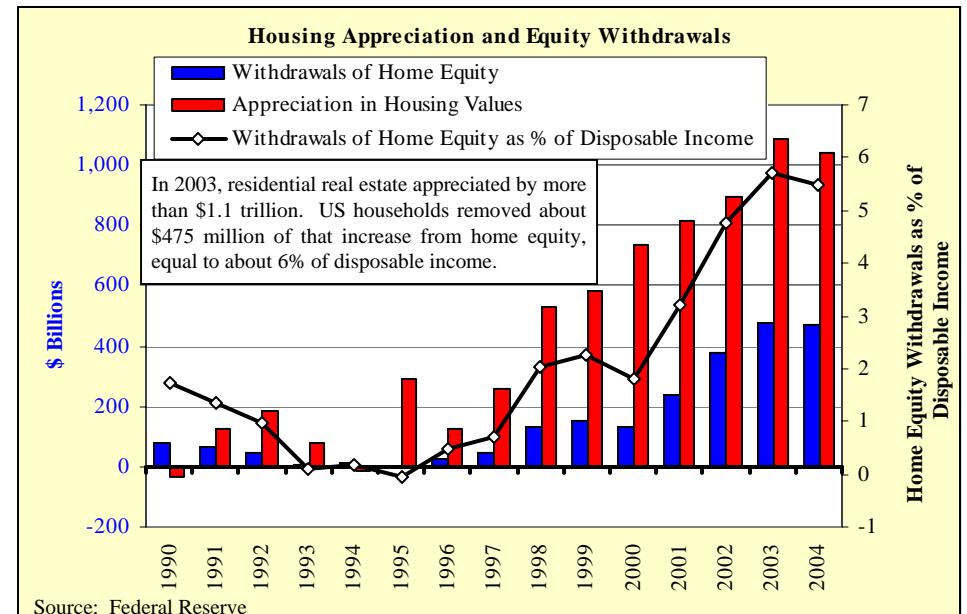
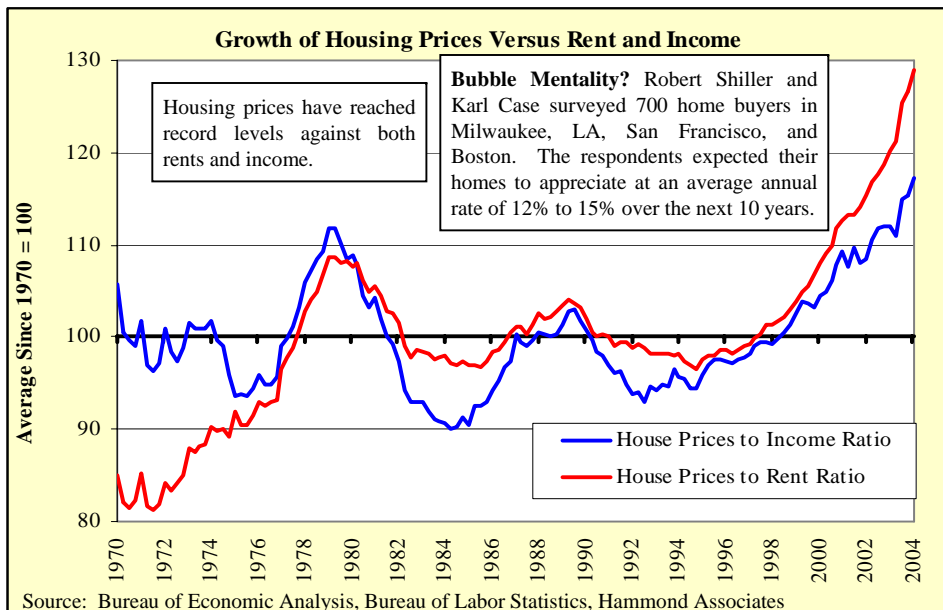
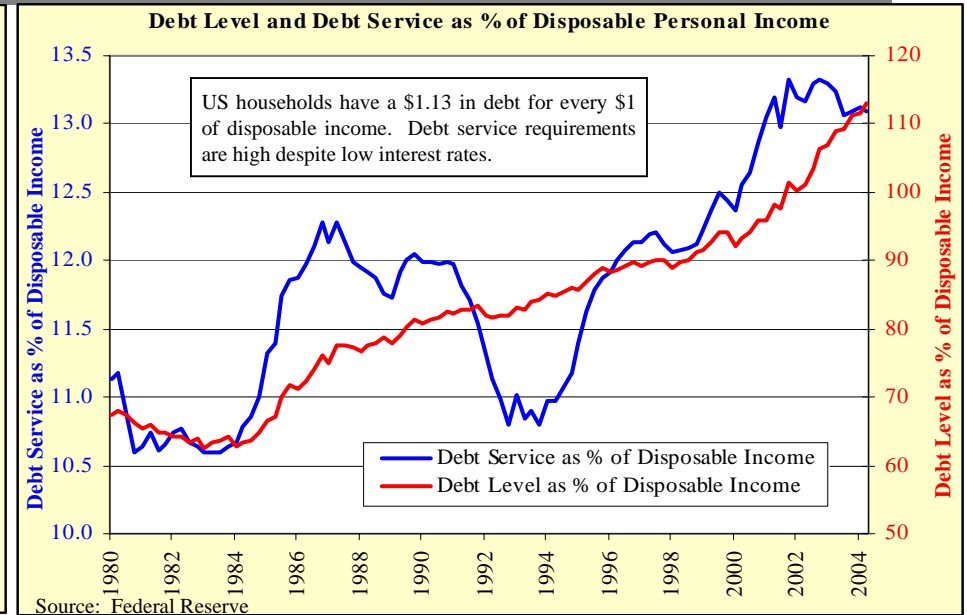
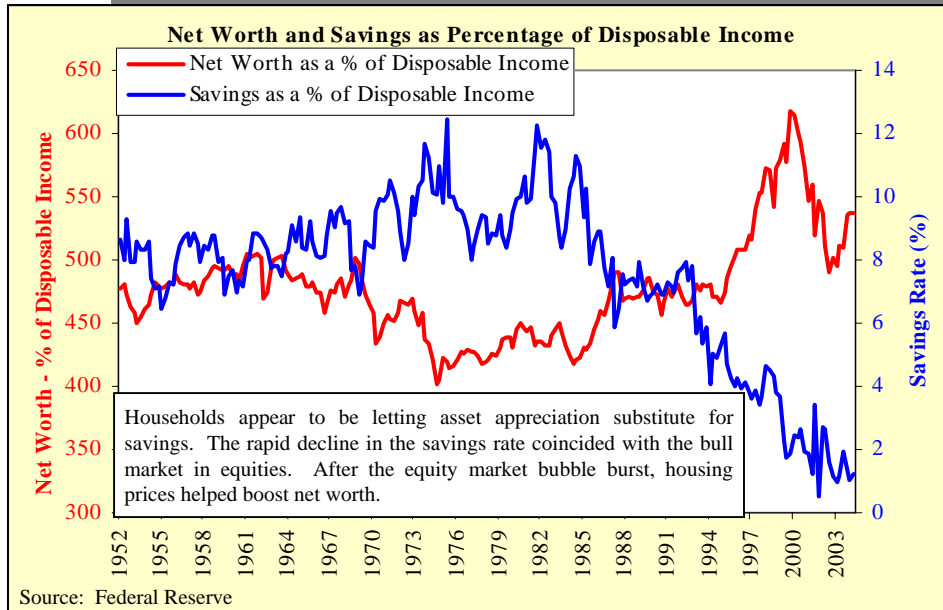
Source: International Energy Agency

Headwinds for Consumer Spending

- Growth in consumer spending was unexpectedly weak in the second quarter at 1.6%, which was the slowest rate since the second quarter of 2001. Early indications are that spending increased by more than 4% in the third quarter on incentive-induced auto sales. Still, we fear the fragile state of household finances will result in a prolonged period of slow growth.
- During this recovery, wage growth has badly lagged prior recoveries. Nevertheless, spending growth has almost kept pace with prior recoveries. Tax cuts and the Fed's accommodative interest rate policy (and resulting housing boom) have allowed consumers to continue their binge.
- The tailwinds of tax cuts and cheap money are fading. In the coming years, households will have to face headwinds from the economic imbalances that have been exacerbated by the Fed's ultra-accommodative policy.
 - ✓ The increase in short-term rates will increase already high debt service requirements. While fixed mortgage debt will be insulated from movements in short rates, floating rate debt costs will increase. CIBC estimates that a quarter of household debt will be immediately affected by higher interest rates.
 - ✓ Households have been removing home equity to support spending. Housing prices now appear dangerously high relative to income and rents. At best, the rate of growth in prices will slow considerably or stagnate. Future spending growth will have to be funded by wage growth.
 - ✓ With a savings rate of 1%, households are counting on asset appreciation to substitute for savings. Given housing and equity valuations, returns from these assets are likely to be far below households' inflated expectations. With baby-boomers approaching retirement, the savings rate is likely to make a slow march upward, which will reduce spending growth.
- With consumer spending representing 70% of the economy, slow consumer spending growth will mean slow economic growth.

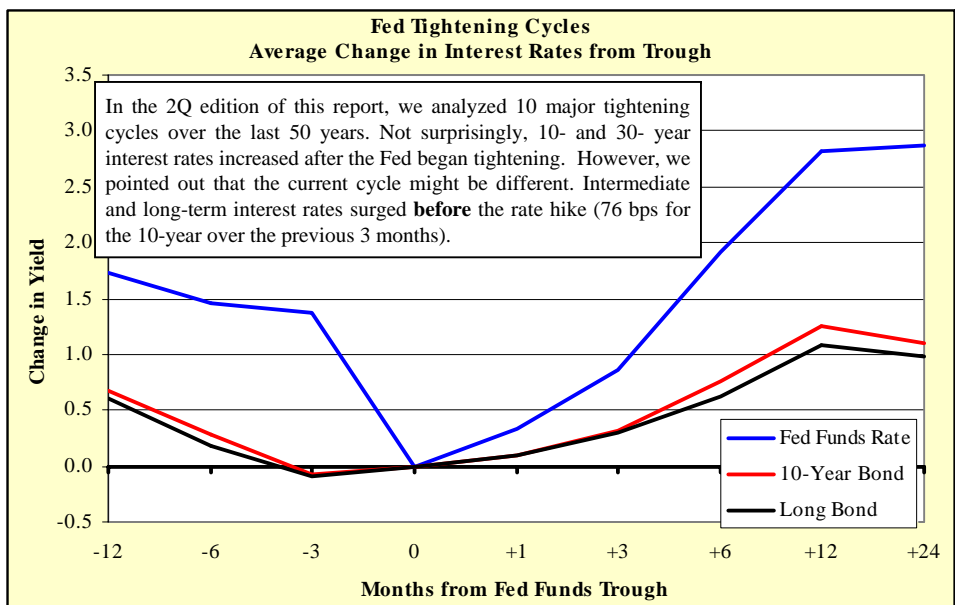
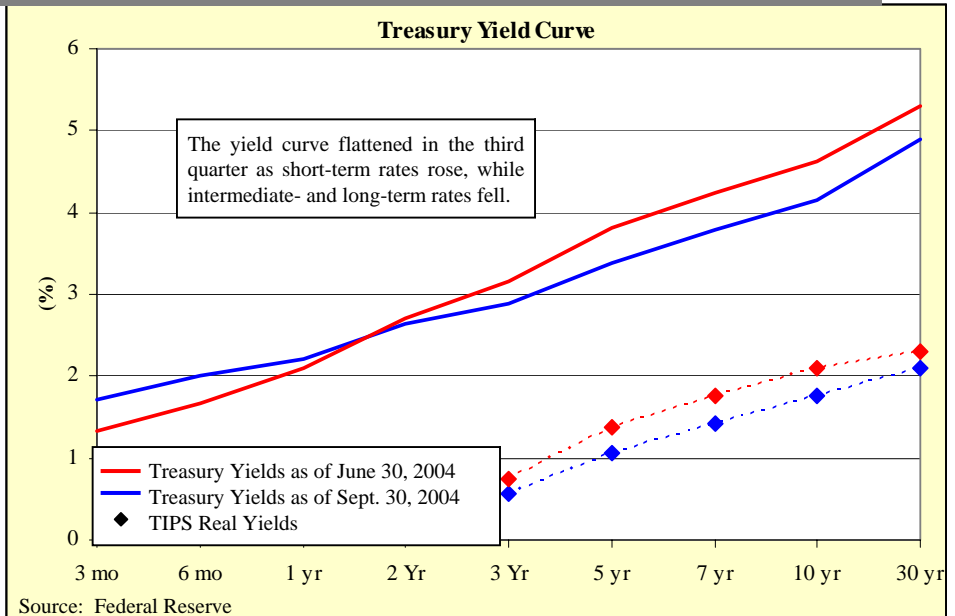


Headwinds for Consumer Spending (cont.)



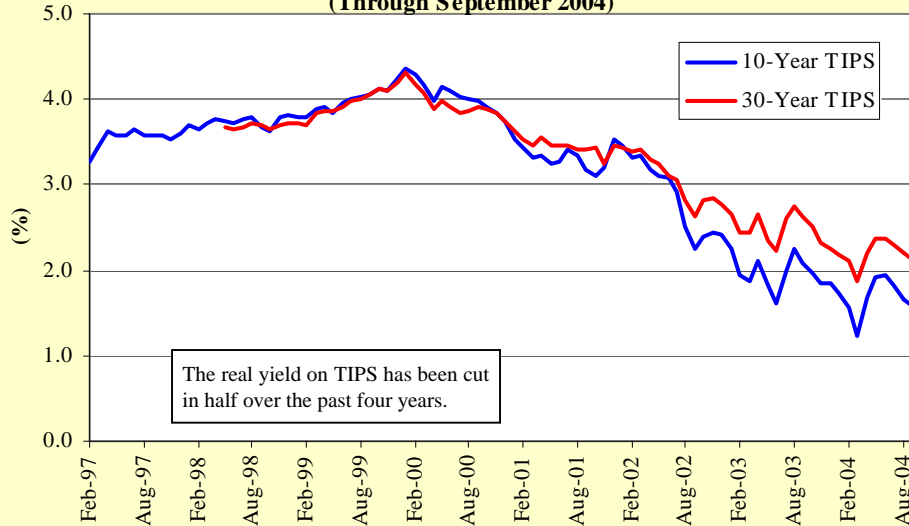
A Surprise from the Bond Market

- The third quarter brought surprises from the bond market. As expected, the FOMC raised the Fed Funds rate by 0.25% at both meetings in the third quarter. The overnight lending rate now stands at 1.75%. However, contrary to expectations, intermediate and long-term interest rates declined. The yield on the 10-year bond fell from 4.62% to 4.14%, and the yield on the 30-year bond fell from 5.31% to 4.89%.
- The decline in nominal rates was mostly driven by a decline in real interest rates, suggesting that the market expects the Fed to increase short-term rates slower than before. Of the 48 bps decline in the 10-year Treasury yield, two-thirds is attributable to a fall in real interest rates. The remaining third was due to a decline in inflation expectations. Are bonds overvalued?
 - ✓ In a long-term historical context, current yields on bonds appear reasonable. If inflation matches what is implied by TIPS, the 10-year Treasury offers a real yield of 1.8%, which remains higher than the 1.6% realized real return on long bonds since 1900.
 - ✓ Some argue that real yields are too low given current economic conditions. The savings-short economy must attract more than \$600 billion of foreign capital per year to offset the current account deficit. The high demand for foreign capital should increase the price we must pay for it, meaning that real interest rates should rise. To date, this has not been a problem because Asian central banks have been willing to lend money to us at low rates to keep us purchasing their goods.
 - ✓ Inflation remains a wild card. Bond markets still don't seem particularly concerned, as evidenced by the modest breakeven rate priced into TIPS. Given high debt loads, inflation may be an irresistible policy to reduce the real value of outstanding debt.
- While the retrenchment in interest rates is a concern, the downside risk in bond markets is a fraction of that in stock markets. We still prefer TIPS relative to nominal bonds.



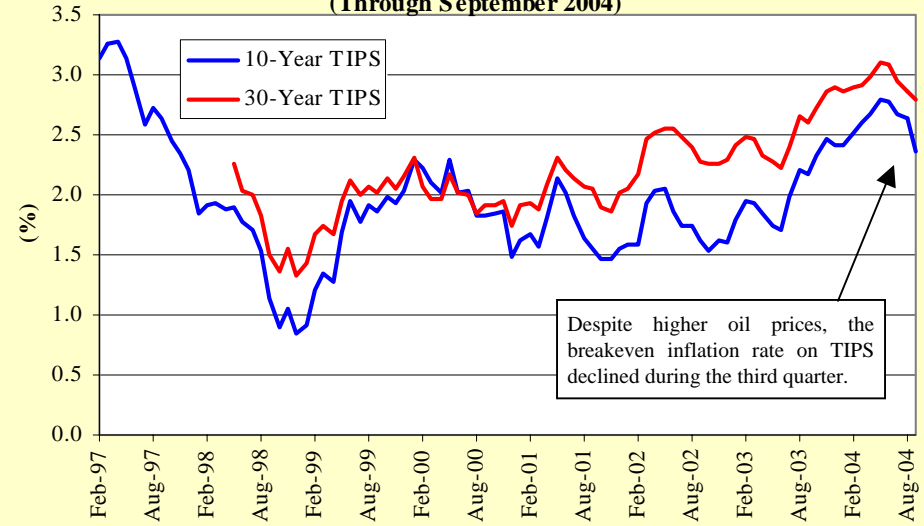
A Surprise from the Bond Market (cont.)

**Real Yields on TIPS
(Through September 2004)**



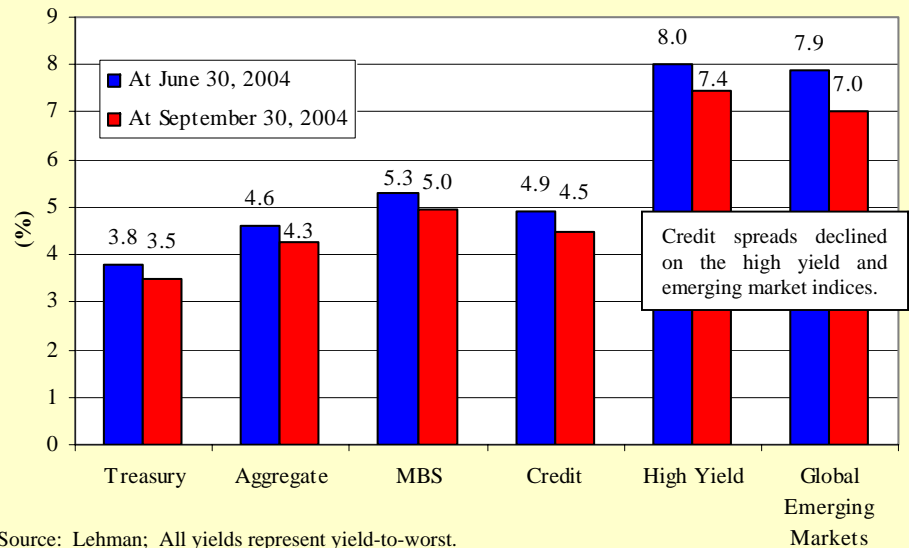
Source: Federal Reserve

**Inflation Breakeven Rate on TIPS
(Through September 2004)**



Source: Federal Reserve

Yields on Lehman Bond Indices



Source: Lehman; All yields represent yield-to-worst.

**Effect of Interest Rate Changes on 10-Year Bond Total Return
(4.25% Coupon, 8/2014 Maturity, Current YTM = 4.14%)**

Ending Yield	Total Return Over Horizon		
	1 Yr (%)	3 Yr (%)	5 Yr (%)
3.5	9.0	5.4	4.7
4.0	5.1	4.4	4.3
4.1	4.1	4.1	4.1
4.5	1.3	3.4	3.8
5.0	(2.3)	2.4	3.4
6.0	(9.1)	0.4	2.5
7.0	(15.3)	(1.5)	1.6

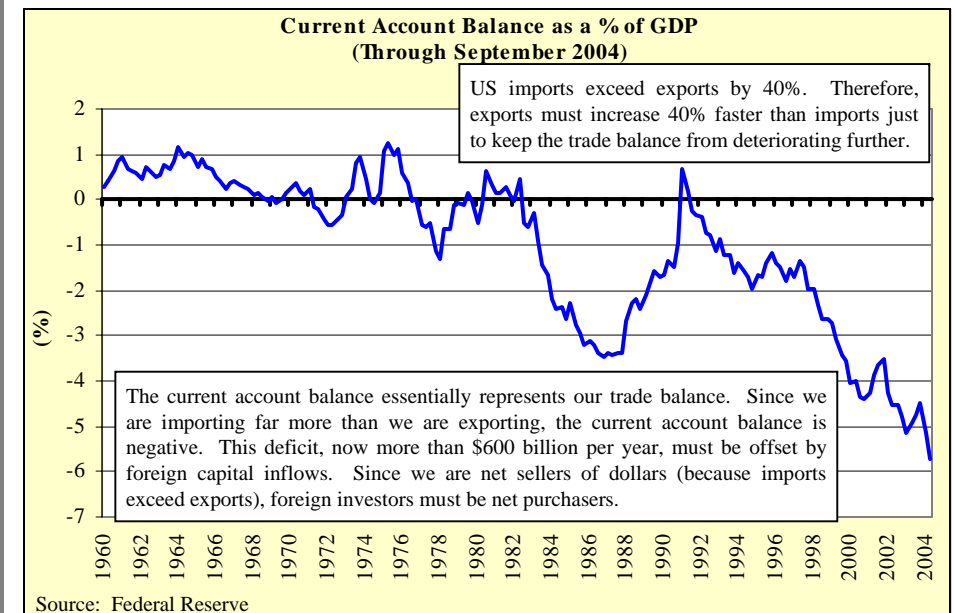
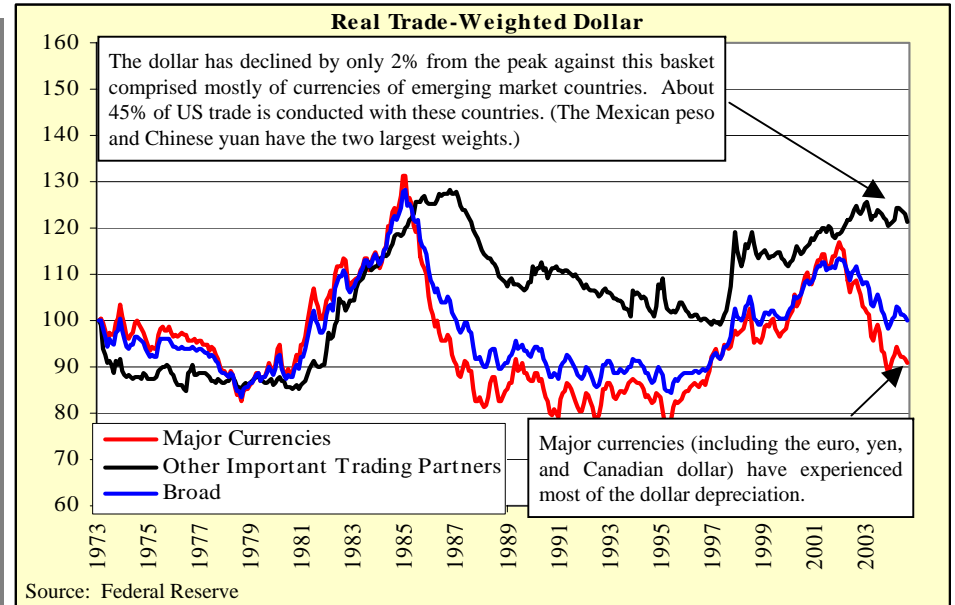
If the yield on the last issued 10-year T-Note rises to 5% over the next year from the current yield of 4.14%, the total return for the bond would be -2.3%. If the yield rises to 5% over the next five years, the annualized total return for the five-year holding period would be +3.4%.

The 10-year bond should outperform cash over the next year so long as the 10-year yield remains below 4.4%.

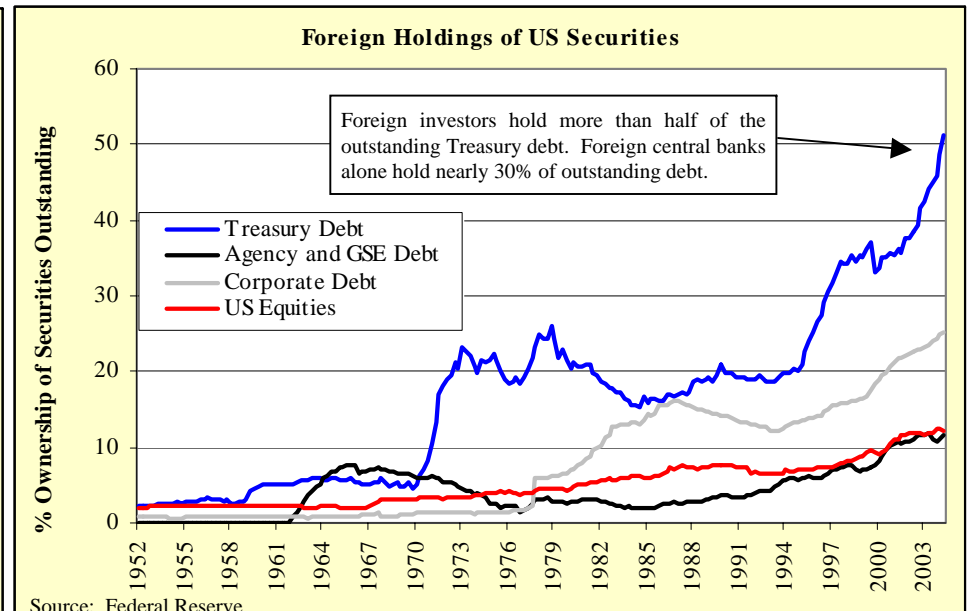
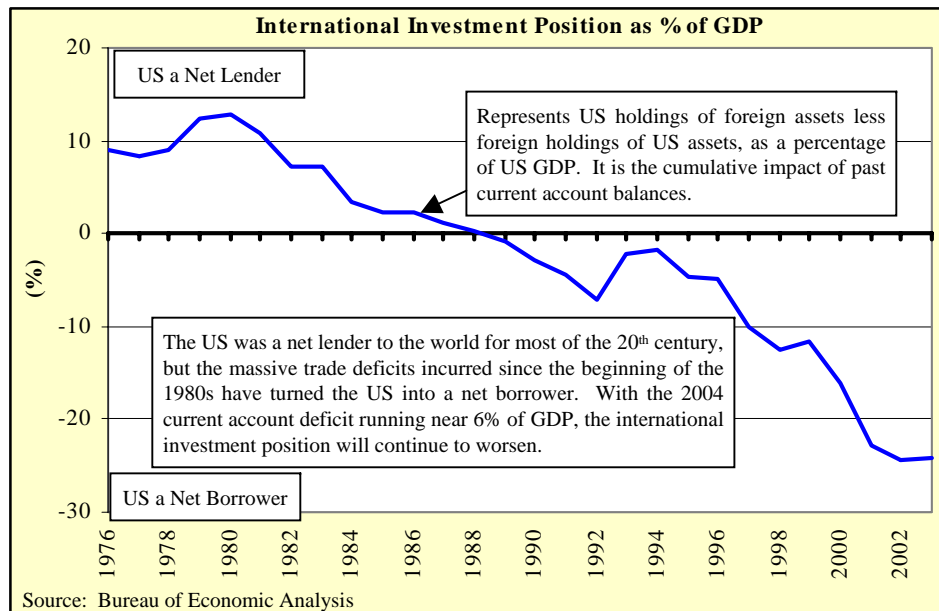
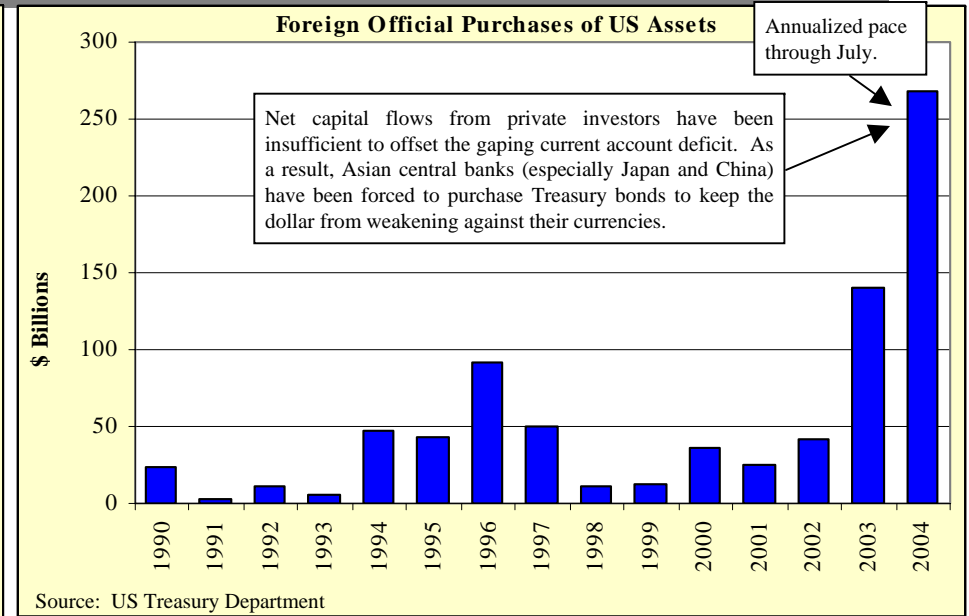
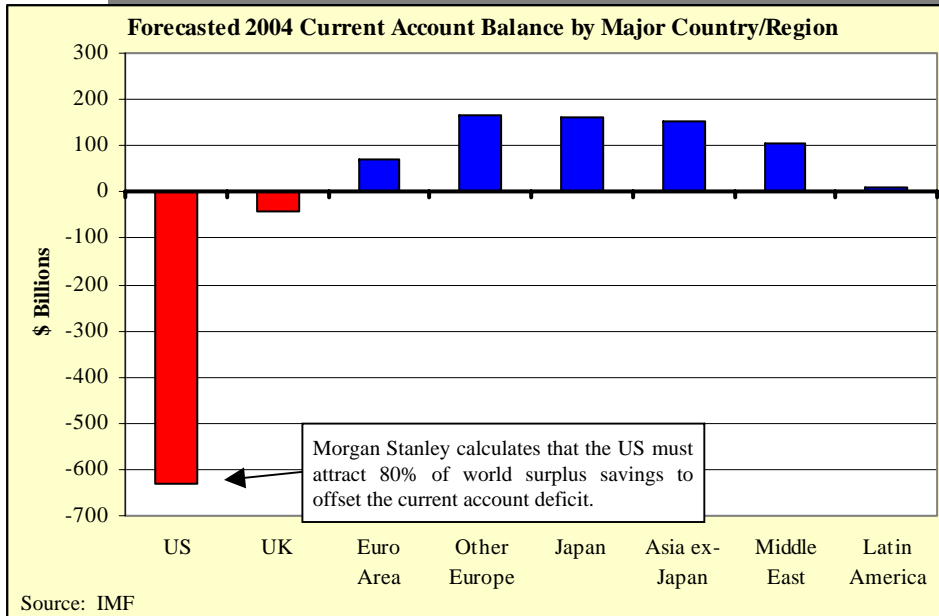
The Lehman Aggregate Bond index would change less in reaction to changing interest rates than the 10-year Treasury Bond. The 10-year bond has a duration of 8 years, while the Lehman Aggregate index has a duration of 4 years.

A Further Decline in the Dollar Seems Inevitable

- The dollar's performance was mixed during the third quarter. The dollar declined by 2.0% against the euro, but gained 0.7% against the yen. Year-to-date, the greenback is ahead 1.4% against the euro and 2.9% versus the yen.
- Since early 2002, the real trade-weighted dollar has fallen 12%. Despite the correction, the current account deficit continues to worsen. High oil prices are likely to help push the current account deficit to more than 6% of GDP in 2005. The dollar needs to fall substantially further to reduce this imbalance.
- The next round of dollar depreciation needs to occur against Asian currencies. As the current account deficit has expanded, the US has been unable to attract the necessary *private portfolio flows* to offset the deficit. To keep the dollar from depreciating, Asian *central banks* have stepped in by purchasing US Treasury bonds. Asian central banks are funding more than a third of the US current account deficit.
- China, with its dollar-pegged yuan, and Japan have been the biggest purchasers of US Treasuries. China has been willing to fund the current account deficit so US consumers will continue to purchase its exports, which in turn helps China to employ its massive work force. Other Asian economies competing with China are also keeping their currencies artificially low.
- This practice is creating dangerous imbalances in both the US and China. It has contributed to low interest rates in the US, which have encouraged higher debt levels and consumption. China's money supply is increasing rapidly, resulting in higher inflation.
- The question now is whether Asian countries (particularly China) will play their role in dollar devaluation or if Europe will continue to bear the pain.

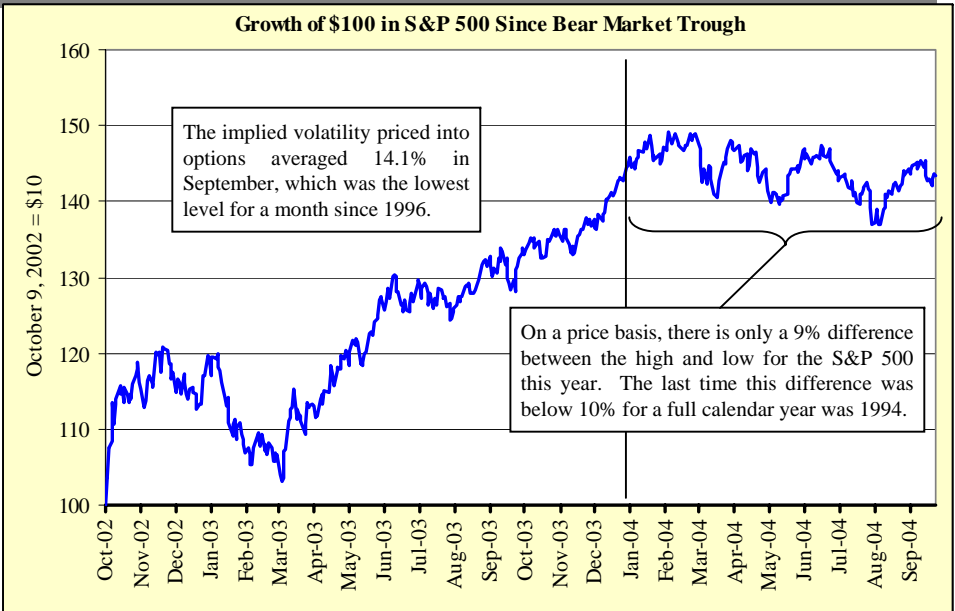


A Further Decline in the Dollar Seems Inevitable (cont.)



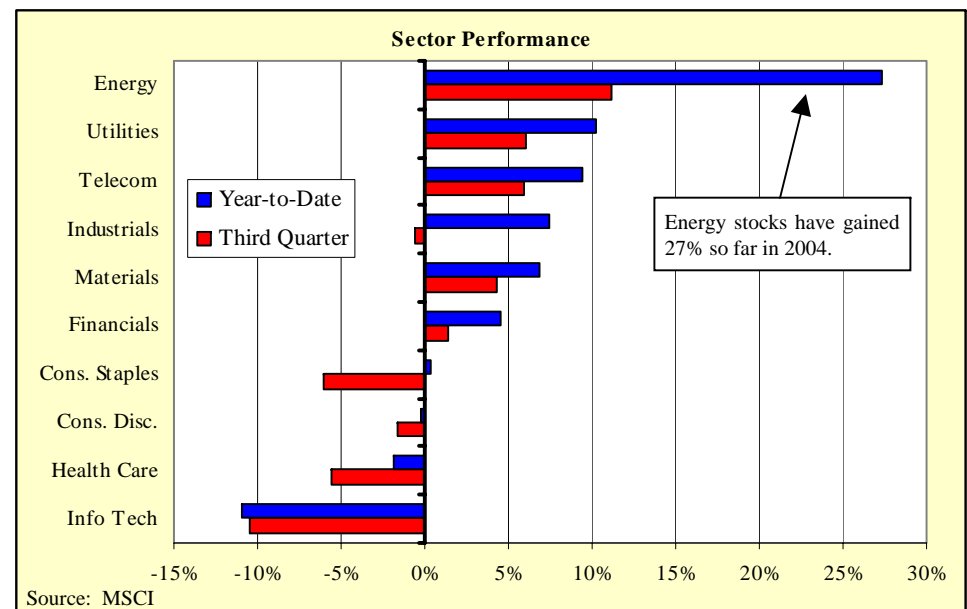
Another Dull Quarter for US Equities

- Equities remained in a tight trading range in the third quarter and finished the quarter down 1.9%. Volatility of the S&P 500 is at an 8-year low. The S&P 500 has moved by 1% or more in only 17% of the trading days in 2004 versus 50% in 2002 and 32% in 2003. The index has yet to move by 2% in a single day. In 2002, the index moved that much one in every five days.
- Earnings growth remains strong, but the rate of growth is declining. Earnings growth in 2005 will likely be in the low single digits, and may even be negative. The depreciation tax bonus is expiring at the end of this year, which will increase the tax burden on Corporate America in 2005 and beyond.
- The Presidential election cycle suggests that 2005 may be a difficult year for the market. Historically, the first year of terms has been the worst in the cycle. The market will be watching for the prospects of extension of the dividend and capital gains tax rate cuts that are set to expire at the end of 2008.
- Stocks are still priced at lofty levels. Based on our normalized earnings measure, stocks are trading at a P/E multiple of 24, which is 50% above the historical average. They are priced to provide about a 2% risk premium versus long-term TIPS.

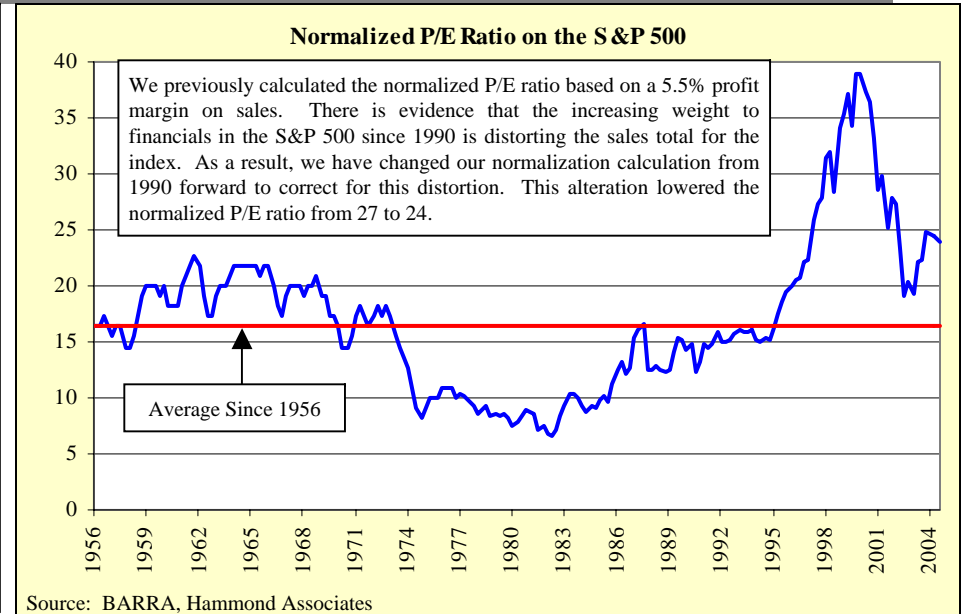
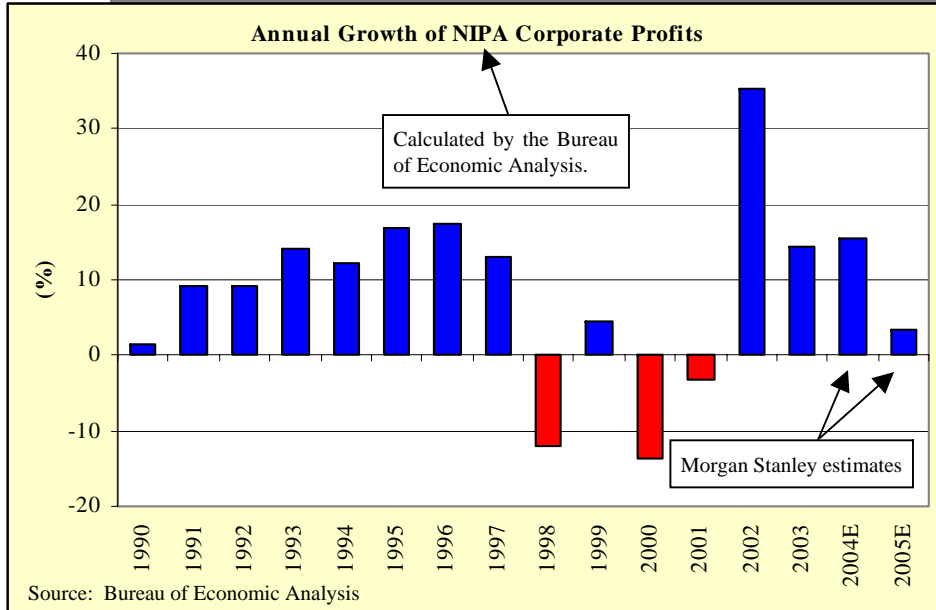


Expected Annualized Real Return on S&P 500 Over Next 10 Years

Annualized GDP Growth	Normalized P/E Ratio at Year 10 (Current = 24)					
	10x	15x	20x	25x	30x	40x
2.0%	-4.2%	-1.0%	1.4%	3.5%	5.2%	8.1%
2.5%	-3.7%	-0.5%	1.9%	4.0%	5.7%	8.6%
3.0%	-3.3%	-0.1%	2.4%	4.5%	6.3%	9.1%
3.5%	-2.8%	0.4%	2.9%	5.0%	6.8%	9.7%
4.0%	-2.3%	0.9%	3.5%	5.5%	7.3%	10.2%

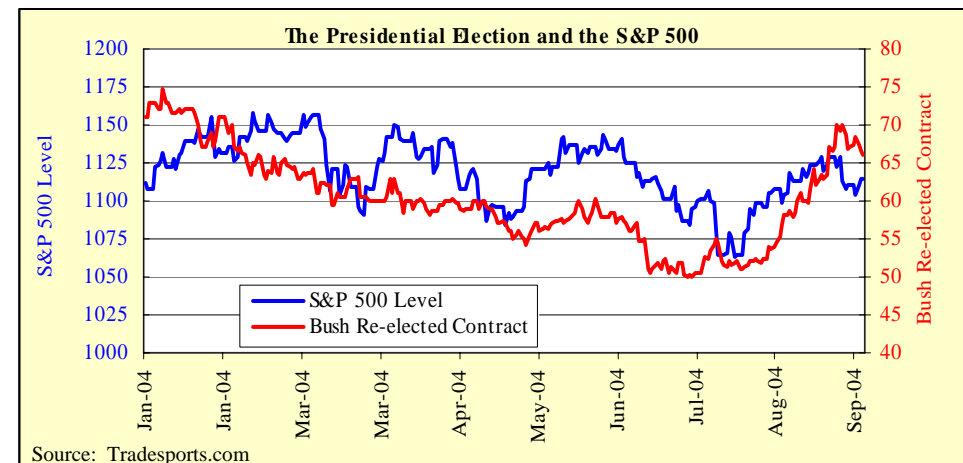


Another Dull Quarter for US Equities (cont.)



The Presidential Election Cycle and S&P 500 Returns				
Political Party	Nov. and Dec.	1st Year of Term	2nd Year of Term	# of Observations
All Elections	3.0	7.6	9.8	14
Republican Party Wins	2.8	1.5	11.0	8
Democratic Party Wins	3.2	15.7	8.3	6
Incumbent Party Wins	1.6	14.7	11.8	7
Challenger Party Wins	4.4	0.5	7.9	7
S&P 500 Arithmetic Average (1949-2003)		13.6		

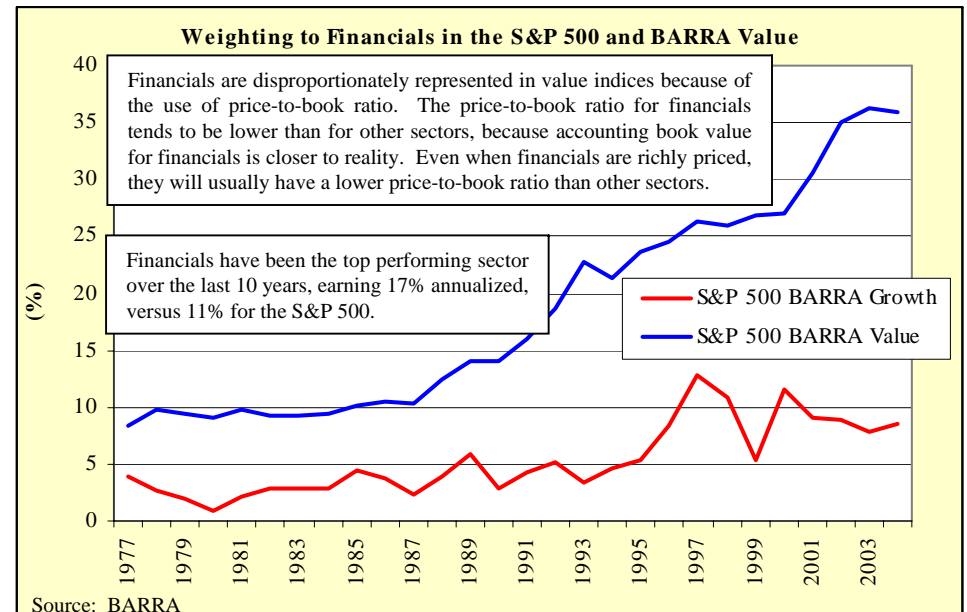
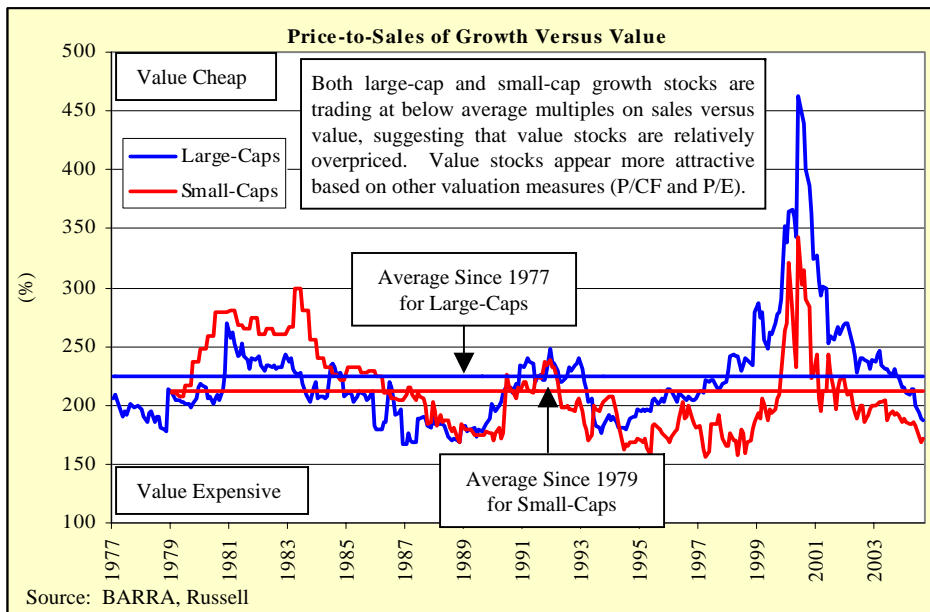
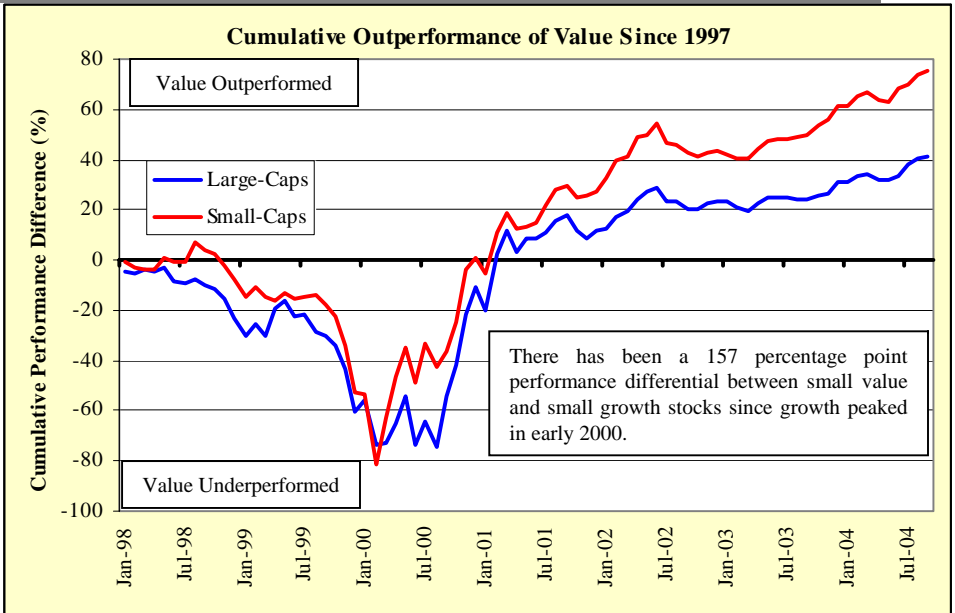
Stocks have performed well in the two months following elections (3% on average, or 19% annualized). However, the first year of terms has been the worst in the Presidential election cycle. The S&P 500 has finished underwater half the time. Seven of thirteen loss years for the S&P 500 since 1949 have occurred in the first year of terms. Stocks have performed better under Democrats than Republicans in the first year, but they have also performed better under the incumbent party than the challenging.



Futures contracts for the Presidential election trade at Tradesports.com. This chart plots the price of the Bush re-elected contract (which pays 100 if Bush is re-elected) against the S&P 500. The two series have shown a positive correlation of 0.55 since the beginning of the year, suggesting that the market may prefer Bush over Kerry. Alternatively, it may simply mean that the fundamental factors that affect Bush's chances also affect the stock market (e.g., the economy, Iraq, oil).

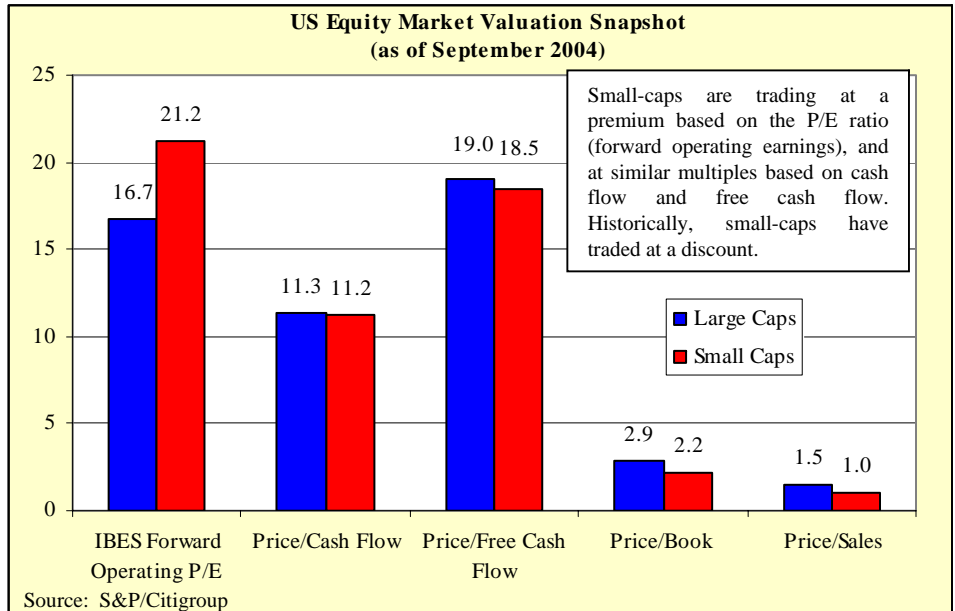
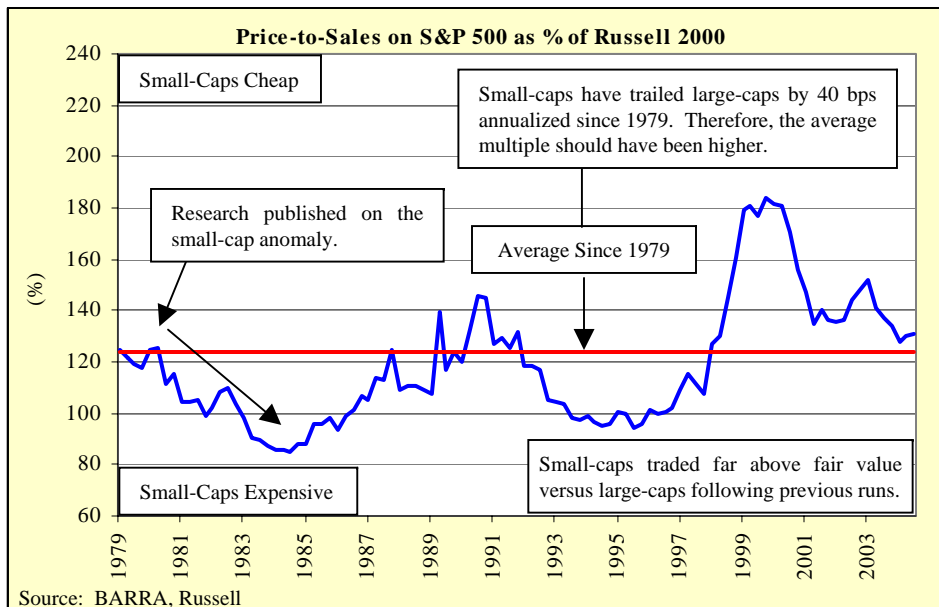
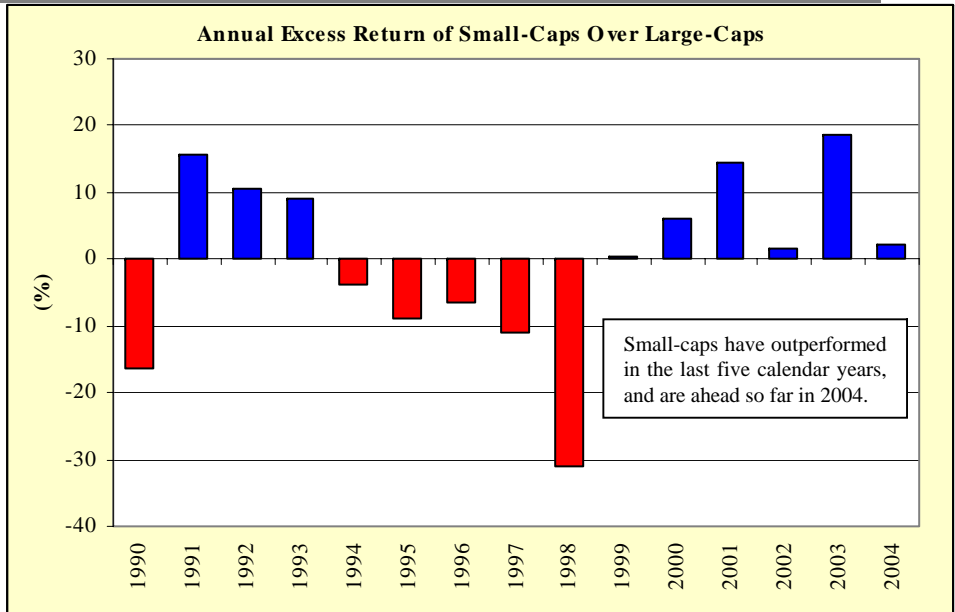
Value Stocks Aren't Such a Good Value

- Value stocks are handily beating growth stocks in 2004. Large value stocks are ahead of large growth stocks by 7 percentage points. Small value stocks have an 8 percentage point lead over growth stocks.
- A concern we have with popular value indexes is sector concentration. Financials and energy combine to make up nearly half of the S&P 500 / BARRA Value index. Financials, with a 36% weight, are of particular concern to us. Financials have been the best performing sector in the market over the past decade. Macroeconomic conditions suggest financials will experience rougher sledding in the future.
- Over the long-term, we believe that value stocks will win out over growth stocks. However, the heavy weight to financials makes value indexes appear vulnerable, especially if there is a major credit mishap. Active managers who take a less conventional approach to finding value may be best positioned to succeed in the future.



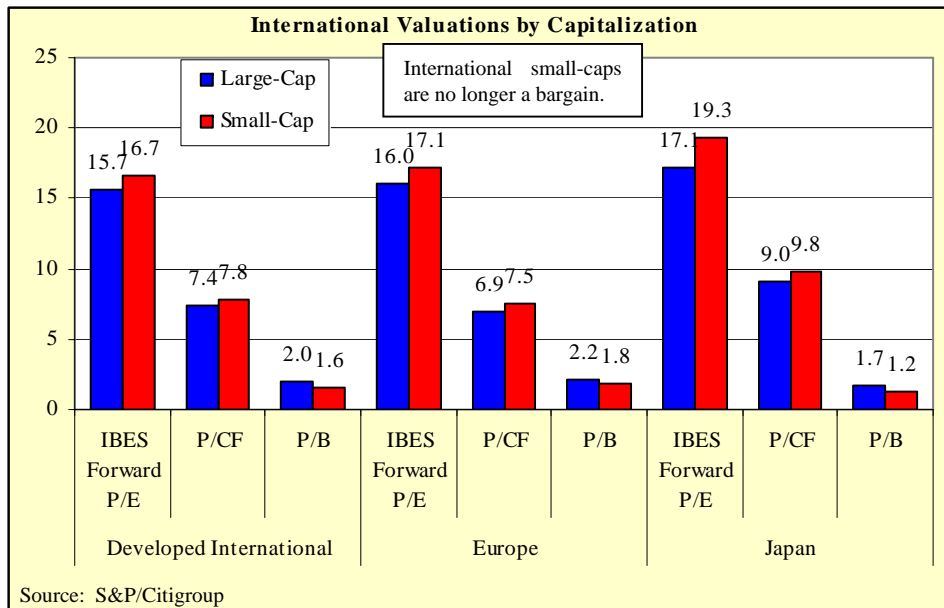
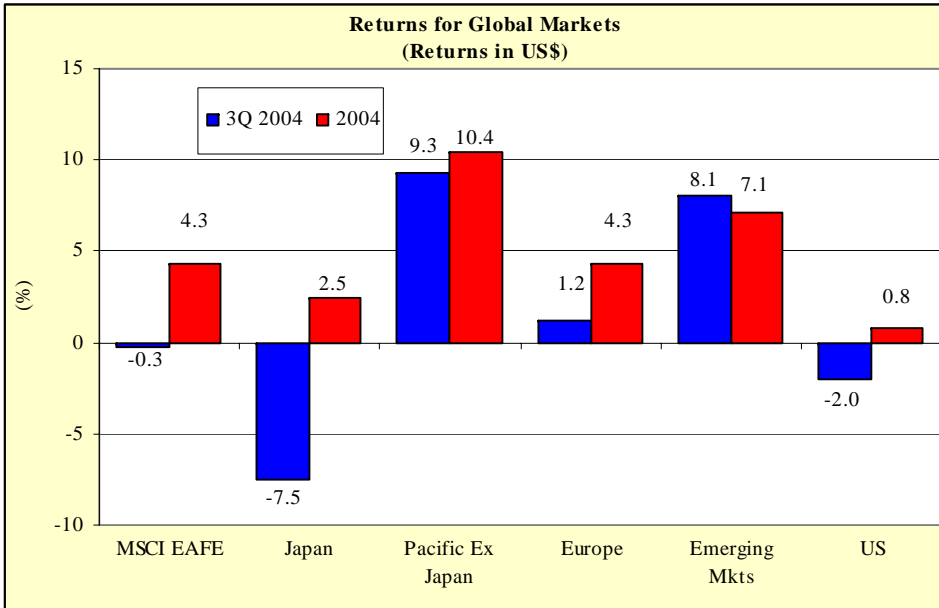
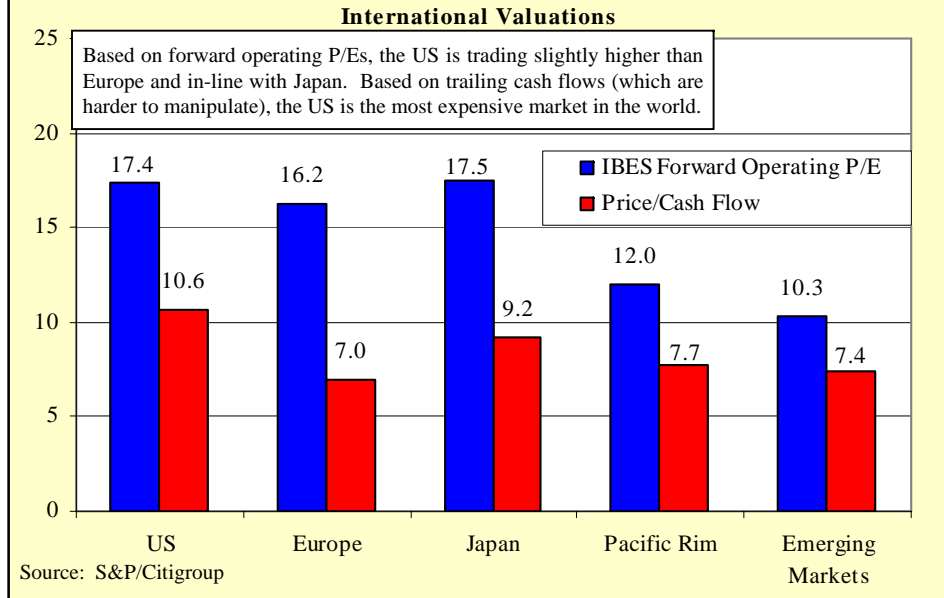
...And Neither Are Small Caps

- Small-caps have performed well versus large-caps over the last five years. Since the beginning of 1999, small-caps have earned 6.9%, annualized, versus a decline of 0.2% for large-caps.
- Small-caps now appear fairly to slightly overvalued relative to large-caps. Anecdotally, a number of money managers we have spoken with who invest across capitalization ranges are finding better values among larger-cap issues.
- Current valuations suggest that small-caps offer only a modest return premium to large-caps. We estimate that the advantage for small-caps will be less than 0.5% over the next ten years. For those with heavy small-cap biases, this modest differential suggests that it may be time to dial back that bet.



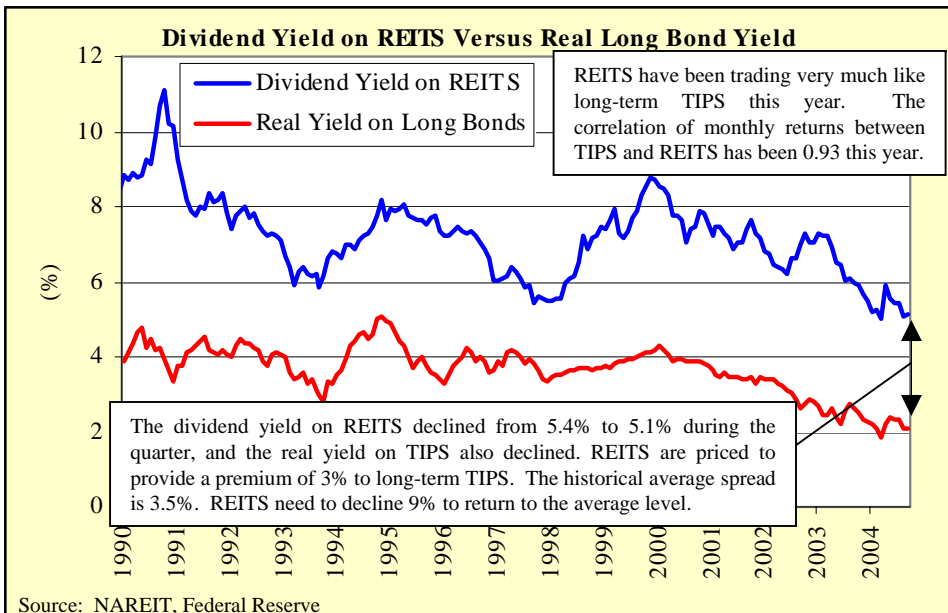
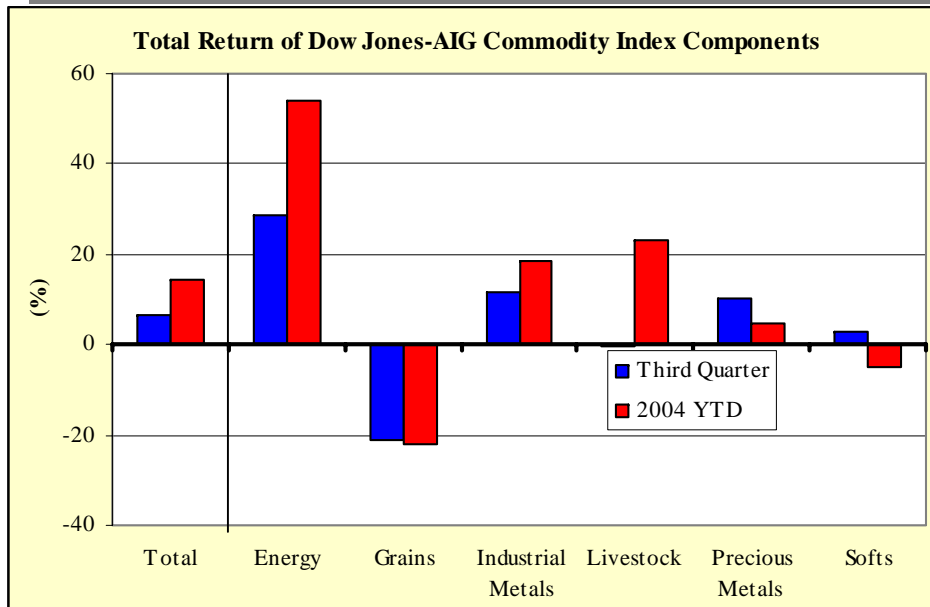
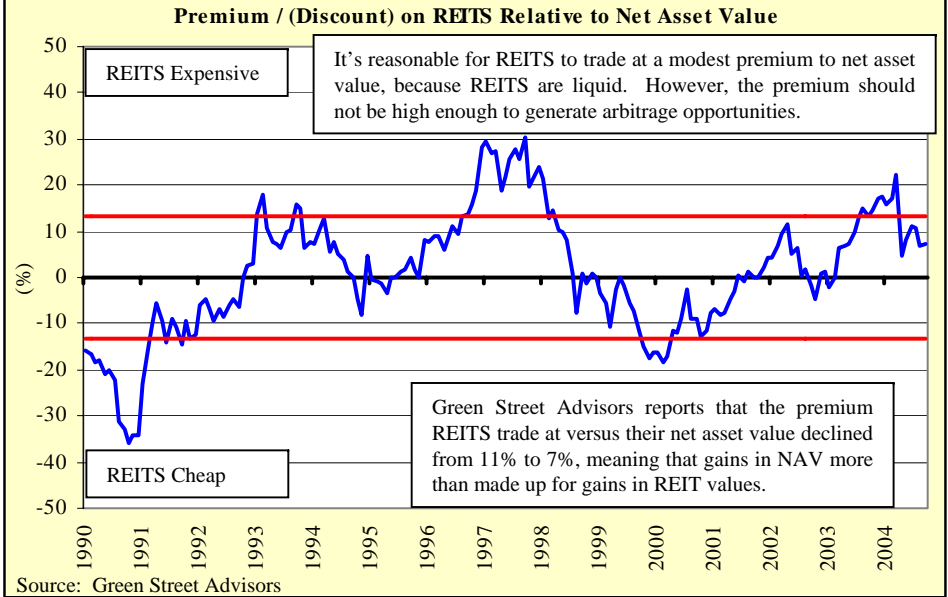
International Stocks Outperform US Stocks

- International stocks modestly outperformed US stocks in the third quarter, thanks in part to the stronger euro. Developed Asian markets and emerging markets were the leaders, earning 9.3% and 8.1%, respectively. Japan was the worst performer among developed markets, finishing the quarter down 7.5%. Year-to-date, most international markets are outperforming the US.
- International stocks, particularly in emerging markets, still offer more attractive valuations than US stocks. Coupled with our expectations of a weaker dollar, we expect international stocks to continue to outperform US stocks.
- Small-caps have outperformed large-caps in international markets in recent years. Over the last three years, international small-caps have earned 19% annualized, versus 9% for large-caps. As in the US, international small-caps are beginning to look pricey.



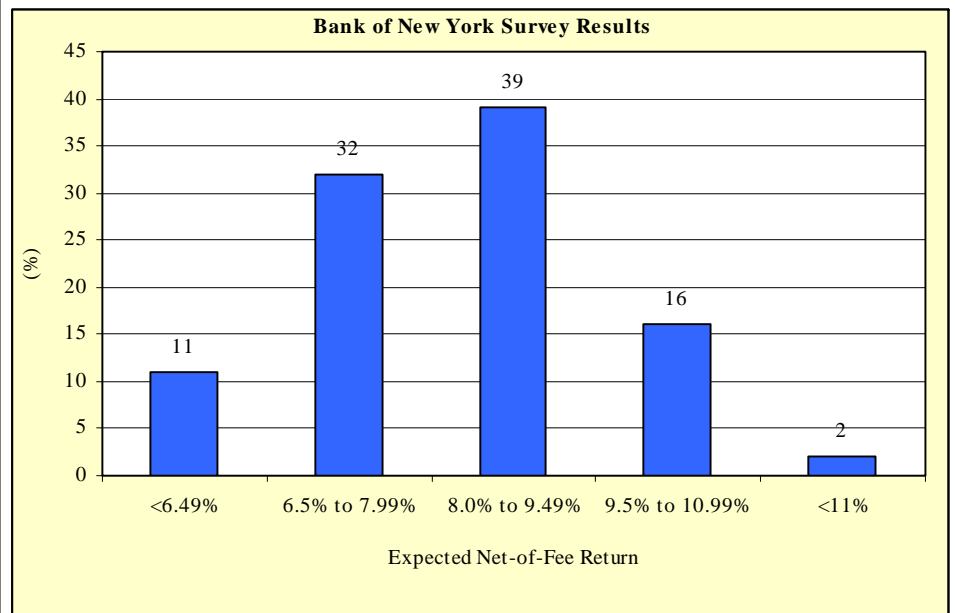
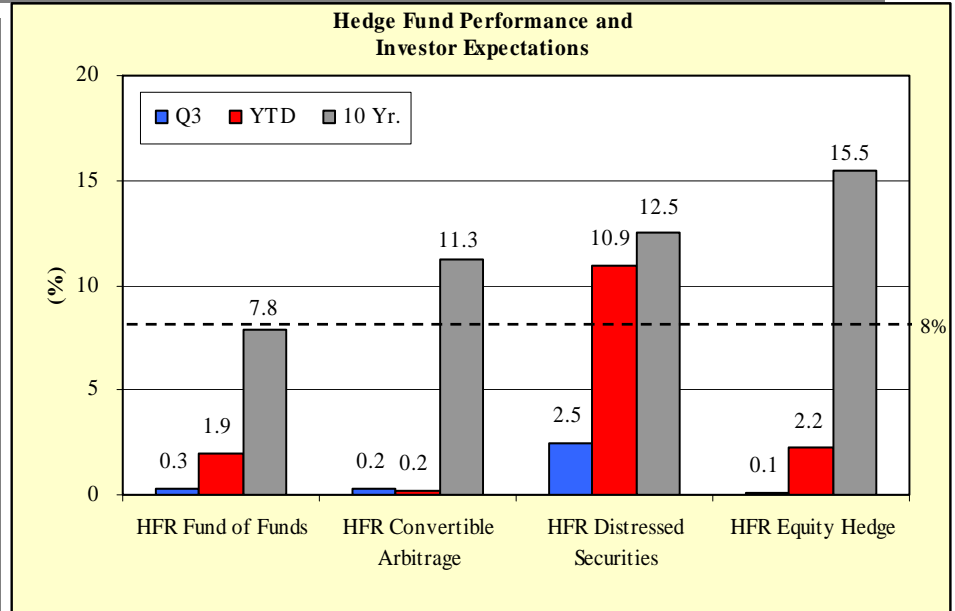
Real Assets: REITS Rebound, Commodities Surge

- REITS gained 8.3% in the third quarter, completely recovering their second quarter loss. Year-to-date, REITS are up a staggering 14.8%. The gain in REITS for the quarter can be explained by the decline in interest rates and increases in the value of underlying properties. Based on the current dividend yield, REITS offer a 3% risk premium to TIPS, which is above our 2% estimate for the S&P 500.
- A concern for REITS are real estate fundamentals. Net operating income is declining for real estate, as leases signed during the boom of the late 1990s are expiring and being renewed at lower rates. Vacancy rates, especially in office buildings, are well above average. As a result, dividend growth for REITS may be depressed in the coming years.
- On gains in energy and metals, the Dow Jones – AIG Commodity index gained 6.8% in the third quarter. Year-to-date, the index is ahead 14.2%. Commodities offer a good play on China's growth and a further weakening of the dollar.



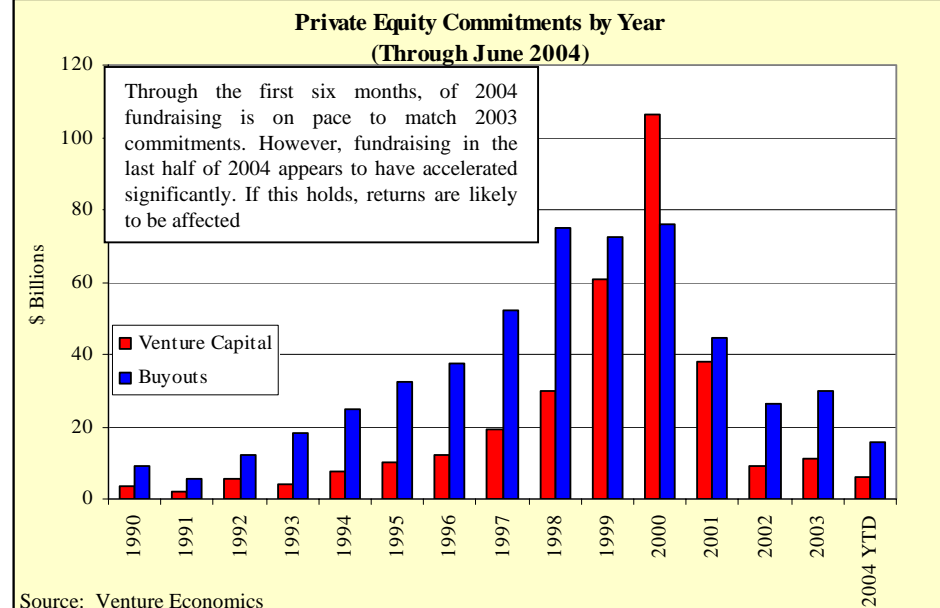
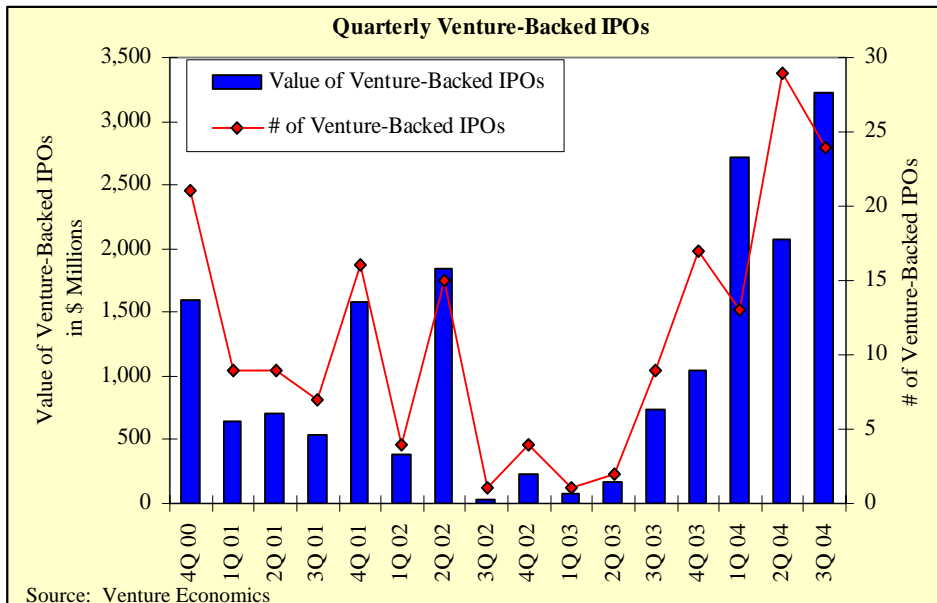
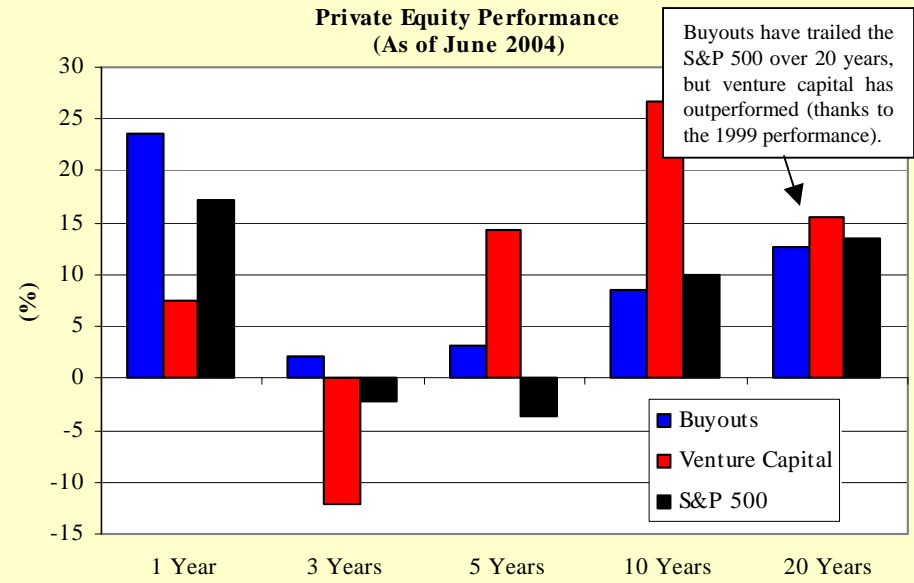
Are Investor Expectations for Hedge Funds Reasonable?

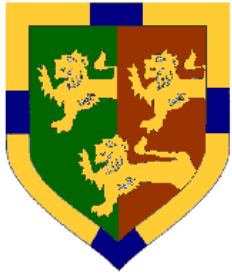
- Hedge fund returns were flat to slightly positive in the third quarter, with the HFR Fund of Funds index gaining 0.3%. The HFR Distressed Securities index was the best performer, with a 2.5% gain.
- Despite tepid performance in many strategies year-to-date, money continued to pour into hedge funds. In the second quarter of 2004, asset flows into hedge funds totaled \$43.3 billion—the largest single quarter increase on record, according to TASS.
- The Bank of New York recently surveyed institutional investors, hedge fund managers, and other experts on return expectations for a diversified hedge fund program.
 - ✓ Respondents predicted an 8% return on average. Nearly one-fifth of those polled predict returns to top 9.5%, going forward. Only 11% of respondents expressed expectations for returns below 6.5%. It's encouraging that few investors expect double-digit returns from hedge funds. But, in the current environment, is even an 8% return expectation reasonable?
 - ✓ The 8% expectation exceeds the actual return of the average fund of funds, as represented by HFR, over the past ten years. The crowded nature of arbitrage trades, historically tight credit spreads, low interest rates, and potential directionless equity markets suggest future returns may fall short of past performance.
 - ✓ With an estimated \$250 billion of institutional money flowing into hedge funds over the next 5 years (according to the same survey), it is unlikely that average future returns will meet investor demands. If so, what will be the impact of institutional investors pouring out of hedge funds?
- Given our lackluster outlook, do hedge funds still make sense? Considering the relative unattractiveness of most traditional asset classes, we believe they do, provided that the allocation is a reasonably sized component of a diversified portfolio and managers are selected with rigor and thoughtfulness.



Private Equity Returns Improving

- Private equity performance is improving. Both buyouts and venture capital posted gains for the 12 months ended June 30. Over 3 years, returns for buyouts are positive, but venture capital returns remain negative. Mega buyouts have been the best performing buyout sector over the last year, while later stage venture has been the top performing venture sector.
- Private equity commitments were on pace to match 2003 totals, but commitments are accelerating. In venture capital, early stage funds raised the majority of the commitments. Top venture capital funds are experiencing no trouble in hitting fundraising targets.
- The IPO market continues to improve. The \$1.7 billion Google IPO helped to make the third quarter the best for IPOs since 2000. However, Google had hoped to raise \$3.8 billion. There were 23 other IPOs in the quarter, raising a total \$1.5 billion.





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