HAMMOND ASSOCIATES

INSTITUTIONAL FUND CONSULTANTS, INC.

RESEARCH REPORT

First Quarter 2005

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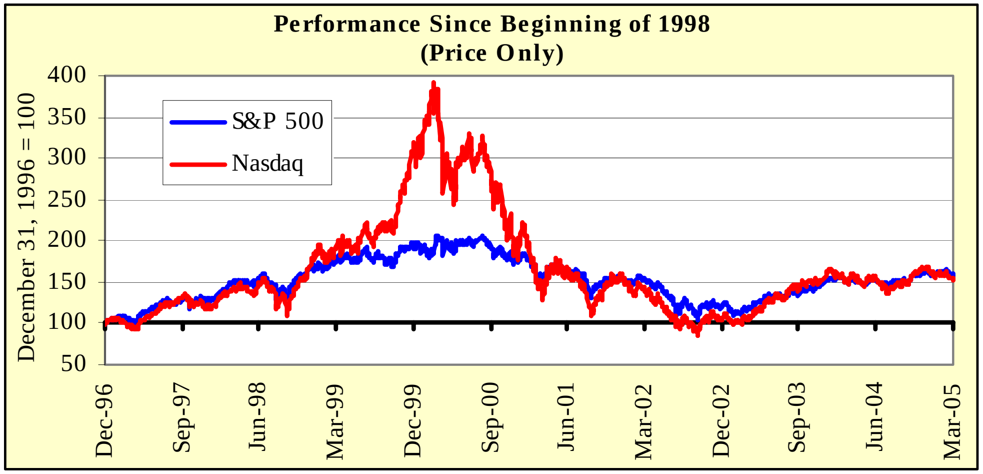
Hammond Associates

Five Years From the Peak

April 2005



March 2005 marked the fifth anniversary of the peak of the US equity market and the height of the tech craze. At the March 24, 2000 peak, seven of the top ten stocks in the S&P 500 index were either tech or telecom stocks. Now there are two (Microsoft and Intel). Cisco and Microsoft battled for the top spot in the index. While Microsoft remains in the top ten at number three, Cisco has fallen to 16. The tech-laden NASDAQ reached a peak of 5,049 on March 10, 2000. It now stands at 1,999. In the meantime, a number of corporate executives faced trials and were subsequently convicted of earnings manipulation and other frauds. In addition, Sarbanes-Oxley legislation was passed by Congress, which adds new layers of accountability for the accuracy of financial statements, but also adds to the regulatory burden on Corporate America.

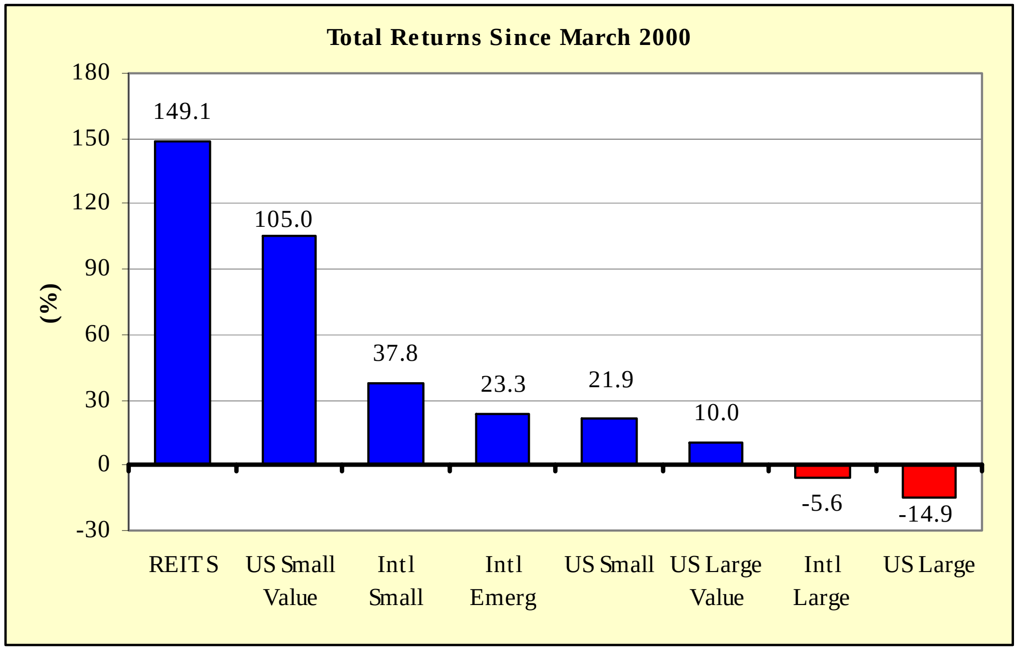
At the peak, the US market had a capitalization of around $16 trillion. The bear market that followed was, by some measures, the worst since the Great Depression. In just 2½ years, nearly $8 trillion of market value vaporized, which was about 80% of GDP. Since reaching the trough on October 9, 2002, the rebound in the market has been impressive. The S&P 500 has surged 52%, but it remains 23% below the peak on a price basis. The NASDAQ, which declined 78% through October 9, 2002, remains 60% underwater. The index needs to rise another 153% to reach its previous peak. The NASDAQ needs to earn a 10% annualized return for the next 10 years to regain the March 2000 level (which seems unlikely).

Anatomy of the Bear Market

Since the peak of the market, the pain has been very unevenly felt. Had one simply avoided the tech and telecom sectors, it would have been a much tamer bear. The tech and telecom sectors, which surged the most during bubble years, dropped the farthest in the aftermath. Peak-to-trough, the tech and telecom sectors plummeted 74% and 82%, respectively. With those two sectors combining to make up 42% of the S&P 500 in March 2000, they were the primary contributors to the decline. Even after a 44% rebound for telecom and a 76% rebound for tech, both sectors remain more than 60% below their peak. Most other sectors also suffered substantial losses. Six of the eight other sectors in the S&P 500 experienced a double-digit decline. However, except for consumer discretionary, all other sectors have recovered their losses during the rebound. Today, on a price basis, seven of the ten S&P 500 sectors are higher than their level at March 24, 2000. **If we were to exclude tech and telecom, we estimate that the S&P 500 would be 9% ahead of its March 24, 2000 peak level.**

	Cumulative % Price Change			*Index Weight*	
	From Peak	*Peak to Trough*	*From Trough*	*Peak*	*Current*
Energy	61.4	(18.5)	98.0	5	9
Consumer Staples	42.5	24.2	14.7	5	11
Materials	36.0	(24.8)	80.9	2	3
Financials	14.4	(25.1)	52.8	13	20
Healthcare	8.3	(6.9)	16.4	9	13
Industrials	4.0	(38.1)	68.1	9	12
Utilities	0.1	(47.7)	91.4	2	3
Consumer Discretionary	(8.0)	(41.2)	56.3	12	11
Telecoms	(62.7)	(74.1)	43.8	7	3
Information Tech	(68.9)	(82.4)	76.4	35	15
S&P 500	**(22.7)**	**(49.1)**	**52.0**	**100**	**100**

Looking outside the S&P 500, it has been even easier to weather the bear market. On a total return basis, from the end of March 2000 the S&P 500 is down a cumulative 15%. Many other asset classes have enjoyed healthy gains. REITS, which were a bargain at the peak, are ahead 149%. Small-cap stocks are 22% higher, and small-cap value stocks are 105% higher. Looking abroad, international large-cap stocks remain 5.6% in the hole, but international small-cap and emerging market stocks have gained 38% and 23%, respectively.



Comparisons to Past Bear Markets

The recent bear market has been one of the most brutal of the 13 bear markets since 1926. The 49% price decline for the S&P 500 was the worst since the 1929-1932 bear market, and is much worse than the 38% average decline of previous bear markets. The loss during the 1973-1974 bear market was slightly less at 48%. The longevity of the bear market is also striking. It took 31 months to go from the peak to the trough, which is 13 months longer than the average. We're now at 30 months from the trough. Eight of the other 12 bear markets had already regained the peak by this point. With the market requiring another 29% gain for a full recovery, it could be a long while before we see the peak again.

S&P 500 Bear Markets Since 1926

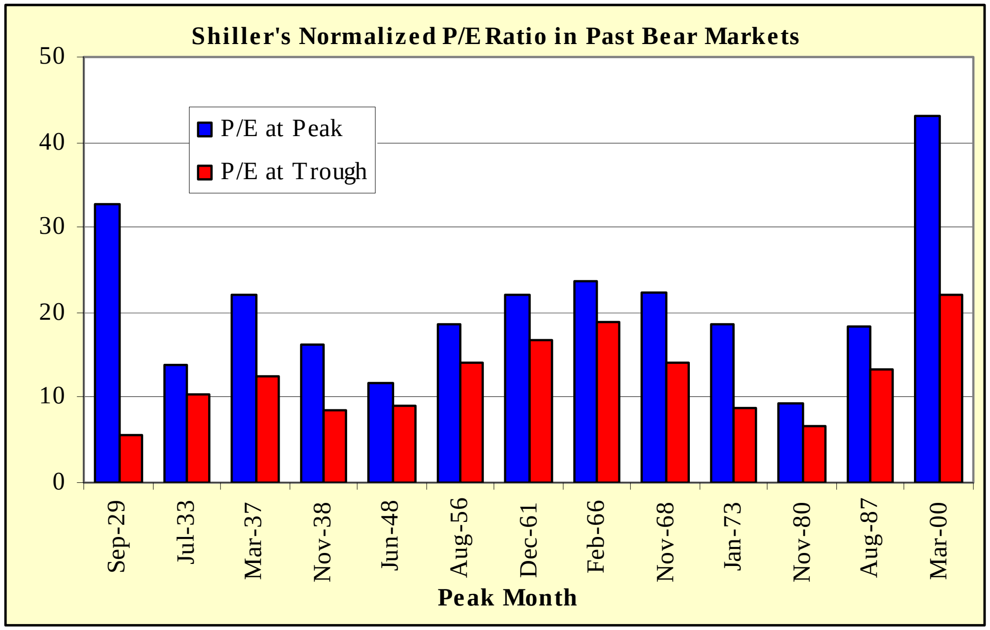
Peak	Trough	Recovery	Peak to Trough Decline	# of Months: Peak to Trough	# of Months: Trough to Peak	# of Months: Peak to Peak
9/7/29	6/1/32	9/22/54	**-86.2**	33	**272**	**305**
7/18/33	3/14/35	10/22/35	-34.0	20	7	28
3/10/37	3/31/38	2/2/46	-54.5	13	96	108
11/9/38	4/28/42	2/13/45	-45.8	**42**	34	76
6/15/48	6/13/49	1/7/50	**-20.6**	12	7	19
8/2/56	10/23/57	9/24/58	-21.6	15	11	26
12/12/61	6/26/62	9/3/63	-28.0	7	14	21
2/9/66	10/7/66	5/4/67	-22.2	8	7	**15**
11/29/68	5/26/70	3/6/72	-36.1	18	22	40
1/11/73	10/3/74	7/17/80	-48.2	21	70	91
11/28/80	8/12/82	11/3/82	-27.1	21	**3**	24
8/25/87	12/4/87	7/26/89	-33.5	**3**	20	23
Average Since 1926			**-38.1**	**18**	**47**	**65**
Average Since WWII			**-29.7**	**13**	**19**	**32**
3/24/00	*10/9/02*	*?*	*-49.1*	*31*	*30+*	*60+*

Is the Bear Truly Dead?

All major indices are now well above the lows set in October 2002, and have exceeded the technical definition of a new bull market (20% gain). Is the bear market of 2000-2002 finished for good, or will the last 2½ years prove to be nothing more than a cyclical bull in a secular bear? While we won't venture a guess on whether the market will re-test the lows, there is clearly downside risk.

Indeed, by some measures, the market was more expensive than ever before in March 2000. Based on Robert Shiller's P/E ratio on trailing 10-year real earnings, the S&P 500 reached a P/E ratio of 43. In 1929, the P/E ratio on the index was 33. The average P/E at the peak of prior bull markets was 19. At the October 2000 trough, the S&P 500 reached a P/E ratio of 22, which remained above the average level for prior peaks. **Even after a 50% decline, the S&P was more expensive at the trough of this bear market**

than it was at the peak of most of the prior bull markets. At prior troughs, the P/E ratio was 12 on average. The worst bear markets left P/Es in the single digits.



Given the extent to which the market was overvalued at the peak, it is surprising that this bear market wasn't worse. When a market becomes extremely overvalued, the norm is for it to overshoot on the downside following the prick, becoming extremely undervalued. After this bear, the market never became cheap, and it's debatable whether it even hit fair value. Are we still in store for a second leg of the bear market? We'd like to think that this time is different. Perhaps, the "Stocks for the Long Run" mantra preached during the 1990s changed investors' behavior.

Unfortunately, in many ways, today's market is far more challenging for investors than it was in March 2000. For those that avoided buying into the tech hype and ventured beyond the S&P 500, there were many attractive investments to be found, such as US small-cap value stocks, international small-cap stocks, REITS, and inflation-protected bonds. Today, in contrast, there are no obvious bargains. And safety pays much less than it did then. The Lehman Aggregate Bond index offered a yield of 7.2% in March 2000. It now yields 4.8%. If the bear reasserts itself, it will be much harder to find a place to hide this time around. What should investors do? Our advice is the same as it was in March 2000—diversify broadly and carefully using a prudent mix of both traditional and so-called alternative investments. Making money in the next half-decade or so may have to take a back seat to loss avoidance.

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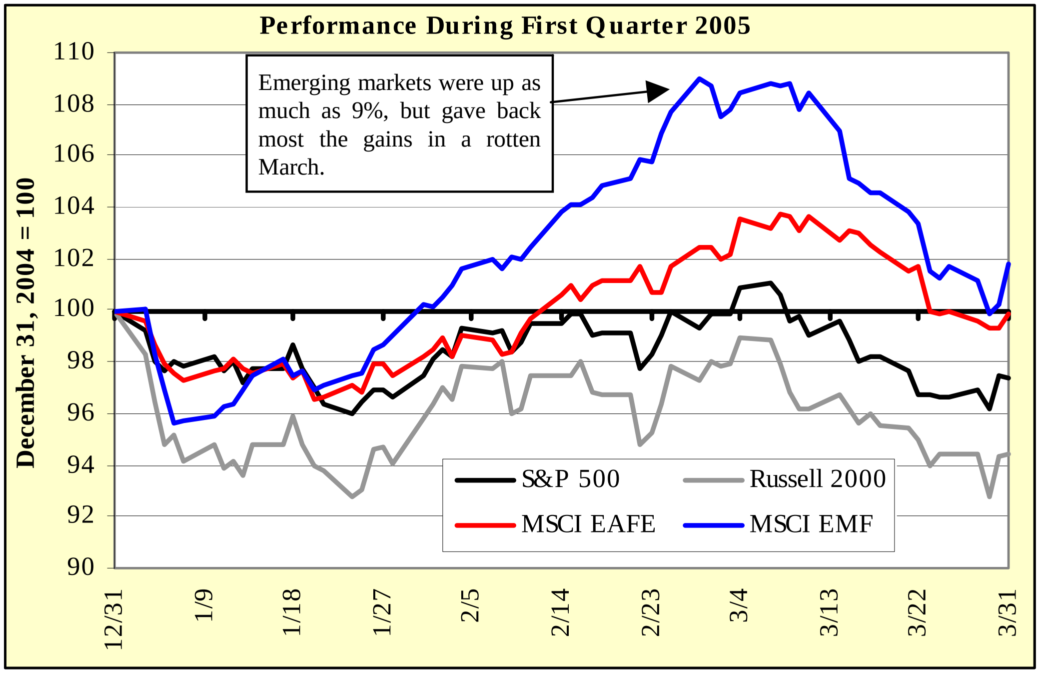
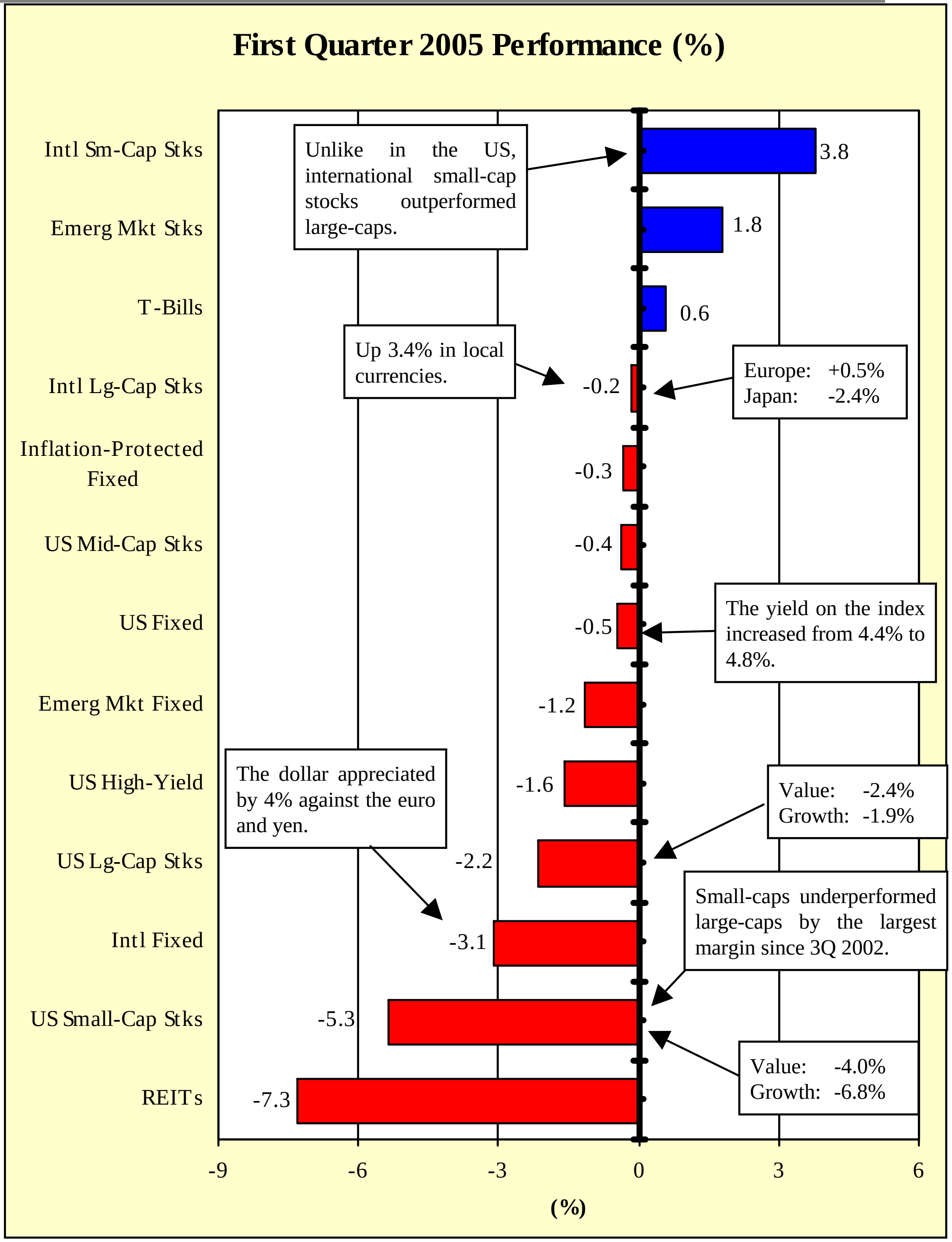
First Quarter Executive Summary

- The first quarter of 2005 was difficult for global markets. Most equity and fixed income investments finished the quarter lower. The S&P 500 ended the quarter 2.2% underwater. Small-cap stocks performed even worse, falling 5.3%. We suspect that the remainder of 2005 will bring more of the same. The first year of Presidential terms has historically been poor for equity markets. Furthermore, stock valuations remain stretched.
- The economy grew at a healthy 4.4% pace in 2004. Economists expect growth to moderate in 2005. Those polled by Bloomberg estimate that GDP grew 3.5%, annualized, in the first quarter and forecast 3.7% growth for the calendar year. A barrel of oil finished the quarter at $55. Barring substantial further increases, high prices alone are unlikely to send the economy into a recession as it has become less sensitive to energy prices since the shocks of the 1970s. Massive tax cuts and the Fed's easy money policy have kept consumers spending in the face of stagnant wages. With the effects of tax cuts long over and the Fed's shift to a tightening monetary policy, wage growth needs to improve to keep spending growth strong.
- The FOMC raised the Fed Funds rate twice during the quarter to 2.75%. Fed Funds futures predict a 4% overnight lending rate by year-end. Intermediate-term interest rates jumped during the quarter as the bond market priced in more rapid tightening expectations. Many of the asset classes that have benefited from the "carry trade" in the past couple of years were losers in the quarter. A key question is what the effects of higher interest rates will be on consumer spending.
- Freddie Mac reports that the average home price surged 10.7% in 2004. Over the last five years, the average house has appreciated by nearly 50%. Gains in the coastal regions have been far higher. Home prices are now at record levels versus both incomes and rents. Prices don't necessarily need to fall to have an adverse effect on the economy. Households have been tapping home equity to support spending while wage growth has been tepid. If prices stagnate, the removal of the impact of home equity withdrawals could weigh on consumer spending.
- The current account deficit topped 6% of GDP ($750 billion) in the fourth quarter as the trade deficit continued to widen. Nevertheless, the dollar rebounded against the euro and the yen, rising 4.4% against each currency. The broad trade-weighted dollar increased 1.6%. The current account deficit cannot stay at these levels. The question now is whether the correction will occur without too many ill effects through a continued slow bleeding of the dollar and gradual increase in domestic savings or if the correction will be more disruptive. Regardless of the solution, we believe diversifying into foreign currency-denominated assets still makes sense.
- Since September 2002, emerging markets equities have gained a cumulative 119%. With these gains, there is far less margin for error. Concerns arise on two fronts. First, emerging market economies are very reliant on US consumers. If US consumers finally decide to rein in spending and increase savings, emerging market economies are likely to slow substantially. A second area of concern is whether current high profitability levels can be sustained. Despite these concerns, we believe emerging market equities are the most promising equity asset class in a low return world and will provide the highest returns of world equity markets over the next ten years.
- Hedge fund returns in the first quarter were generally positive, yet modest. According to HFR, the average fund of hedge funds was up 1.0% during the first quarter. Convertible arbitrage and managed futures suffered losses.
- Following a 33% gain in 2004, REITS took a beating in the first quarter, plunging 7.3%. The good news is that they now offer a better value. According to data published by Green Street Advisors, REITS are trading at a modest discount to net asset value.

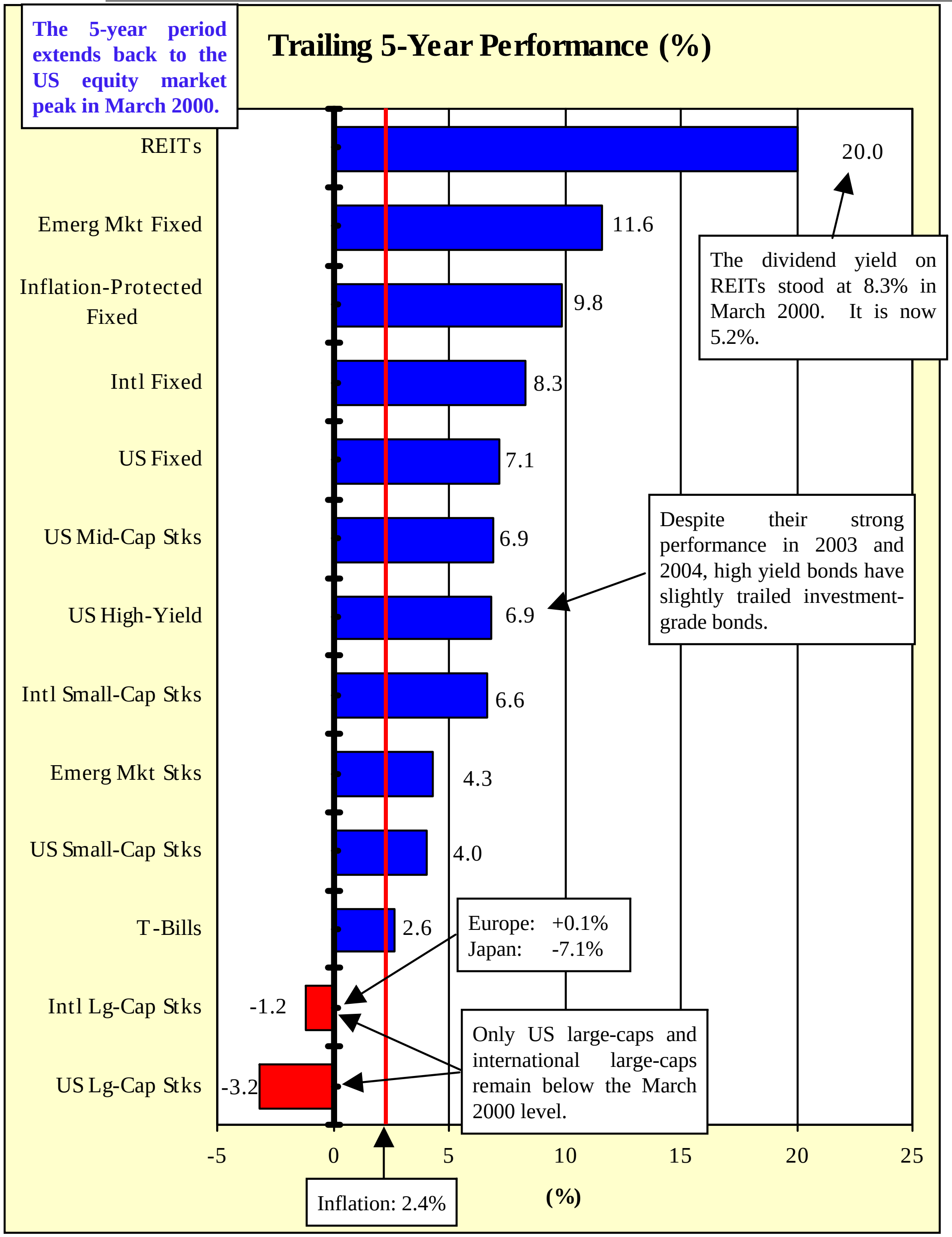
Few Places to Make Money in the First Quarter

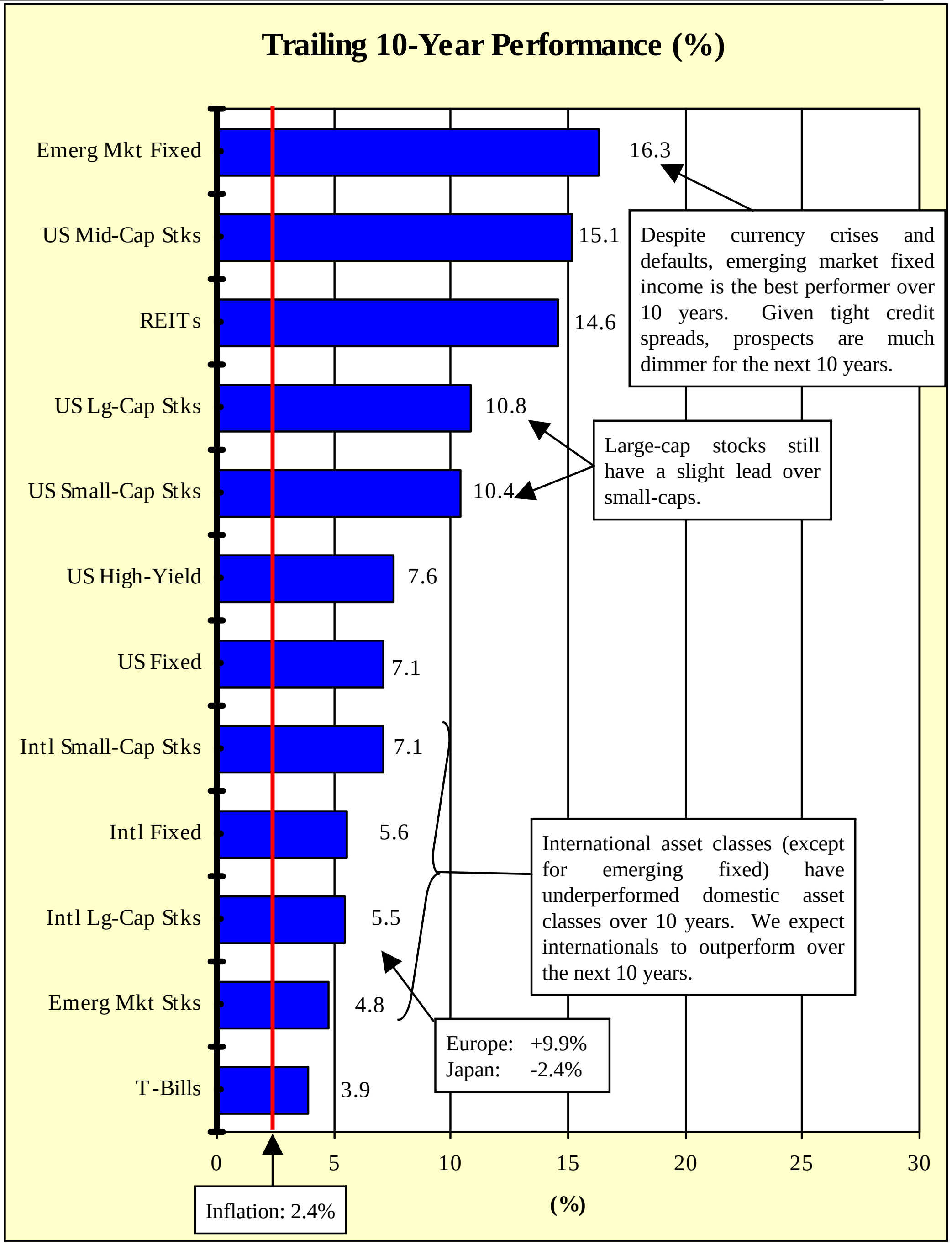
- The first quarter of 2005 was difficult for global markets. Most equity and fixed income investments finished the quarter lower. Only three major asset classes were in the black—international small-cap stocks, emerging market stocks, and T-Bills.
- The S&P 500 ended the quarter 2.2% underwater. Small-cap stocks performed even worse, falling 5.3%. Despite a pop in the dollar, international equity asset classes outperformed domestic equity classes as many foreign markets enjoyed local currency gains.
- Many of the asset classes that have benefited from the "carry trade" in the past couple of years were losers in the quarter. High-yield fixed income, emerging market fixed income, and REITs all finished the quarter lower as the Fed continued to push up short rates.





A Review of the Last 5 and 10 Years





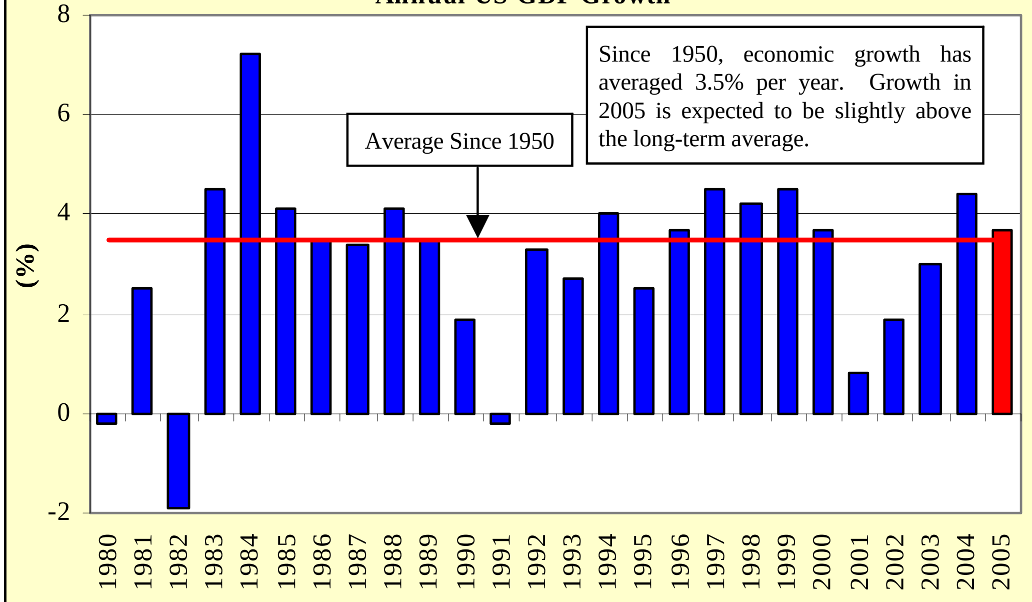
A Debt-Fueled Expansion

- The economy grew at a healthy 4.4% pace in 2004, which was its best performance since 1999. Economists expect growth to moderate in 2005, however. Those polled by Bloomberg estimate that GDP grew 3.5%, annualized, in the first quarter and forecast 3.7% growth for the calendar year.
- Employment growth in the first quarter was disappointing. The economy added an average of 159,000 jobs per month. In contrast, 190,000 were added per month in the fourth quarter.
- After falling in the fourth quarter, oil prices set a new high in the first quarter. A barrel of oil finished the quarter at $55. If prices stay at these levels, it's sure to weigh on the economy because consumers have less for discretionary spending and business costs will increase. However, barring substantial further increases, high prices alone are unlikely to send the economy into a recession. Consumption of energy as a percentage of the economy has fallen significantly since the shocks of the 1970s.
- Massive tax cuts and the Fed's easy money policy have kept consumers spending in the face of stagnant wages. With the effects of tax cuts long over and the Fed's shift to a tightening monetary policy, wage growth needs to improve to keep spending growth strong.

	2004 Growth (%)	*Contribution to 2004 Growth (%)*
Personal Consumption Expenditures	3.8	2.6
Non-Residential Fixed Investment	10.6	1.1
Residential Fixed Investment	9.7	0.5
Change in Inventories	-	0.4
Government Consumption	1.9	0.4
Trade Balance	-	(0.6)
GDP Growth	4.4	

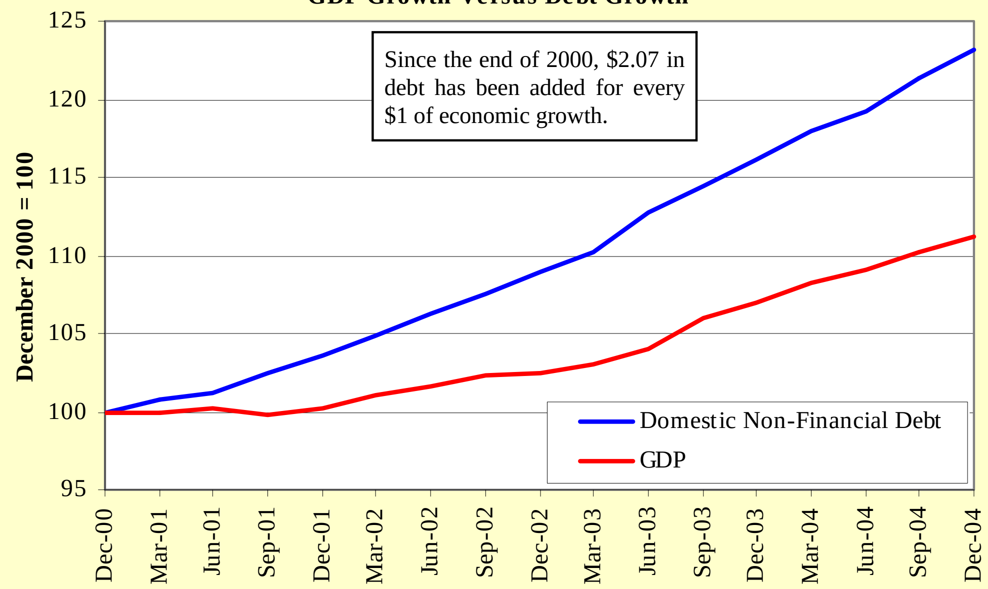
Expansion of the trade deficit was a significant detractor from growth in 2004.

Annual US GDP Growth



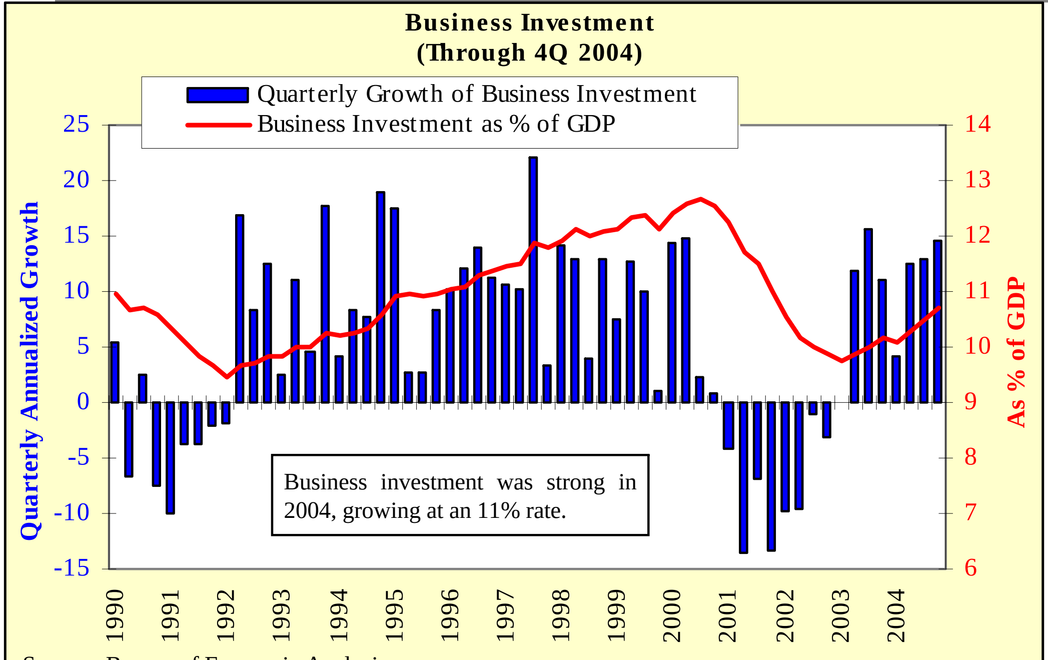
Source: Bureau of Economic Analysis

GDP Growth Versus Debt Growth

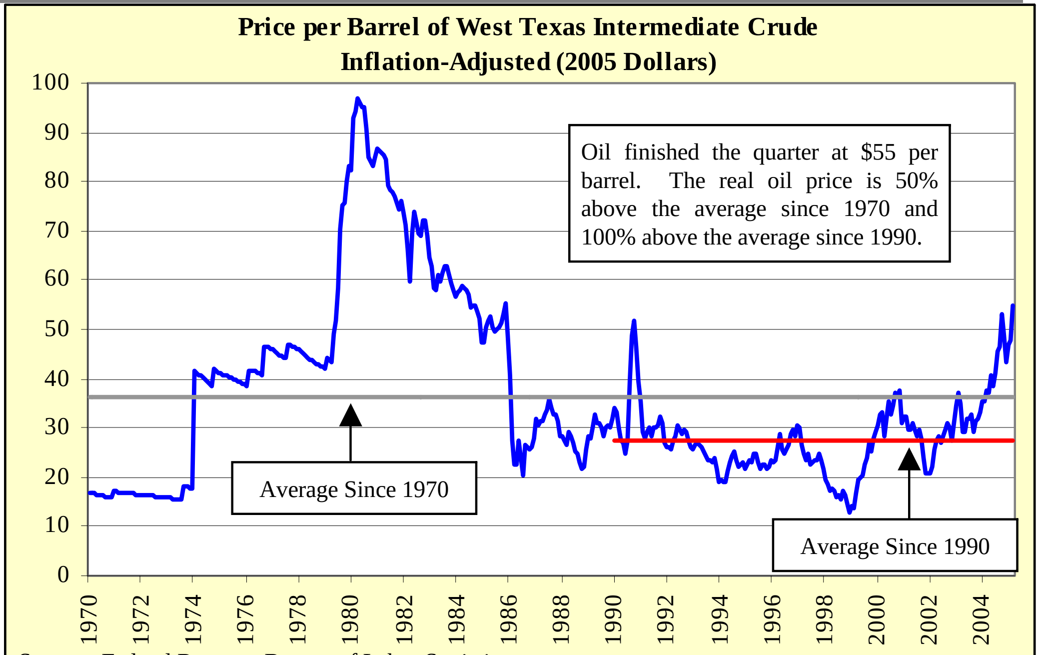


Source: Bureau of Economic Analysis, Federal Reserve

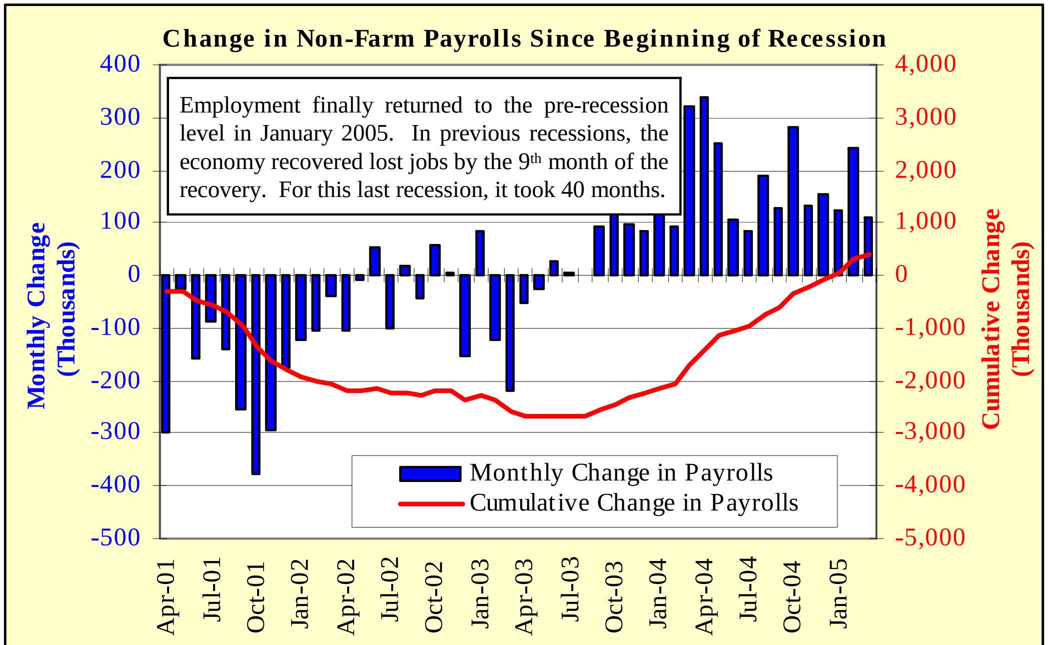
A Debt-Fueled Expansion (cont.)



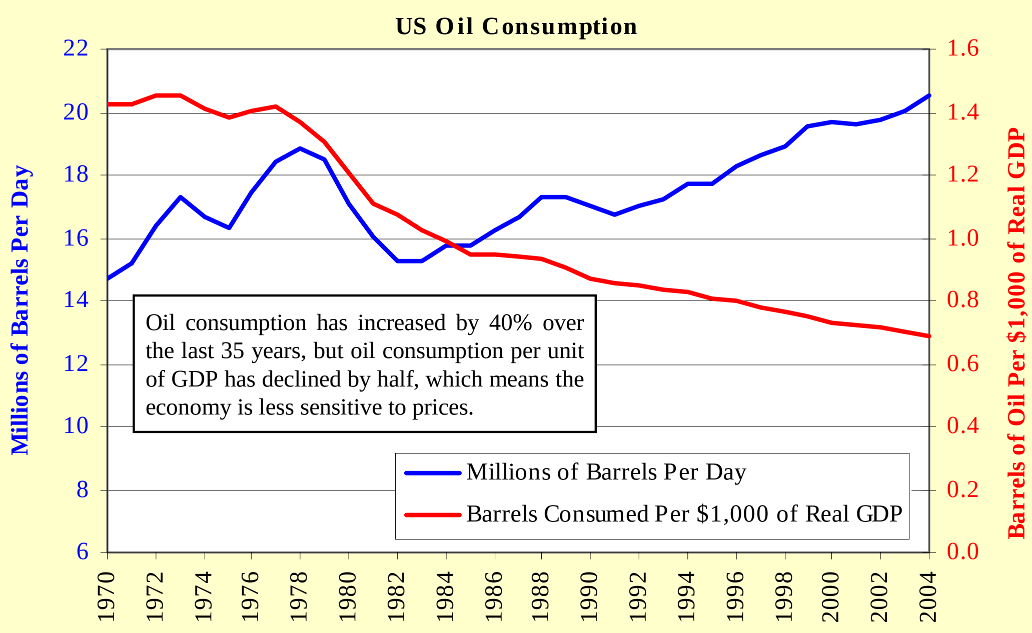
Source: Bureau of Economic Analysis



Source: Federal Reserve, Bureau of Labor Statistics



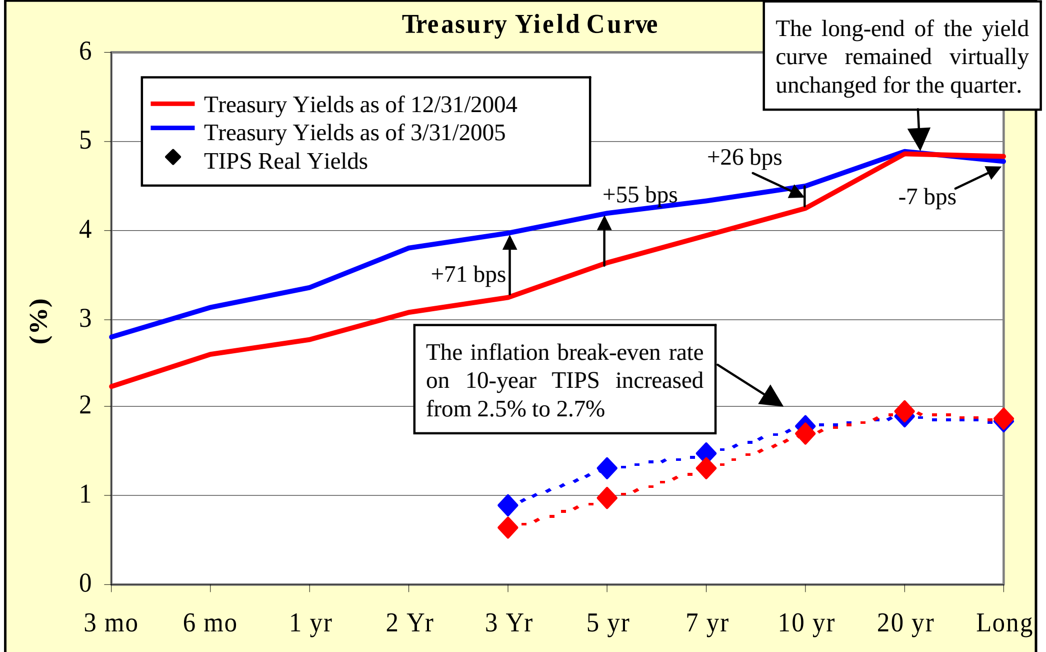
Source: Bureau of Labor Statistics



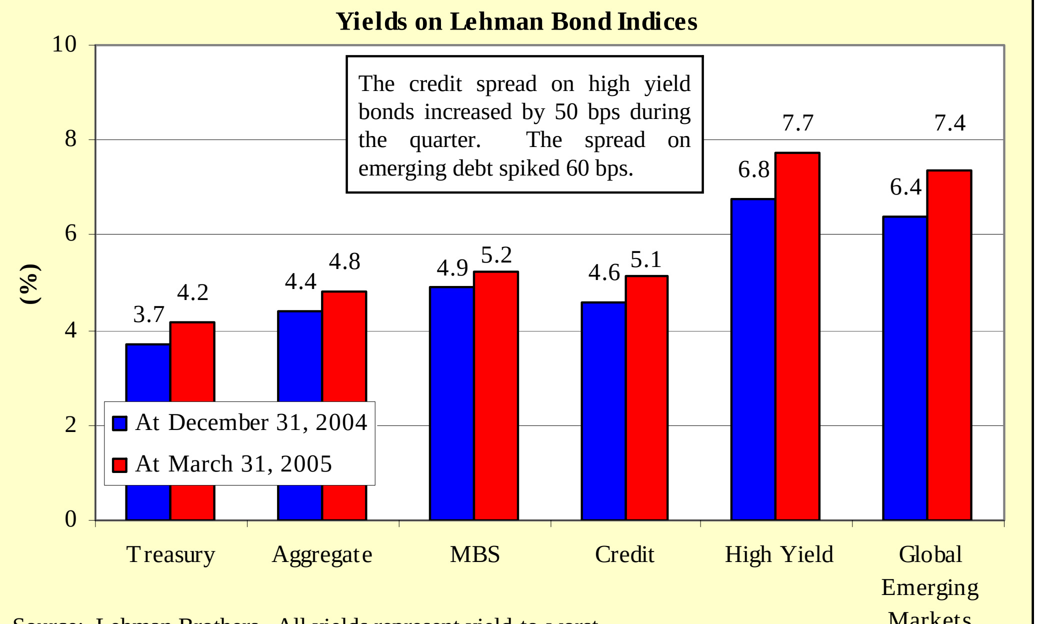
Source: Department of Energy, Bureau of Economic Statistics, Hammond Associates

The Fed Tightened Twice in First Quarter…

- The FOMC raised the Fed Funds rate twice during the quarter to 2.75%. At this level, the real interest rate remains virtually zero. Fed Funds futures predict a 4% overnight lending rate by year-end. Intermediate-term interest rates jumped during the quarter as the bond market priced in more rapid tightening expectations.
- Many of the assets that have benefited from the so-called "carry trade" (including high-yield bonds, emerging market debt, financial stocks, and REITs) performed poorly during the quarter. It may become even rougher for these asset classes if the Fed tightens as much as expected.
- While consumer price inflation is creeping up, the effects of the Fed's lax policy, and the liquidity created by it, are most apparent in asset prices, notably residential real estate.
- A key question is what the impact of higher interest rates will be on consumer spending. The Fed's easy money policy of the last three years has led to an explosion of mortgage debt. Total mortgage debt jumped 43% over the last three years to $7.5 trillion. As a result, debt service's share of income is near record levels despite low interest rates.
- The good news is that most outstanding household debt remains in the form of fixed rate mortgages. However, an increasing portion is in floating debt, which will feel the effects of higher rates more quickly.
  - ✓ In 2004, 32% of new mortgages were adjustable rate mortgages (ARMs). It is estimated that 20% of outstanding mortgage debt is in ARMs.
  - ✓ The amount of home equity lines of credit has increased by 70% over the last three years to $881 billion. Interest rates on HELOCs are usually tied to prime rates, which means borrowers will immediately feel the pain of higher rates.

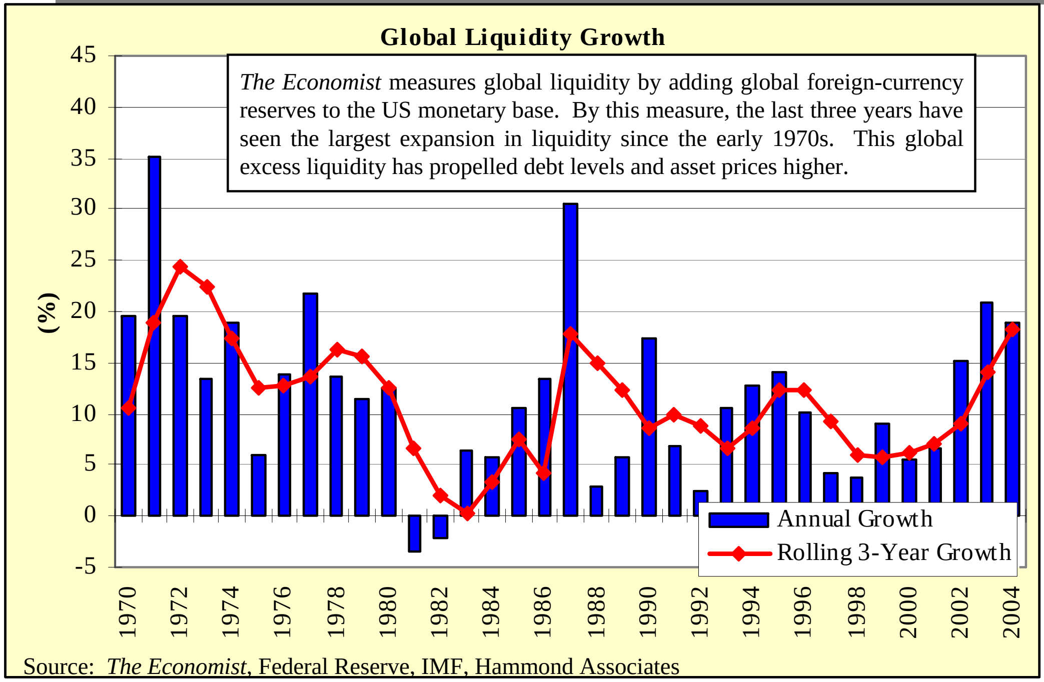


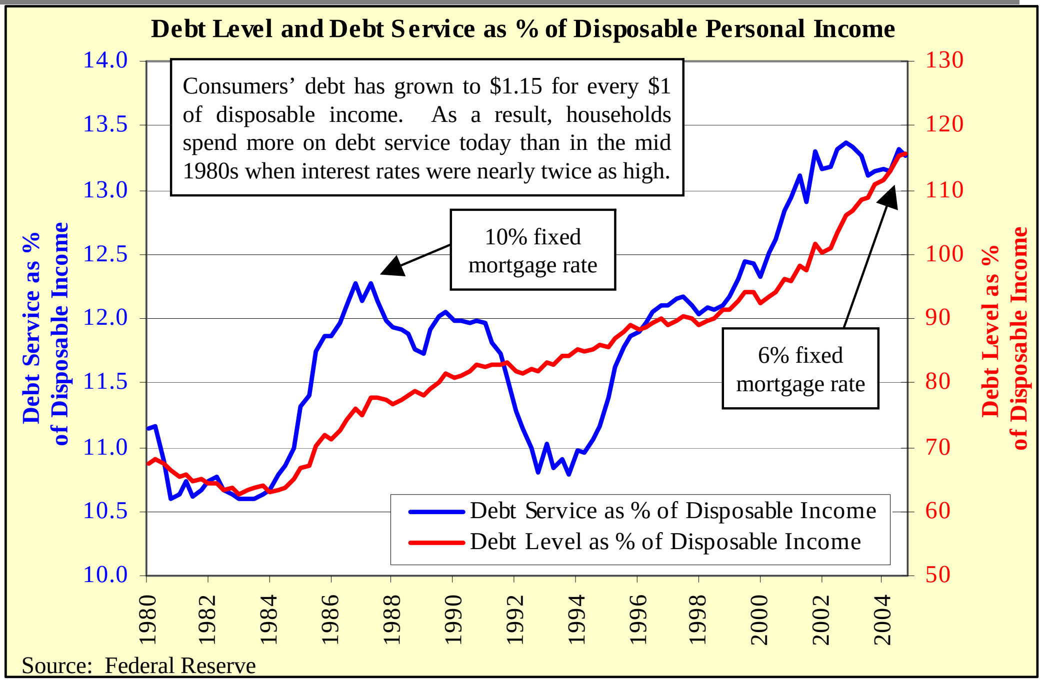
Source: Federal Reserve

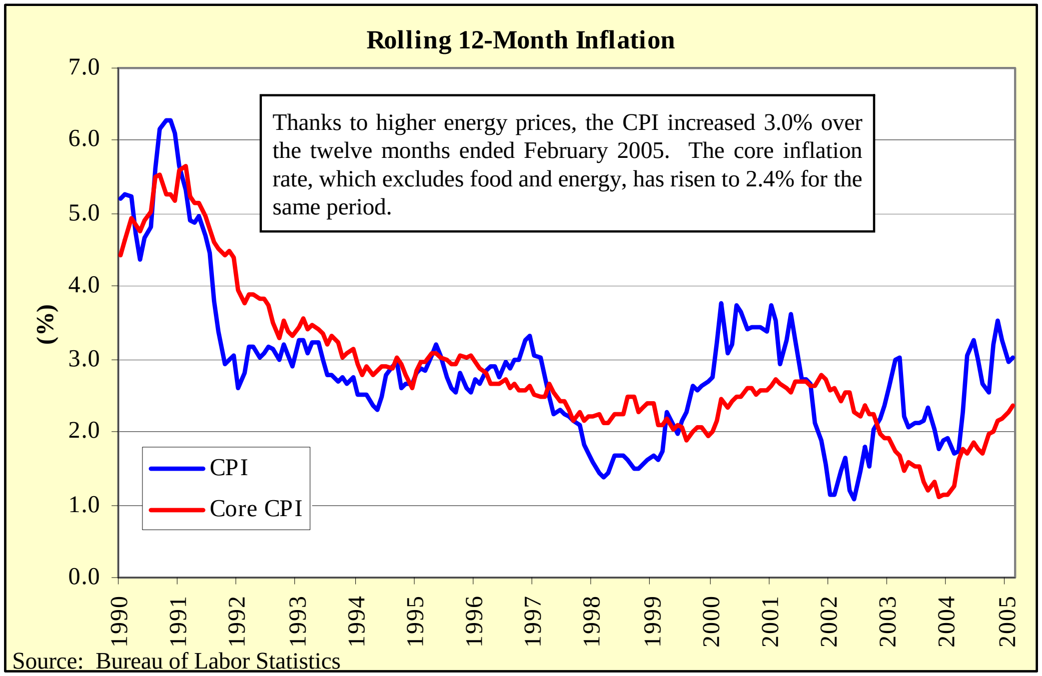


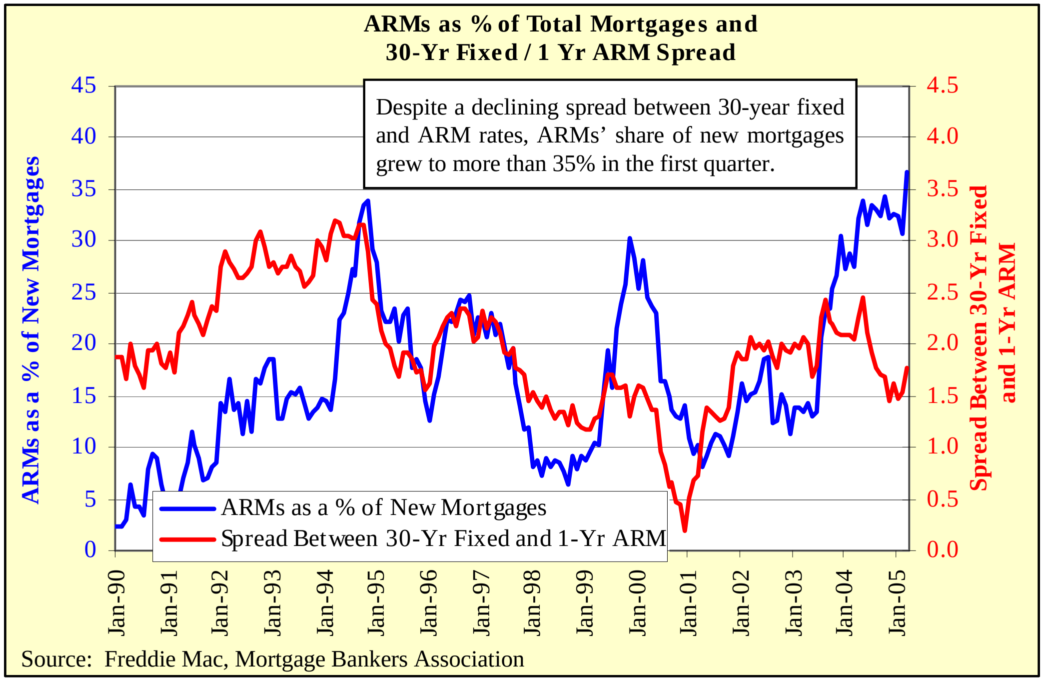
Source: Lehman Brothers. All yields represent yield-to-worst.

…But the World is Still Awash in Liquidity



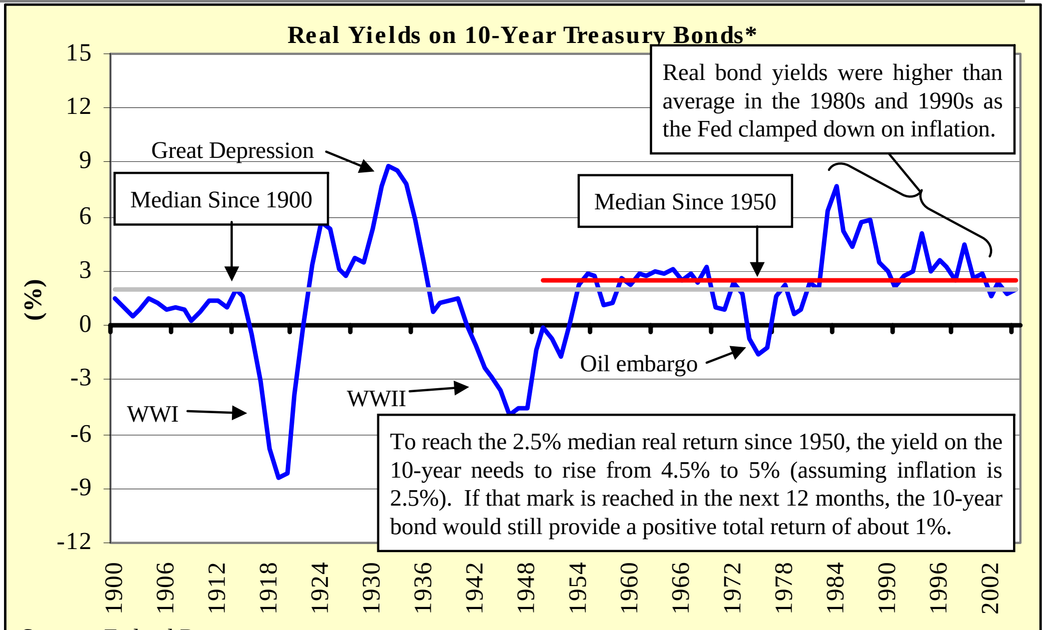






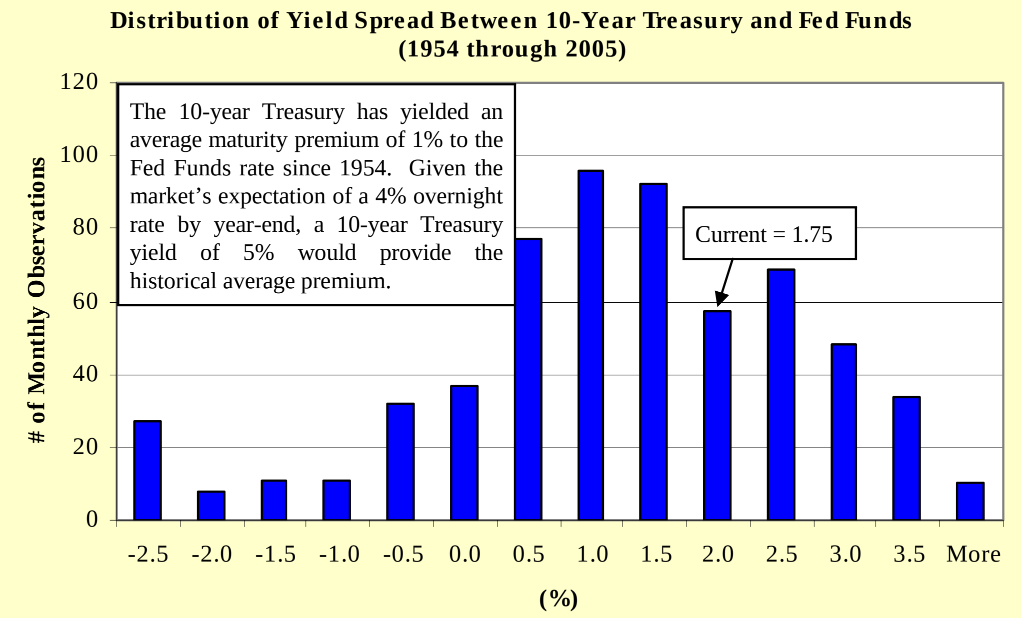
Are Bond Yields Too Low?

- A common perception is that Treasury bond yields are significantly below normal levels. This is accurate when compared to levels in the 1980s and 1990s. However, when taking a longer view, *real* bond yields are not far from average.
  - ✓ Since 1900, the median real yield on 10-year Treasuries is 2%. The median real yield since 1950 is 2.5%.
  - ✓ Currently, the 10-year bond has a yield of 4.5% or a real yield of 2% if inflation is 2.5%. This matches the average since 1900, but is 50 bps below the average of 2.5% since 1950. The real yield on 10-year TIPS, which do not bear inflation risk, is 1.8%.
- Given the macro-environment, there are conflicting arguments on whether we are set for higher-than-average real interest rates in the future.
  - ✓ **A case for high real interest rates**—The large current account deficit (and budget deficit) will eventually force real interest rates higher in order to reduce domestic demand and increase savings, as foreigners (particularly Asian central banks) balk at holding bonds in a depreciating currency.
  - ✓ **A case for low real interest rates**—The debt-laden US economy will force the Fed to keep real overnight rates below normal to avoid inducing a recession. Asian central banks will continue to lend money to us at low rates to avoid appreciation of their currencies, which will keep the longer end of the yield curve in check.
- Our best guess is that the fair value yield on the 10-year Treasury is 5%. Assuming inflation of 2.5%, this would provide a real return of 2.5%, which is in-line with the average since 1950. However, the 2.5% inflation assumption is a risk. If the Fed chooses to allow higher inflation to ease the debt burden on the economy, holders of nominal debt will be the losers. In our view, inflation-protected bonds remain more attractive than nominal bonds.



Source: Federal Reserve

*We estimated real yields on the 10-year Treasury by applying trailing inflation to the yield. Prior to 1950, we used trailing 5-year inflation. Trailing 3-year inflation was applied from 1950 to present.

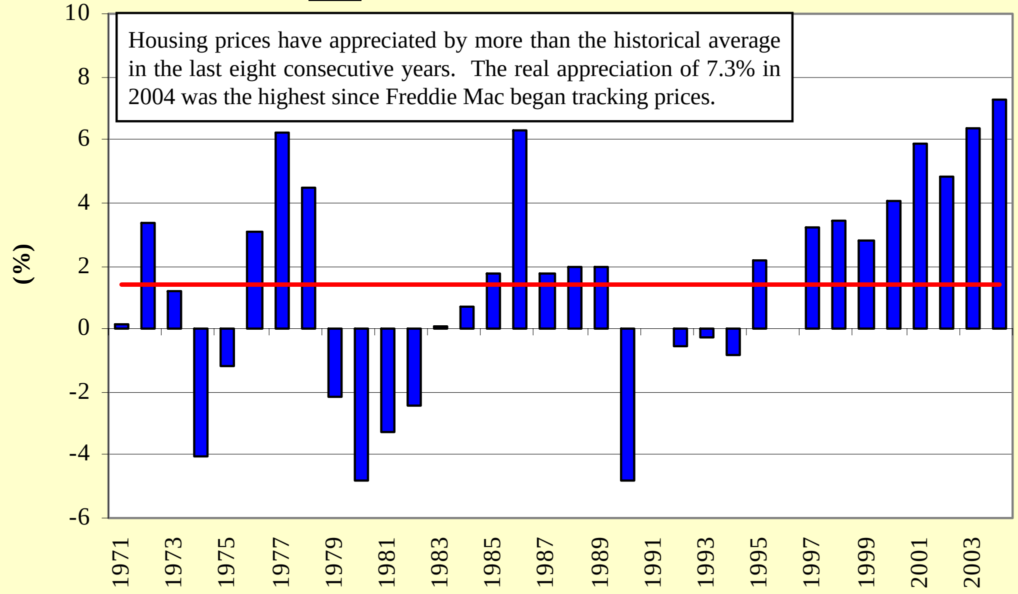


Source: Federal Reserve

Residential Real Estate – The Economy's Largest Risk

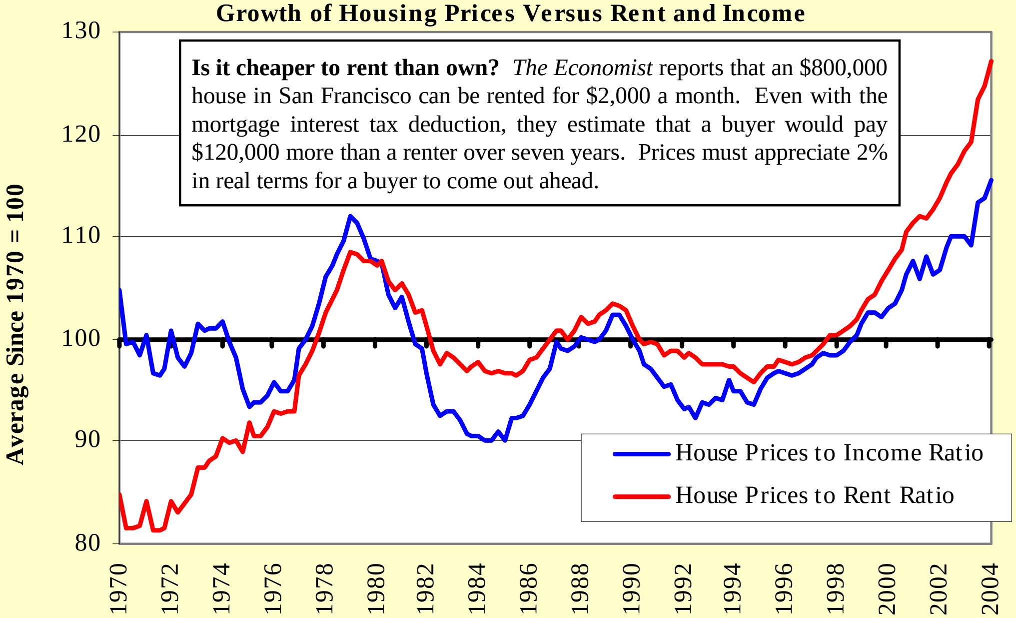
- Freddie Mac reports that the average home price surged 10.7% in 2004. Over the last five years, the average house has appreciated by a cumulative 50%. Gains in coastal regions have been far higher. Prices in the New England and Pacific regions are up 76% and 80%, respectively, over the period. Home prices are now at record levels versus both incomes and rents. Prices have risen 33 percentage points faster than rents and 22 points faster than income over five years.
- The outlook for new demand is worrying. A record 69.2% of households own a home. High prices coupled with higher interest rates are reducing the affordability to first-time buyers.
- Prices don't necessarily need to fall to have an adverse effect on the economy. Households have been tapping home equity to support spending while wage growth has been tepid. If prices stagnate, the removal of the impact of home equity withdrawals could weigh on consumer spending.

Annual Real Appreciation of Residential Real Estate



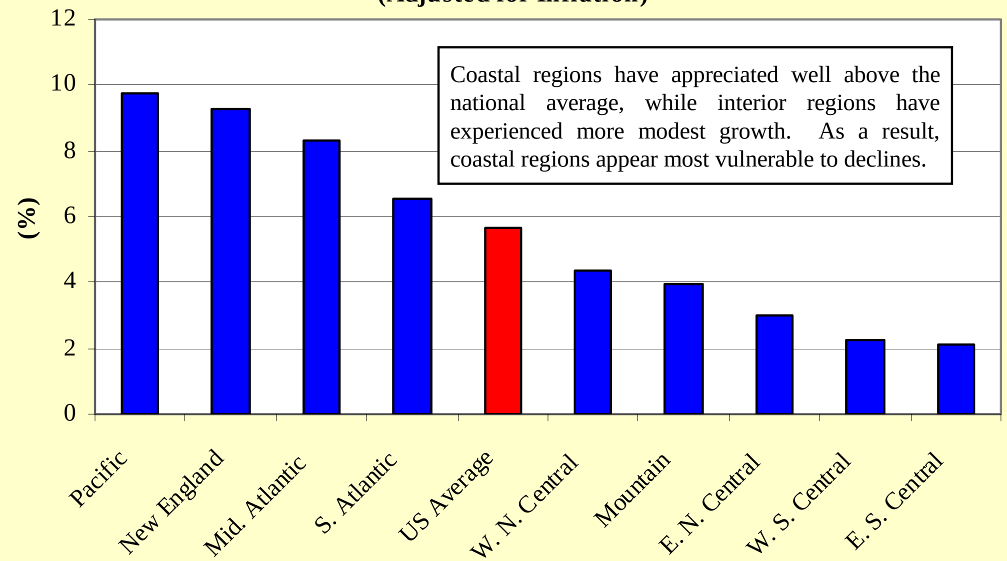
Source: Freddie Mac, Bureau of Labor Statistics

Growth of Housing Prices Versus Rent and Income



Source: Freddie Mac, Bureau of Labor Statistics, Federal Reserve, Hammond Associates

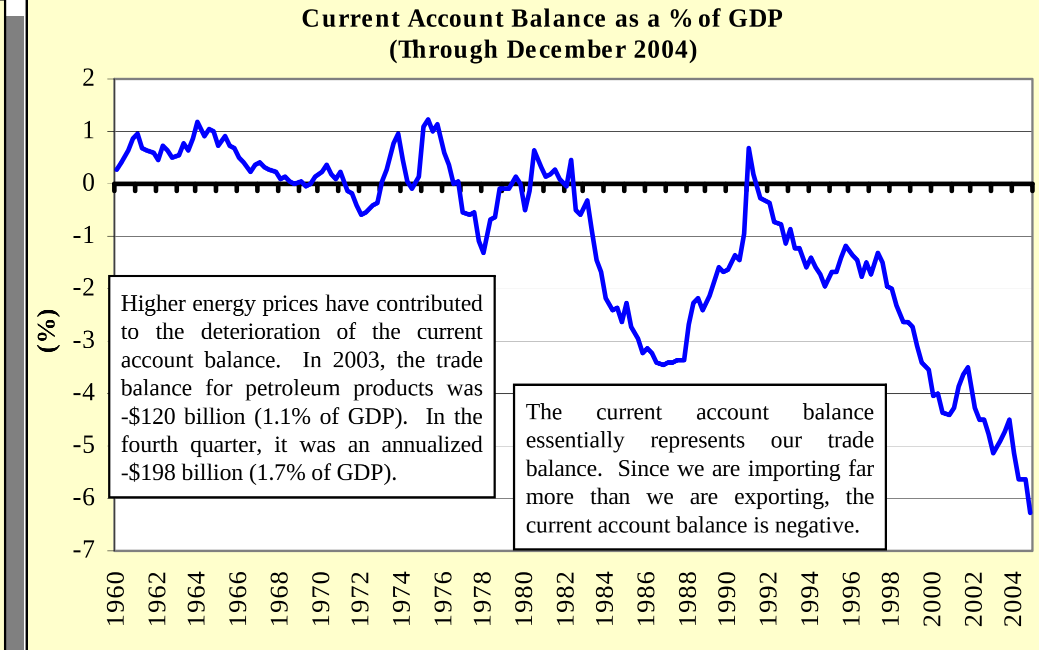
Annualized Appreciation of Housing Prices 2000 through 2004 (Adjusted for Inflation)



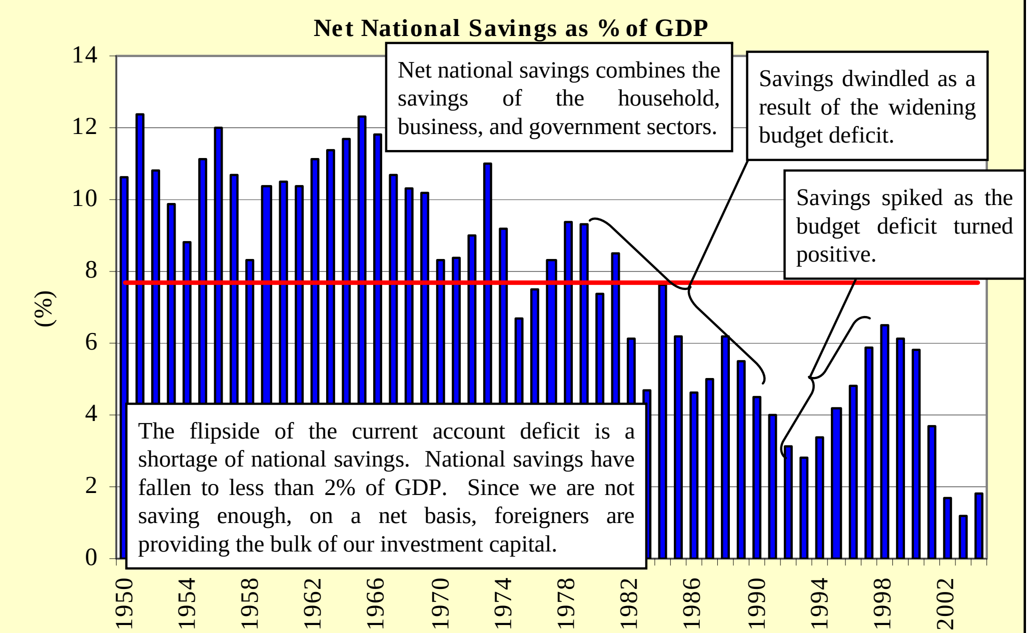
Source: Freddie Mac

Are Current Account Deficit Concerns Overblown?

- The current account deficit topped 6% of GDP ($750 billion) in the fourth quarter as the trade deficit continued to widen. Nevertheless, the dollar rebounded against the euro and the yen, rising 4.4% against each currency. The broad trade-weighted dollar increased 1.6%.
- The US has been running a current account deficit above 3% since 1999. Aside from a drop in the dollar (from extremely overvalued levels), there have been no harmful effects. In fact, the ballooning deficit may have helped the economy. Foreign investors lent us the money to subsidize spending during the recession.
- Are concerns about the current account deficit justified? One argument is that it may not be a problem because it is a function not of US over-consumption but of foreign investors desire to hold US assets. Is the current account deficit primarily being driven by US over-consumption or foreign investors' desire to hold US assets?
  - The argument that the deficit is being driven mostly by the attractiveness of US investments is difficult to support. The proportion of foreign capital flows being funded through "official" purchases (i.e., Asian central banks) is increasing. While private portfolio flows remain strong, their growth has not been enough to offset the deficit. As a result, central bank purchases have risen from 7% of total purchases in 2001 to 26% in 2004. Asian central banks are holding US bonds to avoid currency appreciation, not because of their investment potential.
  - Furthermore, the bulk of foreign portfolio flows are going into bonds. Net equity purchases by foreign investors have dwindled to almost nothing, and foreign direct investments are a small part of total flows. Given current interest rates, it's hard to argue that bonds are a particularly attractive investment to foreign investors, unless they expect the dollar to appreciate.
- The current account deficit cannot stay at these levels. The question now is whether the correction will occur without too many ill effects through a continued slow bleeding of the dollar and a gradual increase in domestic savings (which would put pressure on consumer spending), or if it will be more disruptive. Regardless of the solution, we believe diversifying into foreign currency-denominated assets still makes sense.

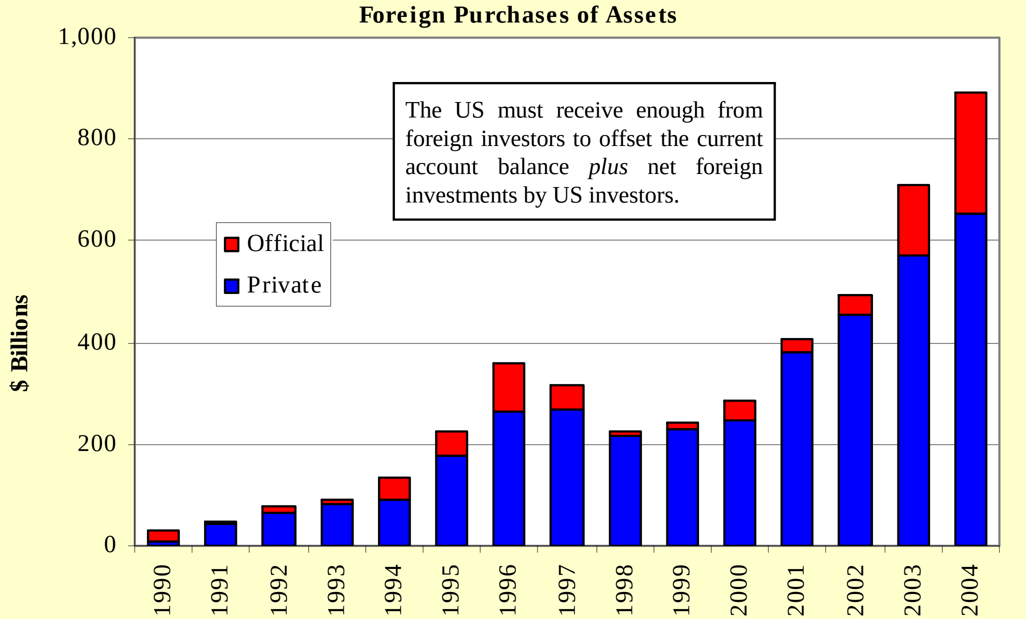


Source: Bureau of Economic Analysis

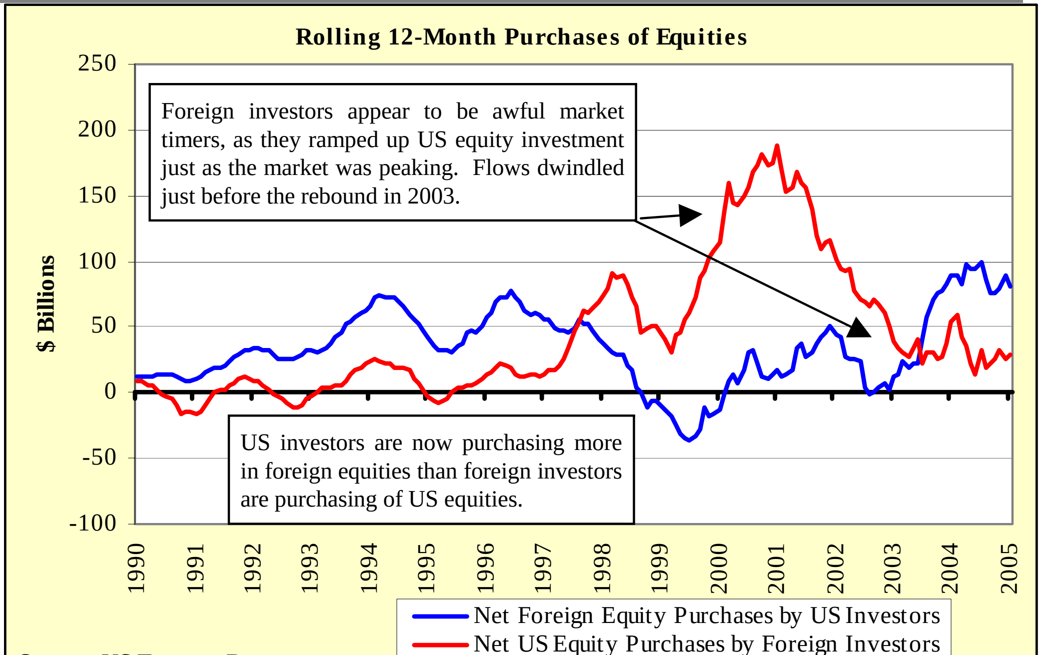


Source: Bureau of Economic Analysis

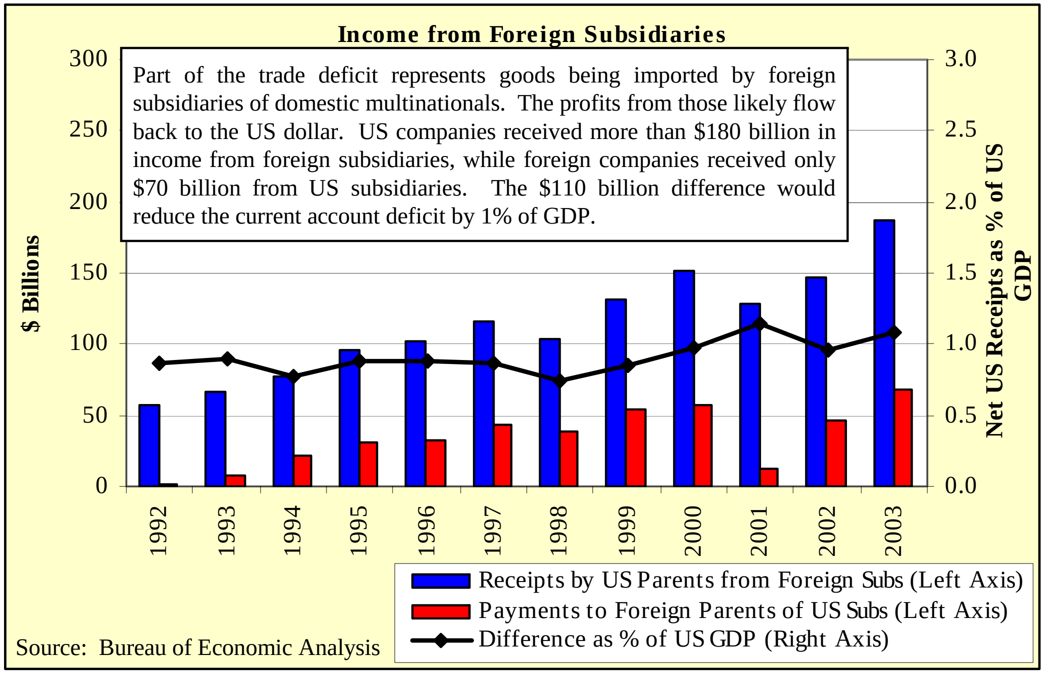
Are Current Account Deficit Concerns Overblown? (cont.)



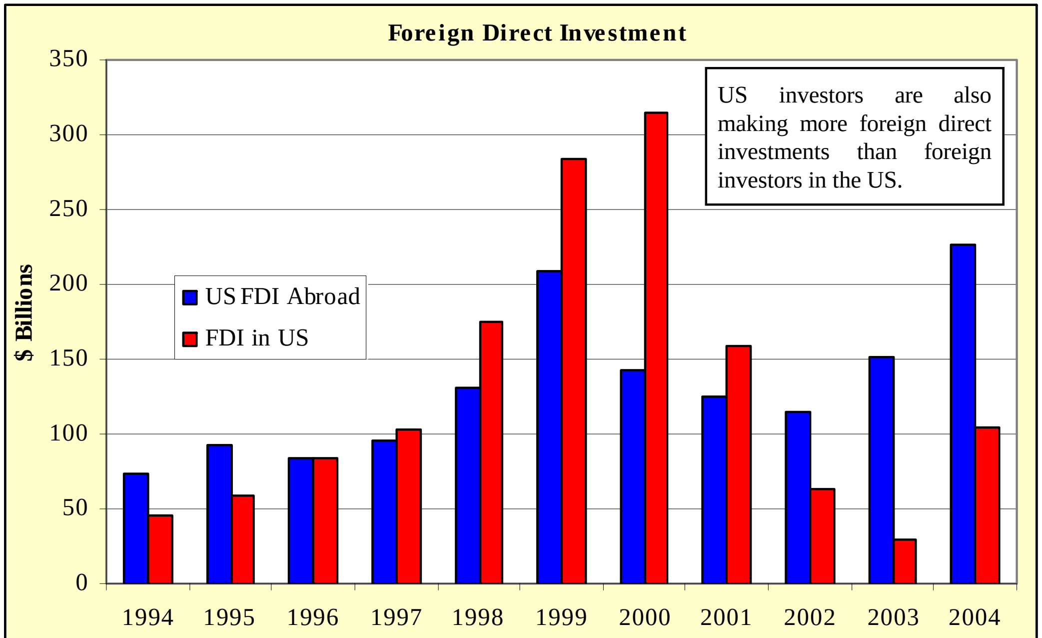
Source: US Treasury Department



Source: US Treasury Department



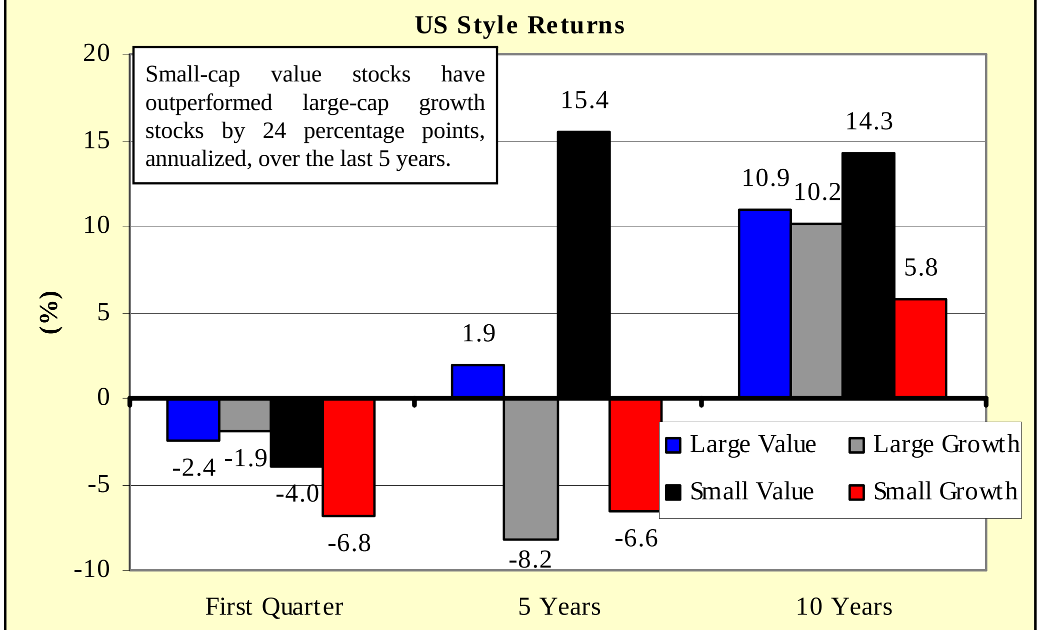
Source: Bureau of Economic Analysis



Source: Bureau of Economic Analysis

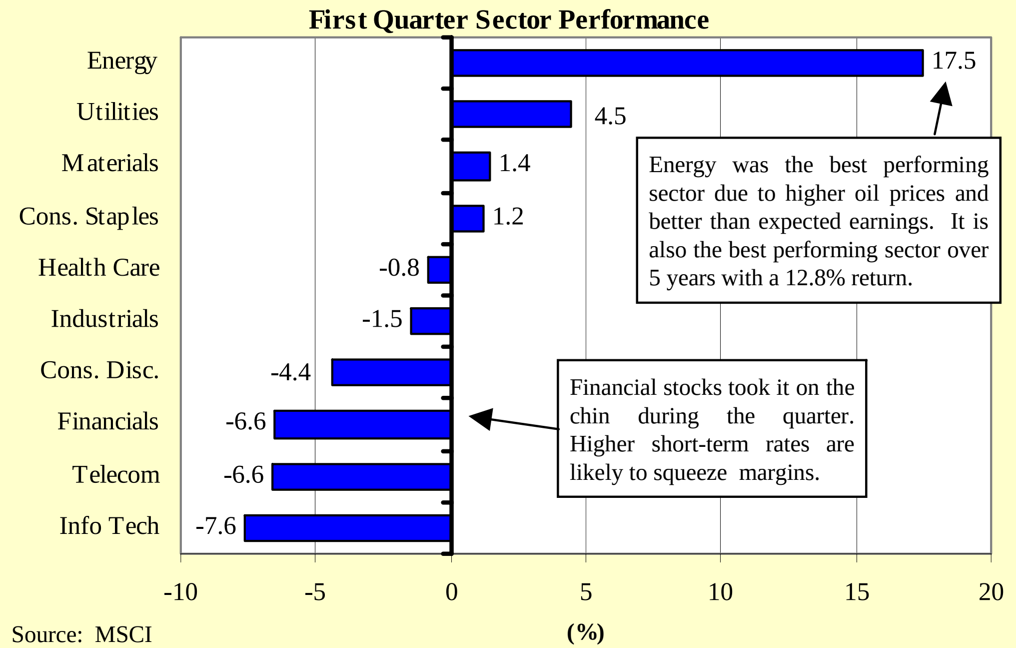
Equities Stumble Out of the Gate in 2005

- The S&P 500 declined 2.2% during the first quarter. There were very few opportunities to make money within the domestic equity markets. Small-cap stocks fell 5.3%. All major US equity styles also declined. Small-cap growth was the worst performer, losing 6.8%. Large-cap growth was the best performer, slipping 1.9%.
- We suspect that the remainder of 2005 will bring more of the same. The first year of Presidential terms historically has been poor for equity markets. The S&P 500 has lost money in half of the first year of terms since World War II.
- Furthermore, stock valuations remain stretched. Based on our measure of normalized earnings, the S&P 500 is trading at a P/E ratio of 24. This implies a long-term expected real return of 4.2% (assuming valuations remain the same). It seems unlikely that investors will be satisfied with that return, so valuations are likely to fall. We estimate that the S&P 500 will provide a real return in the low single digits over the next 10 years as valuations decline to a sustainable level.



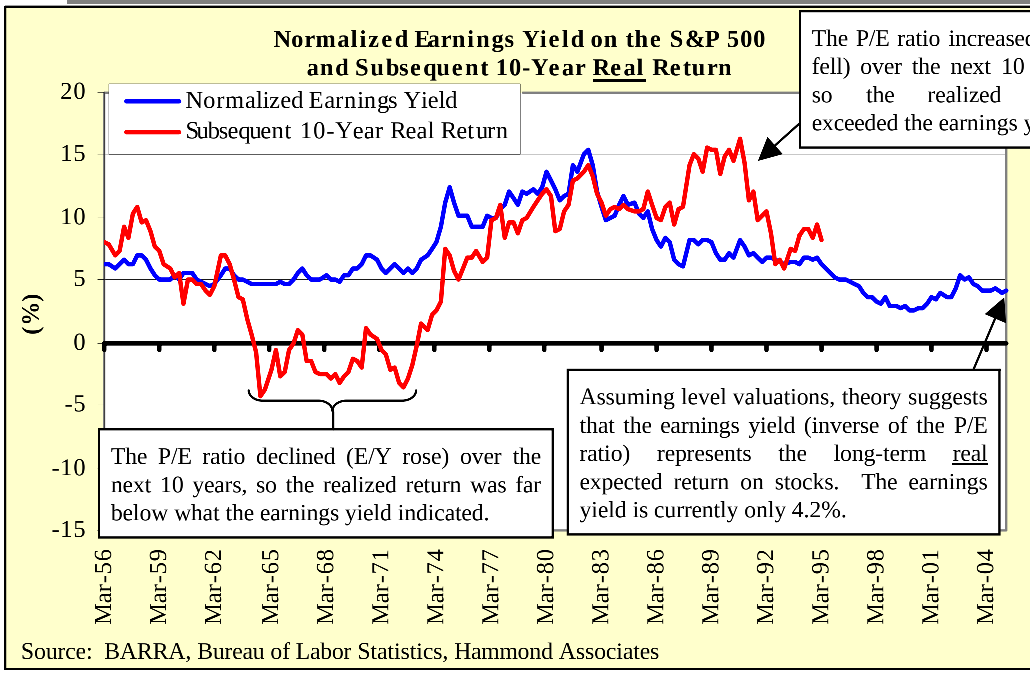
Expected Annualized Real Return on S&P 500 Over Next 10 Years						
Annualized GDP Growth	*Normalized P/E Ratio at Year 10*					
	10x	*15x*	*20x*	*25x*	*30x*	*40x*
2.0%	-4.2%	-1.0%	1.4%	3.5%	5.2%	8.1%
2.5%	-3.7%	-0.5%	1.9%	4.0%	5.7%	8.6%
3.0%	-3.3%	-0.1%	2.4%	4.5%	6.3%	9.1%
3.5%	-2.8%	0.4%	2.9%	5.0%	6.8%	9.7%
4.0%	-2.3%	0.9%	3.5%	5.5%	7.3%	10.2%

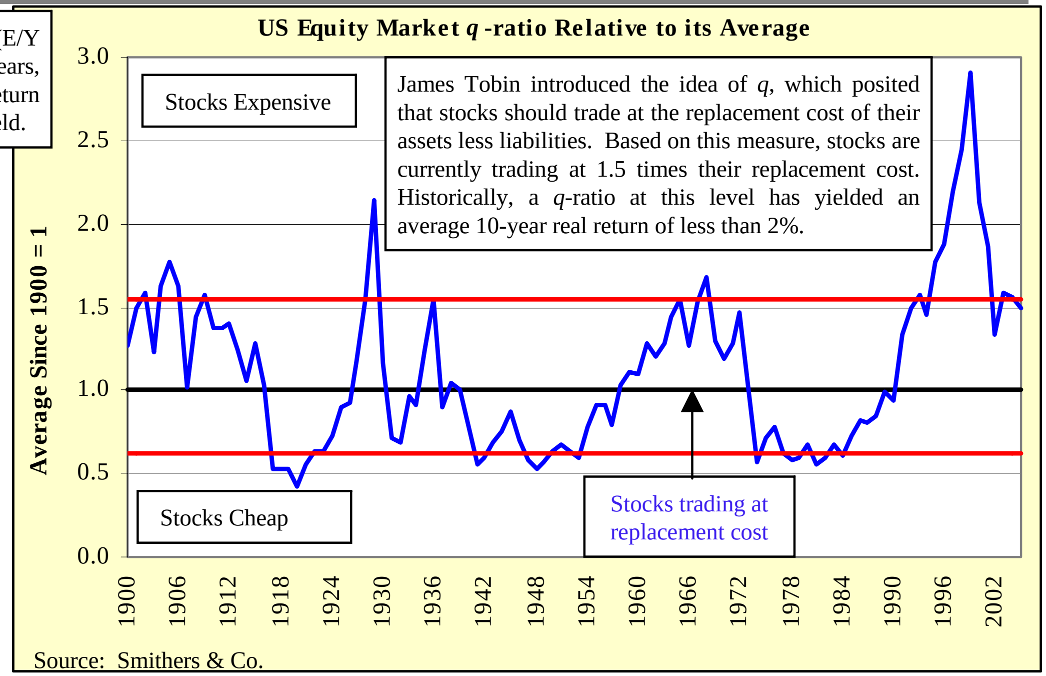
Source: Hammond Associates

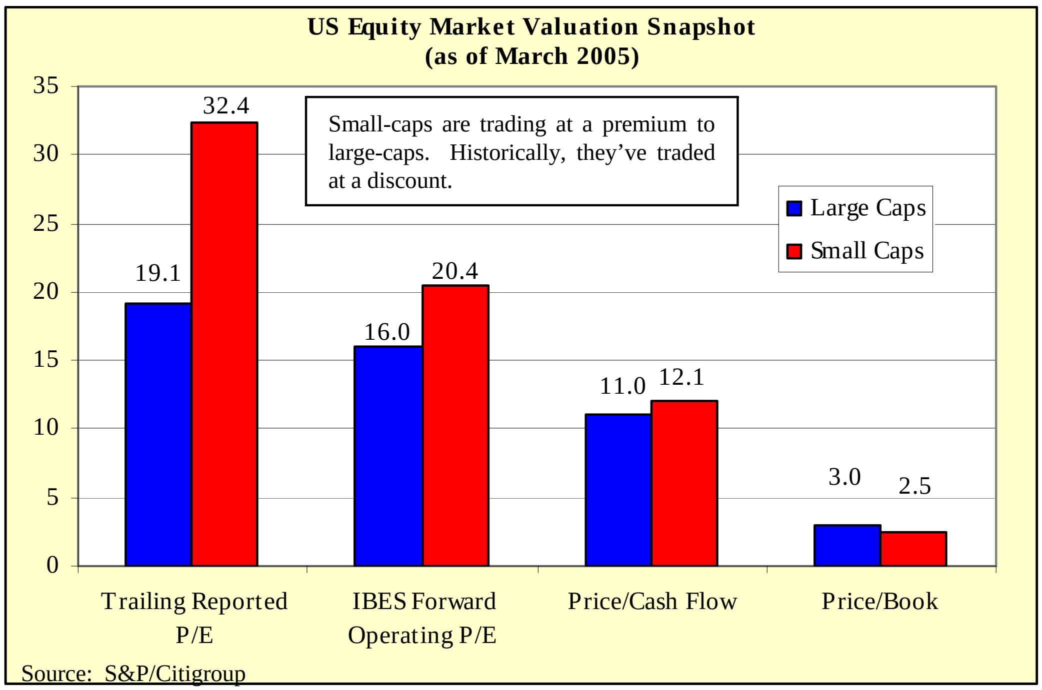


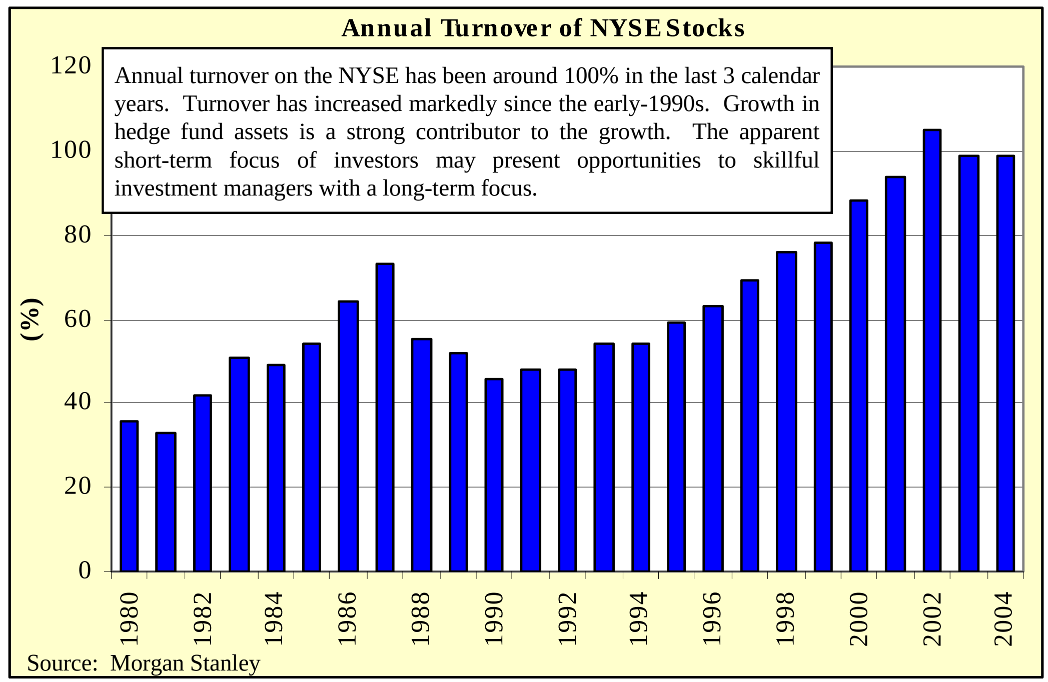
Source: MSCI

Equities Stumble Out of the Gate in 2005 (cont.)



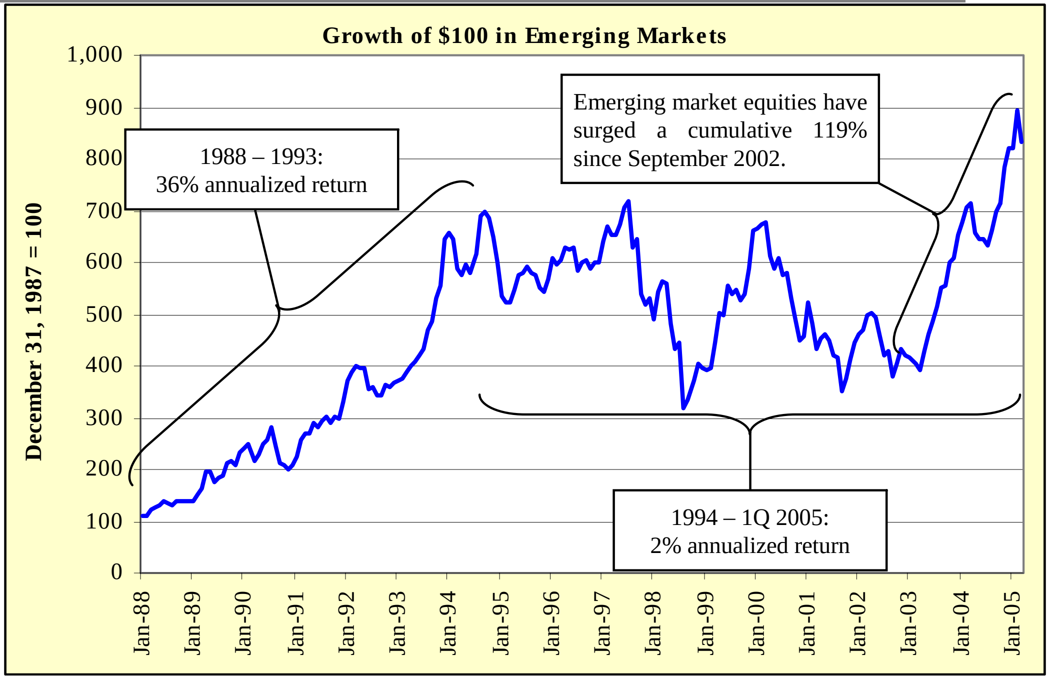


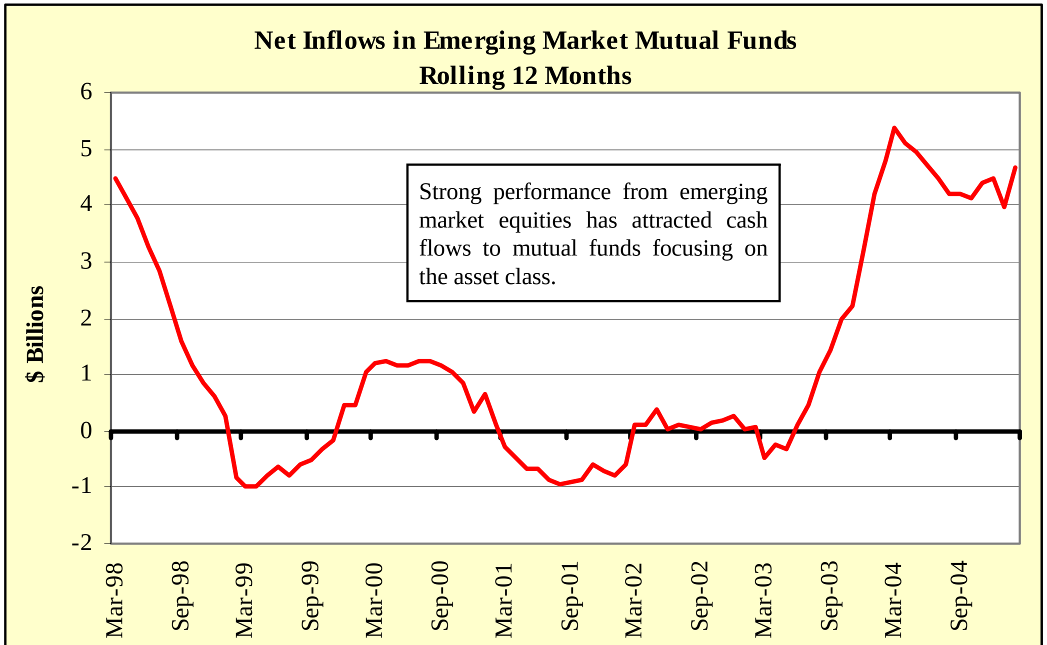




Emerging Markets – Time to Be Nervous?

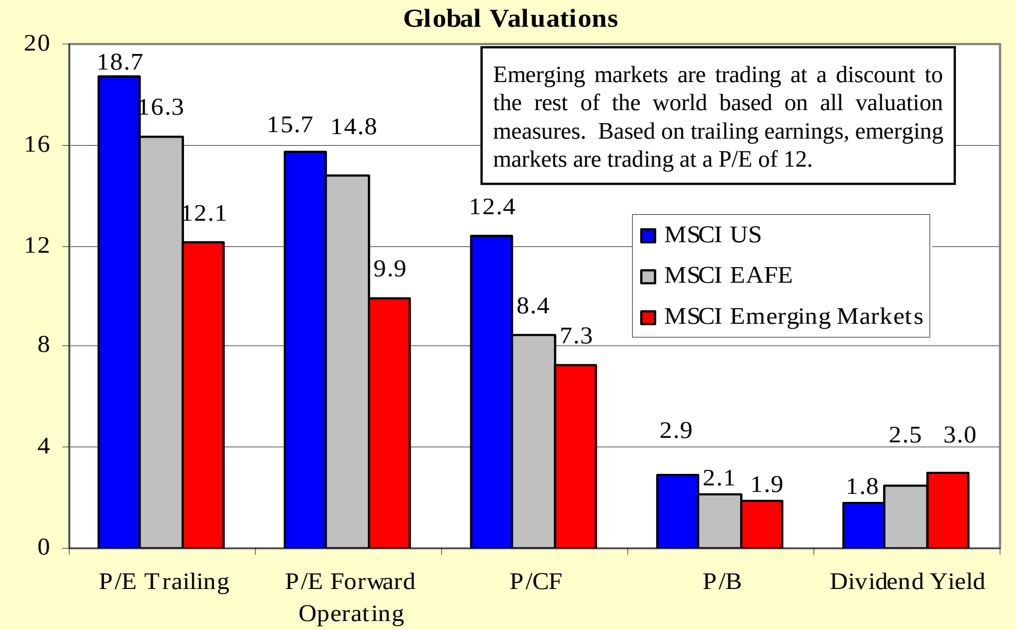
- Emerging market equities had a bumpy ride in the first quarter. At one point they were ahead as much as 9%, but finished the quarter only 1.8% higher. With a 119% cumulative gain since September 2002, there is less margin for error in emerging market equities. Concerns arise on two fronts.
  - ✓ The economies of emerging markets, led by China, have been booming. China has been exporting to the US to fill the insatiable appetite of US consumers, while other emerging market countries are exporting their natural resources to China. The ultimate reliance on US consumers for growth is a concern. If consumers finally decide to rein in spending and increase savings, or more worrisome, if there is crack in the real estate market, emerging market economies are likely to slow substantially.
  - ✓ A second area of concern is whether current profitability levels can be sustained. Emerging market equities, like US equities, have seen substantial growth in profitability over the past two years. The return-on-equity is nearly 16%, compared to a 10-year average of 10%. This profitability growth has pushed the P/E ratio down to 12, making emerging markets a seeming bargain among world markets. However, if profitability reverts to the mean, profits will fall and P/E ratios will rise.
- Aside from economic and market risks, political risks are always present, as shown last year in the Russian Yukos affair.
- Despite these concerns, we believe emerging market equities are the most promising equity asset class in a low return world and will provide the highest returns of world equity markets over the next ten years. But, it's certain to be a very bumpy ride along the way.



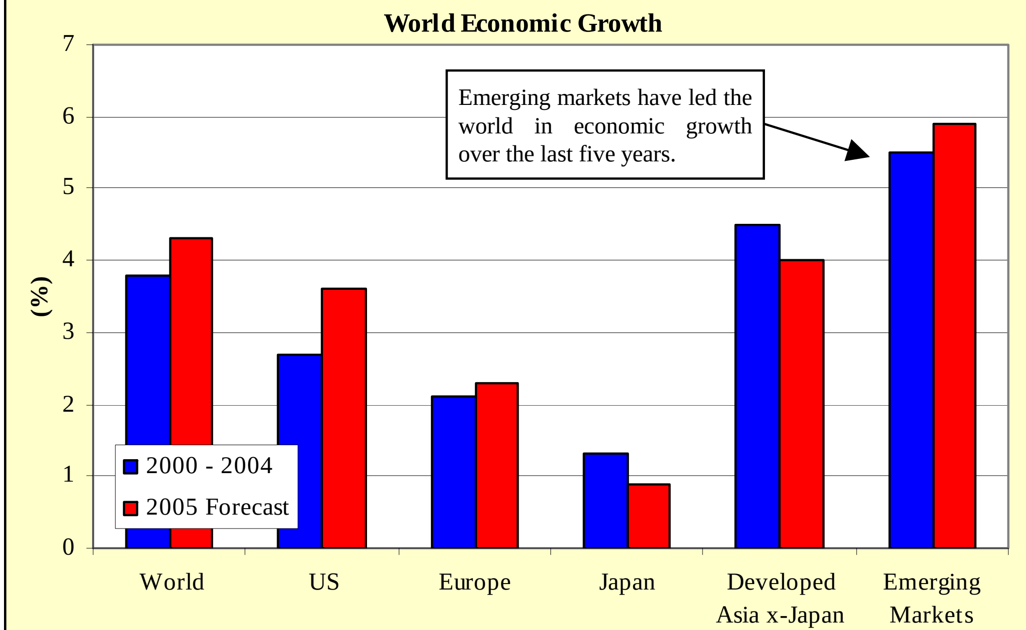


Source: ICI

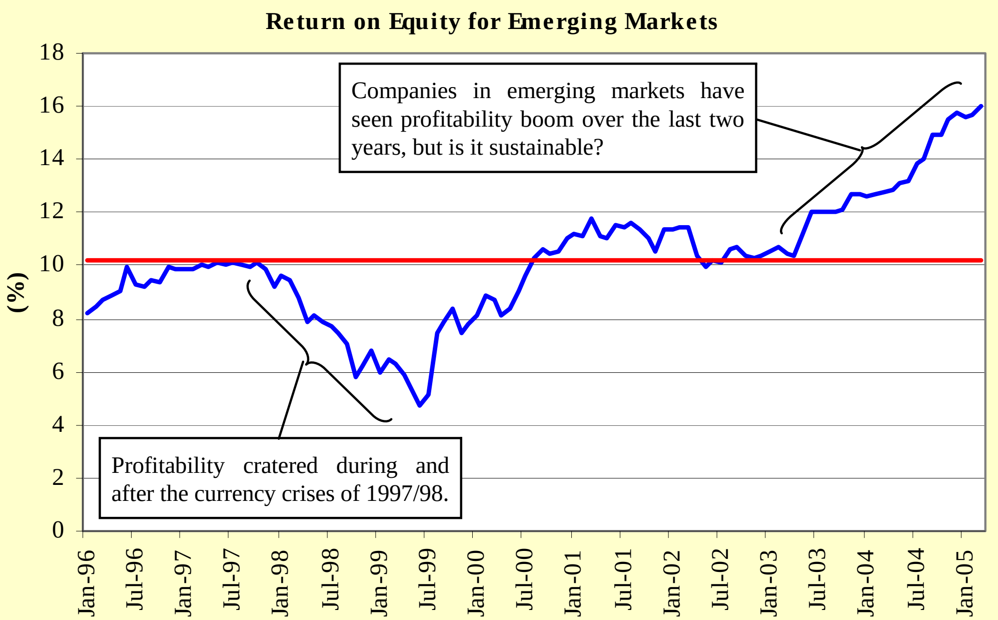
Emerging Markets – Time to Be Nervous? (cont.)



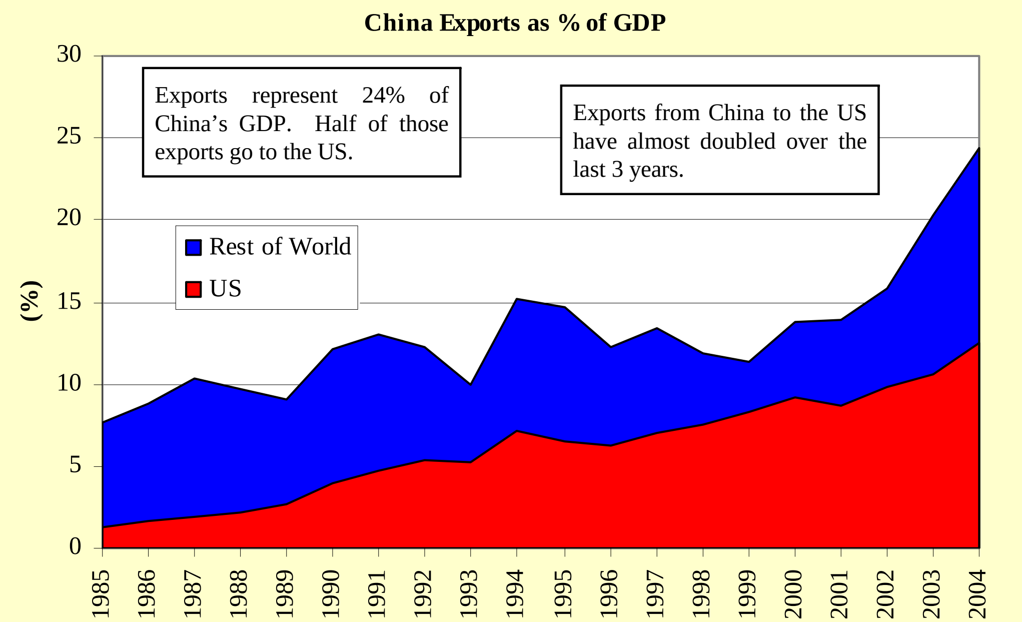
Source: Bloomberg



Source: IMF



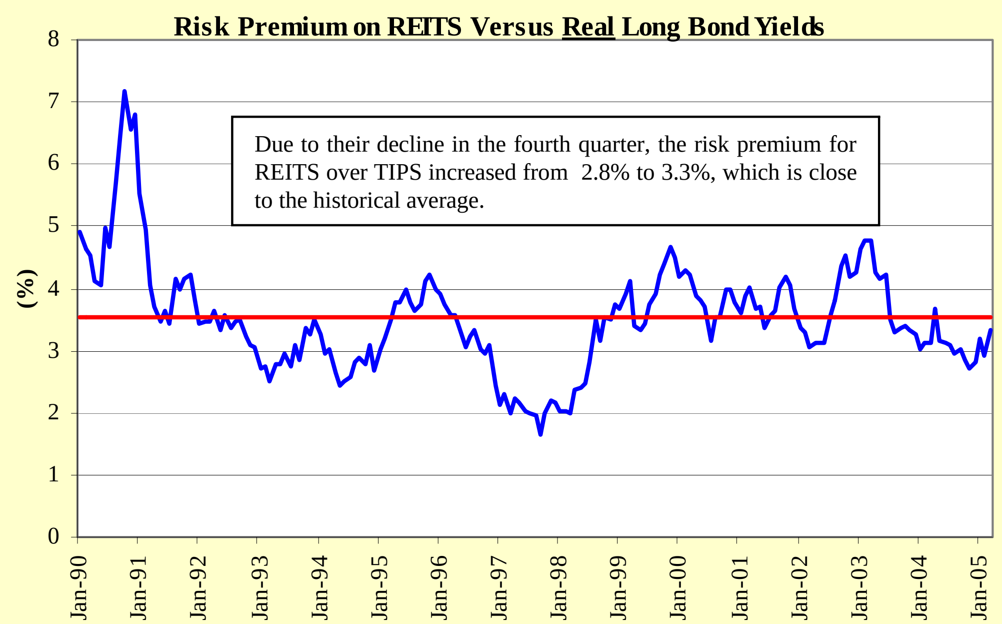
Source: Bloomberg



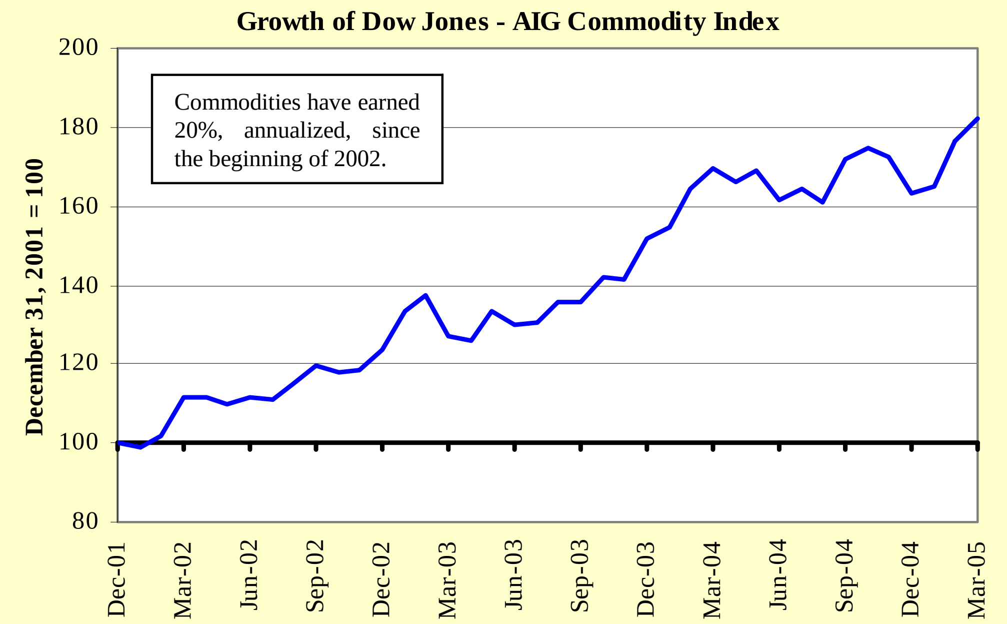
Source: IMF, Bureau of Economic Analysis

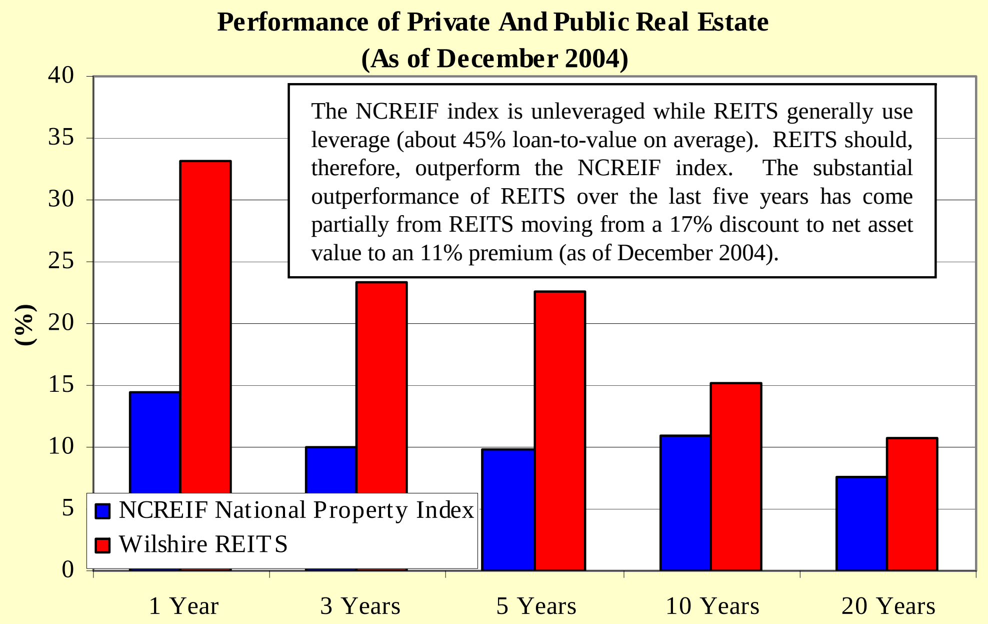
Real Assets: REITS Stumble, Commodities Surge

- REITS took a beating in the first quarter, plunging 7.3%. The good news is that they now offer a better value. According to data published by Green Street Advisors, REITS are now trading at a modest discount to net asset value. The dividend yield is up to 5.2%, which is a healthy 3.3% premium to long-term TIPS.
- While we remain uneasy about underlying real estate fundamentals, REITS are back to being a decent substitute for direct investments in core real estate.
- In contrast to REITS, commodities performed very well during the quarter. The Dow Jones – AIG Commodity Total Return index gained 11%. The petroleum sector led the way with a 28% return. Industrial metals earned 7%. We believe commodities remain a good long-term play on the growth in China and other emerging markets and a weakening dollar.



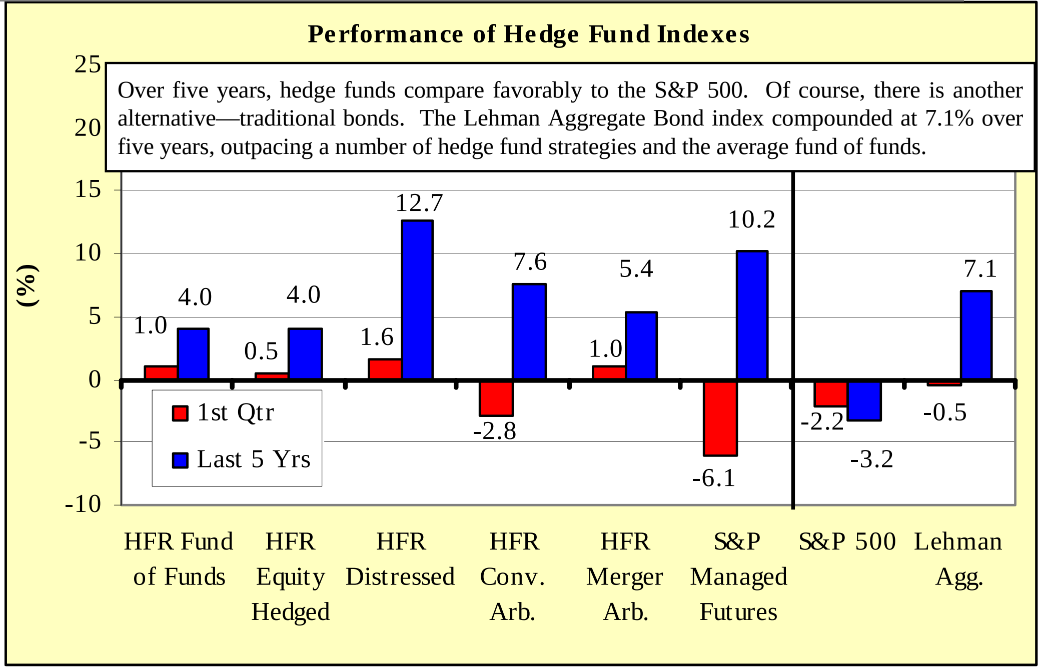
Source: NARIET, Federal Reserve

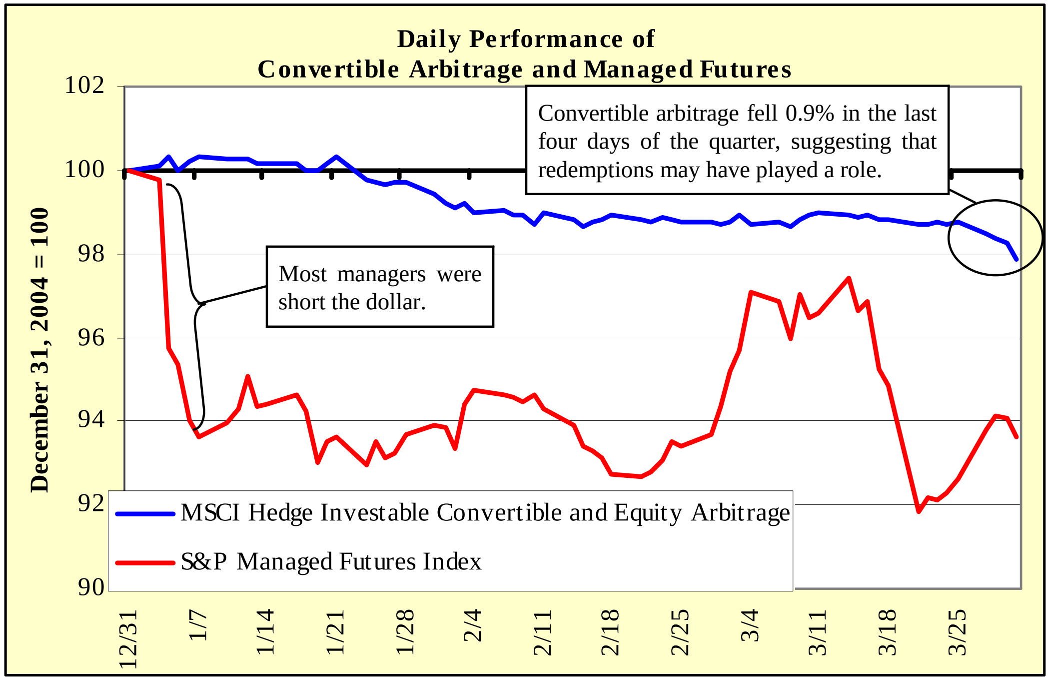




Hedge Funds: A Positive Quarter

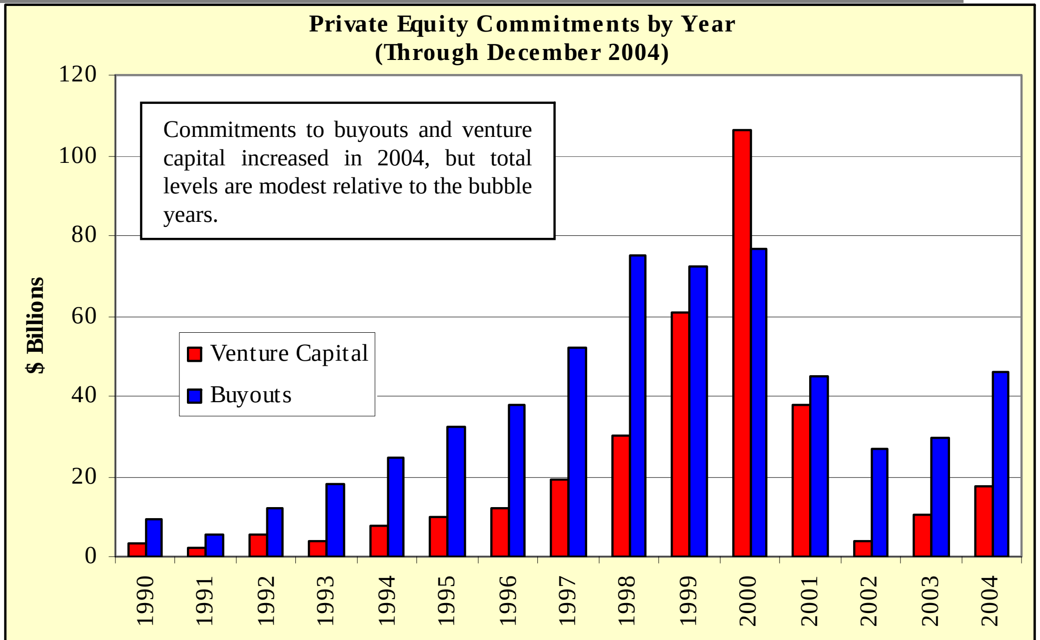
- Hedge fund returns in the first quarter were generally positive, yet modest, which is more than can be said about stocks and bonds. According to HFR, the average fund of hedge funds was up 1.0% during the first quarter. Returns were strong in February and slightly negative in January and March, directionally similar to the performance of the broad equity markets.
- In spite of widening credit spreads, distressed continued its strong run, earning 1.6% in the quarter, albeit with less momentum than the past few years. Merger arbitrage followed-up its strong fourth quarter with a solid showing in first quarter as merger activity continues to strengthen.
- Long/short equity managers made money during the quarter, despite the broad decline in stocks. On average, managers earned their incentive fees through asymmetric market participation—capturing all of the S&P 500's upside in February and only a third of its downside in January and March.
- Convertible arbitrage and managed futures suffered losses during the quarter. Analyzing the daily returns of each pinpoints the problems:
  - Managed futures got hammered right out of the gate in 2005, as many markets, most notably the dollar, reversed sharply. Toward the end of the quarter, the dollar reversed course yet again, creating further losses.
  - Convertible arbitrage continues to struggle, losing 2.8% in the quarter. Just as the strategy got a much needed pickup in volatility, the benefits were swamped by widening credit spreads and rising interest rates. Most troubling, however, is the sell-off at quarter-end. The strategy lost 0.9% in the last four trading days of the month, as it appears managers were raising cash to fund redemptions. A loss of this magnitude in just four days is significant in the generally low volatility world of convertibles hedging. The problem may get worse—the losses are likely to trigger more redemptions, which will trigger more selling.



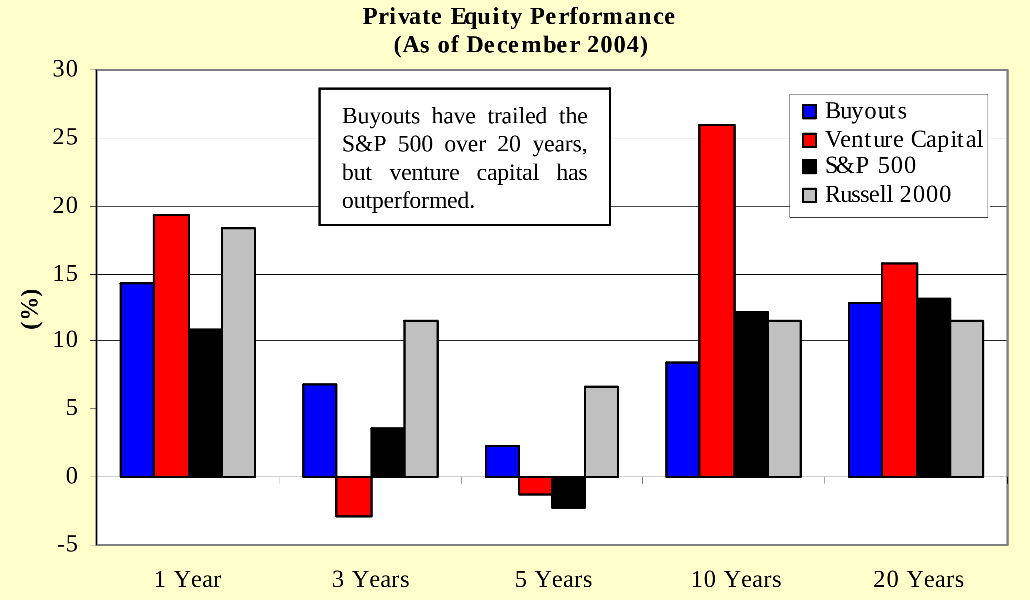


Private Equity: Fundraising Increased in 2004

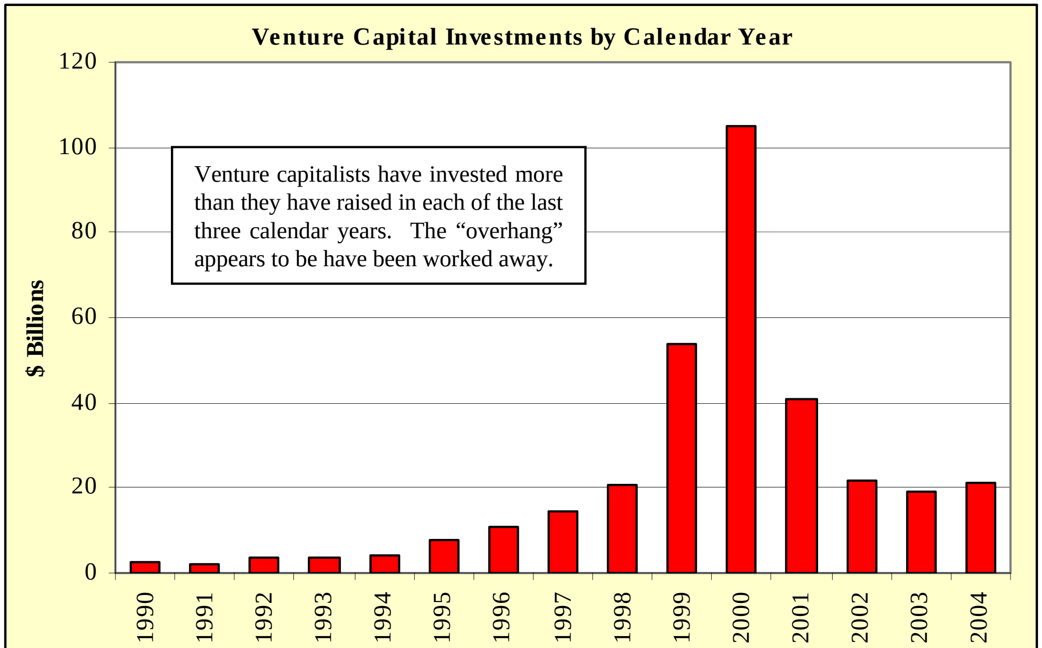
- Private equity performance was positive for the second consecutive year in 2004. Venture capital funds earned 19.3% and buyout funds returned 14.3%.
- Fundraising in buyouts and venture capital was strong in 2004. Venture capital funds raised $17 billion, a 66% increase over 2003. Buyout funds raised $46 billion, representing a 55% increase from the prior year. Fundraising in 2005 should be even healthier. Buyout fundraising has gotten off to a good start. Carlyle Group raised a record $7.8 billion fund. Goldman Sachs topped them a month later with an $8.5 billion fund. There is also high demand for fund of funds targeting top venture capital firms, and more institutions are considering European and emerging market private equity funds.
- On the investing side, buyout multiples have increased significantly since 2002. While spreads increased only modestly in the first quarter, high yield issuance is already being curtailed for the lowest quality credits, perhaps creating opportunities for mezzanine lenders.



Source: Venture Economics



Source: Venture Economics



Source: Venture Economics

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