

HAMMOND ASSOCIATES

INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

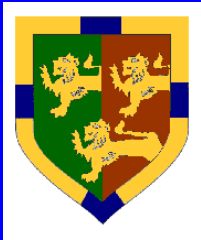
Fourth Quarter 2004

In this report . . .

- ✓ **What a Year a Quarter Makes**
- ✓ **Diversification Rewarded Investors Again in 2004**
- ✓ **What Will 2005 Bring for the Economy?**
- ✓ **2005 Likely to be Challenging for US Equities**

Copyright © Hammond Associates, 2005. All Rights Reserved.





Hammond Associates

Market Commentary

January 2005

Calendar year 2004 was the second straight year to bring investors positive returns from the S&P 500. As we approach the fifth anniversary of the bull market peak in March 2000, the index's gain of 10.9% moved it closer to emerging from the pit. The index remains 13% underwater on a total return basis from the end of March 2000. At the trough, it was 44% off its peak. For investors who ventured beyond the S&P 500, the picture is rosier. Diversification has proved very rewarding since the top of the bull market. That's because there were many asset classes that remained moderately to very attractive in 2000 when the S&P 500 was grossly overvalued. These included value stocks, US small-cap stocks, REITS, international small-cap stocks, and emerging market stocks.

Investors who heavily employed these asset classes have likely found performance since March 2000 satisfactory in absolute terms and outstanding in relative terms. A sample 75% equity / 25% bond diversified index portfolio we track that is tilted towards small-caps, REITS, value stocks and has a healthy allocation to international equities earned 35% cumulative, or 6.6% annualized, since the beginning of the bear market.¹ With inflation of 2.3% over that period, it wasn't too far from providing for a 5% real spending rate. In contrast, a 75% S&P 500 / 25% Lehman Aggregate portfolio was down 0.3% cumulative, or -0.1% annualized, since the peak, which is 7.5 percentage points short of a 5% per annum real return.

The problem today is that many of the opportunities that existed in 2000 have been priced away. There are few, if any, asset classes that are undervalued, and many are fundamentally overvalued.

US Markets

As those who have been reading this report for the last six years are well aware, we believe the domestic equity market is priced to provide disappointing returns in the future. We estimate that the S&P 500 is priced to provide a real return of only 4%

¹The results of the diversified index portfolio are shown for informational purposes only. It does not represent advice given to Hammond Associates' clients. It is comprised of 16% S&P 500, 8% S&P 500 / BARRA Value, 7% S&P MidCap 400, 11% Russell 2000, 5% Russell 2000 Value, 7% Wilshire REIT, 7% MSCI EAFE, 7% Citigroup EMI EPAC, 7% MSCI EMF, 13% Lehman Aggregate Bond, and 12% Lehman TIPS.

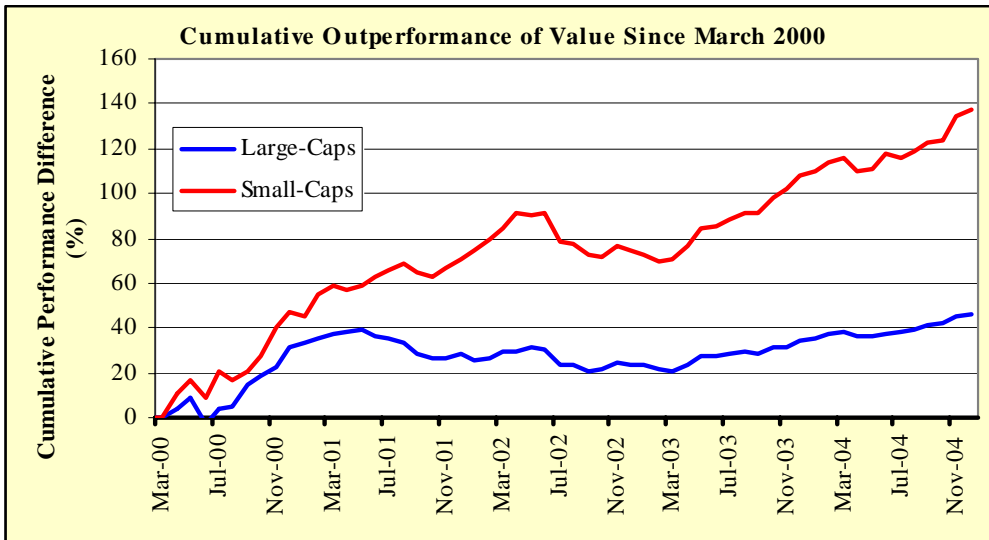
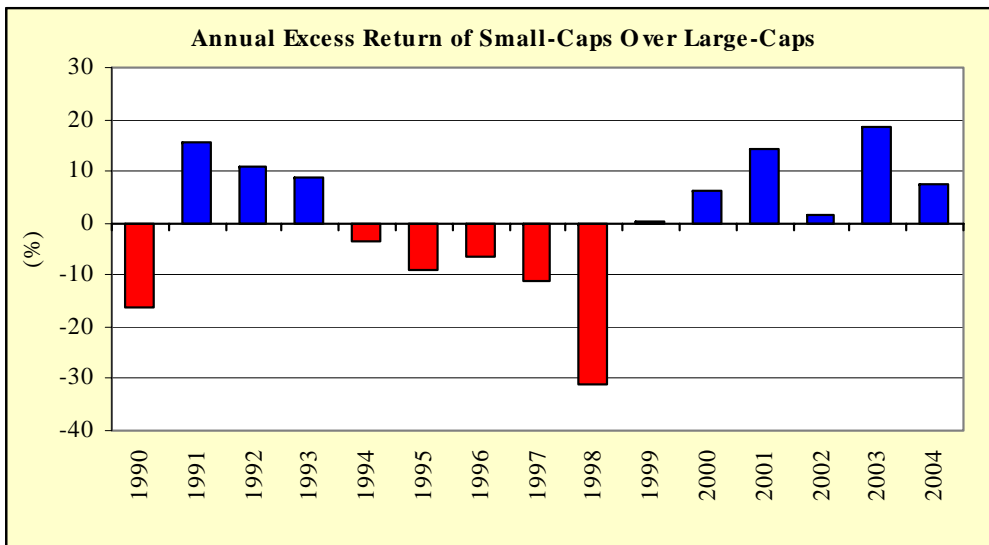
in the future. And that assumes valuations stay at current elevated levels. If valuations decline to historical norms, the realized real return for the index will be much lower than 4%.

Expected Annualized <u>Real</u> Return on S&P 500 Over Next 10 Years						
Annualized GDP Growth	Normalized P/E Ratio at Year 10 (Current = 25)					
	10x	15x	20x	25x	30x	40x
2.0%	-4.6%	-1.5%	1.0%	3.0%	4.7%	7.6%
2.5%	-4.2%	-1.0%	1.5%	3.5%	5.3%	8.1%
3.0%	-3.7%	-0.5%	2.0%	4.0%	5.8%	8.7%
3.5%	-3.2%	0.0%	2.5%	4.5%	6.3%	9.2%
4.0%	-2.8%	0.5%	3.0%	5.1%	6.8%	9.7%

This year offers particular challenges for the domestic equity market. First, it seems very likely that earnings growth will decelerate in 2005, because profit margins are unsustainably high. To the extent this is priced into the market, it may not be an issue. We suspect, however, 2005 earnings will sorely disappoint the market. A second headwind for 2005 is the Presidential election cycle. The first year on average has been the worst of the term. Post World War II, the S&P 500 has produced an average return of 7.6% in the first year, 45% less than the 13.6% arithmetic average return of all years. The index experienced a loss in half the inauguration years, twice the normal rate. Of the thirteen down years the S&P has suffered since 1948, seven occurred in the first year of Presidential terms. We wouldn't be surprised if 2005 is the fourth down year for the index this decade.

Shifting to segments of the domestic equity market, small-caps outperformed large-caps in 2004 for the sixth straight year. Since the beginning of 1999, the Russell 2000 index has earned 8.9% annualized compared to 1.2% for the S&P 500. Due to this run, small-caps now appear overvalued relative to large-caps. They are trading at a premium based on most valuation metrics. Historically, they've traded at a discount. Anecdotally, a number of money managers we recommend who manage money across capitalization ranges are finding better values among larger issues.

This doesn't mean that the small-cap run is over. At the conclusion of some past cycles, they were *very* overvalued relative to large-caps. The differential return of small-caps to large-caps shows strong positive serial correlation. In other words, a cap range that outperforms in one year has a better than even chance of outperforming in the following year. Since World War II, there has been a 67% repeat rate. While momentum may continue to drive small-caps higher, for those with heavy small-cap tilts, it may be a good time to trim the bet.



The advantage of value over growth has probably run its course, as well. In 2004, large-cap and small-cap value stocks outperformed their growth counterparts by 9.6 and 7.9 percentage points, respectively. Since March 2000, large-cap value beat growth by 46 percentage points cumulatively, while small-cap value stocks hammered growth stocks by 137 percentage points. Value indices now appear fairly valued to overvalued versus growth indices. Of particular concern for value indices is their heavy weighting to financial stocks. The S&P/BARRA Value index has a 39% allocation to the sector. Financials have been the top-performing sector over the past decade; however, with short-term rates on the rise, their profits are likely to come under pressure. Also worrisome is the impact of a possible bursting of debt and housing bubbles.

In the coming years, we believe that high quality multinationals (low debt, consistent profits, and a global franchise) are well positioned to outperform the broad market. These stocks were the darling of the market in the mid-1990s, but gave way to techs and small-caps in 1999. Multinationals are far from cheap, but they offer one of the best values within the market. As exporters, these companies should also benefit from the weak dollar.

The opportunity in REITS seems spent. At the beginning of 2000, REITS were trading at a dividend yield of 8.7% and a discount to net asset value of 17%. Today, they offer a dividend yield of 4.7% and trade at a premium to NAV of 13%. This, combined with concerns about real estate fundamentals, suggests that REITS are only marginally more attractive than the broad equity market.

The Lehman Aggregate Bond index earned 4.3% in 2004, which was roughly its yield at the beginning of the year. With a yield of 4.4% entering 2005, not much should be expected from the index. It is likely to give up a modest amount of its yield in 2005 due to interest rate increases. Our guess is that the index will gain 2% to 4% this year. Inflation-protected securities (TIPS) earned 8.5% in 2004. While TIPS aren't the bargain they were a few years ago, we still prefer them to nominal bonds. With a real yield of 1.6%, the 10-year breakeven inflation rate priced into TIPS is 2.6%. This corresponds with our long-term inflation forecast, but we suspect there is significant risk of inflation being higher. With the heavy debt burden of the US economy, the Federal Reserve may find it tempting to generate inflation to reduce the real value of debt.

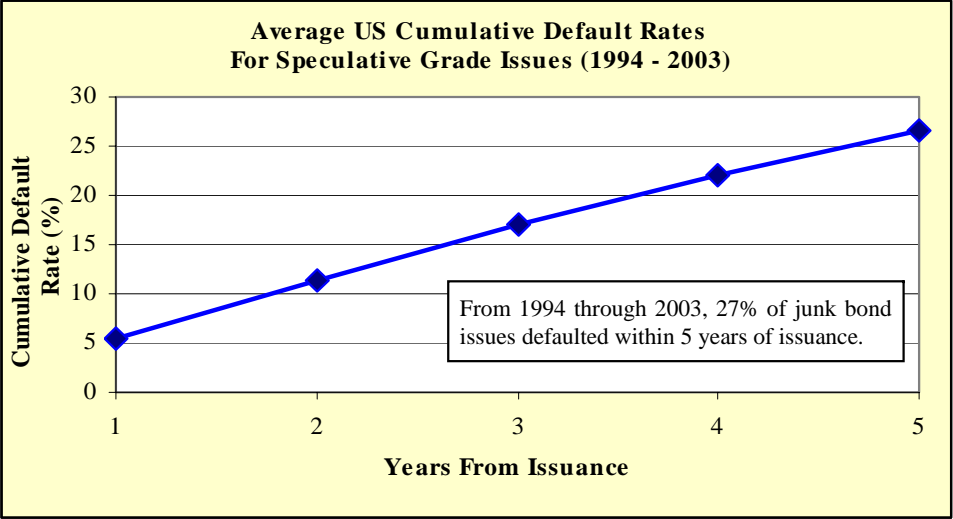
Incredibly Shrinking Spreads

It's fascinating how quickly conditions can change in markets. Just two years ago in this report, we were pointing out the fat credit spreads offered by high yield bonds. (We were recommending that clients play this opportunity through distressed debt, rather than high-yield bonds.) Since then, the tables have dramatically turned. High yield bonds have gone from offering spreads of near-record highs to near-record lows. As of year-end, the Lehman High Yield Bond index had a yield of 6.8%, a scant 3% premium to Treasuries. Research suggests that high yield bond investors should expect to lose in the neighborhood of 2% to 4% of their annual yield to defaults over a cycle. At best, high yield bond investors should expect a 1% premium to Treasuries net of defaults. The last time credit spreads were this thin was in April 1998. From that point forward, high yield bonds have posted disappointing returns relative to Treasuries, underperforming by 1.4 percentage points, annualized, over this period.

Falling credit spreads have attracted supply to the market. According to Thomson Financial, junk bond issuance totaled a record \$140 billion in 2004, which was slightly higher than the \$136 billion raised in the previous year. The prior record was 1998 with \$138 billion, and we all know what happened a few years later. We

certainly can't fault the companies issuing the debt. Why wouldn't a corporation with a junk credit rating with any business investment opportunities at all issue debt at less than 7%? It increases the upside for equity holders (and management's stock options) at a very low cost. We just question those buying paper with a 7% annualized upside and a 100% possible downside.

It may be that investors are taking comfort from low current default rates. Moodys reports a default rate of only 2.2% in December 2004. If that's the case, it is astoundingly shortsighted. We're still in the midst of an economic recovery, following a brutal shakeout in high yield bonds. Default rates *should* be low right now. The weak credits went under during the recession and its aftermath, and all the companies recently issuing high yield debt haven't had time to default yet. With \$275 billion of high yield debt offerings in the last two years, we suspect that distressed debt investing will present attractive opportunities in a few years. Distressed debt managers are likely licking their chops at this prospect. Until then, we'll be recommending exposure to managers that are adept at shorting credit, some of whom are net short.



International Markets

Thanks in large part to the weak dollar, international equities outperformed US equities in 2004. The MSCI EAFE index earned 20.2% for the year, versus 10.9% for the S&P 500. More than 7 percentage points of the outperformance was due to the declining buck. International small-caps earned 28.8% in 2004. As in the US, international small-caps look expensive relative to large-caps. Based on valuations, international equities appear attractive relative to US equities, although they are expensive on an absolute basis. Despite a 56% return in 2003 and 26% return in

2004, emerging market equities are still the most reasonably valued public equity market in the world.

We expect the trade-weighted dollar to continue to weaken; however, it may not help developed market indices that much. Roughly 70% of the MSCI EAFE index is made up of the euro and other European currencies, which have already experienced significant appreciation versus the greenback. Today, the euro appears overvalued against the dollar. We expect the euro to remain overvalued for an extended period because of our current account deficit, but we don't expect it to appreciate much further. The Japanese yen and other Asian currencies remain undervalued, but they make up only 22% and 3% of the EAFE index, respectively. Asian currencies make-up about 60% of the emerging market equity universe; therefore, emerging market equities might still enjoy a positive currency effect.

Conclusion

Looking around today, it's difficult to find attractive opportunities. It will likely be harder to make a 5% real return over the next five years than it was over the last five. Diversifying away from the S&P 500 is unlikely to be as profitable as it was, since many of the mispricings that provided the differential have been corrected. Nevertheless, in a low return world, we think it is particularly important to diversify broadly. There's little reason to make *large* bets on particular asset classes or strategies when the expected return premium is modest with high potential for error. But, keep a watch for opportunities that arise. Two of the more compelling opportunities we see today are long volatility strategies, such as managed futures, and short credit strategies.

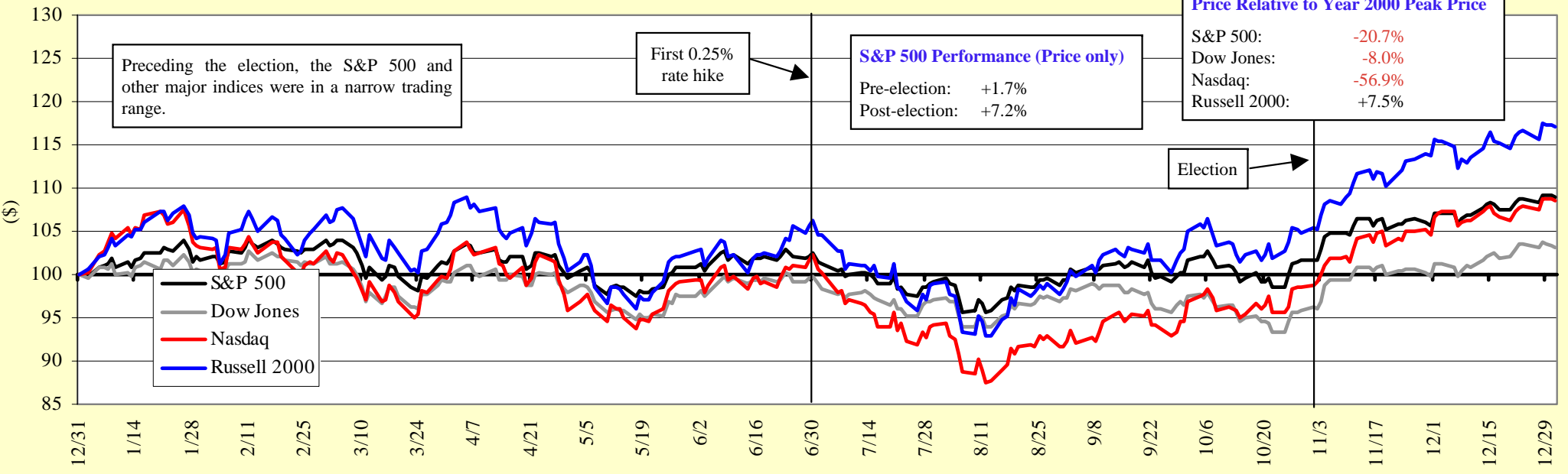
*Anthony Brown, CFA
 Director of Research
 abrown@hammondassociates.com*

Fourth Quarter Executive Summary

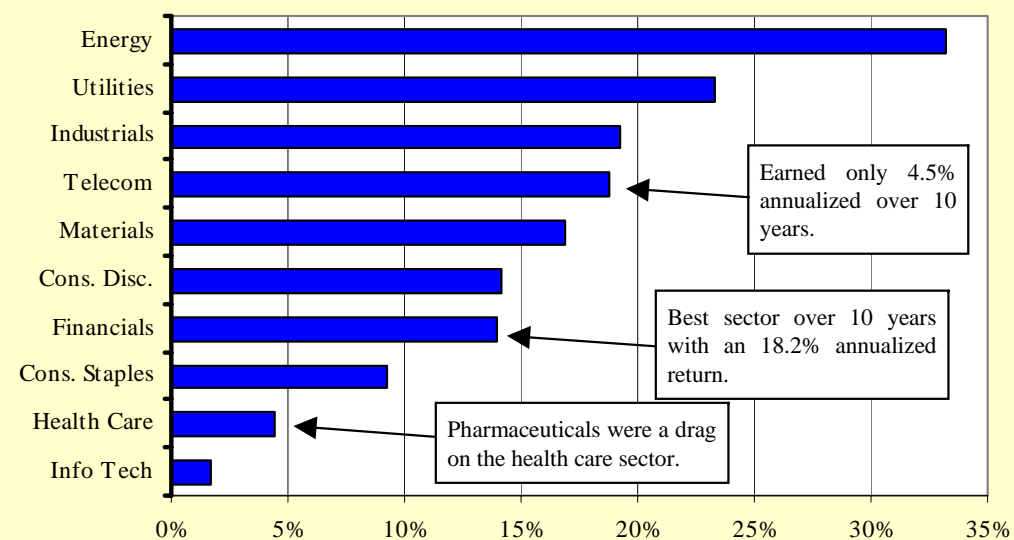
- 2004 was a good year for equity markets worldwide. The S&P 500 earned 10.9% with most of the return (9.2%) coming in the fourth quarter. Even better returns were available outside the S&P 500. Small-cap stocks earned 18.3%, marking the sixth consecutive year they have outperformed large-caps. REITS surged 33.1%. REITS have been the best performing major asset class over the last 5 years with a 22.6% annualized return. International equities, aided by the weak dollar, outperformed domestic equities for the third consecutive year. International large-cap stocks earned 20.2%, and international small-cap stocks returned 28.8%. Emerging market stocks also performed well, posting a 25.6% return.
- The economy grew at an estimated 4.5% rate in 2004. Forecasters polled by *The Economist* expect growth of 3.5% in 2005. Our concern remains the imbalances in the economy (current account deficit, low savings, high debt loads, and Federal budget deficit). While these factors may not affect 2005 growth, we expect that GDP growth will be below the historical average of 3% over the next decade as the imbalances are corrected.
- The Federal Reserve shifted to tightening mode in 2004. It raised the Fed Funds target rate to 2.25%. Fed Funds futures are predicting a 3.5% overnight rate by the end of 2005. The tightening had a dramatic effect on the short to intermediate end of the yield curve. Surprisingly, longer term rates finished the year slightly lower. Going into 2005, two things to watch are the effects of unwinding of carry trades on financial markets and whether foreigners continue to be willing to subsidize our spending by purchasing bonds, thereby keeping our interest rates artificially low.
- Investors' hunger for yield and the carry trade have pushed credit spreads for risky fixed income securities to absurdly low levels. High yield bonds and emerging market debt are offering spreads of only 3% to Treasuries. Treasuries are far from attractive at current yields; however, they offer the best risk-adjusted returns among major domestic bond sectors. We expect that Treasuries will be the best performing bond sector over the next few years as spreads revert to normal.
- After staying fairly stable in the first three quarters of 2004, the bottom dropped out of the dollar in the fourth quarter. With the depreciation in 2004, the trade-weighted dollar appears *fairly valued*. The current account deficit, approaching 6% of GDP, continues to worsen. The trade-weighted dollar likely must become significantly *undervalued* for an extended period to reduce the deficit to a sustainable level.
- 2005 could be a difficult year for the S&P 500 index. The rate of earnings growth will likely fall in 2005, and a decline in earnings is possible. Also, the first year of Presidential terms has historically been relatively poor for the market. We wouldn't be surprised to see the S&P 500 finish 2005 flat to lower. Within the US market, there are no obvious bargains. Small-caps appear overvalued versus large-caps, and value indices look fairly valued to overvalued versus growth indices. There's a fair chance 2005 will be the first year since 1998 when large-cap growth is the top performing style.
- While international stocks look pricey on an absolute basis, they are still trading at more attractive valuations than US stocks. We believe they will outperform again in 2005. With the performance of the dollar in 2004, investors should not count on much of a currency pop from developed market indices. While the dollar should continue to weaken on a trade-weighted basis, the case for it weakening against European currencies, which make up 70% of MSCI EAFE, is less compelling. There remains some currency upside to emerging market equities.
- Hedge fund returns in 2004 were not spectacular, but they weren't terrible either. According to HFR, the average fund of hedge funds earned 6.4% in the year. The most compelling strategies for 2005 are those with long volatility exposure, such as managed futures, and short credit exposure.
- REITS now appear overpriced. They still offer a marginally better value than stocks, but the advantage dwindled substantially in 2004. An increase in interest rates could prove to be a double whammy for REITS.

What a Year a Quarter Makes

Growth of \$100 During 2004

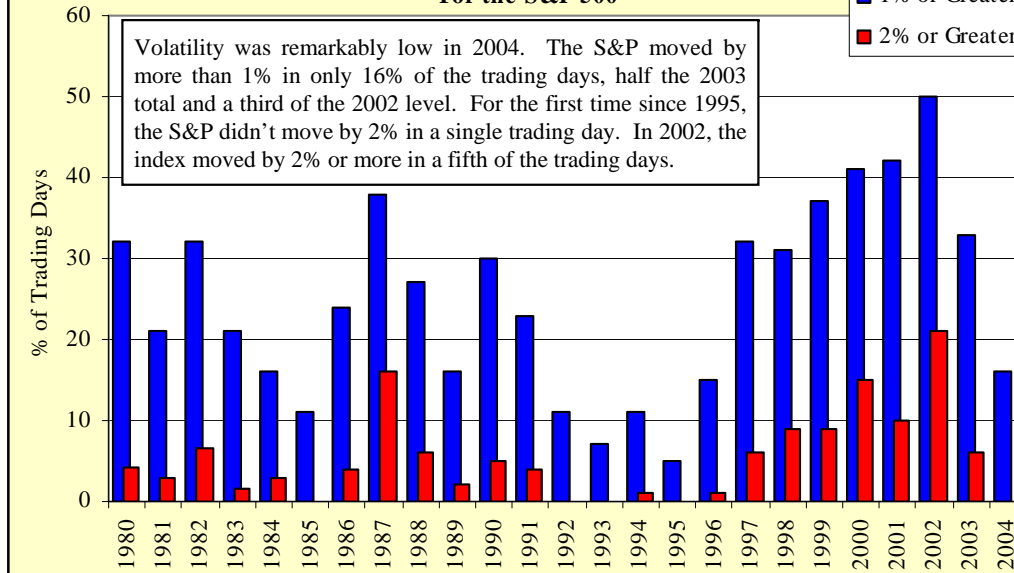


2004 Sector Performance



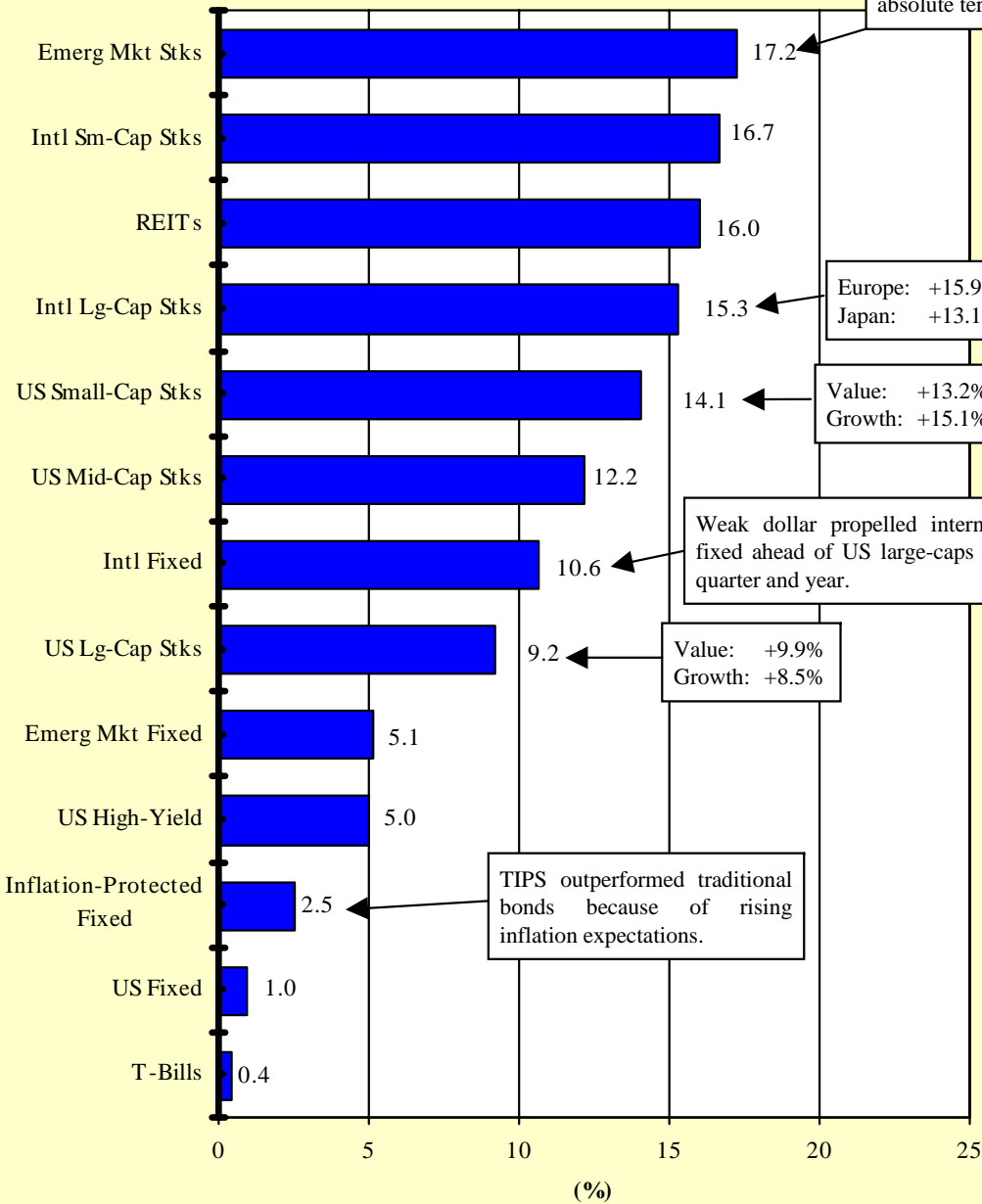
Source: MSCI

Percentage of Trading Days with 1% and 2% Moves For the S&P 500

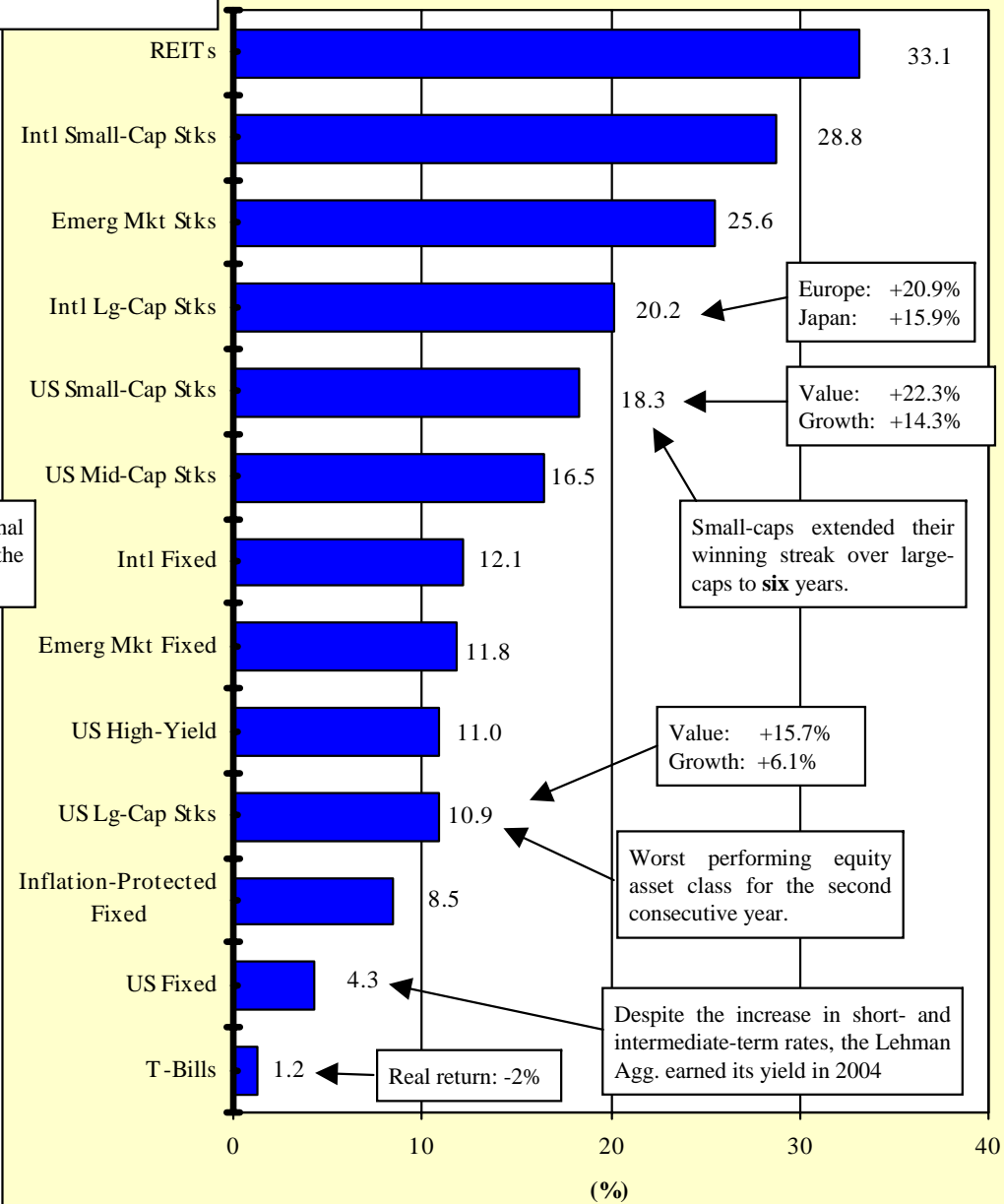


International Equities and REITS Top 2004

Fourth Quarter 2004 Performance (%)



2004 Performance (%)

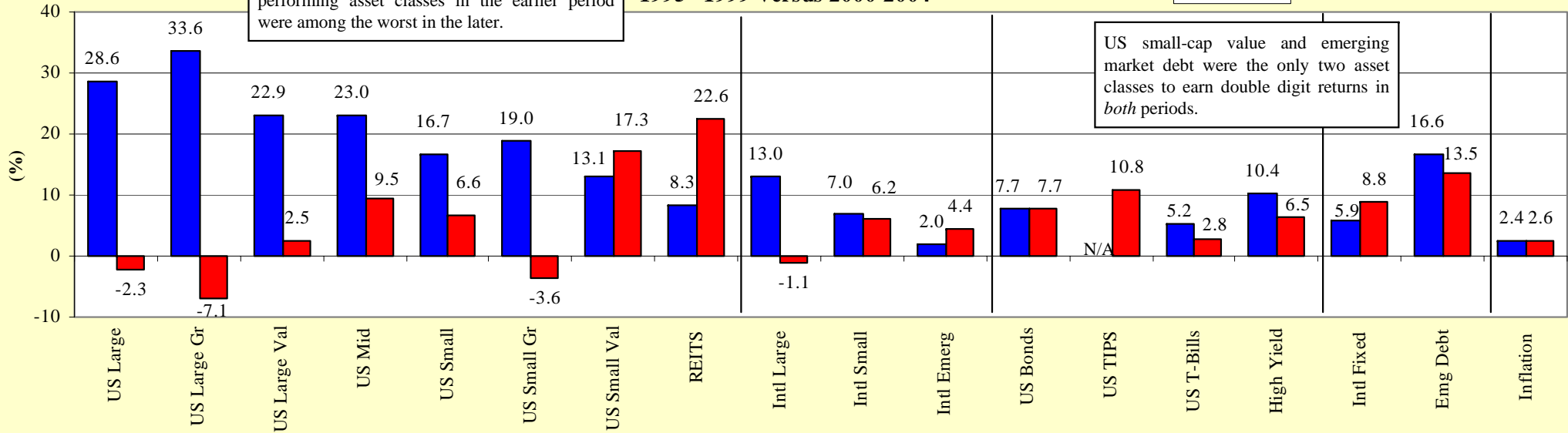


A Look at the Last 10 Years

Performance in the first period was much different than the second. Many of the best performing asset classes in the earlier period were among the worst in the later.

**Performance Comparison
1995 - 1999 Versus 2000-2004**

■ 1995-1999
■ 2000-2004

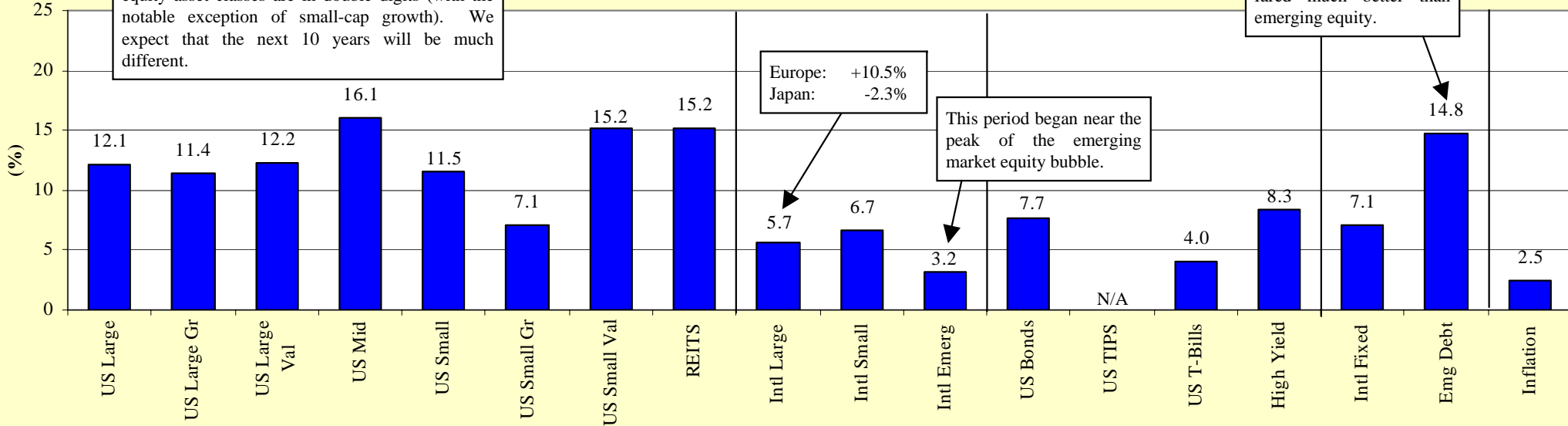


US small-cap value and emerging market debt were the only two asset classes to earn double digit returns in *both* periods.

Even with the bear market, 10 year returns for US equity asset classes are in double digits (with the notable exception of small-cap growth). We expect that the next 10 years will be much different.

**Performance Comparison
Last 10 Years**

Emerging market debt has fared much better than emerging equity.

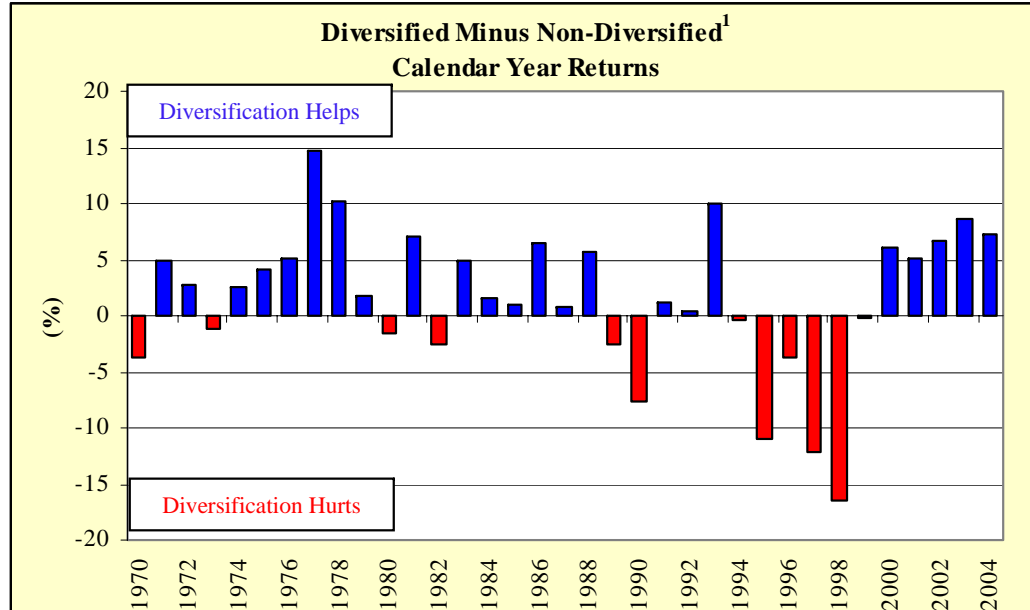
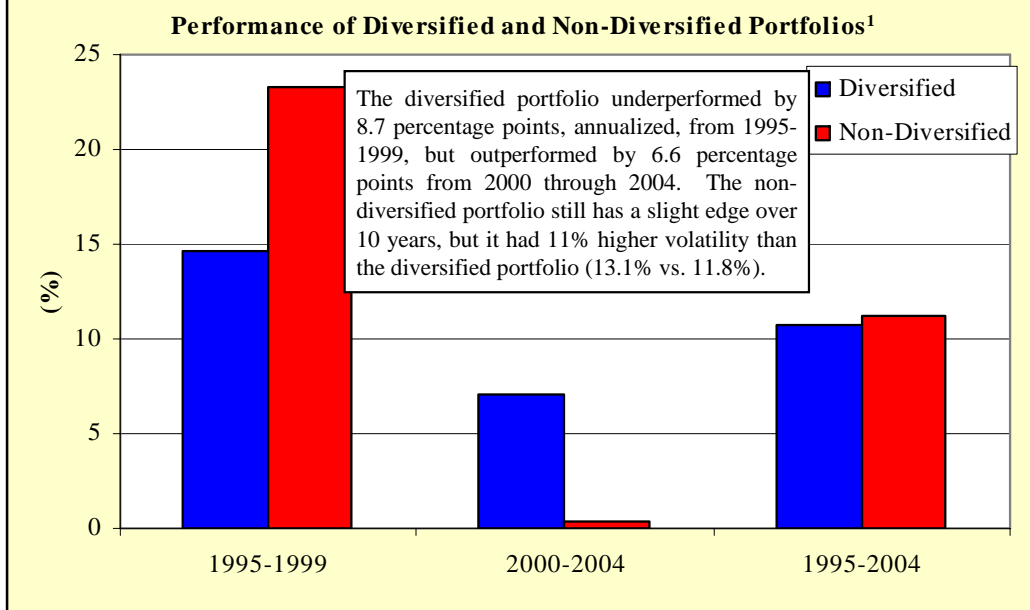


Europe: +10.5%
Japan: -2.3%

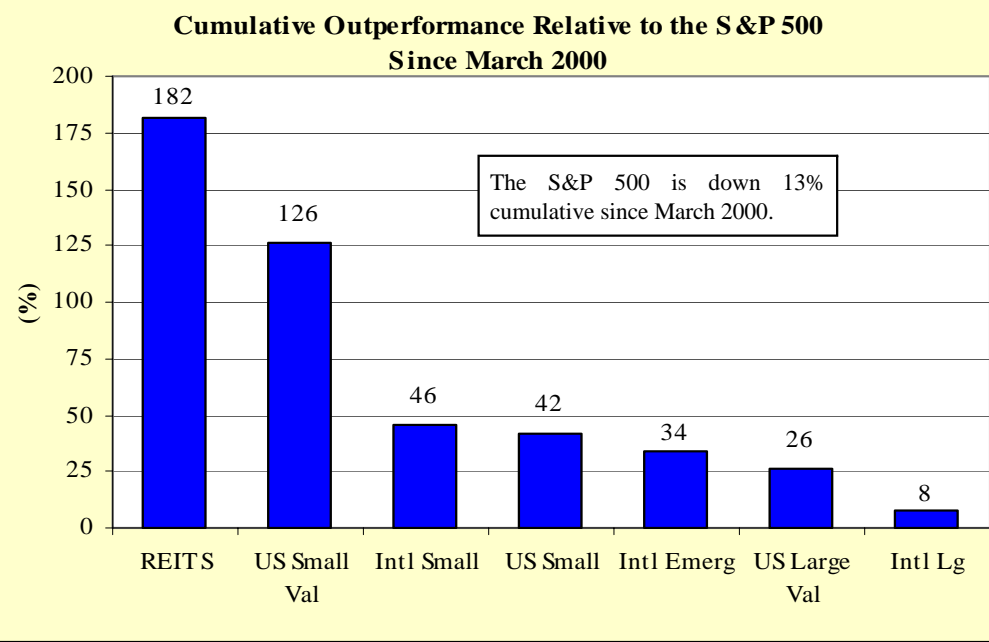
This period began near the peak of the emerging market equity bubble.

Diversification Rewarded Investors Again in 2004

- **The Good News:** Broadly diversified portfolios have performed fairly well over the last five years in a very difficult environment for the S&P 500. A diversified 75% equity / 25% bond portfolio tilted towards small-caps, value, and international stocks has earned 7.1% over the last five years, barely missing a common return goal of 7.5% (5% spending plus inflation). A 75% S&P 500 / 25% Lehman Aggregate Bond portfolio, in contrast, has earned only 0.4%, about 2% less than inflation.¹
- **The Bad News:** Many of the relative mispricings that existed at the beginning of 2000 (small-cap stocks, value stocks, REITS, etc., versus the S&P 500) have been corrected and in some cases overcorrected. As a result, it's unlikely that diversifying away from the S&P 500 will be as fruitful over the next five years. Among traditional asset classes, international equities offer the best opportunities.

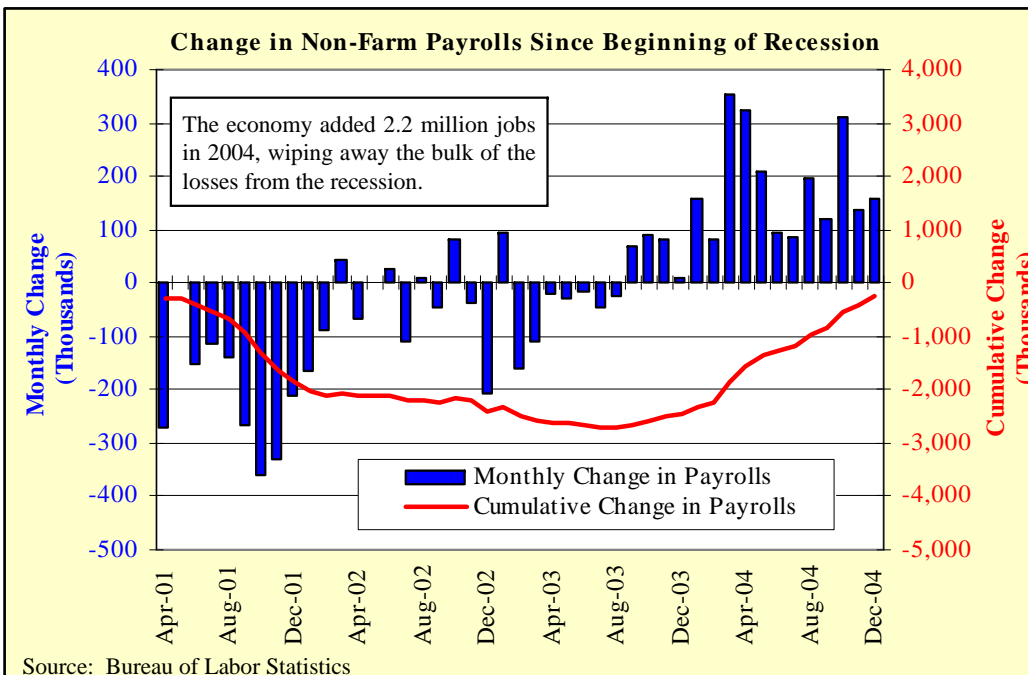
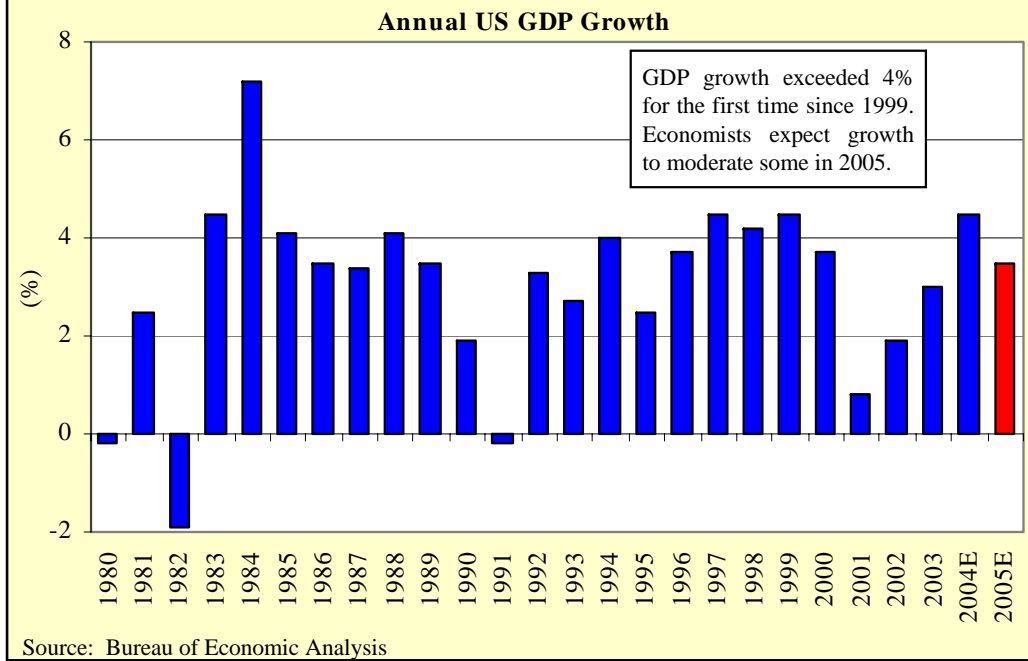


¹The results of the diversified and non-diversified portfolios are shown for informational purposes only. The portfolios do not represent advice given to Hammond Associates' clients. The non-diversified portfolio is comprised of 75% S&P 500 and 25% Lehman Aggregate Bond. The diversified portfolio is comprised of 16% S&P 500, 8% S&P 500 / BARRA Value, 7% S&P MidCap 400, 11% Russell 2000, 5% Russell 2000 Value, 7% Wilshire REIT, 7% MSCI EAFE, 7% Citigroup EMI EPAC, 7% MSCI EMF, 13% Lehman Aggregate Bond, and 12% Lehman TIPS.



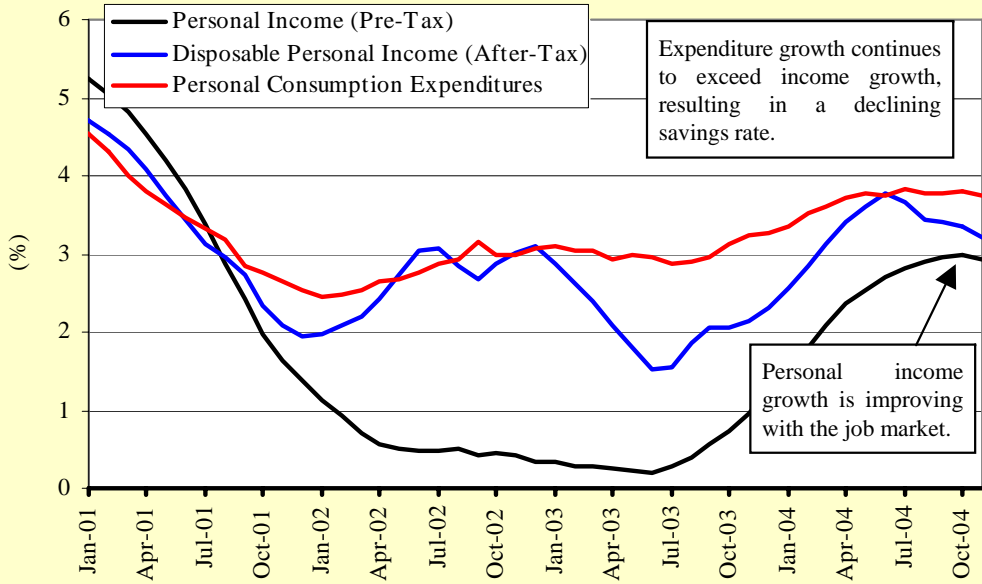
What Will 2005 Bring for the Economy?

- The economy grew at a 4% annualized pace in the third quarter. Fourth quarter growth is expected to come in at 4%, which would put full year growth at 4.5%. Forecasters polled by *The Economist* expect growth of 3.5% in 2005.
- The job market improved in the fourth quarter. An average of 200,000 jobs were added per month. For the year, the economy added 2.2 million jobs. Business investment was strong in 2004. Investment increased an estimated 10% for the year. The ISM index still points to continued business expansion. Consumer spending remained strong in 2004, growing about 3.7%.
- After hitting \$55 per barrel early in October, oil prices declined to \$44 by the end of December. If oil prices stay at current elevated levels, they will likely be a modest drag on the economy in 2005, but should not seriously derail growth.
- Looking to 2005 and beyond, we remain concerned about the imbalances in the economy.
 - ✓ Consumer spending, which makes up 70% of the economy, appears increasingly stretched. Savings rates are miniscule as a result of the spending binge of the last decade, and debt is at record levels. Rising interest rates will increase debt service burdens and, more seriously, will risk pricking the housing bubble.
 - ✓ The Federal budget is deep in the red and is likely to remain there for the foreseeable future. With the retirement of baby-boomers approaching, entitlement programs make the long-term budget prospects even worse.
 - ✓ Due to high consumption and lack of savings, the US needs to attract over \$650 billion of net foreign capital each year to offset the current account deficit and provide investment capital.
- While these factors may not affect 2005 growth, we expect that GDP growth will be below the historical average of 3% over the next decade as the imbalances are corrected.



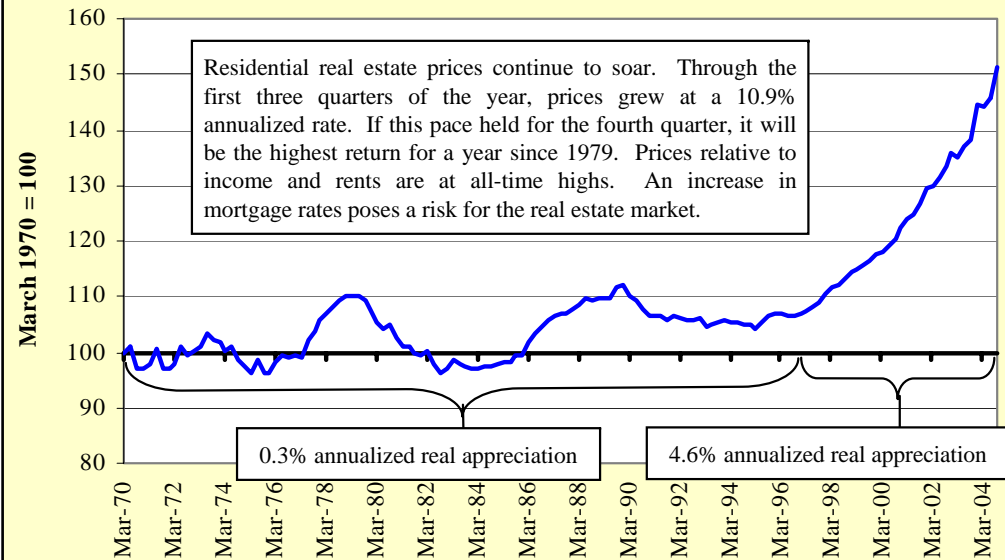
What Will 2005 Bring for the Economy? (cont.)

Year-Over-Year Change in Real Personal Income and Expenditures



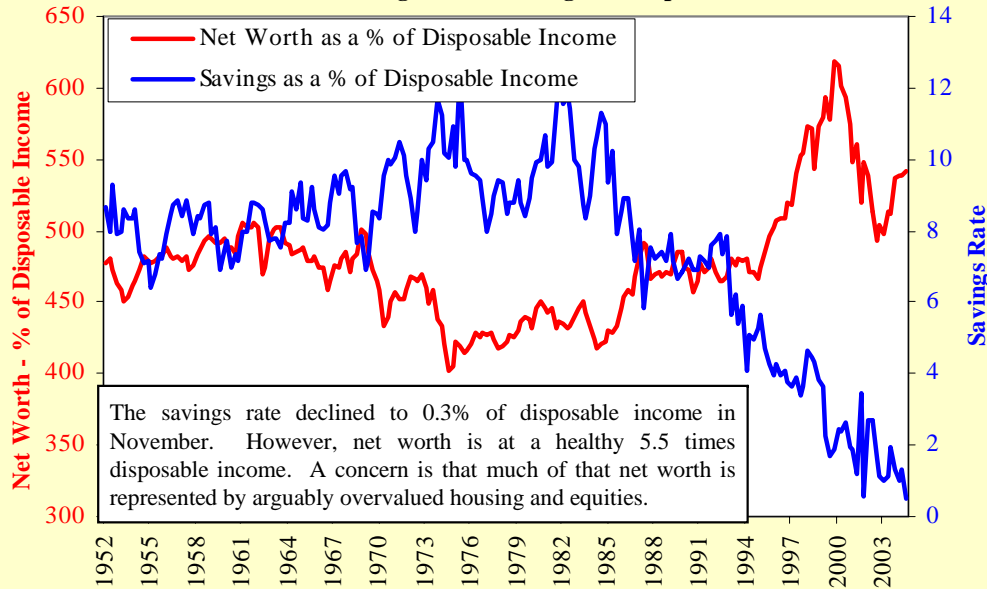
Source: Bureau of Economic Analysis

Growth of Inflation-Adjusted Residential Real Estate Prices (Through September 2004)



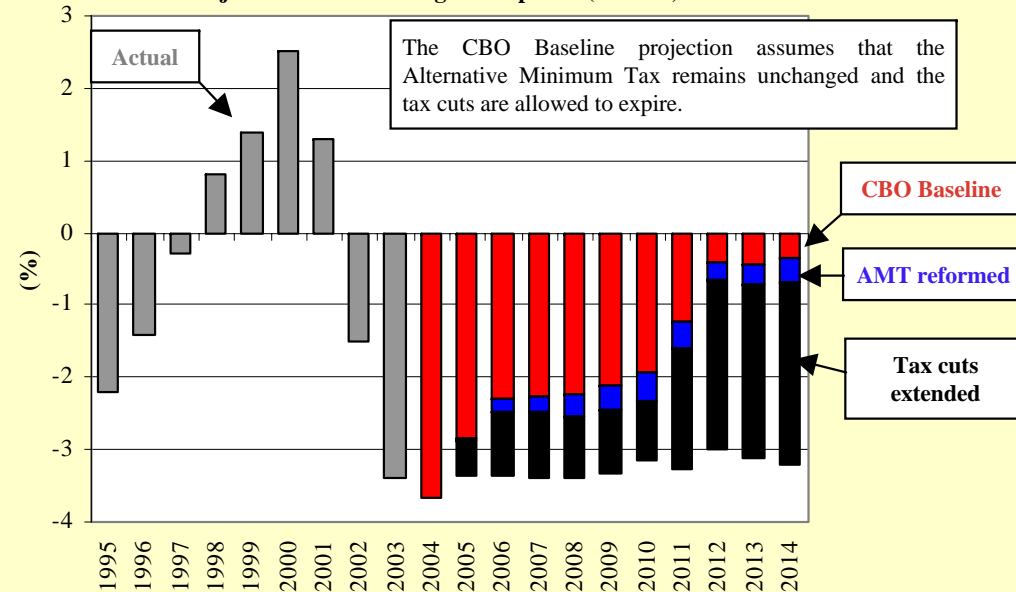
Source: Freddie Mac

Net Worth and Savings as Percentage of Disposable Income



Source: Federal Reserve

Projected Federal Budget Surplus / (Deficit) as % of GDP



Source: Congressional Budget Office

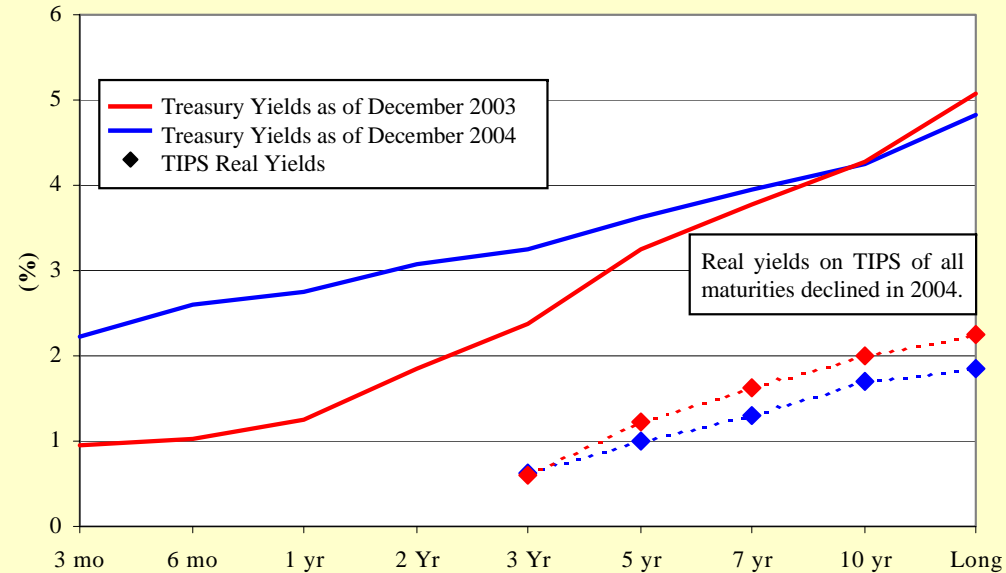
The Yield Curve Became Flatter in 2004

- The Federal Reserve shifted to tightening mode in 2004. It raised the Fed Funds target rate five times in 2004, from 1% to 2.25%. Fed Funds futures are predicting a 3.5% overnight rate by the end of 2005.
- The tightening had a dramatic effect on the short to intermediate end of the yield curve. Surprisingly, longer term rates finished the year slightly lower. The yield on the 10-year Treasury declined by 0.03% in 2004, and the yield on the long bond declined by 0.24%.
- Higher energy prices lifted inflation to 3.6% for the twelve months ended November. Core inflation (ex. food and energy) was 2.2%. While still low in absolute terms, the core inflation rate has doubled over the last year.
- Inflation-indexed bonds are reflecting higher inflation expectations. The breakeven inflation rate on 10-year TIPS rose from 2.3% to 2.6% in 2004, and the breakeven rate on long bonds increased from 2.8% to 3.0%.
- Going into 2005, two questions arise from the shift in Fed policy:
 - ✓ What impact will the unwinding of the “carry trade” have on financial markets and returns?
 - ✓ Will foreign investors and central banks continue to be willing to subsidize our spending by purchasing bonds, thereby keeping our interest rates artificially low?

Excerpt from 12/14/2004 FOMC Meeting Minutes (*emphasis added*)

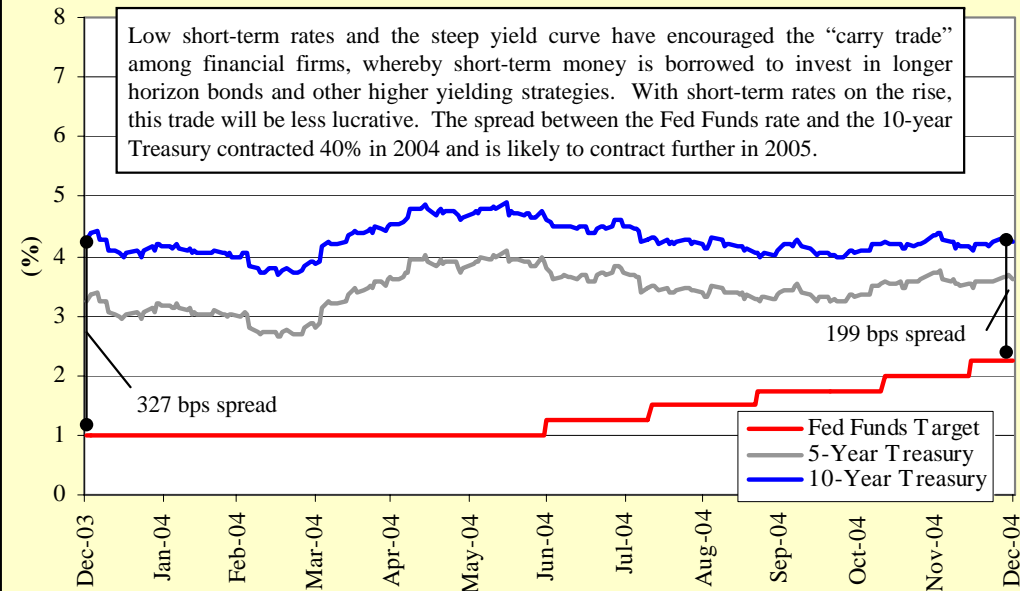
“Some participants believed that the **prolonged period of policy accommodation** had generated a significant degree of liquidity that might be contributing to signs of potentially **excessive risk-taking in financial markets** evidenced by **quite narrow credit spreads**, a pickup in initial public offerings, an upturn in mergers and acquisition activity, and anecdotal reports that **speculative demands were becoming apparent in the markets for single-family homes and condominiums.**”

Treasury Yield Curve



Source: Federal Reserve

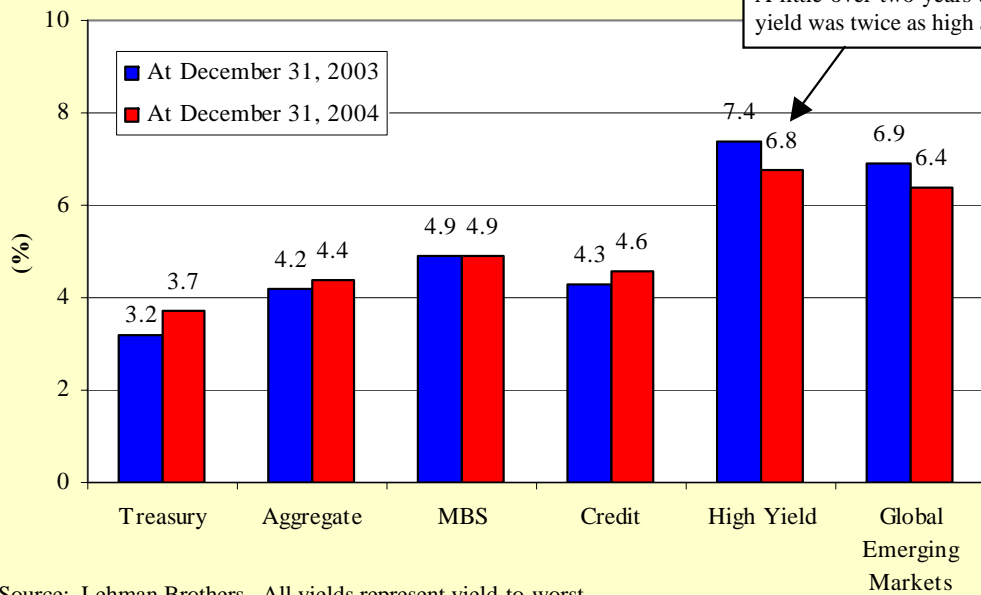
Daily Interest Rates



Source: Federal Reserve

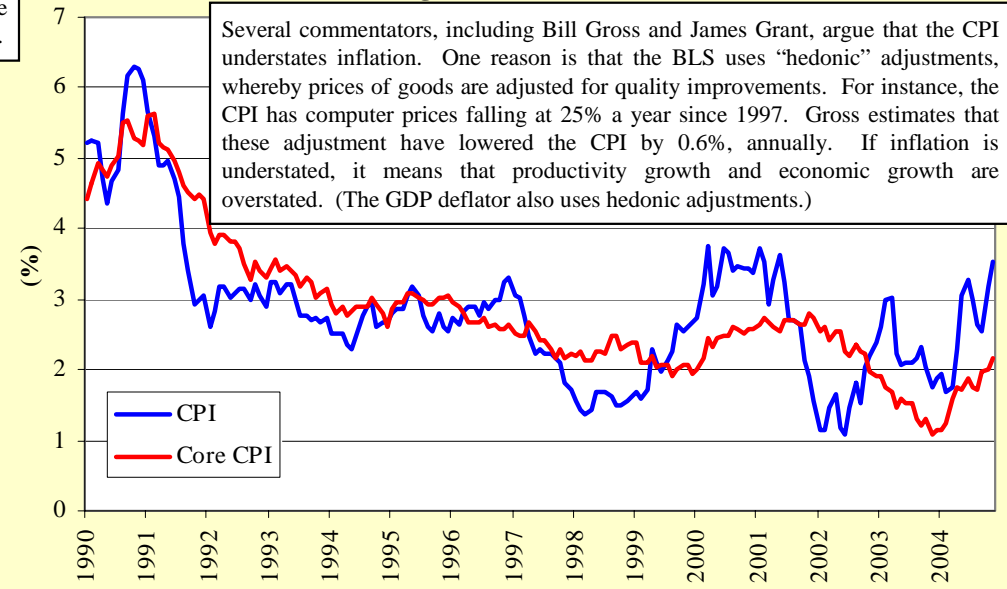
The Yield Curve Became Flatter in 2004 (cont.)

Yields on Lehman Bond Indices



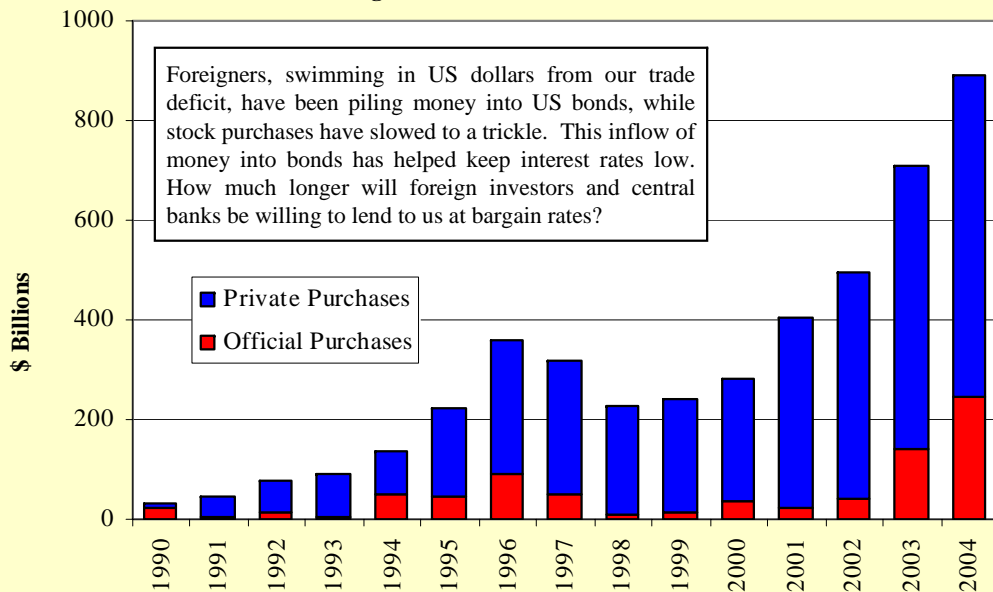
Source: Lehman Brothers. All yields represent yield-to-worst

Rolling 12-Month Inflation



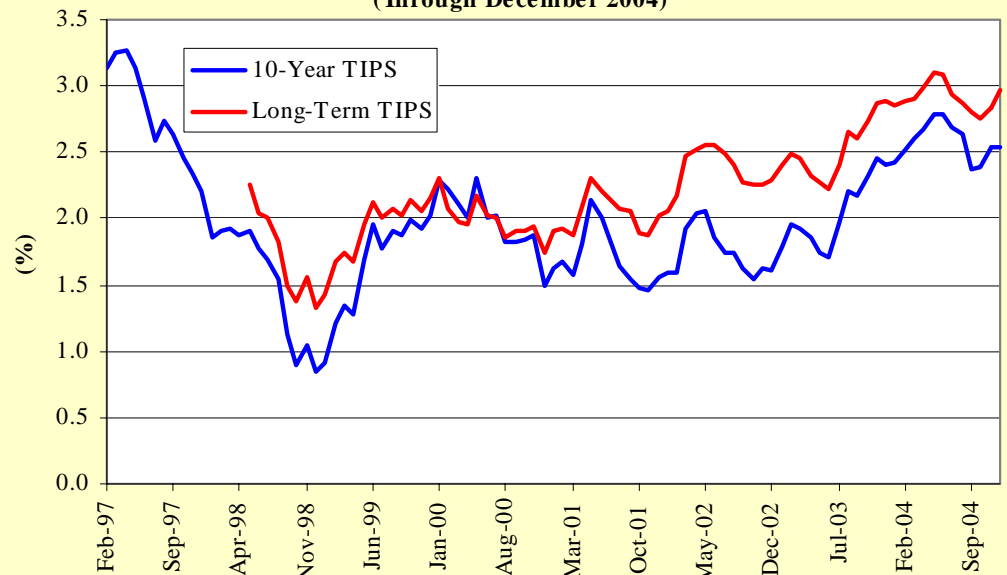
Source: Bureau of Labor Statistics

Foreign Net Purchases of US Bonds



Source: US Treasury Department

Inflation Breakeven Rate on TIPS (Through December 2004)

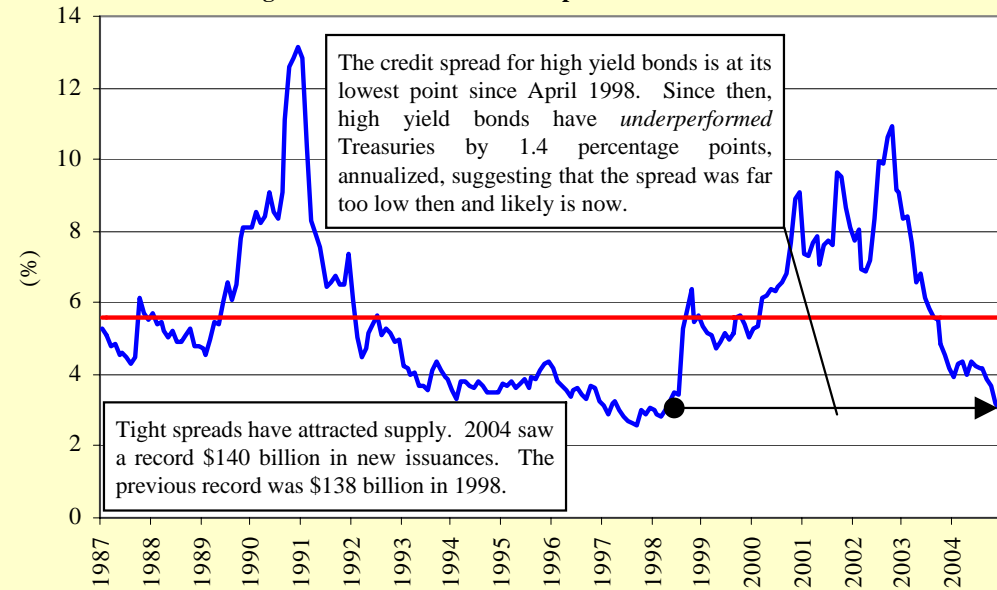


Source: Federal Reserve

Evaporating Credit Spreads

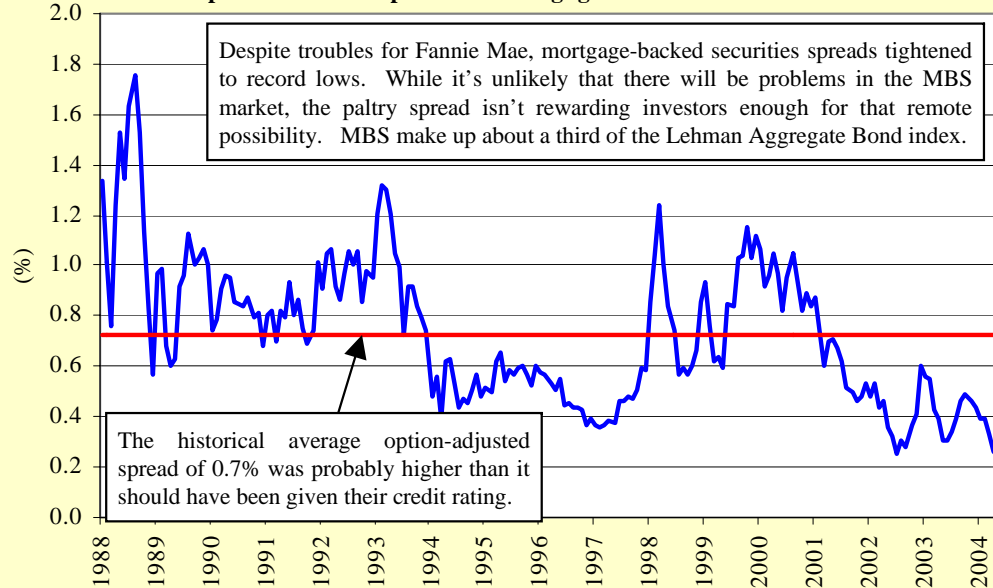
- Investors' hunger for yield and the carry trade have pushed credit spreads for risky fixed income securities to absurdly low levels. High yield bonds and emerging market debt are offering spreads of only 3% to Treasuries.
- Spread contraction is also apparent in higher quality segments. Mortgage-backed securities are trading at a record low option-adjusted spread of 0.2%. Investment-grade corporates also have below average credit spreads. The Lehman Credit index offers a 0.4% premium to Treasuries, which is 40% below average.
- At current yields, Treasuries are far from attractive. However, they offer the best risk-adjusted returns among major domestic bond sectors. We expect that Treasuries will be the best performing bond sector over the next few years as spreads revert to normal.

High Yield Bonds - Credit Spread to Treasuries



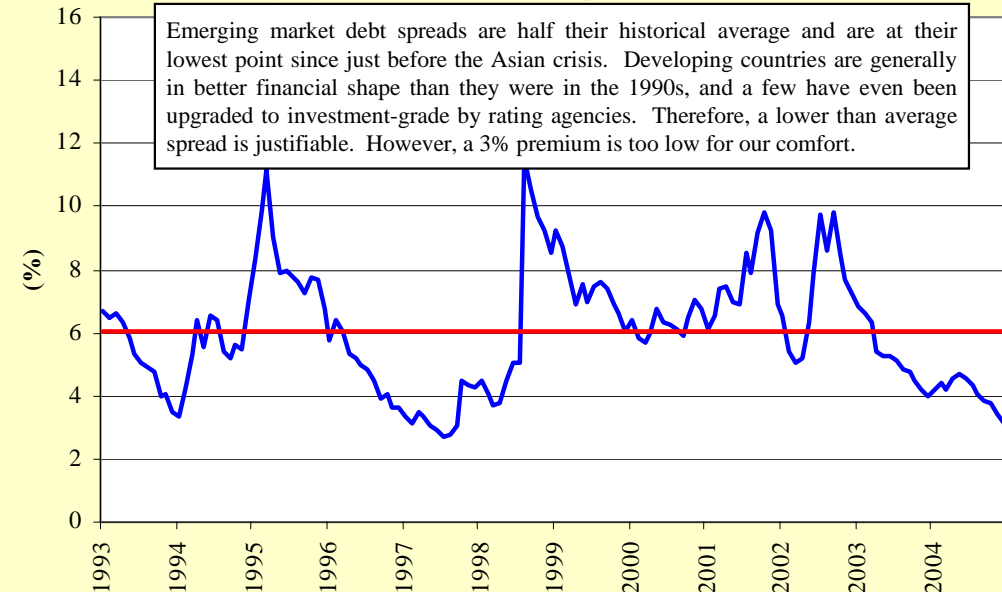
Source: Lehman Brothers

Option-Adjusted Spread on Mortgage-Backed Securities



Source: Lehman Brothers

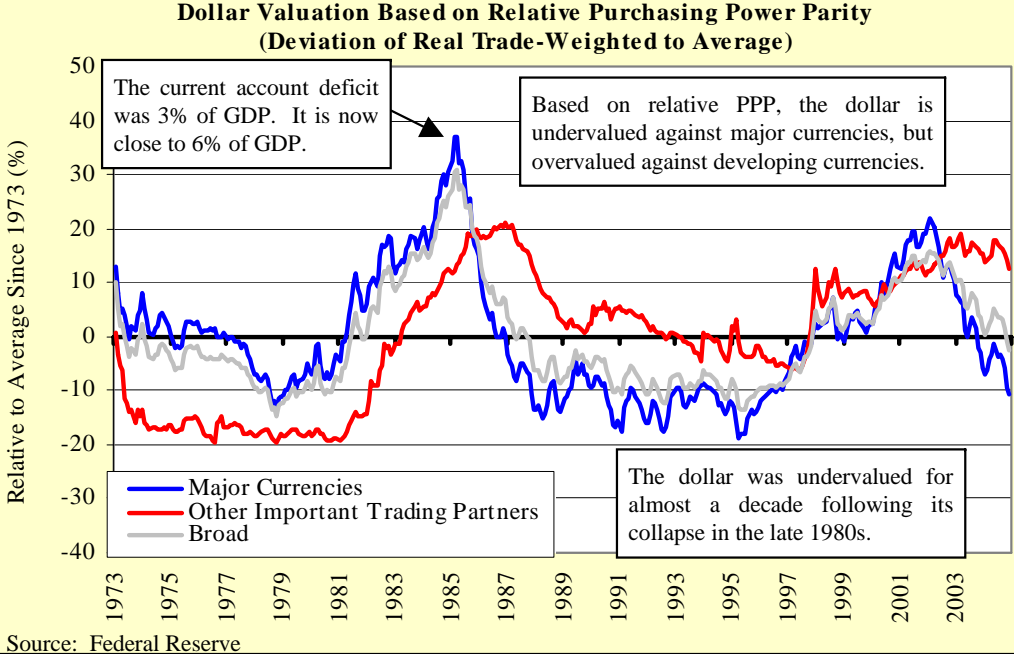
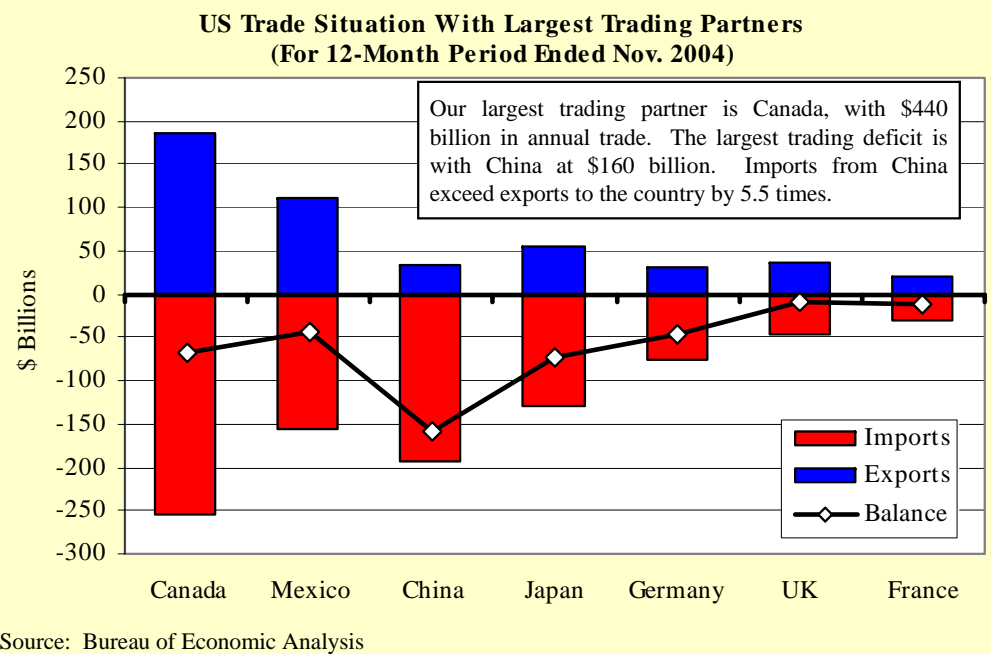
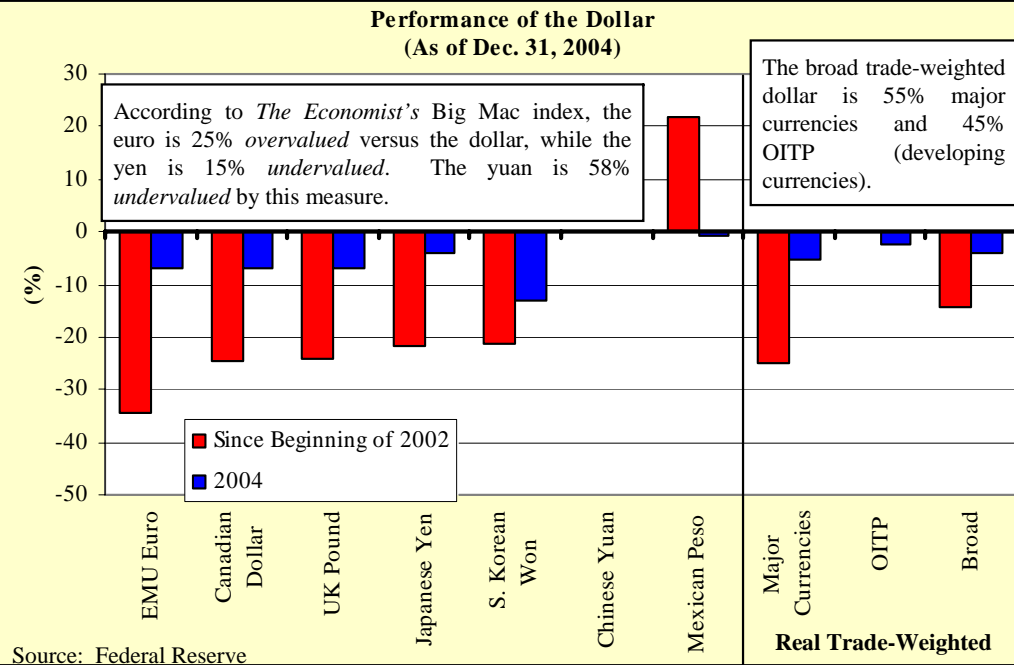
Emerging Market Debt Credit Spread to Treasuries



Source: Lehman Brothers

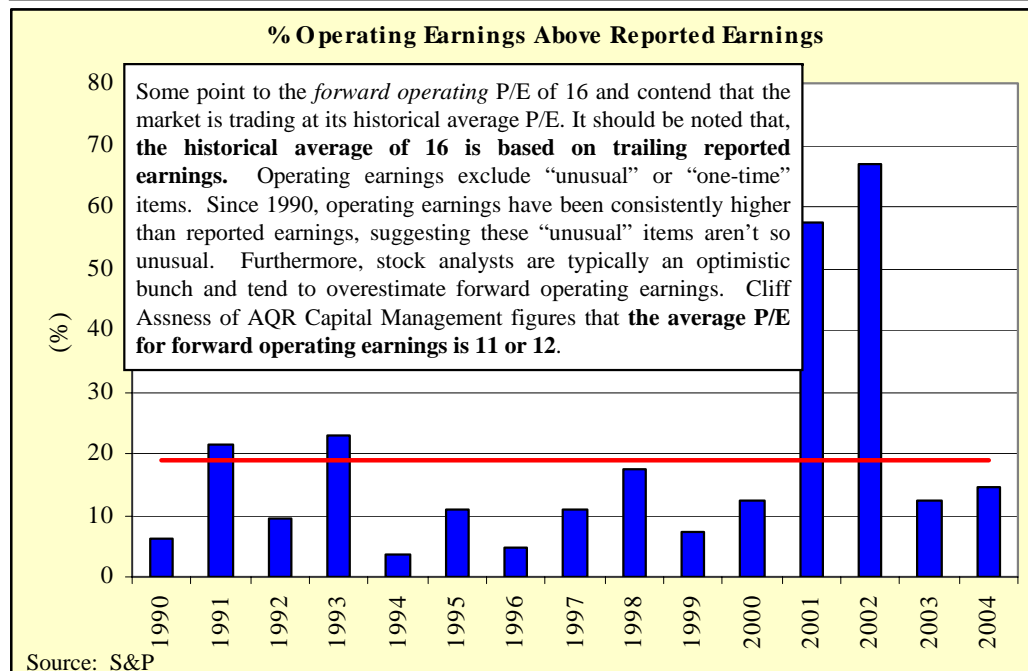
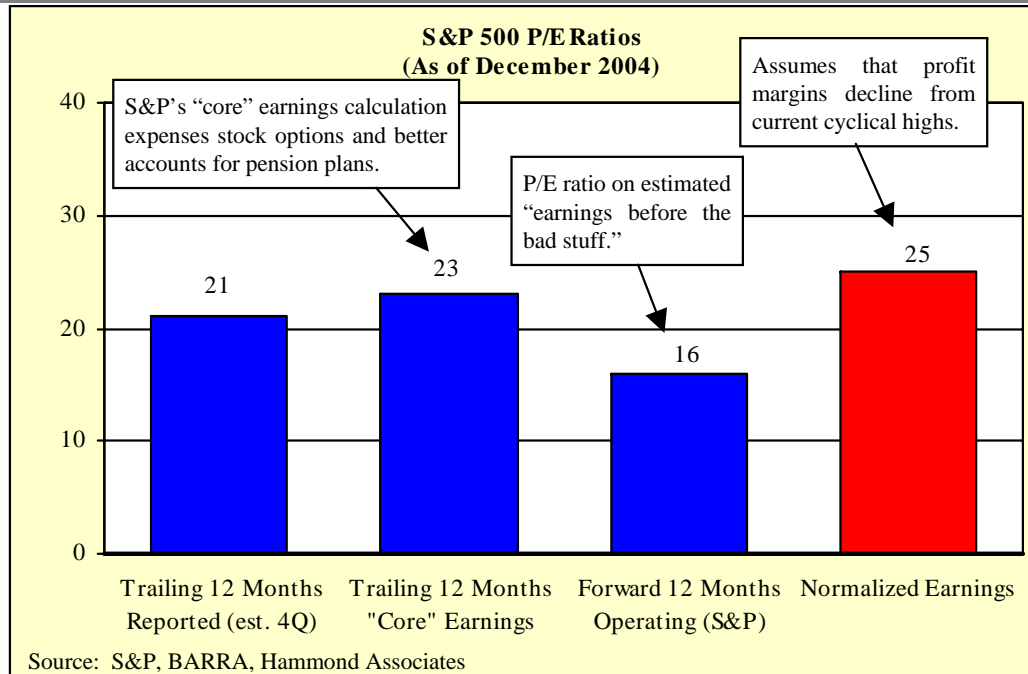
The Greenback Resumes Its Descent

- After staying fairly stable in the first three quarters of 2004, the bottom dropped out of the dollar in the fourth quarter. Against the euro, the buck declined 7% during 2004, and has lost a third of its value versus the euro over the last three years. The real trade-weighted dollar fell 4.1% in 2004 and 14% over the last three years.
- With the depreciation in 2004, the trade-weighted dollar appears *fairly valued* on a purchasing power parity basis. Against major currencies the dollar now appears *undervalued*, but remains *overvalued* against currencies of developing markets (most significantly, China).
- Despite the buck's fall, the current account deficit, now approaching 6% of GDP, continues to worsen. The trade-weighted dollar likely must become significantly *undervalued* for an extended period to reduce the deficit to a sustainable level. It may already be where it needs to be against the euro and other European currencies. Future depreciation needs to occur against the Chinese yuan and other Asian currencies.



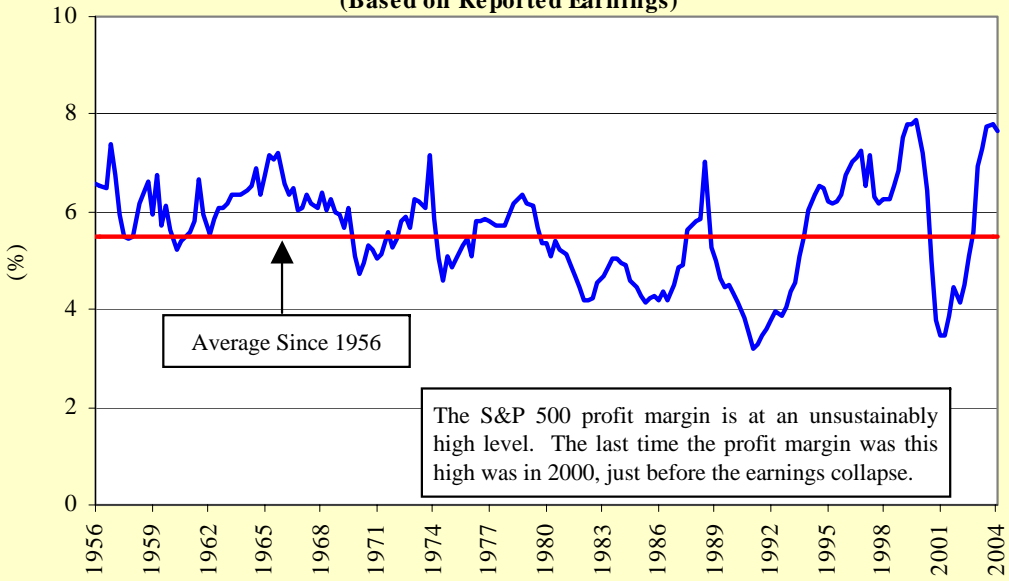
2005 Likely to be Challenging for US Equities

- Earnings growth remained strong in 2004. Reported earnings on the S&P 500 grew 20% during the year (est. 4Q), exceeding the 10.9% return on the index. As a result, the P/E ratio on reported earnings declined from 23 to 21 during the year. However, we fear that current profits are unsustainable. The profit margin on the S&P is 7.8%, which is well above the historical average of 5.5%. On our measure of normalized earnings, which assumes that profit margins decline (although not all the way back to the historical average), the index is trading at a P/E of 25.
- Earnings from financials seem especially vulnerable. Financials make up 23% of the S&P 500, but contributed 45% of index's operating earnings in 2004. Financial companies have benefited from the carry trade. With short-term rates already up 125 bps and almost certain to head higher in 2005, the trade will become less profitable.
- Given current valuations, we estimate that the S&P 500's real return will be in the low single digits over the next 10 years. 2005 could be a difficult year for the index. The rate of earnings growth will likely fall, and a decline in earnings is possible. Also, the first year of Presidential terms has historically been relatively poor for the market. We wouldn't be surprised to see the S&P 500 finish flat to lower in 2005.
- Within the US market, there are no obvious bargains. After six consecutive years of outperformance, small-caps appear overvalued versus large-caps. Value indices (which are heavily exposed to financial stocks) look fairly valued to overvalued versus growth indices. Overvalued tech stocks notwithstanding, there's a fair chance 2005 will be the first year since 1998 when large-cap growth is the top performing style.



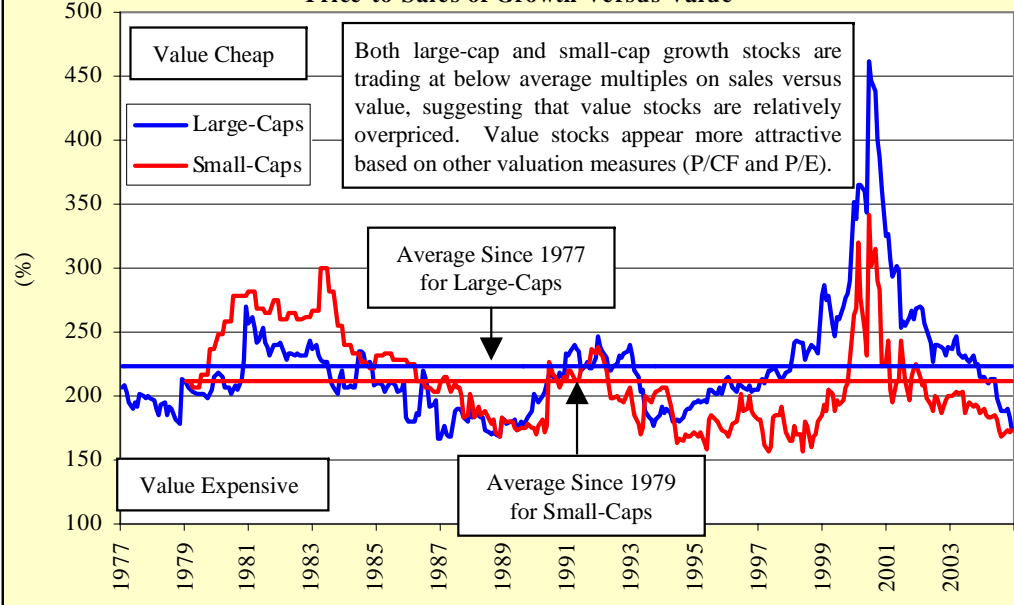
2005 Likely to Be Challenging for US Equities (cont.)

**Profit Margin on the S&P 500
(Based on Reported Earnings)**



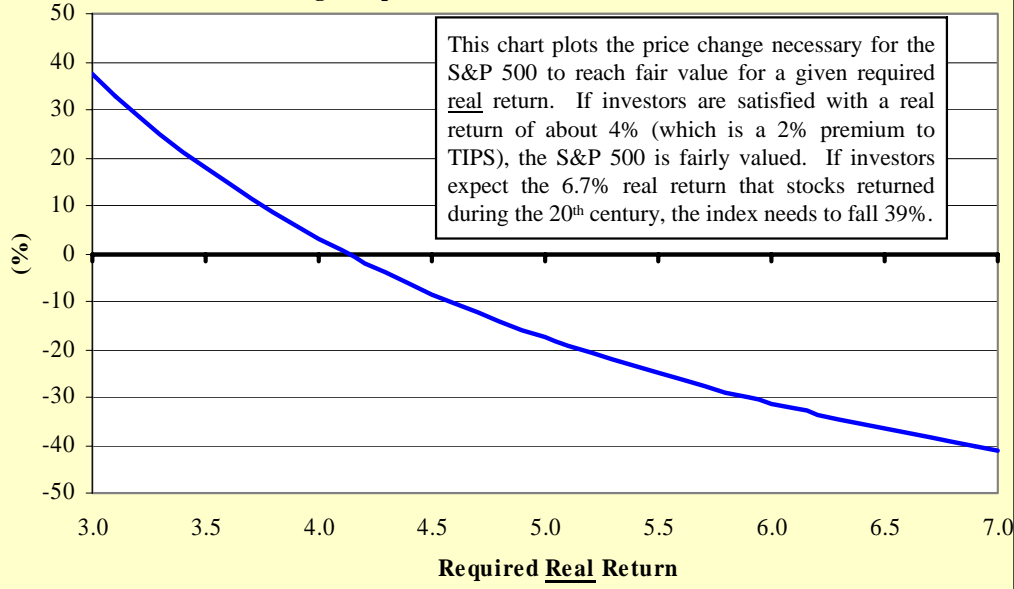
Source: S&P, BARRA

Price-to-Sales of Growth Versus Value

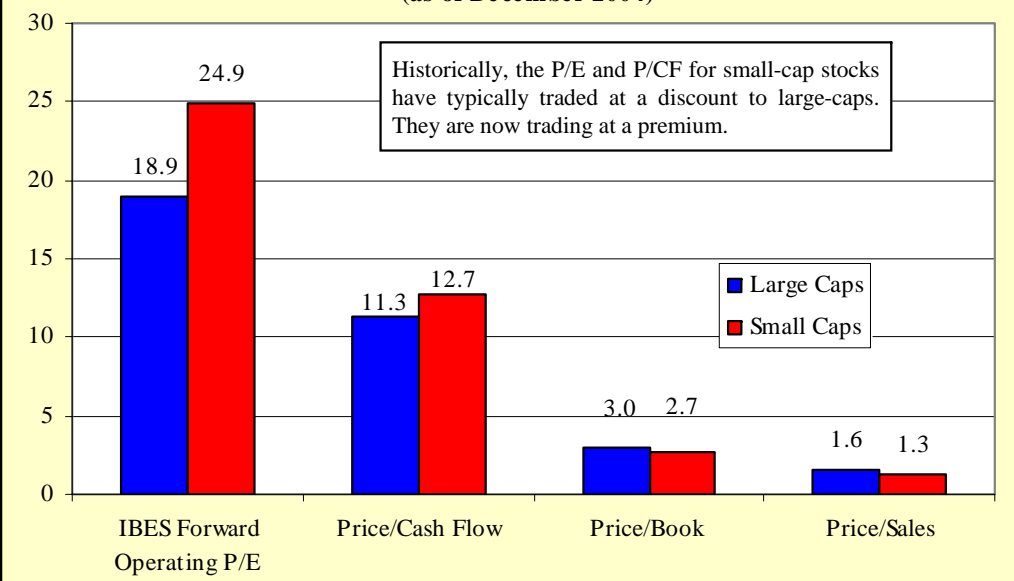


Source: BARRA, Russell

Price Change Required for S&P 500 to Reach Fair Value



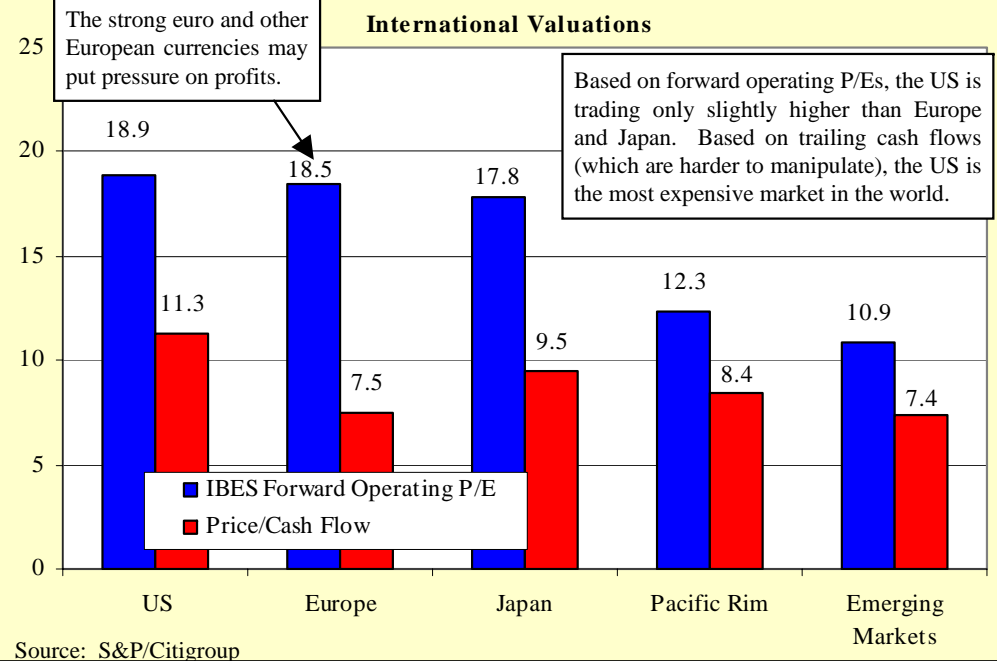
**US Equity Market Valuation Snapshot
(as of December 2004)**



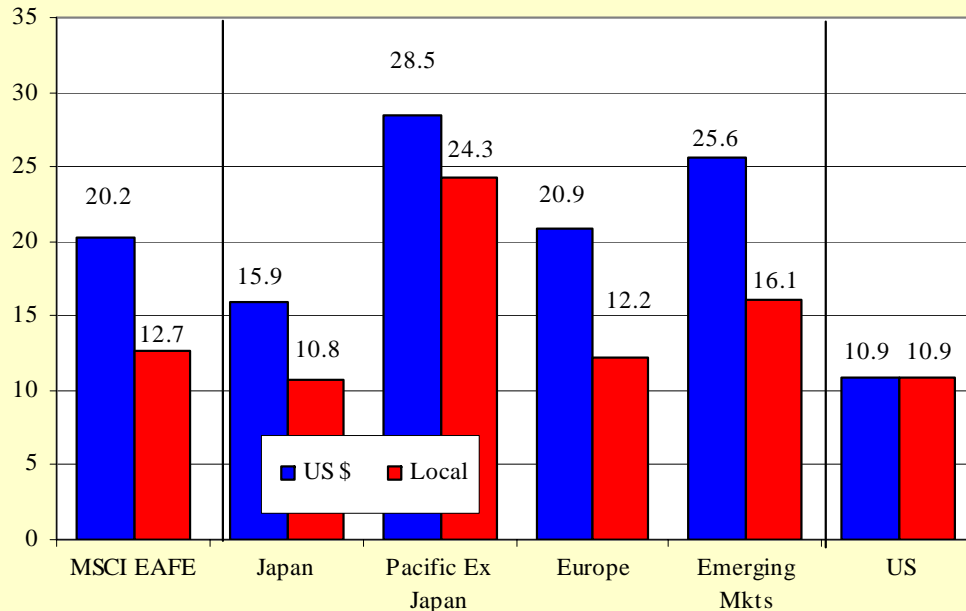
Source: S&P/Citigroup

Weak Dollar Propels International Equities

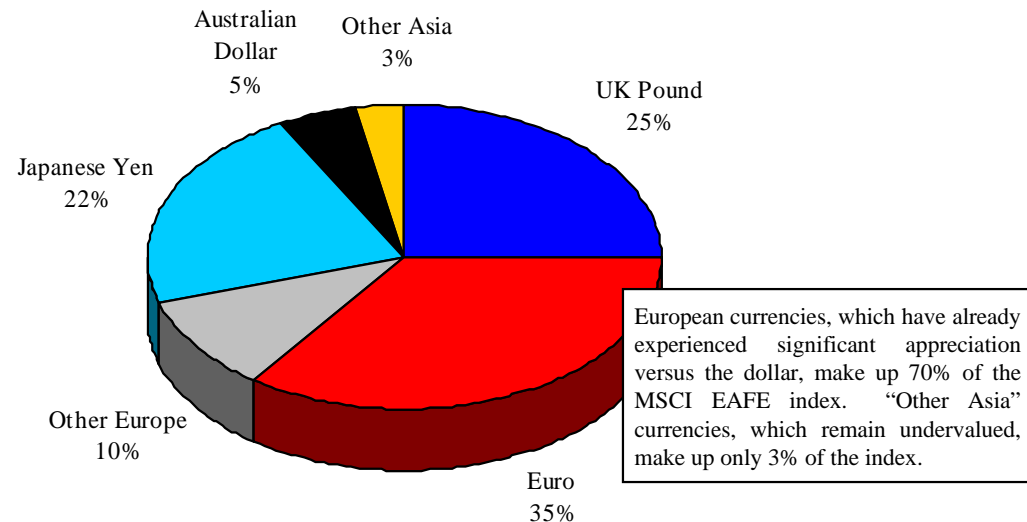
- International equities outperformed US equities for the third consecutive year in 2004. Measured in local currency returns, the MSCI EAFE index gained 12.7% for the year versus 10.9% for the S&P 500. However, in US dollar terms, the MSCI index returned 20.2%, nearly twice the S&P 500 return. Emerging market stocks, also benefiting from the weak dollar, earned 25.6% during the year.
- While international stocks look pricey on an absolute basis, they are still trading at more attractive valuations than US stocks. We expect them to outperform again in 2005.
- With the performance of the dollar in 2004, investors should not count on much of a currency pop from developed market indices. While the dollar is likely to continue to weaken on a trade-weighted basis, the case for it weakening against European currencies, which make up 70% of MSCI EAFE, is less compelling. There remains some currency upside to emerging market equities.



2004 Returns for Global Markets



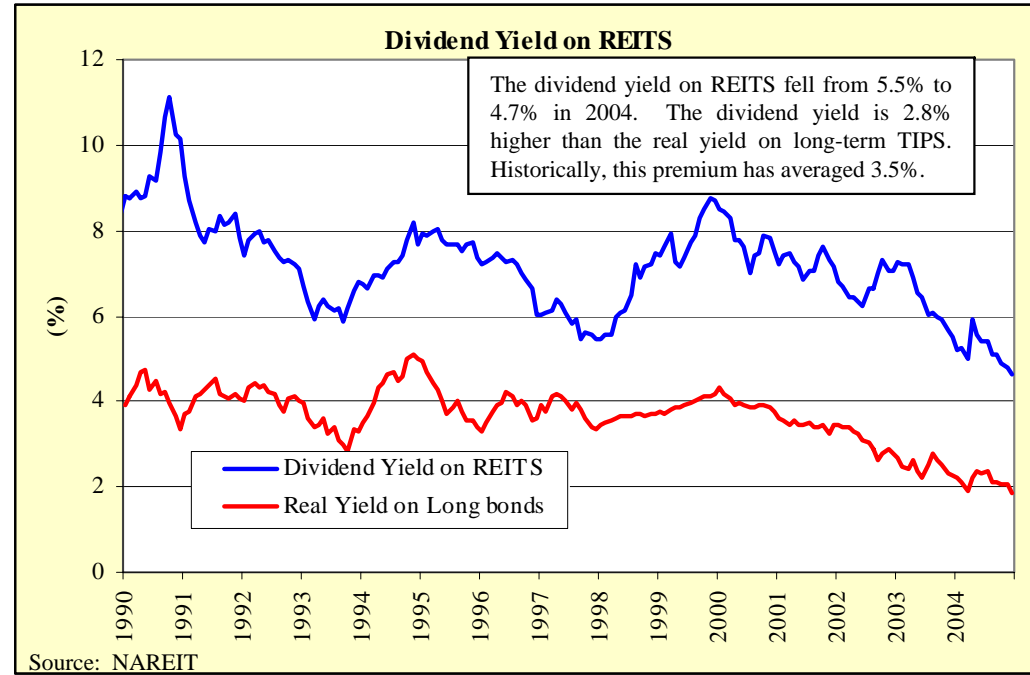
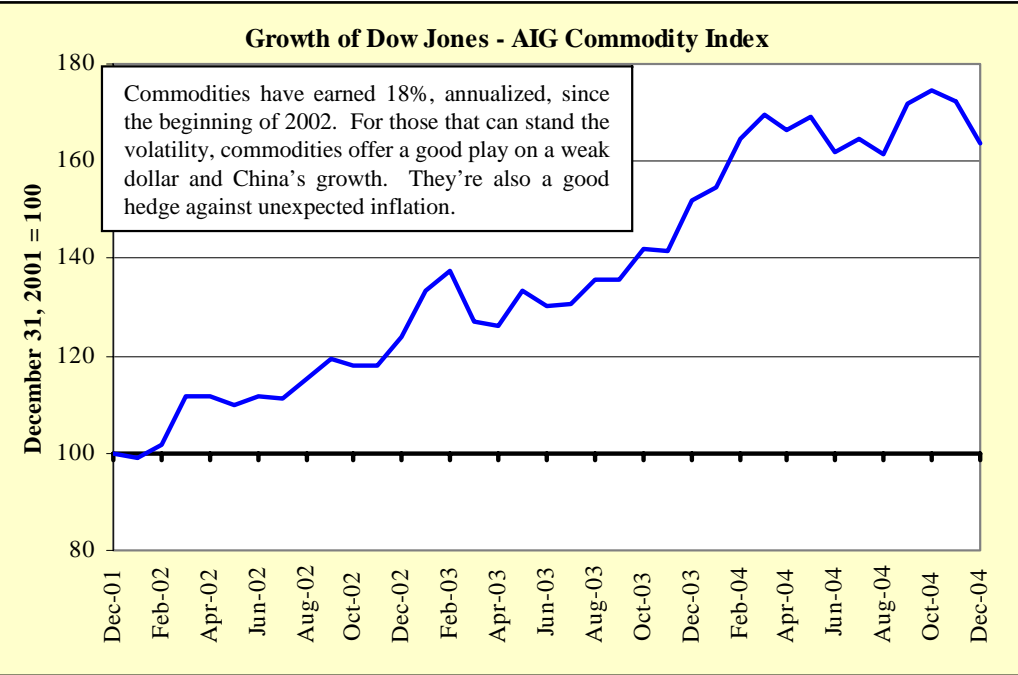
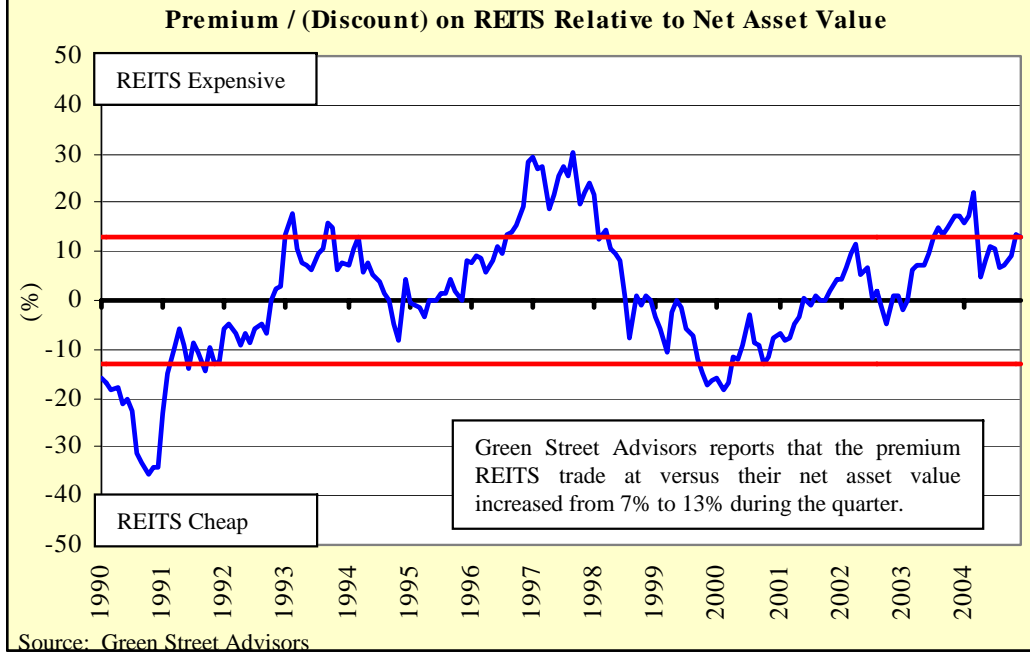
Currency Weightings of MSCI EAFE



Source: MSCI

Real Assets: REITS Become Even More Expensive

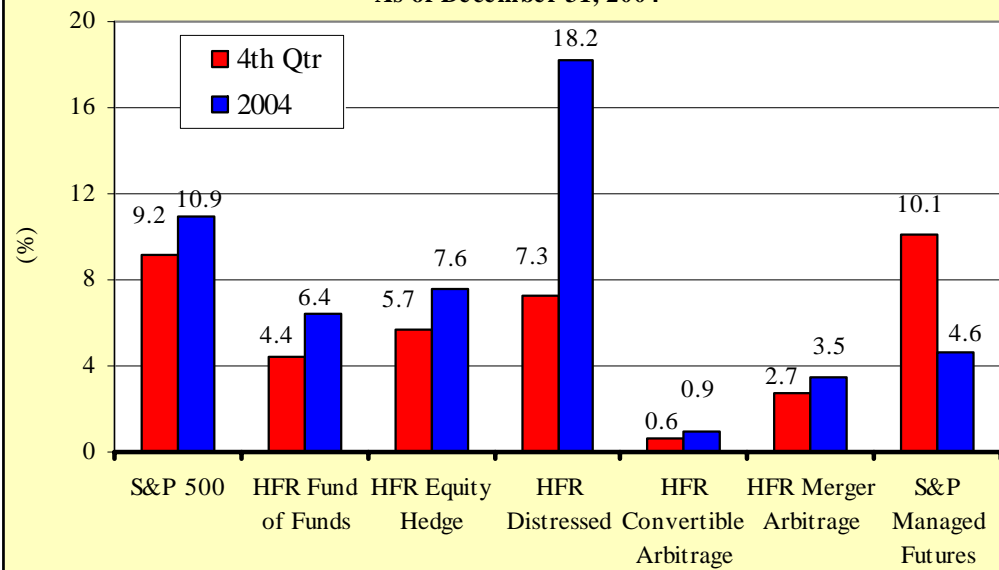
- REITS continued to surge in the fourth quarter, gaining 16.0%. For the year, REITS earned 33.1%. Investors continue to be attracted by the high dividend yield (another carry trade). According to Green Street Advisors, they trade at a 13% premium to net asset value.
- REITS now appear overpriced. They still offer a marginally better value than stocks, but the advantage dwindled substantially in 2004. An increase in interest rates could prove to be a double whammy for REITS. First, the value of their underlying properties could fall with rising rates. Second, to those investors attracted by the dividend yield, REITS would become relatively less attractive in a higher rate environment, perhaps pushing the dividend yield higher and their premium to NAV down.
- Commodities stumbled in fourth quarter on lower energy and gold prices. The Dow Jones – AIG Commodity Index lost 4.5% during the quarter, but gained 16.4% for the year.



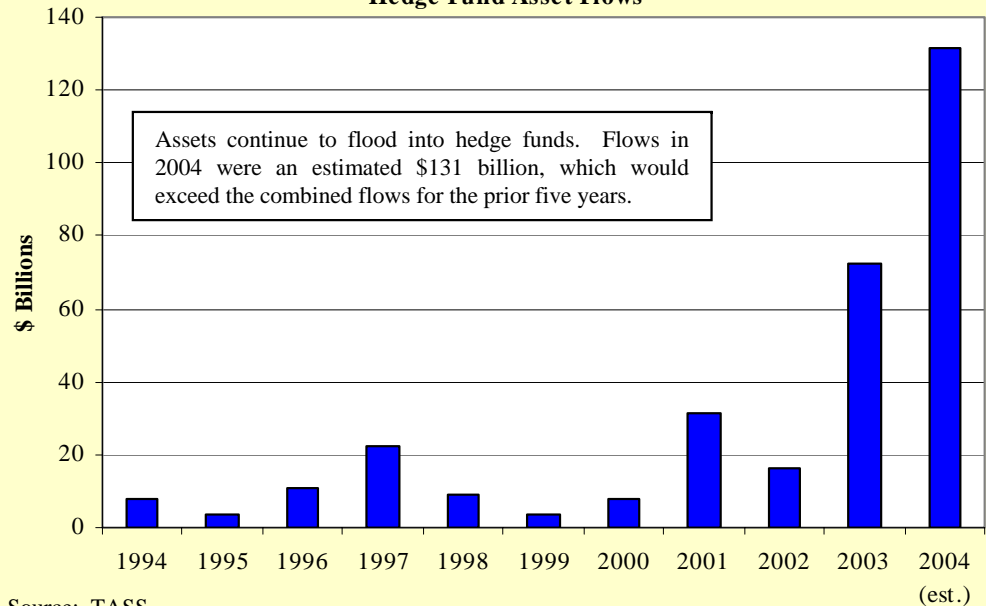
Hedge Funds Returns Mediocre in 2004

- Hedge fund returns in 2004 were not spectacular, but they weren't terrible either. According to HFR, the average fund of hedge funds earned 6.4% in the year. Fund of funds underperformed the S&P 500, but outperformed bonds. Much of the return for 2004 came in the last two months of the year. The average fund of funds more than doubled its year-to-date return during November and December alone. Once the election ended, market action and direction returned in force and most hedge fund managers capitalized.
- Distressed managers enjoyed a very strong year, up 18.2%. With credit spreads extremely tight, 2005 will be more difficult. Managers with a focus on smaller deals, active involvement, and those *shorting credit* may be best positioned for 2005.
- Convertible arbitrage managers earned 0.9% in 2004. The meager returns should trigger redemptions, which may enhance future opportunities. Merger arbitrage bounced back in the fourth quarter and earned 3.5% in 2004. A number of large deals came to market in December, and managers are describing the spreads as "reasonable."
- Long/short equity managers returned 7.6% in 2004. Should market volatility increase and correlations decrease, the strategy holds promise, provided you are with the right managers.
- Managed futures enjoyed a strong turnaround in the fourth quarter. A number of profitable trends emerged, led by the declining dollar. In an investing environment free of compelling traditional opportunities, investors may need to consider unique alternatives. Managed futures is a strategy that is "long volatility," meaning it generally profits when volatility rises. With volatility well below historical levels and poised to rise, the strategy may enjoy a solid 2005.

Performance of Hedge Fund Indexes
As of December 31, 2004



Hedge Fund Asset Flows

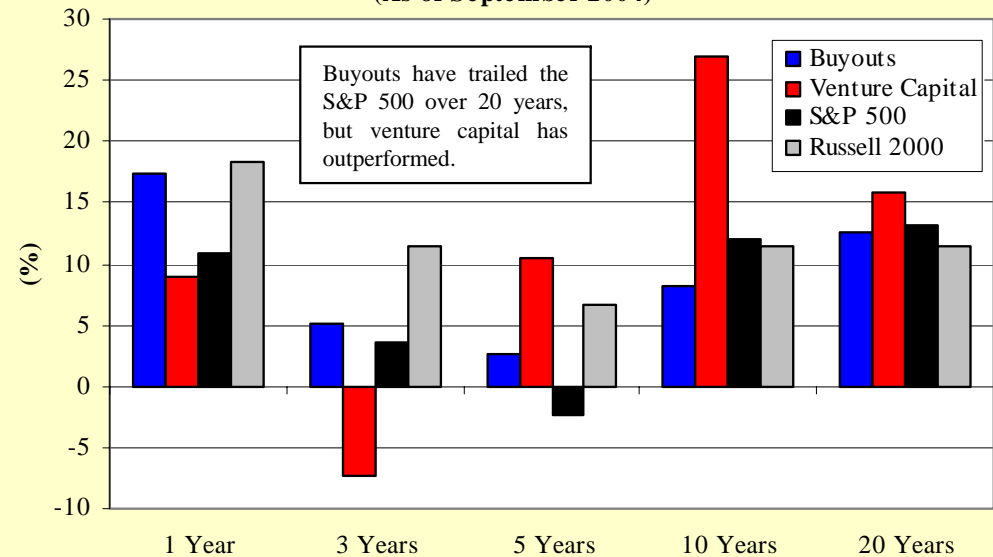


Source: TASS

Private Equity: The Return of the IPO

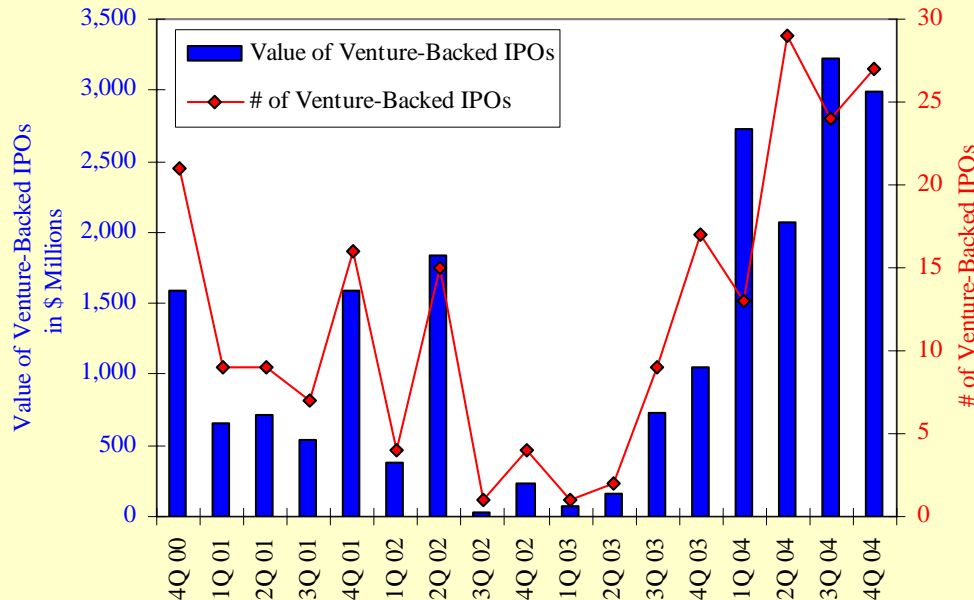
- Fundraising through the first nine months of 2004 already topped 2003 totals. Venture funds raised \$11.2 billion through September versus \$10.5 billion for all of 2003. Encouragingly, investments exceeded fundraising. Venture funds invested \$15.2 billion through September, 35% more than new commitments, meaning that the “overhang” continues to be worked down.
- A concern is the “secondary overhang”—the money that institutions are earmarking for private equity investments but have yet to commit.
- 2004 was a strong year for IPOs. NVCA reports that there were 93 venture-backed IPOs that raised a total of \$11 billion, which was more than was raised in the prior three years combined. Four-fifths of the companies received their first round of funding prior to the tech bubble burst.

**Private Equity Performance
(As of September 2004)**



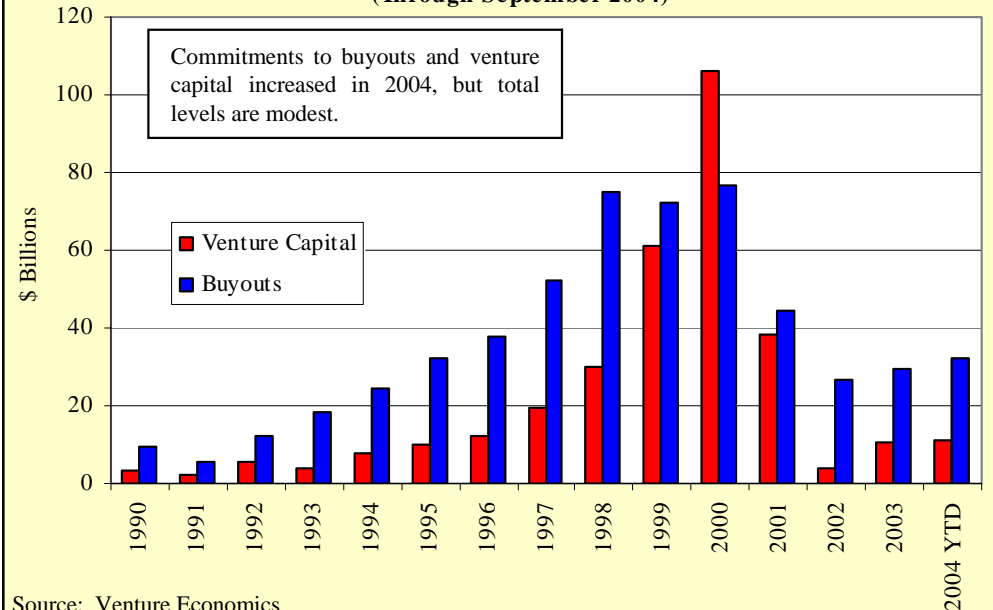
Source: VentureExpert

Quarterly Venture-Backed IPOs



Source: Venture Economics

**Private Equity Commitments by Year
(Through September 2004)**



Source: Venture Economics

Active Managers Underperformed in 2004

*% of Surviving Mutual Funds that Have Outperformed Their Index
(As of 12/31/04)*

<i>Asset Class</i>	<i>Index</i>	<i>1 Year (%)</i>	<i>3 Years (%)</i>	<i>5 Years (%)</i>	<i>10 Years (%)</i>	<i>20 Years (%)</i>
US Large-Cap Growth	Russell 1000 Growth	64	53	72	47	44
US Large-Cap Blend	S&P 500	35	38	55	20	13
US Large-Cap Value	Russell 1000 Value	17	17	40	13	10
US Mid-Cap Blend	S&P 400	45	38	37	22	1
US Small-Cap Growth	Russell 2000 Growth	42	49	67	85	81
US Small-Cap Blend	Russell 2000	54	63	85	80	77
US Small-Cap Value	Russell 2000 Value	38	37	34	58	67
International Large Cap	MSCI EAFE	28	33	41	69	44
Emerging Market Equities	MSCI EME	42	44	56	72	N/A

Large-cap and mid-cap managers have posted disappointing long-term results.

Small-cap managers have performed well, but survivorship bias is likely skewing the results.

Numbers in red indicate that two-thirds of managers underperformed the index, numbers in blue indicate that two-thirds of the managers outperformed the index.

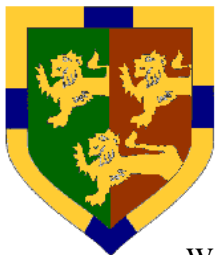
Active managers struggled in 2004. The median manager outperformed in only 2 of 9 asset classes.

<i>Morningstar Category Average Returns for 1996</i>			
<i>Asset Class</i>	<i>As Reported in 1996</i>	<i>As Reported in 2004</i>	<i>Difference</i>
US Large-Cap Growth	21.1	20.0	(1.1)
US Large-Cap Blend	20.6	21.4	0.8
US Large-Cap Value	19.9	20.5	0.6
US Mid-Cap Blend	19.1	20.1	1.0
US Small-Cap Growth	17.3	19.6	2.3
US Small-Cap Blend	21.2	22.1	0.9
US Small-Cap Value	22.1	23.5	1.4
Foreign Equities	12.4	14.9	2.5
Emerging Market Equities	12.3	14.4	2.1

The average return for 1996 did not increase very much for large-cap blend and value between 1996 and 2004 and actually fell for large-cap growth.

The return for mid-cap, small-cap, and foreign stocks increased substantially. The largest differences were for small-cap growth and foreign equities. The small-cap growth return for 1996 as reported in 2004 was 2.3 percentage points higher than the 1996 return as reported in 1996. The foreign equities return was 2.5 percentage points higher.

In order to measure the potential affects of survivorship bias on mutual fund universes, we examined historical Morningstar data. We calculated the average return for 1996 in several Morningstar categories using their year-end 1996 software. (We used 1996 because that was the first calendar year-end that Morningstar classified funds into categories.) We then calculated the category average return for 1996 using the December 2004 Morningstar software.



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 continue to expand the depth and breadth of our staff to accommodate growth in our clientele. Several new staff members were hired in 2004. Two of our newest consultants are highlighted below.

Jerry V. Woodham, MBA

previously

- Chief Investment Officer for the San Diego Employees Retirement Association
- Treasurer and Chief Investment Officer of Saint Louis University
- Chief Investment Officer of Washington University

K. Beth Johnson, CFA

previously

- An Investment Director at Vanderbilt University
- Investment Analyst at Duke University Management Company

•Firm

- Founded in 1985
- National Practice
- Mid-Sized and Growing Responsibly
- Independent Fiduciary
- Proprietary Research

•Clientele

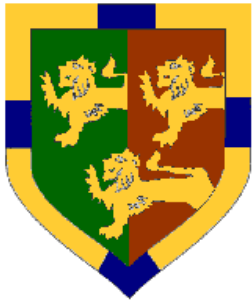
- 41 Educational Institutions
- 29 Foundations
- 19 Pension Plans and Health Care Institutions
- Private Wealth Clients

•Staff

- 52 Staff Members
- 43 Investment Professionals
- 24 Advanced Degrees (includes 2 Ph.D.s)
- 11 Holders, Chartered Financial Analyst (CFA) Designation
- 1 Certified Public Accountant (CPA)
- Over 350 Years of Combined Investment Expertise

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.

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



Are *You* The Right Person to receive the *Quarterly Research Report?*

- YES!** (Please fill in any changes in current address information along with your e-mail address below.)
- NO.** Please redirect future Quarterly Research Reports to the person listed below and remove my name: _____

NO. Please remove my name from your mailing list. Name: _____

CONTACT ME regarding Investment Consulting Services for my company/organization/family (circle one).

Please send me future editions of the **ALTERNATIVE INVESTMENTS UPDATE**

SEND ME the following
HAMMOND ASSOCIATES
RESEARCH NOTES:

- LIABILITIES AND ENDOWMENT MANAGEMENT
- IMPACT OF AN AGING POPULATION
- INVESTING IN A LOW RETURN ENVIRONMENT
- LOOMING CRISIS IN ENDOWMENT SPENDING
- IMPACT OF SURVIVORSHIP BIAS ON PEER RANKING COMPARISONS
- PERSISTENCE IN HEDGE FUND RETURNS
- HEDGE FUNDS REVISITED
- PRIVATE EQUITY INVESTING
- TIMBERLAND

NAME: _____

TITLE: _____

COMPANY: _____

ADDRESS: _____

CITY, STATE, ZIP: _____

PHONE: _____ FAX: _____ E-MAIL: _____

SEND a copy of the Quarterly Research Report to: _____

FAX THIS FORM TO 314-746-1699 OR E-MAIL INFO TO: MAIL@HAIFC.COM.

Visit our web site www.HAMMONDASSOCIATES.com for a complete listing of HAMMOND ASSOCIATES' articles and publications.

HAMMOND ASSOCIATES INSTITUTIONAL FUND CONSULTANTS, INC., 101 S. Hanley Road, Third Floor, Saint Louis, MO 63105-3406

The Research Report is also available via e-mail within three weeks of each quarter-end. Contact HAMMOND ASSOCIATES at 314-746-1600 or mail@haifc.com. The Research Report is published quarterly by Hammond Associates Institutional Fund Consultants, Inc., 101 S. Hanley Road, Third Floor, St. Louis, Missouri 63105-3406. The Research Report is written by Anthony W. Brown, CFA, Director of Research. The sources of information used in this report are believed to be reliable. Hammond Associates has not independently verified all of the information contained herein. Copyright © Hammond Associates, 2004. All rights reserved.