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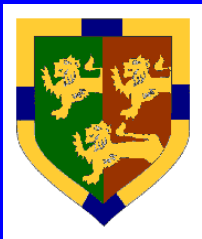
RESEARCH REPORT

Third Quarter 2005

In this report . . .

- ✓ Domestic Equity Strategy: Have We Reached an Inflection Point?
- ✓ Hurricanes Worsen Energy Woes
- ✓ How Will the Current Account Deficit be Corrected?
- ✓ International Equities Still a Better Buy than Domestics





Hammond Associates

Domestic Equity Strategy: Have We Reached an Inflection Point?

October 2005

We have been advocates of small-cap and value tilts within equity portfolios for most of our history. Academic evidence has shown that both of these tilts can enhance the long-term performance of a portfolio versus a straight S&P 500 investment. Following the tech-led bubble in the late 1990s, small-cap stocks and value stocks were a particular bargain relative to the broad market (especially to large-cap growth). As a result, they have been tremendously beneficial to equity portfolios since the bubble burst. The combination of small-cap and value has produced exceptional returns. Small-cap value stocks have outperformed the S&P 500 by an annualized 18 percentage points (+16% vs. -2%) since March 2000. However, the opportunities in these areas appear to have been priced away, and one can make a strong case that they are now materially overvalued relative to the broad market.

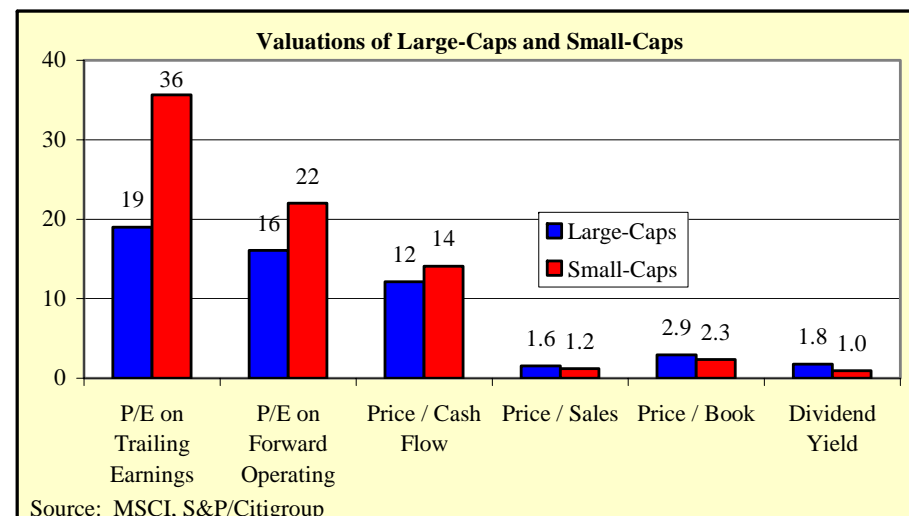
Over the long-term, we still believe small-cap and value tilts will pay off. Over the next five years, however, we would not be surprised to see large-cap growth stocks top the domestic styles. In particular, high-quality large-cap growth stocks appear to be the most attractive segment of the domestic equity market.

Performance and Current Valuations

The bear market for equities was mild for investors who were willing to significantly overweight small-cap stocks and value stocks. From the peak of the market in March 2000 to its trough in September 2002, the S&P 500 shed 44% of its value (cumulative). In contrast, large-cap value stocks fell 33%, and small-cap value stocks returned a positive 14%. During the recovery period of October 2002 forward, the S&P 500 has rebounded 59%, while small-cap value stocks have surged 95%. Just looking at the size differential, the Russell 2000 index of small-cap stocks (including growth and value) outperformed the S&P 500 by 13 percentage points during the bear market and by 32 percentage points during the recovery.

	Annualized Returns (%)					
	4/00 to Present	4/00 to 9/02	10/02 to Present	1/95 to 3/00	Last 10 Years	Last 25 Years
S&P 500	(2.0)	(20.6)	16.7	27.6	9.5	12.8
S&P/BARRA Growth	(6.8)	(26.3)	13.4	32.8	8.7	12.0
S&P/BARRA Value	2.9	(14.7)	20.2	21.8	9.8	13.2
Russell 2000	5.3	(13.5)	24.1	17.4	9.4	11.5
Russell 2000 Growth	(4.4)	(29.4)	23.2	20.0	4.7	7.9
Russell 2000 Value	15.6	5.4	24.9	13.3	13.3	14.7

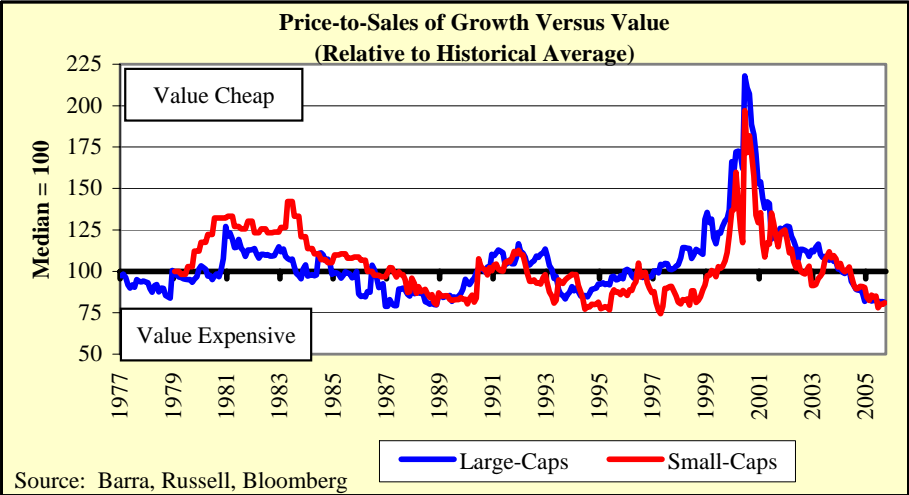
The bad news is that both small-cap stocks and value stocks now appear expensive versus the broad market. Small-cap stocks trade at a substantial premium to large-caps based on the price-to-earnings ratio and the price-to-cash flow ratio. Historically, small-caps have traded at a discount. Based on price-to-sales and price-to-book, small-caps are trading at a discount to large-caps, but this is to be expected, because large-cap stocks have consistently produced higher profit margins on sales and a higher return-on-book value than small-caps.



Comparing valuations of value and growth indexes shows that investors are not willing to pay as much for growth today as usual. Investors should be willing to pay a premium for growth stocks because those companies experience higher earnings growth than value companies (although not usually by as much as investors initially expect). Since 1978, the S&P/BARRA Growth Index has traded at an average 2.2x premium to the S&P/BARRA Value Index based on the price-to-sales ratio. Currently this premium stands at 1.7x, or 25% below average. It hasn't been this

low since November 1988. From November 1988, growth outperformed value by 2.0 percentage points, annualized, over the next five years and by 4.3 percentage points over the following 10 years.

Small-cap growth stocks are also trading at below-average valuations to small-cap value stocks. However, the performance of small-cap growth stocks has been so dismal versus small-cap value stocks that it's difficult to draw conclusions. As with large-cap growth, small-cap growth stocks are trading at a valuation premium similar to 1988 levels. However, from the end of 1988 small-cap value stocks still outperformed growth stocks over the following 5 and 10 years. Based on performance, it appears that small-cap growth stocks have been persistently overpriced relative to value stocks. As shown in the table on the prior page, small-cap growth stocks have been the worst performing style over the last 25 years. We are not willing to bet the future will be different. It may make sense to reduce a small-cap value overweight in favor of large-cap growth, but we are not inclined to bet on small-cap growth.

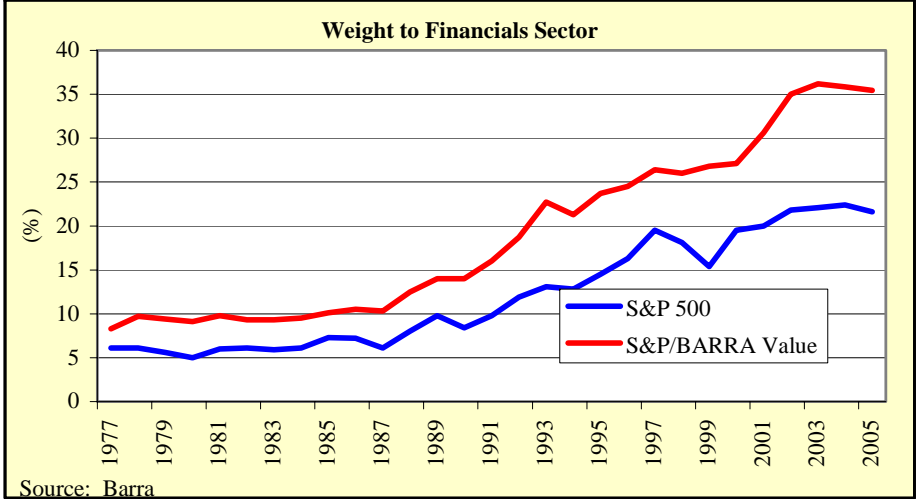


Financials

Another concern we have with value indexes and those managers that closely track them is their relatively large stake in financial companies. Financials have been among the top performing sectors over the past twenty years. These companies have benefited from the secular decline in interest rates and the increasing importance of finance in the economy. In recent years, the Fed's ultra-accommodative policy and the steep slope of the yield curve have boosted profits. Financials now make up 22% of the S&P 500, compared to just 10% at the

beginning of 1990. Value indexes give financials an even higher weight because of their low valuation ratios. The S&P/BARRA Value index currently has 35% in financials. The Russell 1000 Value index also has a 35% allocation to the sector. Passive investments in value indexes represent a heavy bet on financials.

There are now warning signs on the horizon for financials. The flatness of the yield curve will reduce the profitability of the "carry trade" (borrowing short and lending long in riskier assets). With short rates on the rise and intermediate to long-term rates mostly unchanged, the spread available from maturity extension has markedly decreased. Furthermore, tight credit spreads mean that financials are being compensated less for exposure to credit risk. Also worrisome is the impact of a possible bursting of debt and housing bubbles. While financials remain one of the most profitable sectors of the market, the macroeconomic environment suggests a need for caution. We would avoid the financials bet implicit in value indexes.



High Quality Stocks

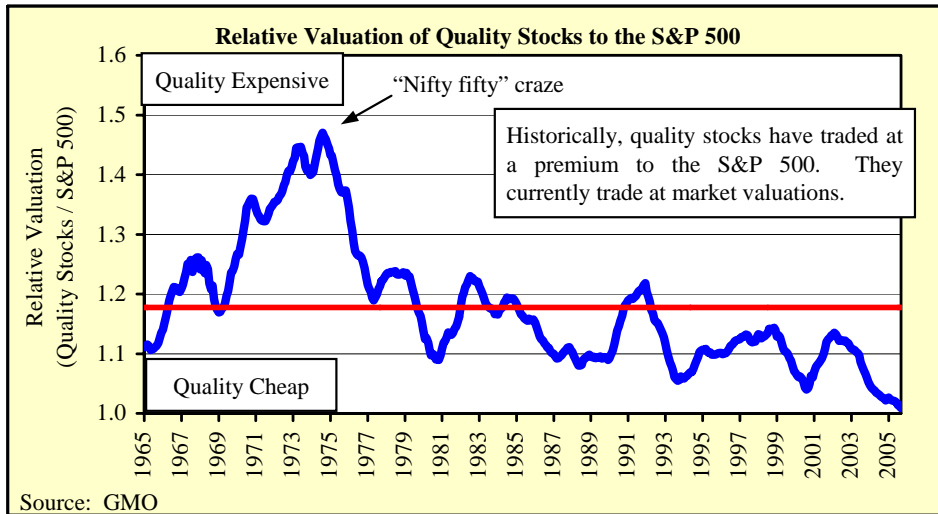
An area that appears relatively attractive within the US market are high quality stocks. These stocks are typically large (often multinational) companies with stable, growing earnings. They tend to have high profit margins, strong balance sheets, and low debt. They are most represented in consumer staples, health care, and other industries where intangible assets (patents, brand names, etc.) are most important. Because of their high profitability, they tend to have higher-than-average price-to-book ratios, and as a result, they often wind up in growth indexes.

Historically, high quality stocks have outperformed the broad market with less risk. However, they have lagged the market during the recent recovery, which has

Conclusion

avored low quality, economically sensitive stocks. Oakbrook's Large-Cap Stable Growth index, which is an approximation of this universe, has underperformed the S&P 500 by 5 percentage points annualized from October 2002.¹ Yet, over the last 20 years, the Stable Growth index has outperformed the S&P 500 by 0.9 percentage points, annualized, with lower risk. The Stable Growth index has also outperformed the S&P/BARRA Value index over this period.

GMO has compared the current valuations of high quality stocks to historical levels. They estimate that high quality stocks are currently about 15% undervalued relative to the S&P 500. They figure that these stocks will outperform the S&P 500 by more than 3 percentage points, annualized, over the next seven years.² Aside from valuations, another point in favor of high quality stocks is that they tend to be multinationals. If the dollar begins to fall again and US growth lags global growth (as US households increase their savings rate), multinationals should benefit relative to the rest of the market. They will find it easier to export to foreign markets with a weak dollar, and they will benefit from higher relative growth rates. High quality, large-cap stocks appear to be the best bet within the US market.



At the peak of the equity market bubble in 2000, investors could have found shelter from the ensuing carnage by overweighting small-cap stocks and value stocks, especially the combination of the two. The rebound from the bear market trough also brought outperformance for these segments. But, all good things must come to an end. Small-cap stocks and value stocks now look expensive relative to the broad market. For investors who have tilted their portfolios to these areas, now is a good time to reduce or eliminate those bets. It may even be worth considering overweighting large-cap growth stocks. However, we shy away from recommending large-cap growth bets because it means overweighting some of the most speculative stocks in the market, where investor enthusiasm often results in overpaying for growth. Instead, we recommend overweighting high quality stocks, which appear to be trading at a discount relative to the market.

A large part of the decision of whether to reposition a portfolio should come down to the managers an institution employs. Value managers come in different shapes and sizes. Those that are less benchmark conscious, and are willing to purchase growth stocks when they are undervalued, could thrive in this environment. (Anecdotally, we have observed some value managers our clients employ purchasing high quality, growthier names.) Conversely, value managers that are very sensitive to style purity and benchmark sector weights may continue to perform well against their value indexes, but may find it challenging to outperform the broad market in the coming years. On the small-cap side, most dedicated small-cap managers will not be willing to move too far beyond the small-cap space, so an explicit reduction in the small-cap allocation may be necessary.

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

¹Oakbrook created a series of indexes to further divide the growth and value categories into *variable* and *stable*. Stable companies tend to have low earnings volatility, while variable companies have high earnings variability. Oakbrook's data on these indexes extend back to 1985. Interestingly, the results of the data show that much of the value effect, at least since 1985, has come from avoiding variable growth companies, which is where speculative stocks (tech, telecom, etc.) land. Stable Growth stocks have performed almost as well as value stocks. The underperformance by variable growth companies is not a surprise because that is where investors are most prone to overestimate future growth potential.

²GMO is fairly dour when it comes to US equities. They expect the S&P 500 to lose 0.7% in real terms over the next seven years and high quality stocks to earn 2.4% real.

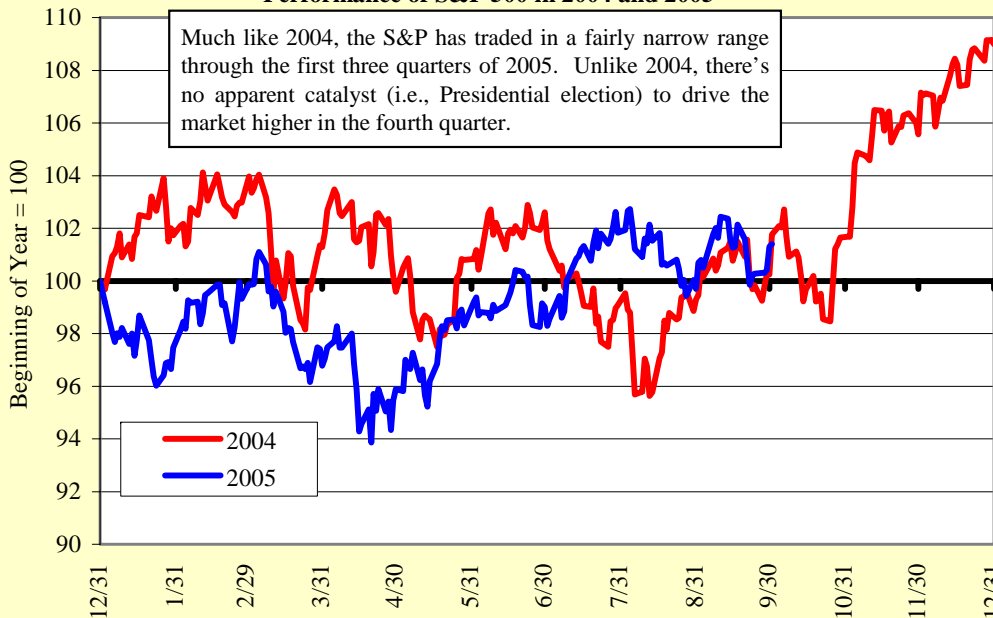
Third Quarter Executive Summary

- The S&P 500 earned 3.6% during the quarter, lifting the return to positive territory for 2005, at 2.8%. The MSCI EAFE index gained 10.4%, and emerging market stocks produced an 18.0% return **for the quarter**. Year-to-date, the MSCI EAFE index has outperformed the S&P 500 by more than six percentage points. Most fixed income asset classes struggled during the quarter as interest rates drifted higher. The Lehman Aggregate Bond index slipped 0.7%. Commodity-oriented investments performed very well thanks to higher energy prices.
- Hurricanes Katrina and Rita put further strains on energy markets. The storms shut down most oil and natural gas production in the Gulf. Refineries representing 11% of domestic capacity were also shuttered. Oil surged from \$56 per barrel to \$66 during the quarter, although all the gains came prior to the storms. The price of natural gas doubled during the quarter, and gasoline prices also jumped. Pricing pressures should ease as infrastructure is brought back on-line. **From an investment standpoint, the hurricanes show the value of investments in energy and other natural resources.**
- The economy grew at a 3.3% annualized rate in the second quarter, which represented a modest deceleration from the 3.8% pace of the first quarter. Hurricane Katrina has caused economists to trim expectations for third and fourth quarter growth due to lost output in the devastated areas and higher energy prices. On the surface, it does not appear that Katrina will do serious damage to the economy.
- The Fed raised the Fed Funds rate twice during the quarter from 3.25% to 3.75%. Intermediate- and long-term interest rates also drifted upwards. The yield on the 10-year Treasury rose from 3.94% to 4.34%. Hawkish comments from Fed officials and the minutes from the last meeting suggest that no pauses are impending. Fed Funds futures predict that the Fed is almost certain to lift the overnight lending rate to 4.25% by year-end.
- The steep rise in energy prices has resulted in the highest inflation rate since 1991. For the twelve months ended September, the Consumer Price Index increased 4.7%. Nevertheless, market expectations for long-term inflation remain tame.
- Consumers continue to tap home equity, and reduce their savings rates, to sustain spending. The personal savings rate fell into negative territory in July for the first time on record. However, the burden of rising energy prices, higher interest rates, and a potential cooling of the housing market hint that an end to the spending binge may be near.
- Due to our over-consumption and lack of savings, the current account deficit could reach 7% of GDP this year. The current account deficit cannot stay at these levels. The question is when and how it will be corrected. This could happen in an orderly fashion, or we could experience a hard landing. Regardless, it seems inevitable that the dollar will resume its decline and will become significantly undervalued for an extended period. **We believe diversifying into foreign currency-denominated assets is prudent.**
- Valuations on domestic equities remain stubbornly high. The current normalized P/E suggests a long-term real expected return for the S&P 500 of 4.2%. International developed markets still appear much more attractive than US markets on a valuation basis. Emerging markets also still appear attractive on a valuation basis, but the gap is rapidly narrowing to that of developed markets. The most significant short-term concern we have about emerging markets is their ultimate reliance on US consumers for economic growth.
- Hedge funds generally enjoyed a strong quarter, with the HFR Fund of Funds Index gaining 4.3%. Performance for the quarter exceeded that of domestic stocks and bonds. Buyout funds returned 20% for the year ended March 2005. Valuations are trending higher in buyouts, and fundraising will likely reach record levels in 2005, which raises concern over future returns.

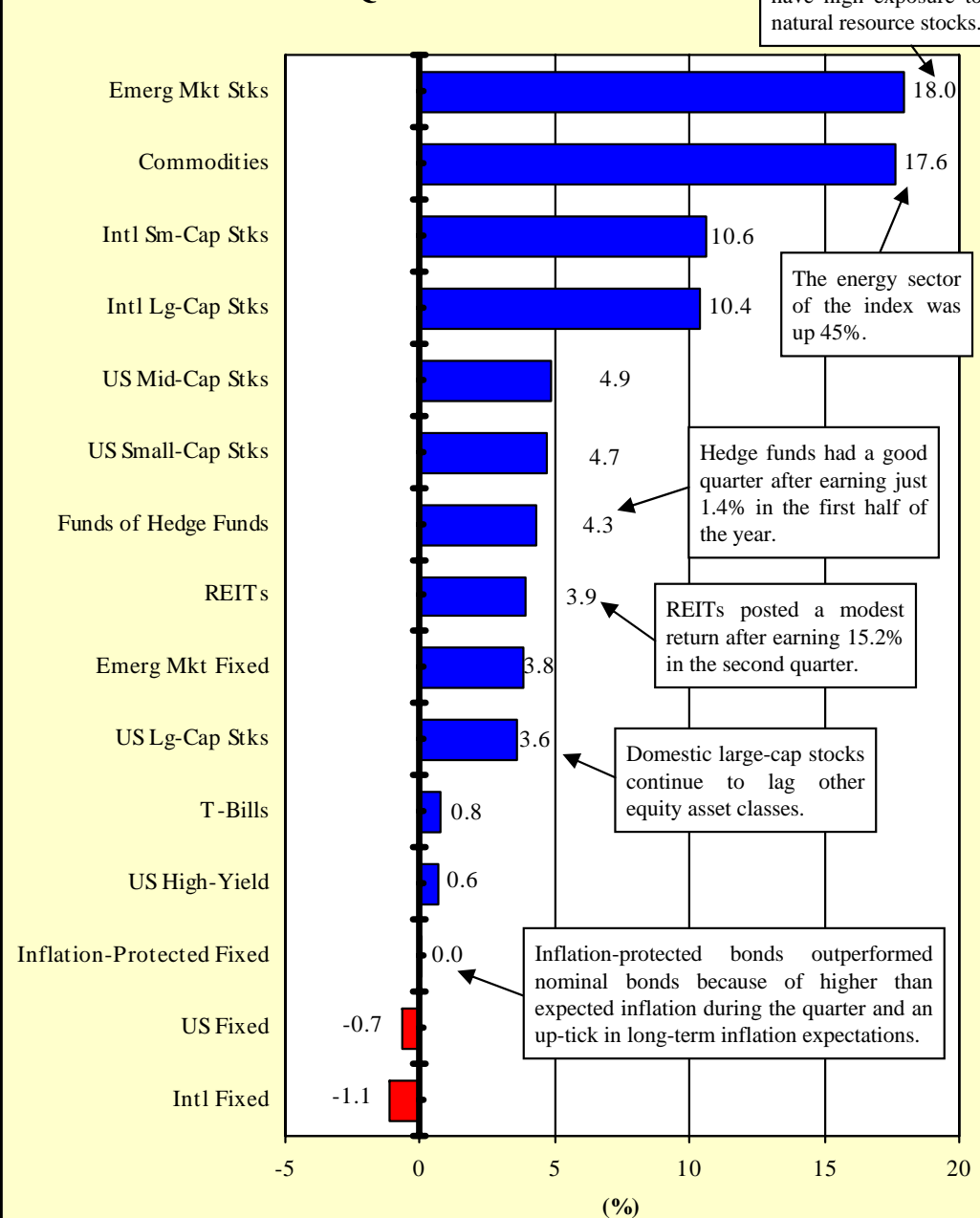
Emerging Market Stocks Led the Way in the Quarter

- The S&P 500 earned 3.6% during the quarter, lifting the return to positive territory for 2005, at 2.8%. Small-cap stocks modestly outperformed large-caps, as the Russell 2000 index gained 4.7%.
- International equities significantly outperformed domestic equities during the quarter. The MSCI EAFE index gained 10.4%, and emerging market stocks produced an 18.0% return.
- Most fixed income asset classes struggled during the quarter as interest rates drifted higher. The Lehman Aggregate Bond index slipped 0.7%. Inflation-protected bonds finished the quarter flat.
- Funds of hedge funds earned 4.3%, outperforming domestic large-cap stocks and bonds. Commodities gained 17.6% on higher energy and gold prices.

Performance of S&P 500 in 2004 and 2005

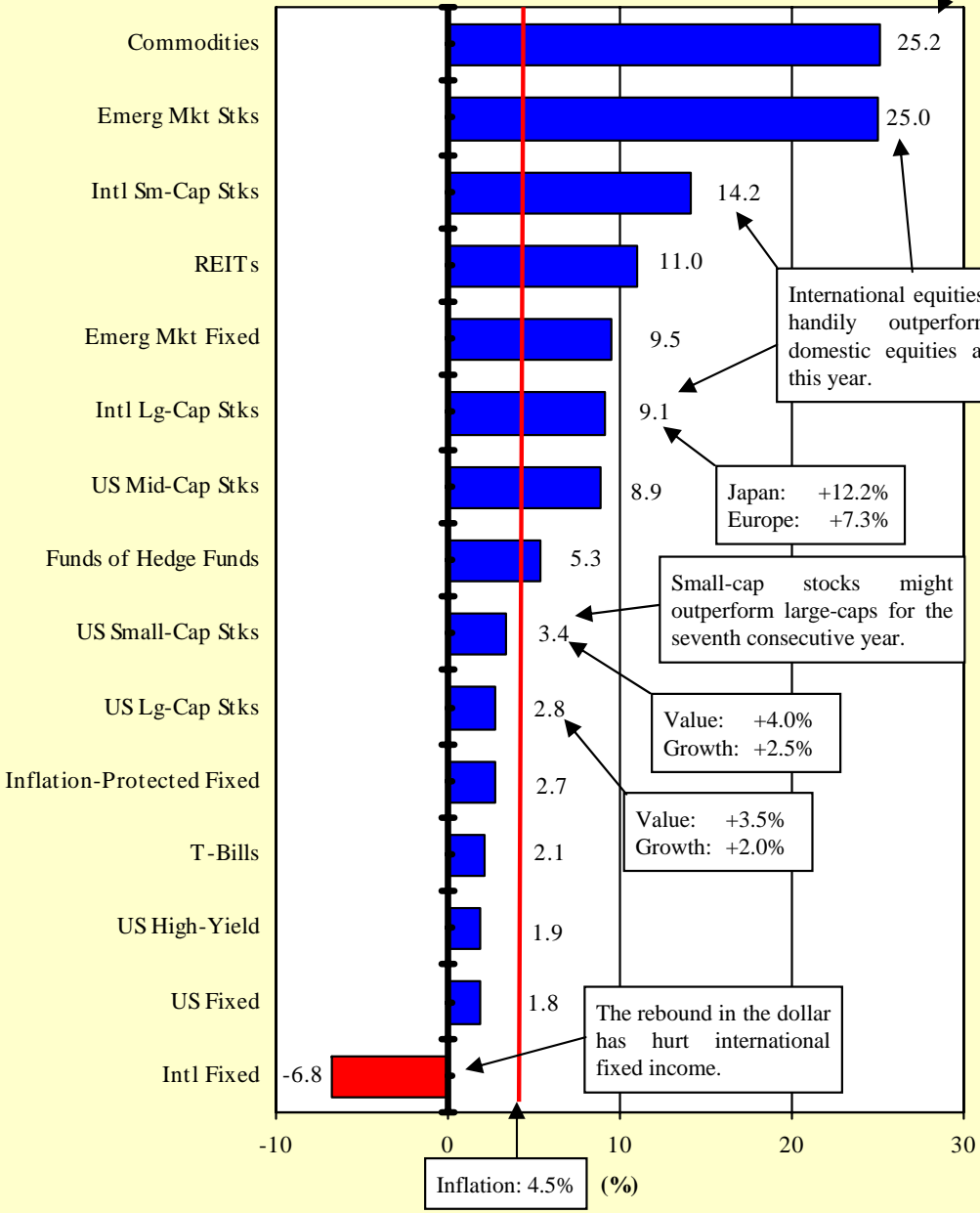


Third Quarter 2005 Performance

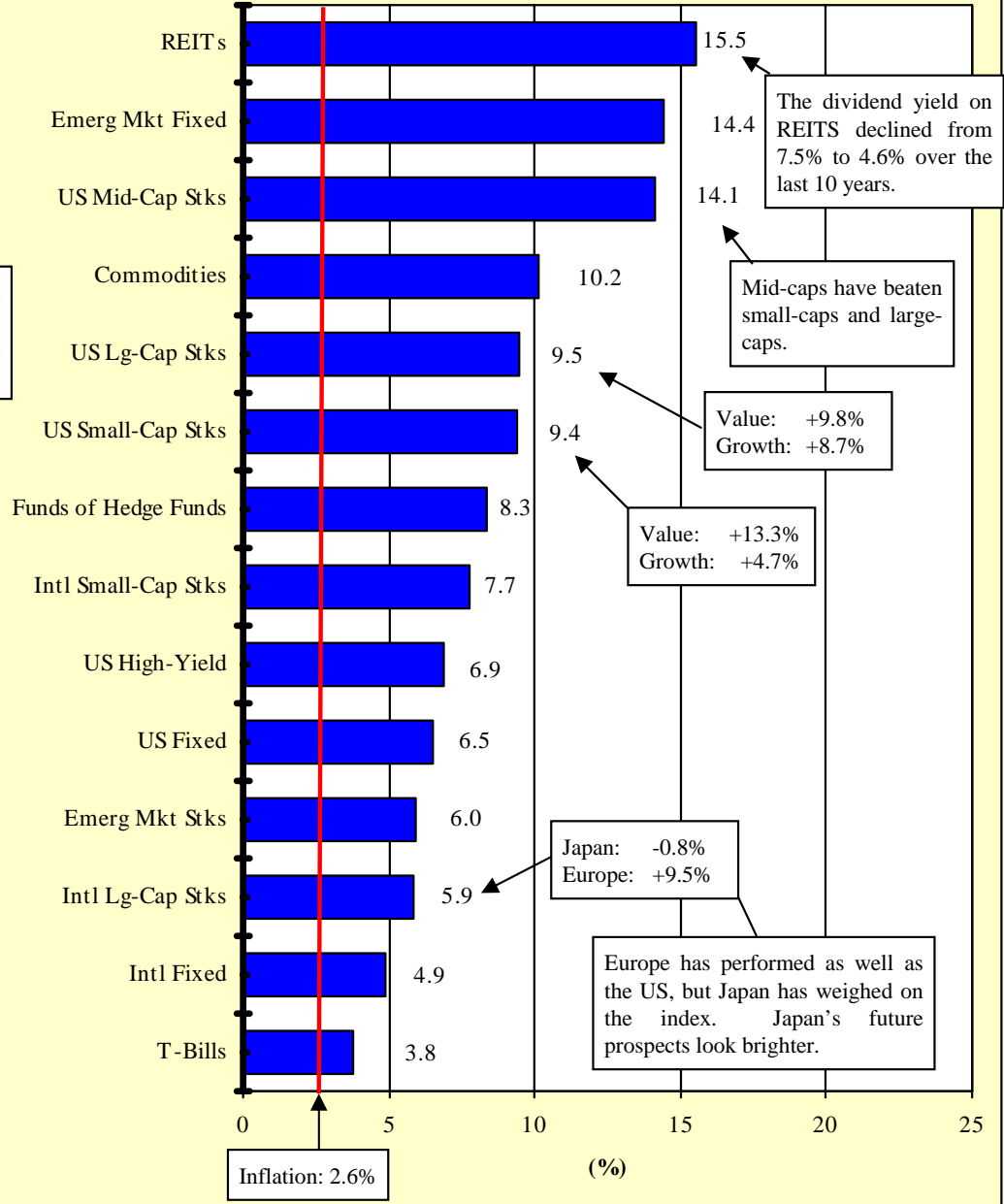


Commodities On Top in 2005

Year-to-Date 2005



Trailing 10-Year Performance



Hurricanes Worsen Energy Woes

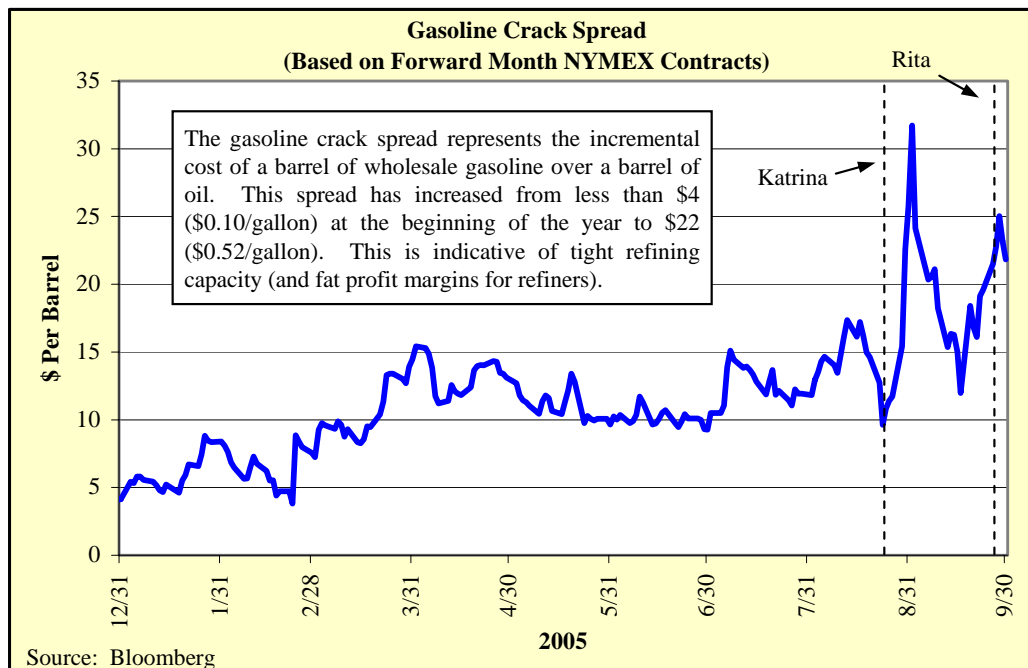
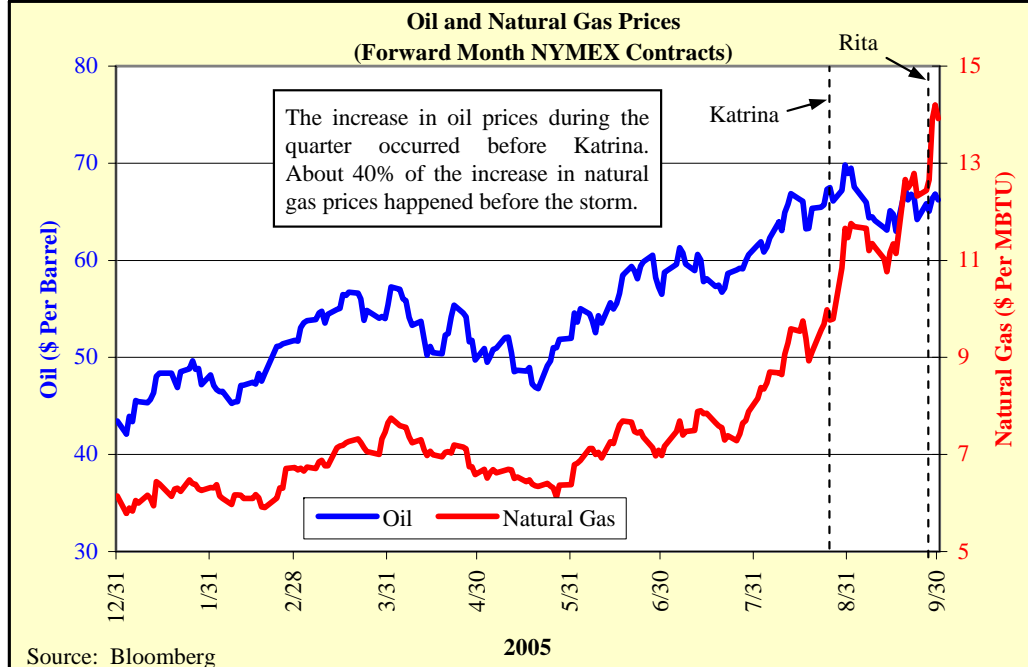
➤ Hurricanes Katrina and Rita put further strains on energy markets. The storms shut down as much as 97% of oil and 87% of natural gas production in the Gulf, and refineries representing 11% of domestic capacity were shuttered.

- ✓ Oil surged from \$56 per barrel to \$66 during the quarter. All of the increase occurred *before* the storms hit. Gulf oil production represented only 7% of US demand and 2% of global demand before the storms hit. The release of oil from the Strategic Petroleum Reserve, and reduced demand because of refinery outages, helped to restrain prices.
- ✓ The price of natural gas doubled during the quarter, from \$6.98 per million BTU to \$13.92. Natural Gas production in the Gulf represented about 17% of US demand. The shortfall cannot be made up with imports because the required infrastructure is not in place. There is not a strategic reserve for natural gas.
- ✓ Gasoline and heating oil prices rose during the quarter due to higher oil prices and refinery outages. The wholesale gasoline price (excludes retail markup and taxes) began the quarter at \$1.57/gallon, and reached a peak of \$2.61. It ended September at \$2.14, a 36% increase for the quarter.

➤ The situation continues to improve as infrastructure is brought back on-line, which should ease pricing pressures. As of October 11, 67% and 60% of Gulf oil and natural gas production, respectively, remained off-line. The Energy Information Agency estimates that outages will decline to 33% for oil and 21% for natural gas by December. Only 2% of refinery capacity is expected to remain down in December.

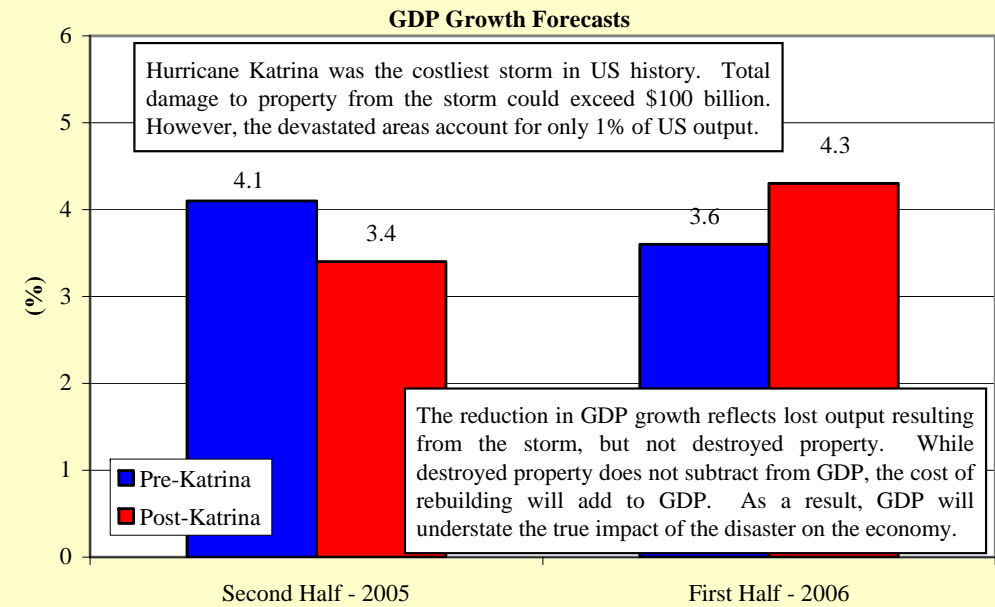
➤ From an investment standpoint, the hurricanes show the value of investments in energy and other natural resources.

- ✓ Access to reasonably priced energy is a linchpin of the world economy. Disruption to energy supplies, whether from natural disasters, terrorism, or political events, is one of the most significant event risks faced by the economy, and by extension, capital markets.
- ✓ Energy exposure in portfolios helps to hedge against this risk. While reasonable arguments can be made that energy is overpriced and likely to fall, we believe the diversification benefits make an allocation useful to most institutions, even in this high price environment.

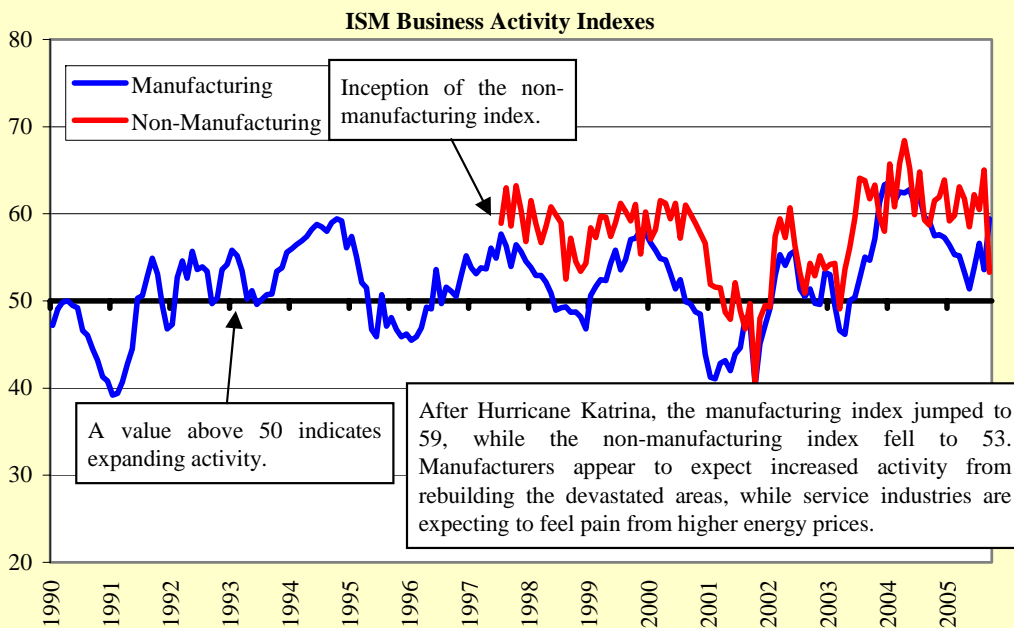


Hurricane Katrina Likely to Dampen Growth this Year

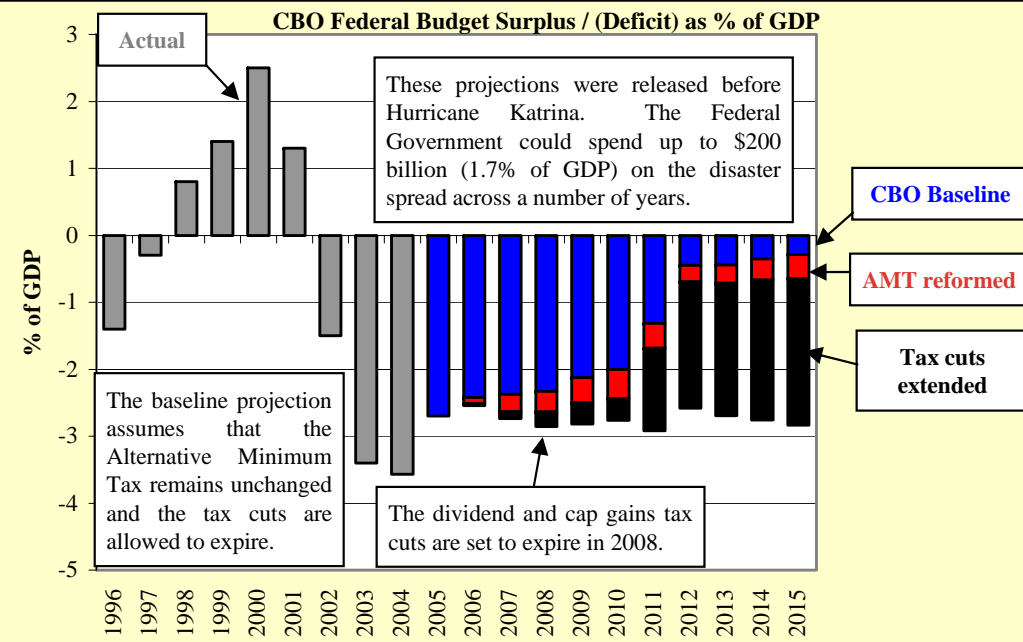
- The economy grew at a 3.3% annualized rate in the second quarter, which represented a modest deceleration from the 3.8% pace of the first quarter. Hurricane Katrina has trimmed third and fourth quarter growth expectations due to lost output in the devastated areas and higher energy prices.
- Employment growth was strong before Katrina, and held up better than expected after Katrina. The economy added 277,000 jobs in July and 211,000 jobs in August. Only 35,000 jobs were lost in September, compared to the consensus expectation of a 175,000 drop.
- On the surface, it does not appear that Katrina will do serious damage to the economy. However, our lingering concern is that the economy was looking vulnerable even before the disaster, due to reliance on consumer spending (see pages 12 and 13). Katrina, and the resulting rise in energy prices, has put our unbalanced economy in a somewhat more precarious position.



Source: Economy.com



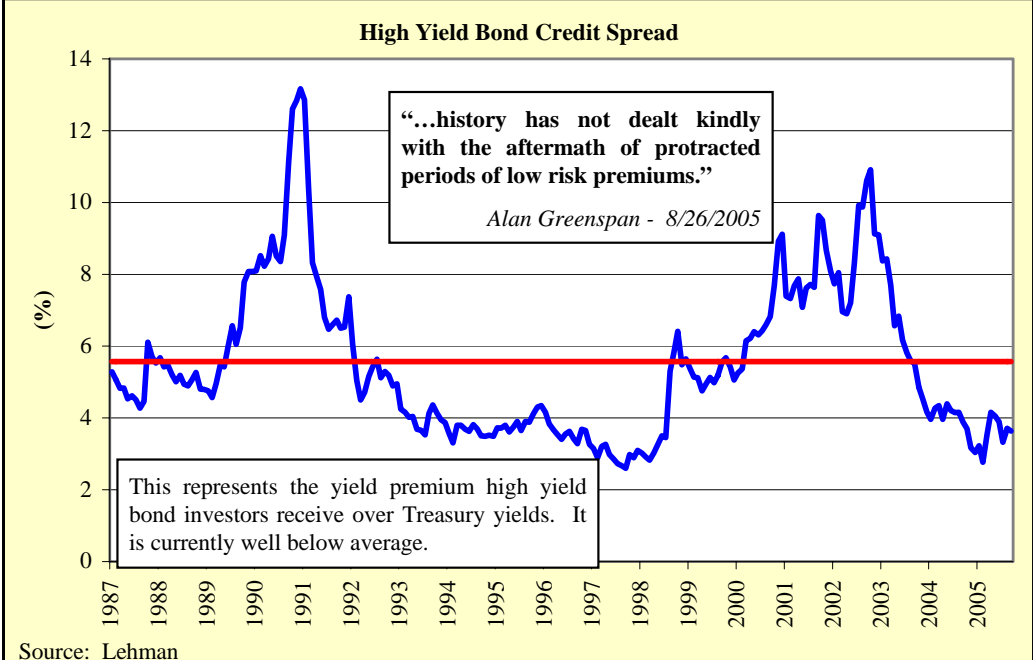
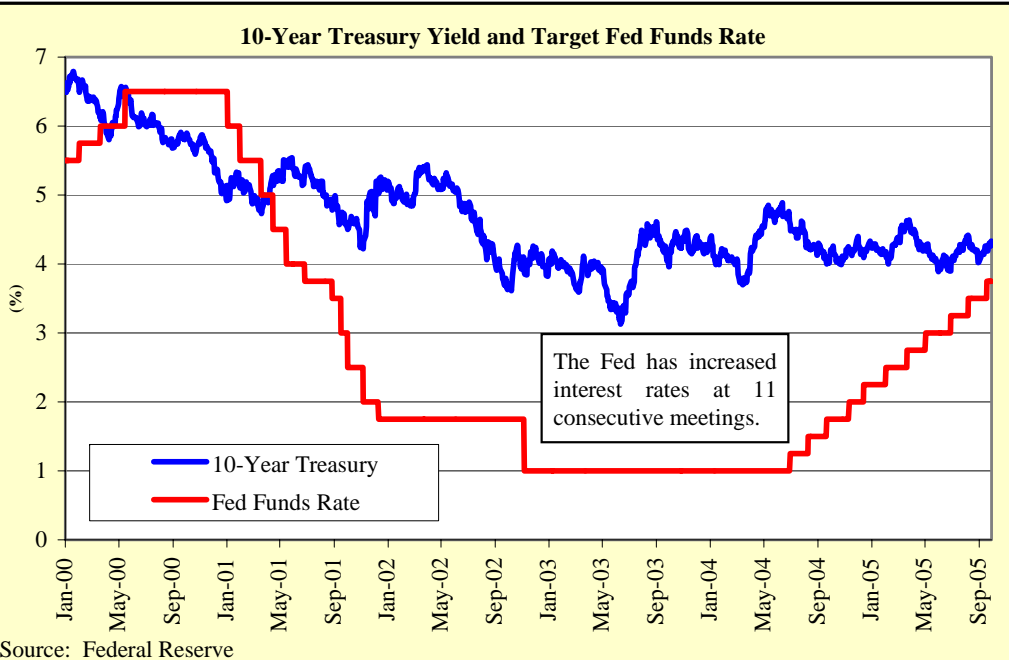
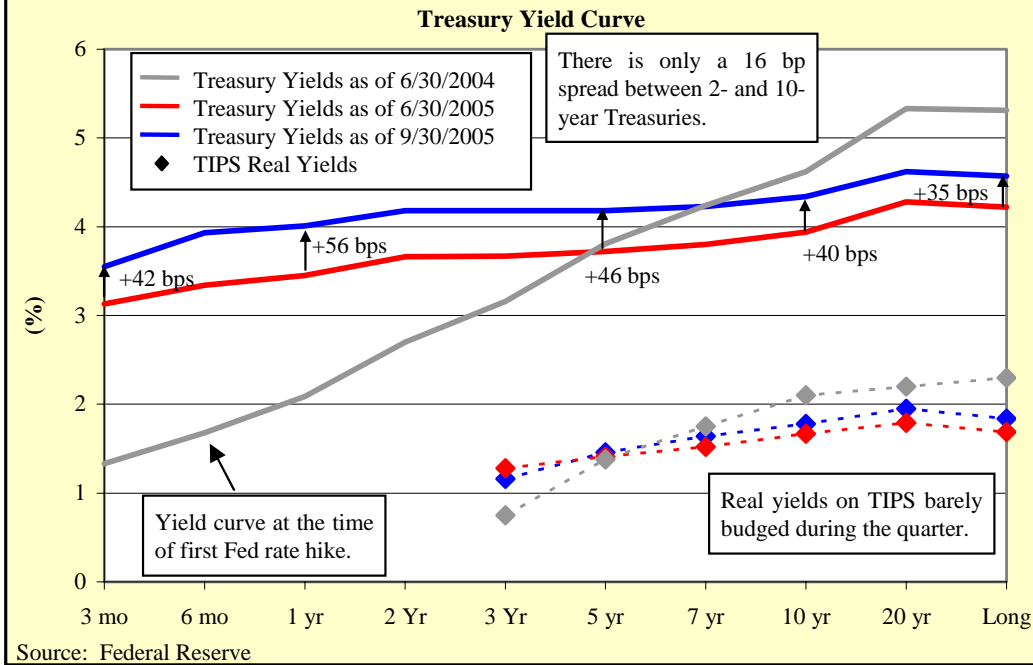
Source: Bloomberg



Source: Congressional Budget Office

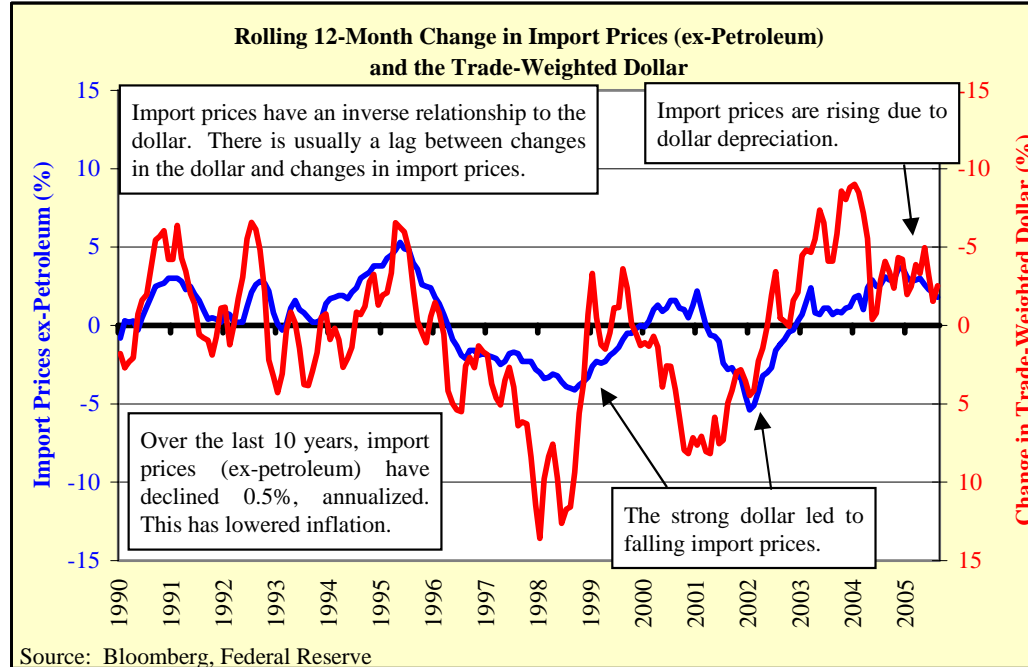
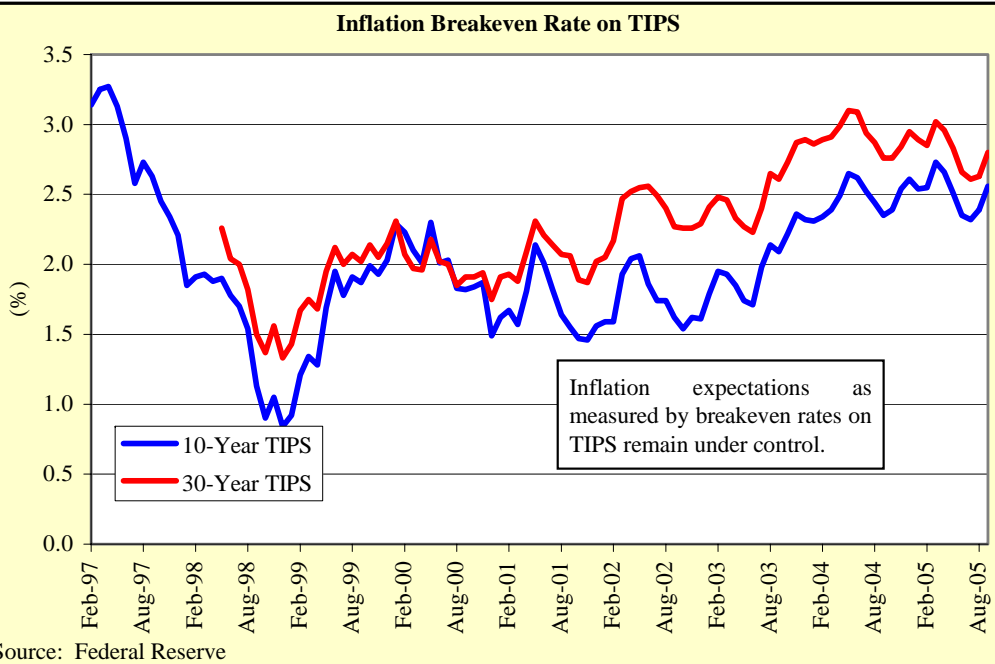
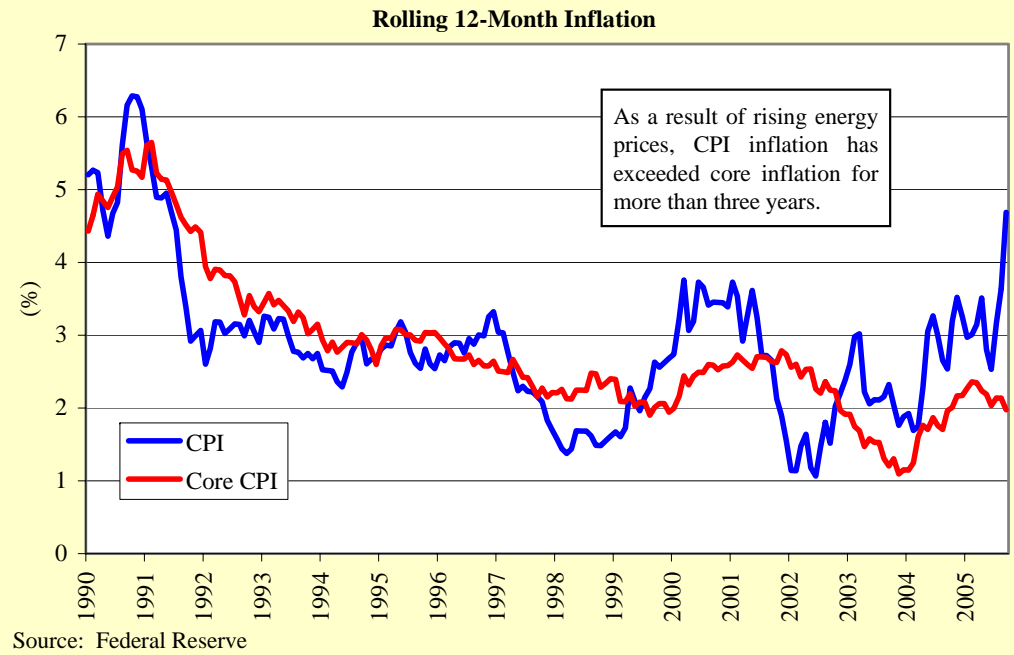
The Fed Expected to Continue Tightening

- Despite Hurricane Katrina, the Fed raised the Fed Funds rate twice during the quarter from 3.25% to 3.75%. Intermediate- and long-term interest rates also drifted upwards. The yield on the 10-year Treasury rose from 3.94% to 4.34%. Much of the increase on the 10-year appears attributable to higher inflation expectations. The real yield on 10-year inflation-protected bonds increased only 11 basis points.
- Hawkish comments from Fed officials and the minutes from the last meeting suggest that no pauses are pending. Fed Funds futures predict that the Fed is almost certain to lift the overnight lending rate to 4.25% by year-end. In addition, the Fed is predicted to raise the rate to 4.50% at the first meeting in 2006. There is less than a 33% chance that the Fed will go beyond 4.5% in 2006.
- Credit spreads on domestic bonds declined during the quarter. The spread on investment-grade bonds fell from 90 bps to 84 bps, while the spread on junk bonds narrowed from 389 bps to 364 bps.



Inflation Reached 14-Year High

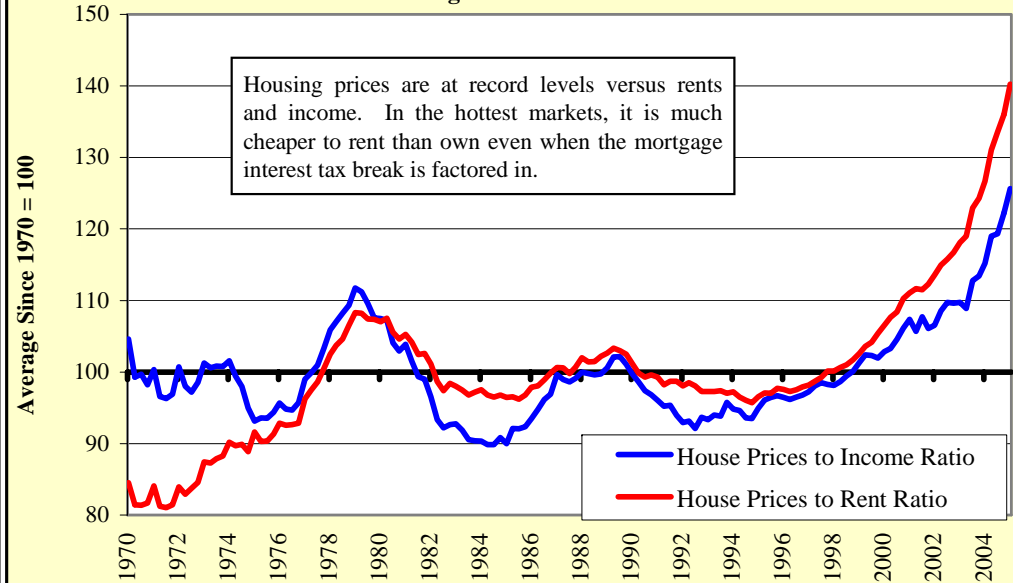
- The steep rise in energy prices resulted in the highest inflation rate since the early 1990s. For the twelve months ended September, the Consumer Price Index increased 4.7%. The last time inflation exceeded 4% for a twelve month period was in 1991.
- The “core” CPI, which excludes food and energy, has risen 2% over the last twelve months. If energy prices stay at these elevated levels, spillover into core inflation is a risk. Manufacturers and service providers will likely seek to pass along higher energy costs to consumers.
- Nevertheless, market expectations for long-term inflation remain tame. While inflation expectations increased during the quarter, the breakeven inflation rate priced into 10-year inflation-protected bonds is only 2.6%.



Will Consumers Continue Their Spending Binge?

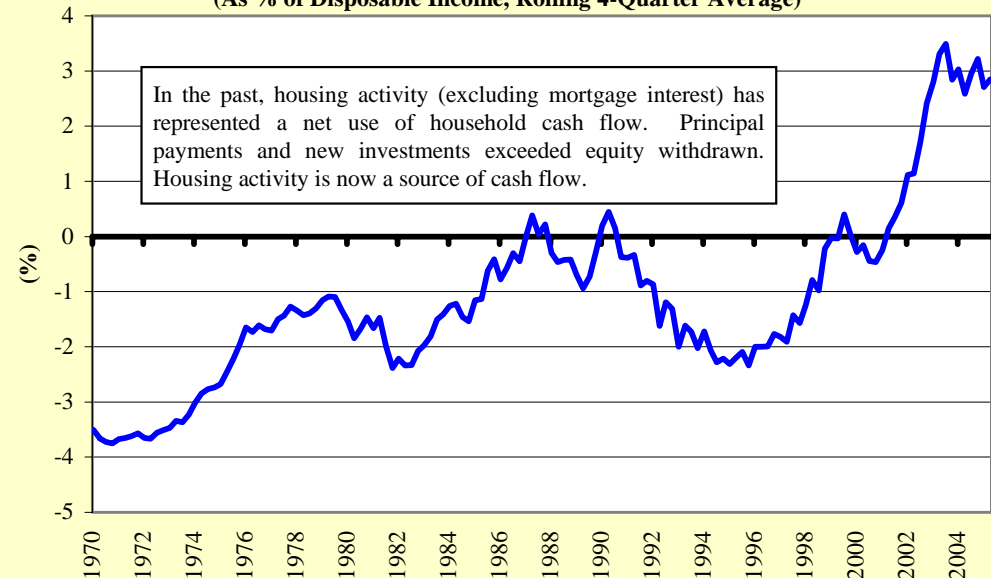
- Consumers continue to tap home equity and reduce their savings rates to sustain spending. The personal savings rate fell into negative territory in July for the first time on record. However, events during the third quarter hint that an end to the spending binge may be near.
- The surge in energy prices will put a strain on the budget of many households, particularly those with lower income.
 - ✓ The US consumes about 140 billion gallons of gasoline per year. The price per gallon has increased about \$1 so far this year. If prices stay at current levels, it means about \$140 billion in additional annual spending.
 - ✓ It's going to be an expensive winter for many households. The Energy Information Agency reports that households heating primarily with natural gas can expect to pay an average of 48% more than last winter (\$1,096 versus \$740). Those who use heating oil can expect to pay 32% more (\$1,577 versus \$1,199).
- Rising interest rates will also put a dent in budgets for many households. The good news is that most outstanding household debt remains in the form of fixed rate mortgages. However, an increasing portion is floating rate debt.
 - ✓ There is now nearly \$1 trillion in home equity lines of credit, which is more than twice the level outstanding just five years ago. These loans are usually tied to the prime rate, which means borrowers immediately feel the pain of higher rates.
 - ✓ Roughly 20% of mortgage debt is in ARMs. While the majority of these are issued with three- to five-year horizons before the interest rate is reset, many of these will be reset over the next year or two.
- It seems likely that the housing market will cool soon. Home affordability for first-time buyers continues to deteriorate. Most economists doubt that we'll see declines in nominal prices on a national level. But, housing prices need not fall to have an adverse impact on spending. If prices level off, households will be less likely to tap home equity to support spending. This could result in an increase in savings rates and a decline in spending growth.

Growth of Housing Prices Versus Rent and Income



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

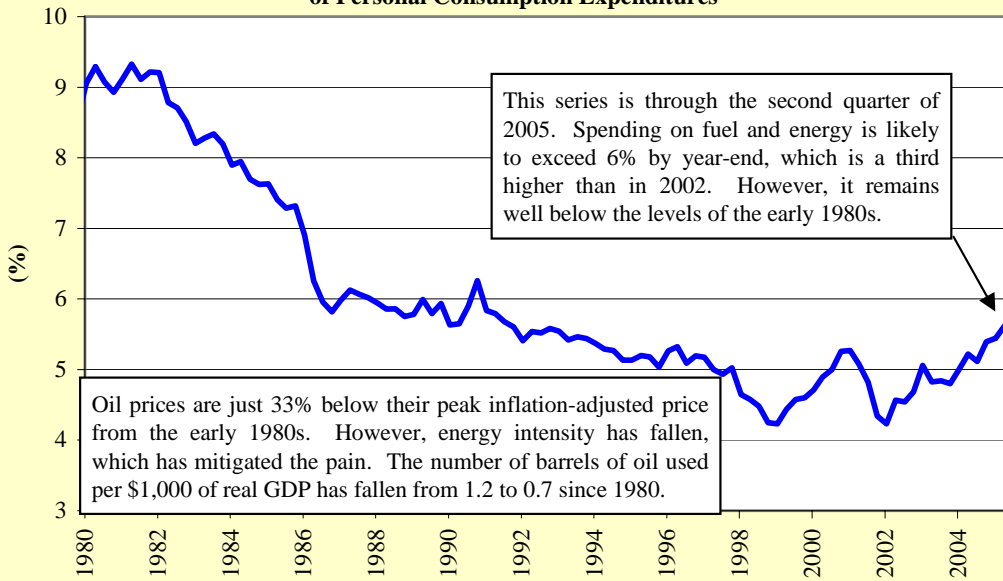
Households' Cashflow from Residential Real Estate
(As % of Disposable Income, Rolling 4-Quarter Average)



Source: Federal Reserve, Hammond Associates calculations

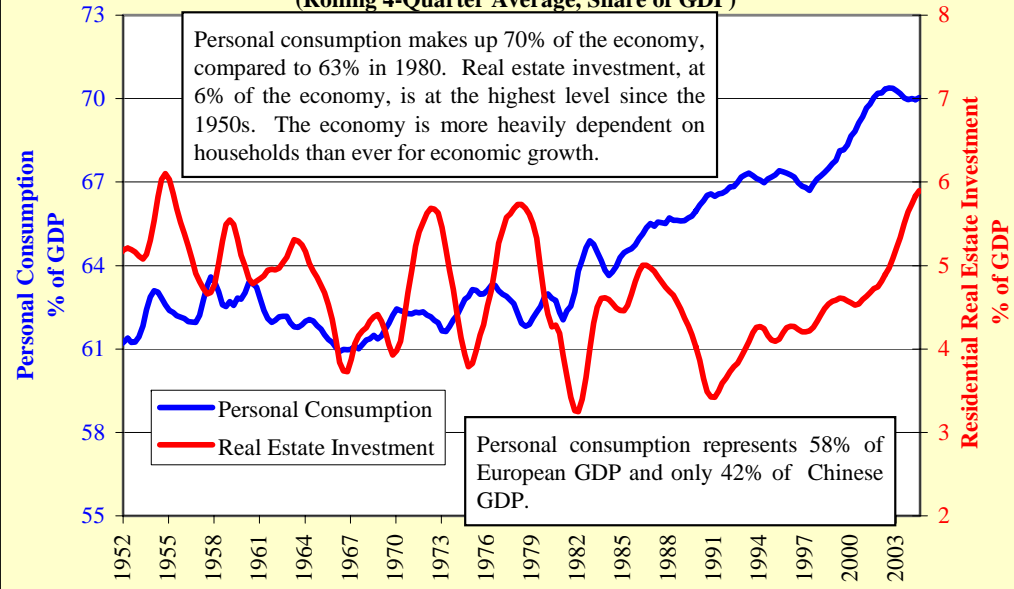
Will Consumers Continue Their Spending Binge? (cont.)

Fuel and Energy Costs as % of Personal Consumption Expenditures



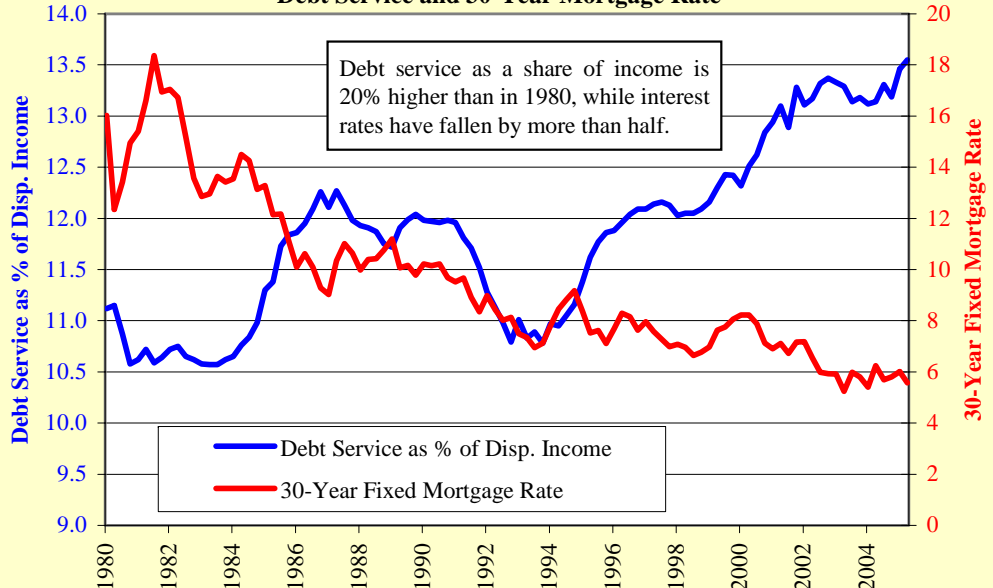
Source: Bureau of Economic Analysis

Personal Consumption and Real Estate Investment (Rolling 4-Quarter Average, Share of GDP)



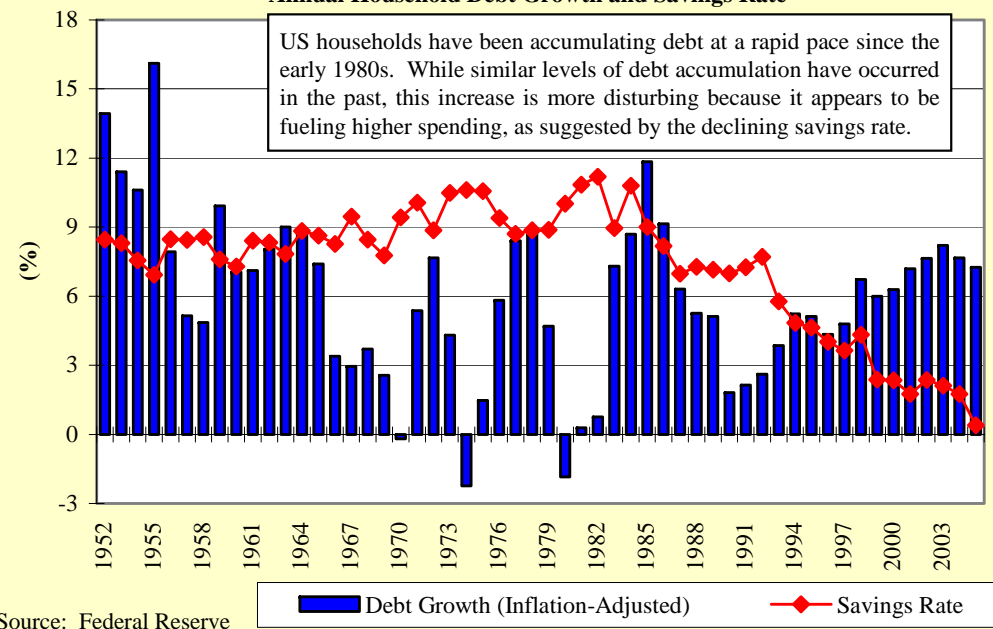
Source: Bureau of Economic Analysis

Debt Service and 30-Year Mortgage Rate



Source: Federal Reserve, Freddie Mac

Annual Household Debt Growth and Savings Rate



Source: Federal Reserve

How Will the Current Account Deficit be Corrected?

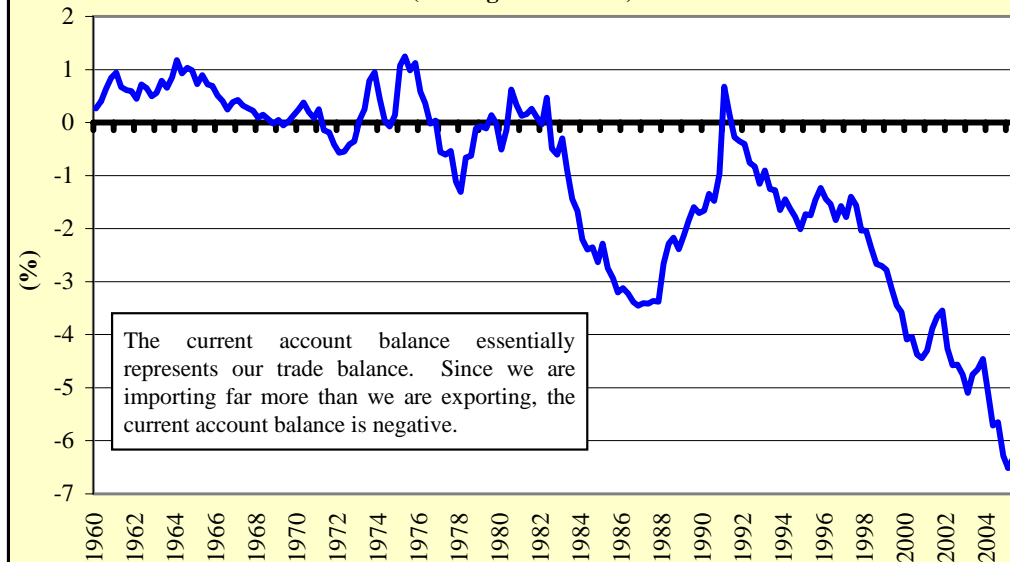
- Due to our over-consumption and lack of savings, the current account deficit could reach 7% of GDP this year. At a 7% deficit, the US will have to attract \$850 billion of net foreign capital per year. Because of the persistent deficits of the past decade, the international investment position is likely to approach 30% of GDP by year-end, meaning that foreign investors will hold about \$3.5 trillion more of our assets than we hold of theirs.
- The current account deficit cannot stay at these levels. The dollar's status as the primary reserve currency has helped to support our profligate spending. However, foreign investors (increasingly, central banks) will eventually tire of lending us money at low interest rates. Alternatively, our debt service burden will simply become too much for the economy to bear. The question is when and how it will be corrected. Two potential scenarios are outlined below.

✓ **Orderly Correction** – A continued slow (but very substantial) bleeding of the dollar and a gradual increase in real interest rates induces a rise in savings and a decline in consumption. This, combined with increased demand for our exports, gradually reduces the current account deficit to a more sustainable level (2% or less). The correction could result in a mild recession because higher savings rates results in a slowdown in personal consumption growth.

✓ **Hard Landing** – Foreign central banks stop buying our bonds and private investors lose confidence in the dollar. The dollar crashes as China and other Asian countries abandon pegs, resulting in higher import prices and inflation. Real interest rates spike causing a reduction in domestic investment and great pain in financial markets. There is a deep worldwide recession.

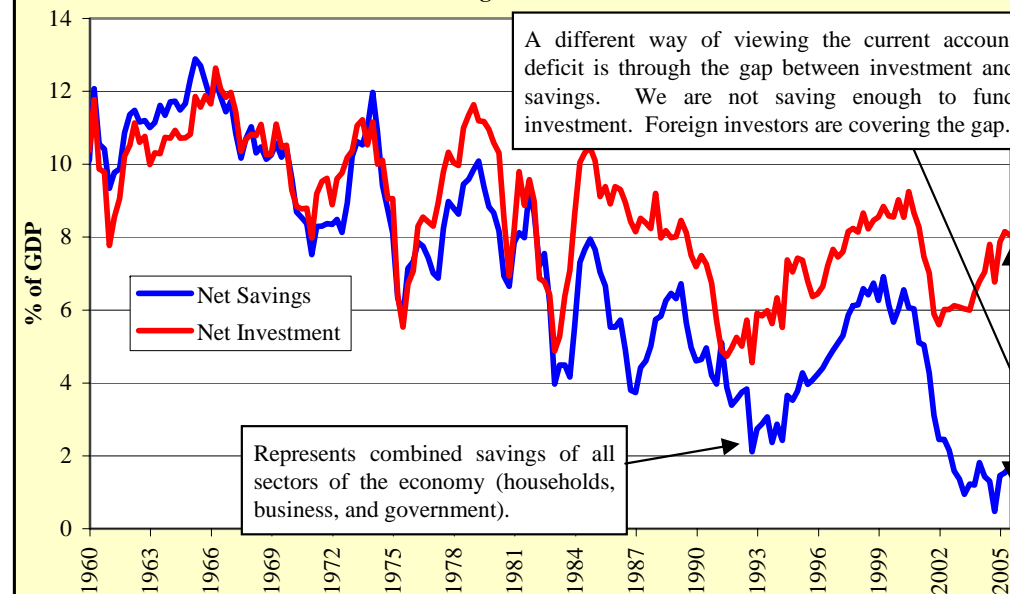
- Something along the lines of an orderly correction scenario appears to remain the most likely case. However, the worse the imbalances become, the greater the odds of a hard landing.
- Regardless, it seems inevitable that the dollar will resume its decline and will become significantly undervalued for an extended period. We believe diversifying into foreign currency-denominated assets is prudent.

Current Account Balance as a % of GDP
(Through June 2005)



Source: Bureau of Economic Analysis

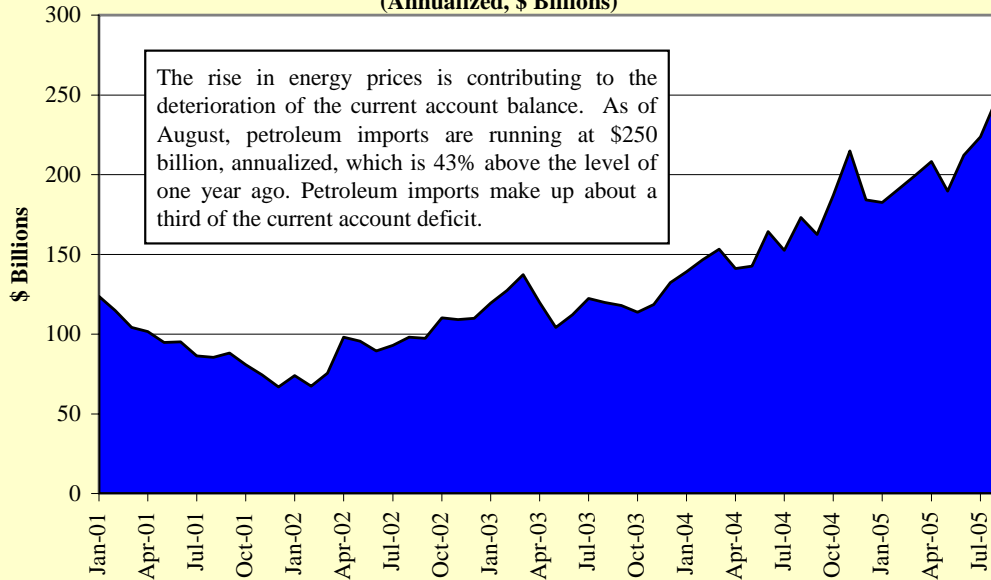
Savings and Investment



Source: Bureau of Economic Analysis

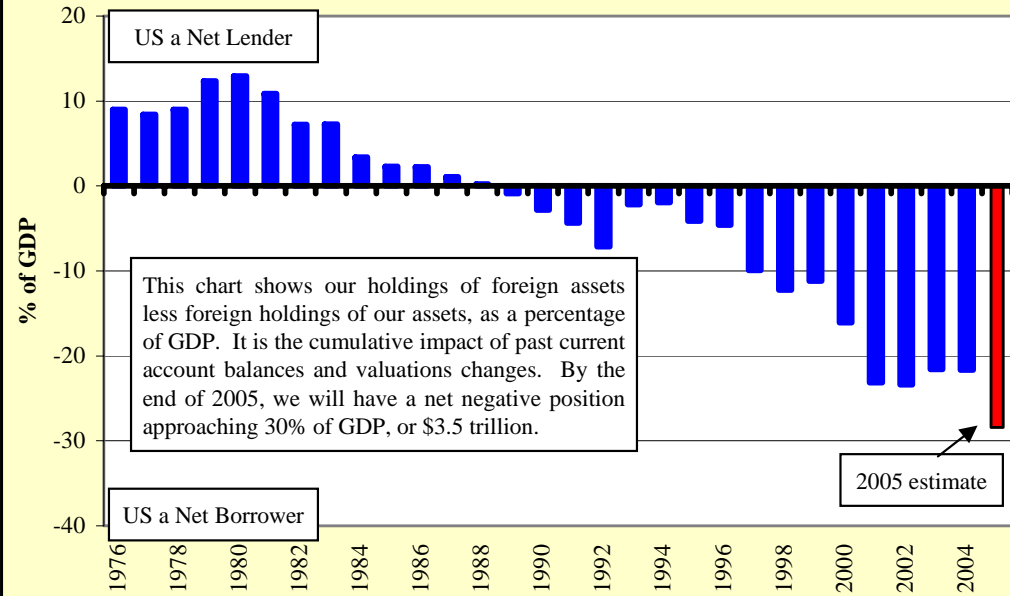
How Will the Current Account Deficit be Corrected? (cont.)

Monthly Petroleum Net Imports
(Annualized, \$ Billions)



Source: Census Bureau

International Investment Position as % of GDP



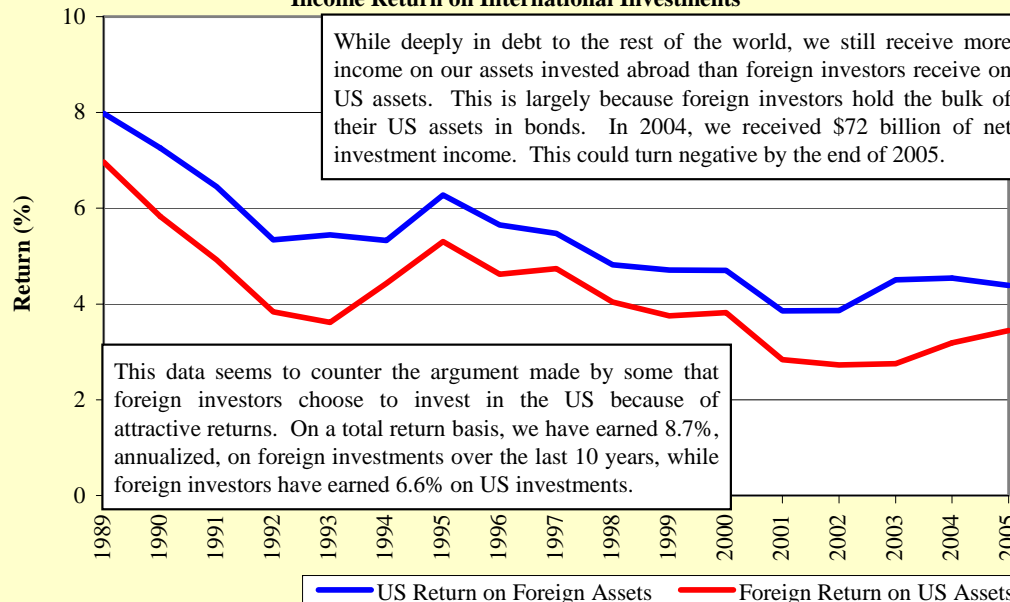
Source: Bureau of Economic Analysis

Real Broad Trade-Weighted Dollar Versus Average



Source: Federal Reserve

Income Return on International Investments



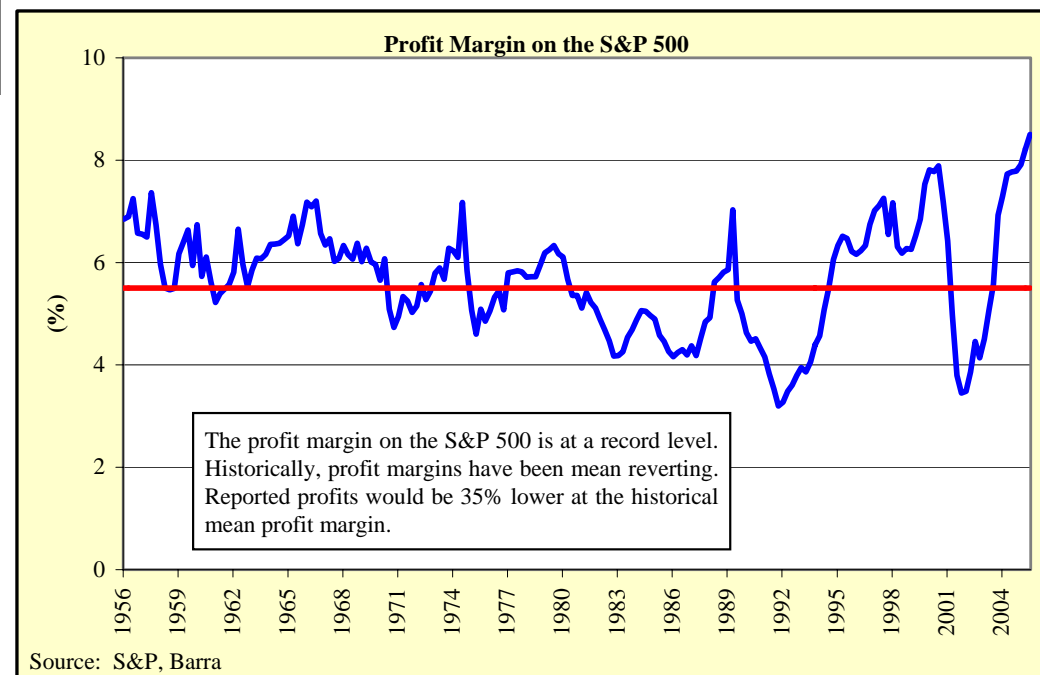
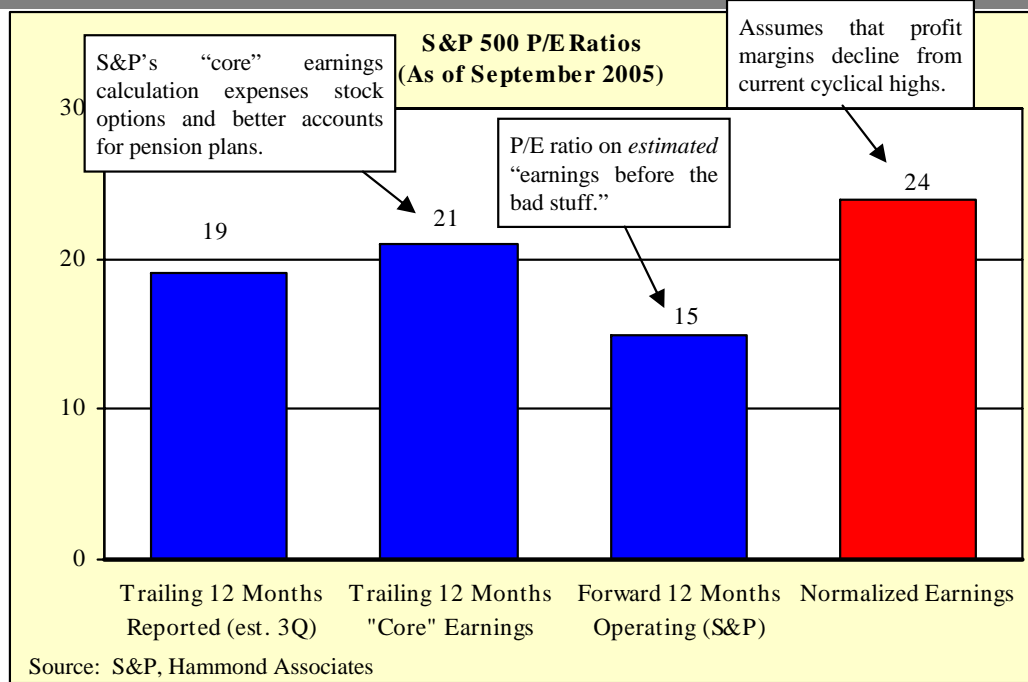
Source: Bureau of Economic Analysis

Energy Stocks Lift the S&P 500

- The S&P 500 earned 3.6% in the second quarter. As a result, the index is back into positive territory for 2005 with a 2.8% return. So far, the Presidential election cycle prediction is holding up this year. Historically, stocks have earned well below average returns in the first year of Presidential terms (7.6% for the first year of term versus the 13.6% average for all years).
- The S&P 500 index is being led by energy stocks. The sector gained 18% during the quarter, which lifted the year-to-date return to 40%. Excluding energy stocks, the index is down about 1% year-to-date.
- Valuations on domestic equities remain high. Based on trailing earnings, the S&P 500 is trading at a P/E ratio of 19. We fear that the reported P/E ratio is based on unsustainably high profit margins. Based on our normalized earnings measure, the index is trading at a P/E of 24. A P/E at this level implies a long-term real expected return for the index of 4.2%.

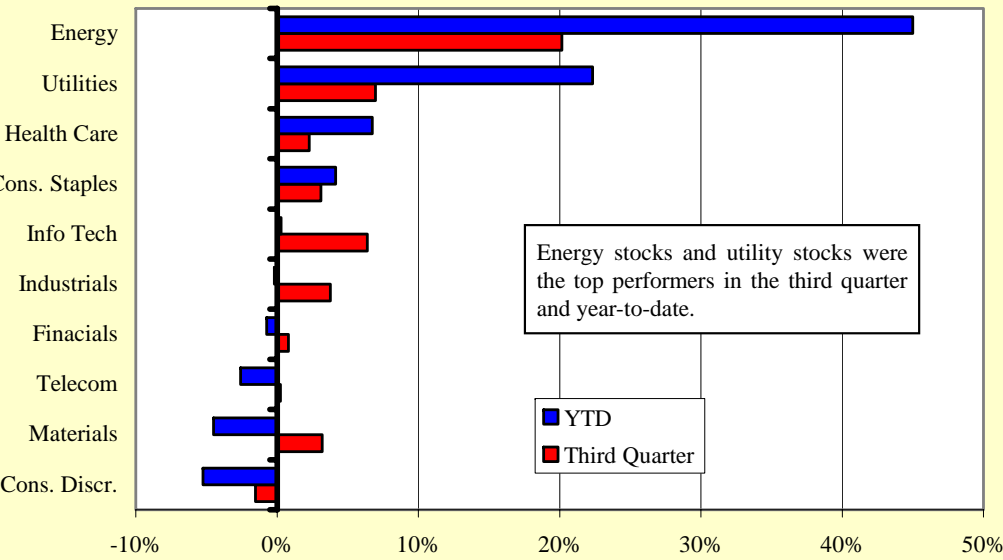
Long-Term TIPS Yield (%)	Price Change Needed for S&P 500 to Reach Fair Value					
	Required Equity Risk Premium Over TIPS (%)					
	1.5	2.0	2.5	3.0	3.5	4.0
1.5	38.9	19.0	4.2	(7.4)	(16.7)	(24.2)
1.8	24.8	8.5	(4.0)	(13.9)	(22.0)	(28.7)
2.0	19.0	4.2	(7.4)	(16.7)	(24.2)	(30.6)
2.5	4.2	(7.4)	(16.7)	(24.2)	(30.6)	(35.9)
3.0	(7.4)	(16.7)	(24.2)	(30.6)	(35.9)	(40.5)
3.5	(16.7)	(24.2)	(30.6)	(35.9)	(40.5)	(44.4)

Based on a 2.5% required equity risk premium, the S&P 500 is only modestly overvalued if real interest rates stay at current levels. However, the S&P is priced to provide a real return of only 4.2%, or 6.7% nominal.



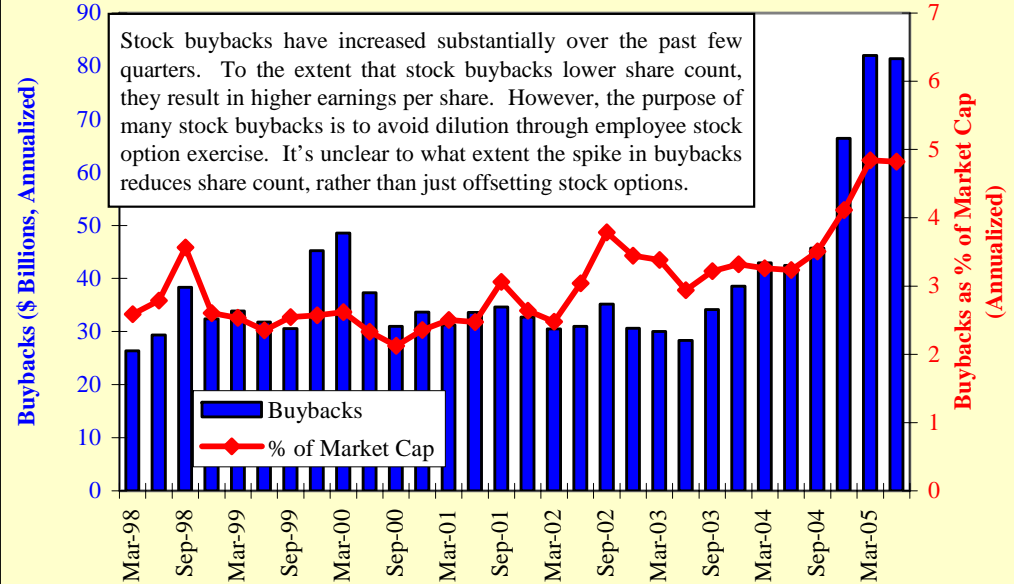
Energy Stocks Lift the S&P 500 (cont.)

Sector Performance



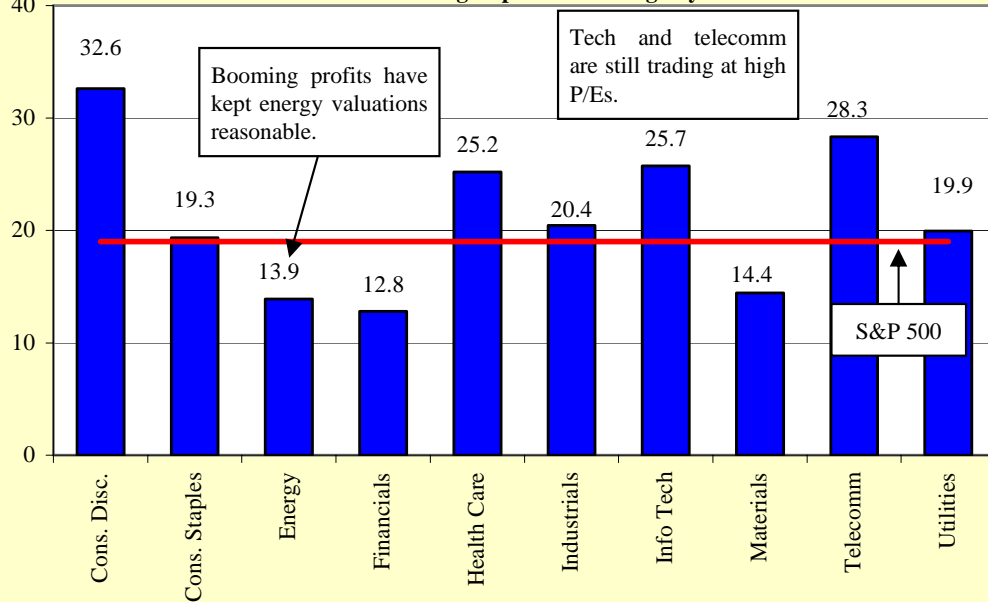
Source: MSCI

S&P 500 Stock Buybacks



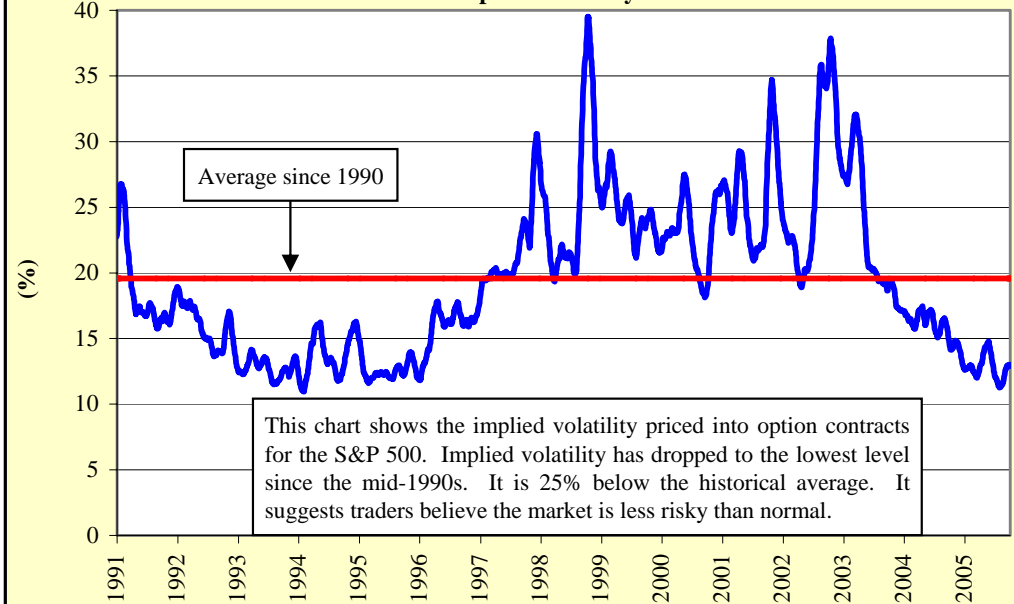
Source: S&P

P/E Ratios on Trailing Reported Earnings By Sector



Source: S&P

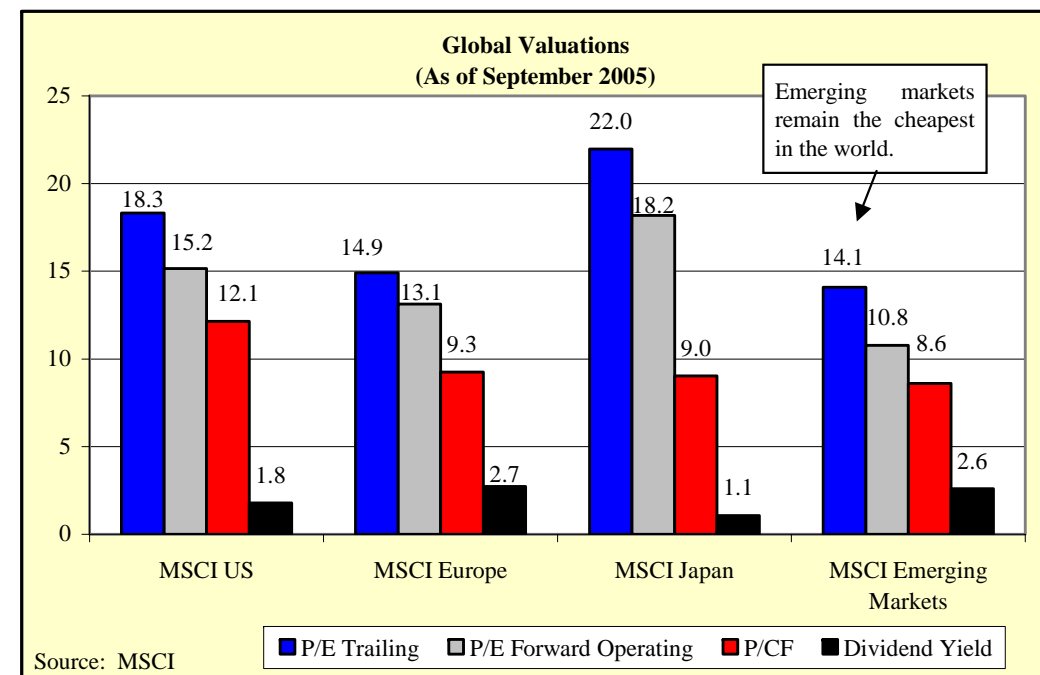
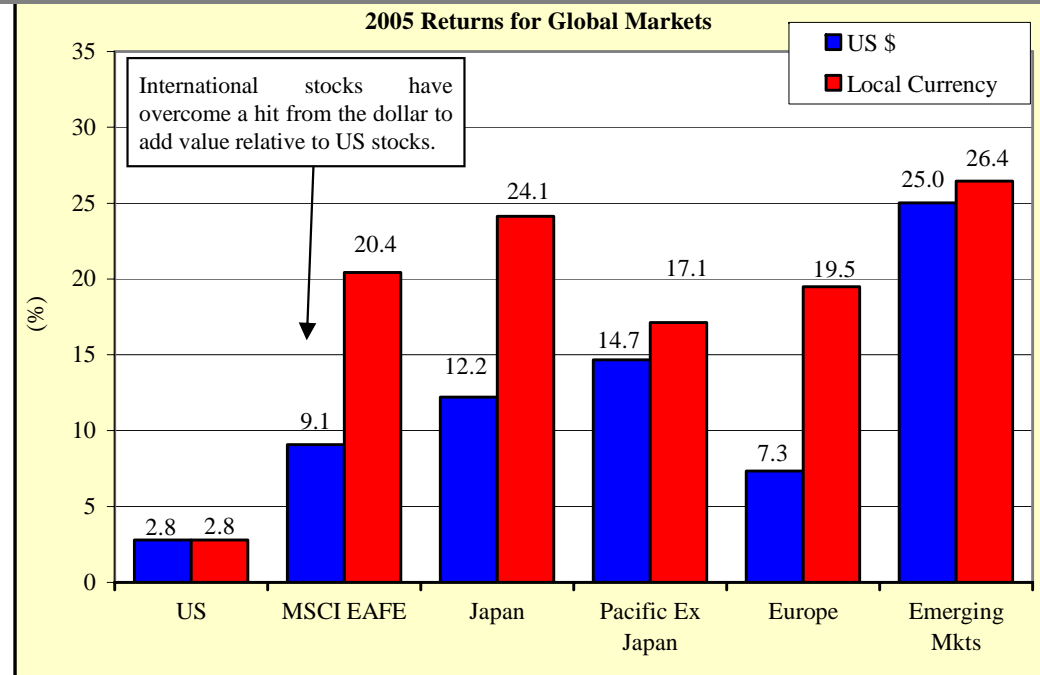
S&P 500 Implied Volatility Index



Source: CBOE

Int'l Equities Remain Better Buy than Domestics

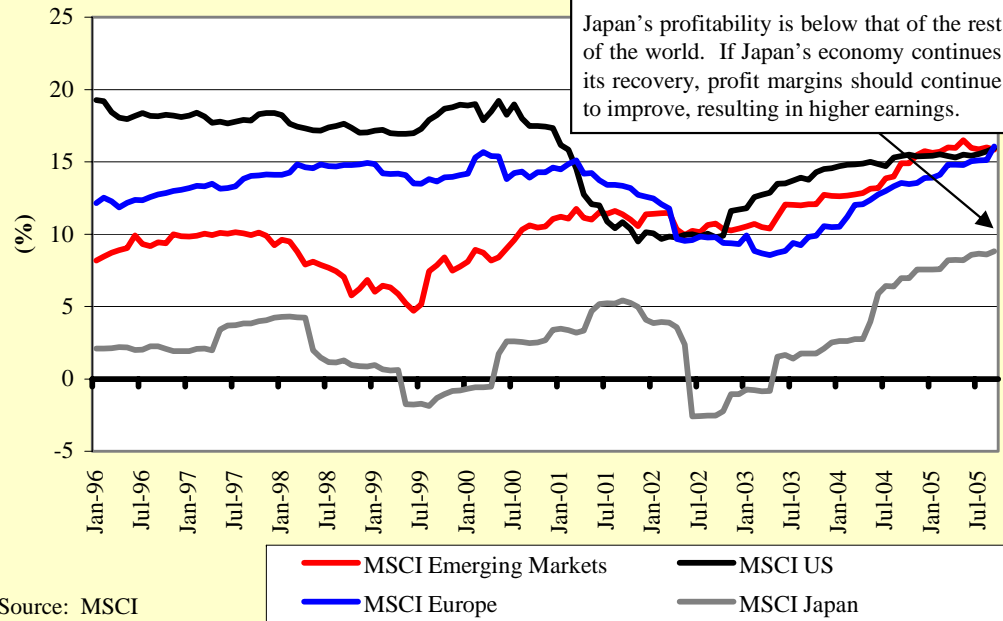
- International equities performed much better than domestic equities during the second quarter. The MSCI EAFE index gained 10.4% for the quarter, compared to the S&P's return of 3.6%. Emerging markets surged 18% during the quarter.
- Despite a strong dollar in 2005, international equities have also performed better than US equities year-to-date. Even with a negative 10% currency impact, EAFE has outperformed the S&P 500 by more than six percentage points.
- International developed markets still appear much more attractive than US markets on a valuation basis. Europe trades at nearly a 20% discount to the US based on trailing P/E ratio and a 23% discount based on P/CF. Japan is trading at a higher P/E multiple than the US, but Japan's valuations could improve significantly if their economic recovery takes hold and profitability improves.
- Emerging markets still appear attractive on a valuation basis, but their edge is rapidly narrowing to that of developed markets. At current valuations, there is far less margin for error than three years ago.
- The most significant short-term concern we have about emerging markets is their ultimate reliance on US consumers for economic growth. China's export-led economy is heavily dependent on US demand, and other emerging market countries in Asia and Latin America are exporting raw materials and other supplies to China. A hiccup in the US is likely to spill over into emerging markets.
- Nevertheless, we still believe emerging markets offer the highest long-term return potential among equity asset classes. As the populations of these countries become more productive, standards of living will increase. As this occurs, they should be able to generate more growth internally.



Source: MSCI

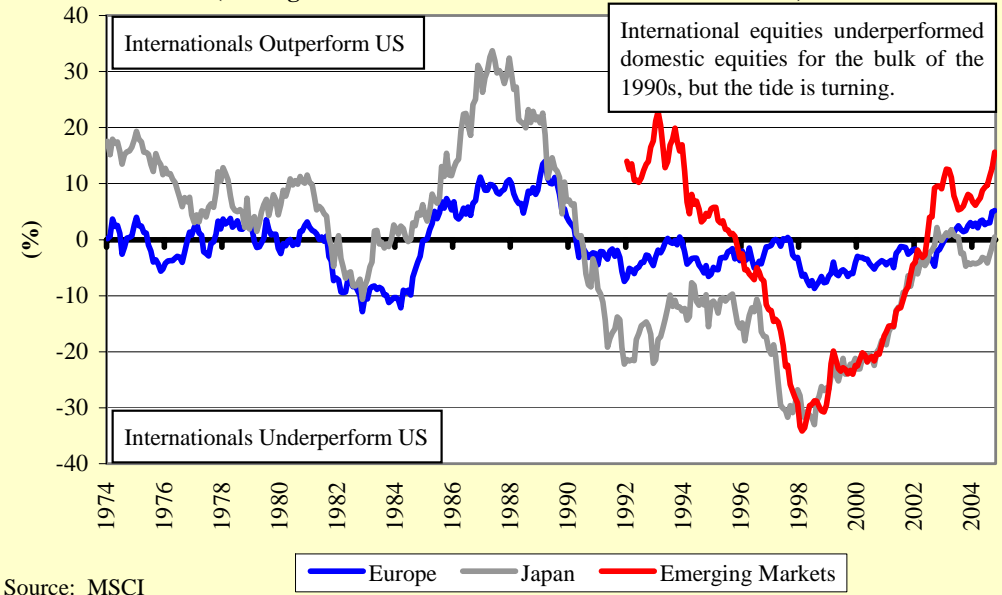
Int'l Equities Remain Better Buy than Domestics (cont.)

Return-On-Equity for Global Markets



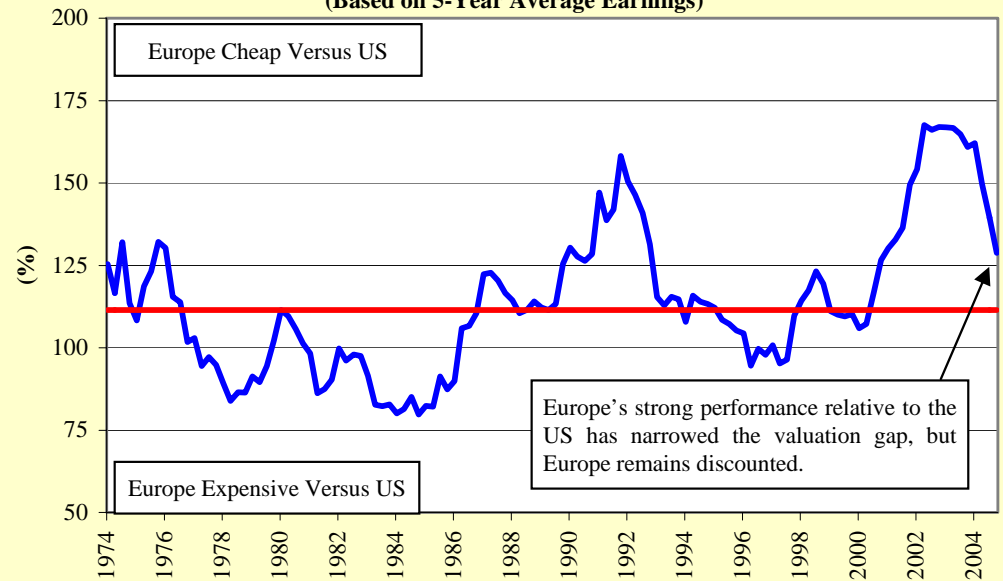
Source: MSCI

Performance of International Markets Relative to US (Rolling 5-Year Annualized Excess Return to S&P 500)



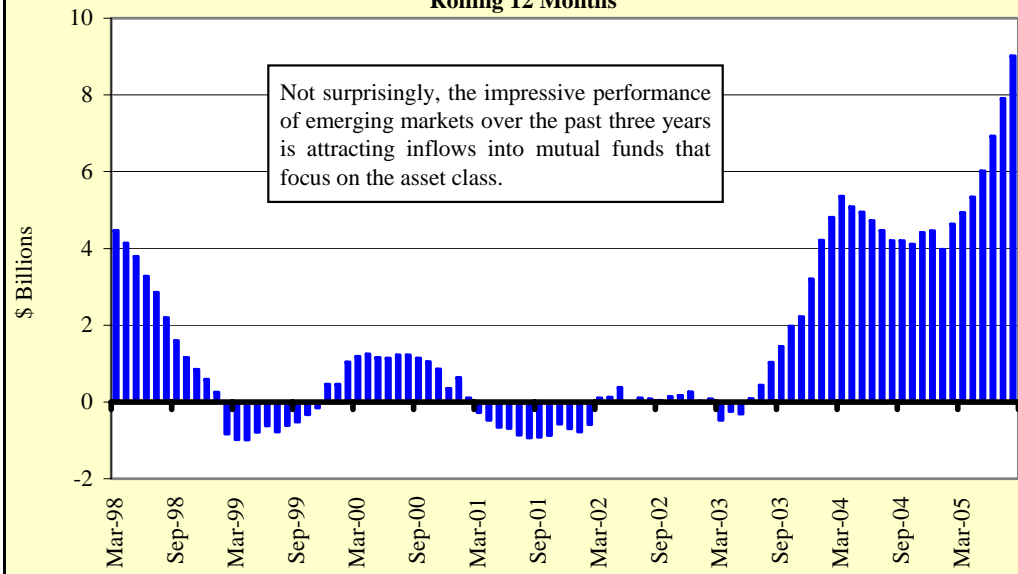
Source: MSCI

P/E Ratio of US Relative to Europe (Based on 5-Year Average Earnings)



Source: Global Financial Data, MSCI, S&P

Net Inflows to Emerging Market Mutual Funds (Rolling 12 Months)

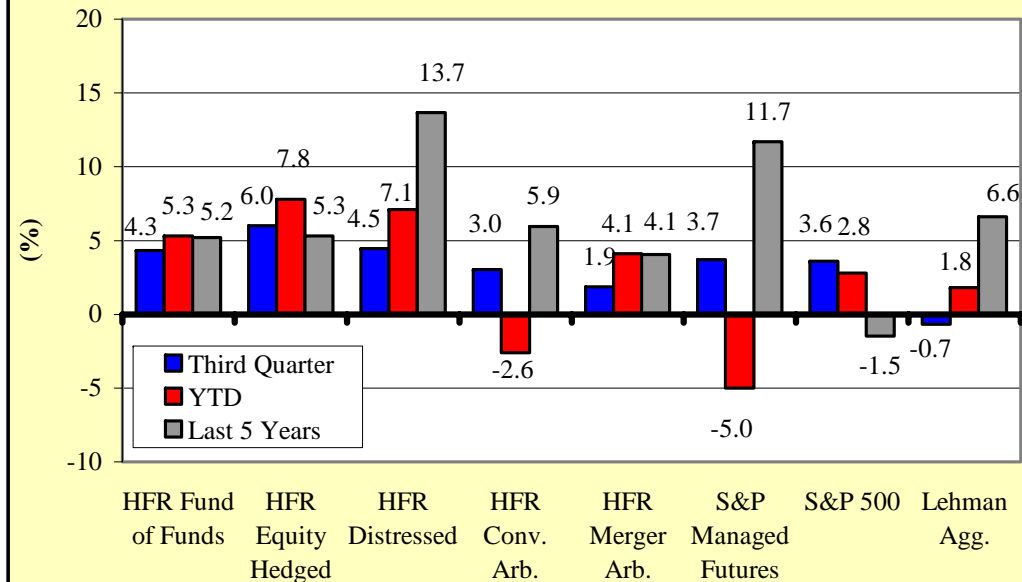


Source: ICI

Solid Quarter for Hedge Funds

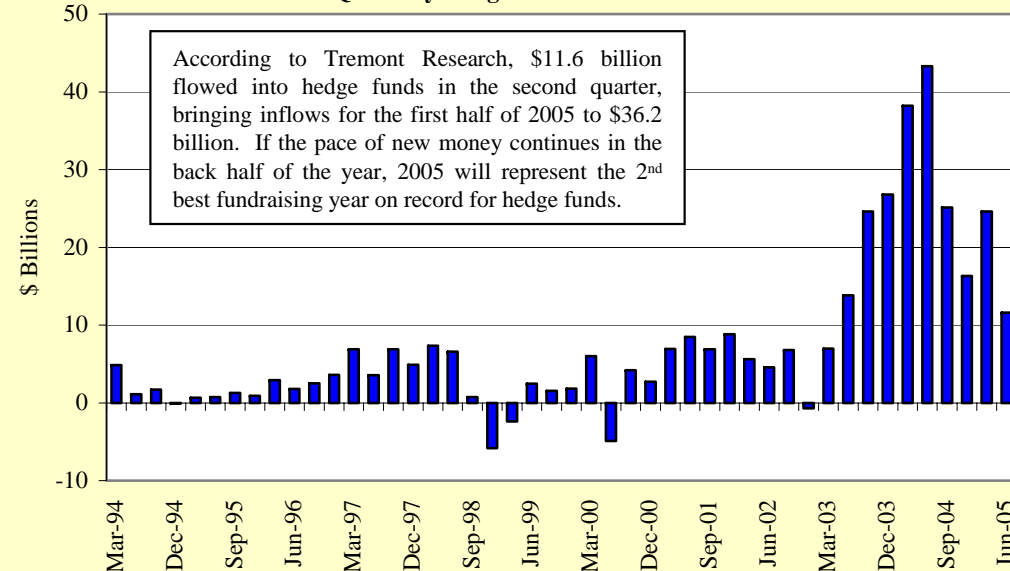
- Hedge funds generally enjoyed a strong quarter, with the HFR Fund of Funds Index gaining 4.3%. Performance for the quarter exceeded that of domestic stocks and bonds, as the S&P 500 gained 3.6% and the Lehman Aggregate Bond Index declined 0.7%.
- Long/short equity managers, as represented by the HFR Equity Hedge Index, led the way with a return of 6.0% for the quarter, bringing the year-to-date return to 7.8%. Long/short equity managers have benefited from increased dispersion in stock returns.
- Distressed securities managers continued to chug along, gaining 4.5% for the quarter, bringing the year-to-date return to 7.1%. Managers continue to reap rewards, but have we reached the end of the cycle?
- Convertible arbitrage solidified during the quarter. Credit market conditions improved, while a mid-quarter up-tick in volatility created opportunity for trading profits. The strategy remains in the red year-to-date (-2.6%). Future success is likely dependent on a strong new issuance calendar.
- Merger arbitrageurs enjoyed solid deal volume, as US and cross-border deals for the year-to-date period have already exceeded last year's volume. Still, spreads remain tight, and the strategy has only earned 4.1% so far in 2005.
- Managed futures rebounded substantially during the quarter (+3.7%), curtailing the year-to-date decline to 5.0%. A substantial portion of the return for the quarter was booked during a handful of trading days following Hurricane Katrina as trends emerged in futures markets.

Performance of Hedge Fund Indexes



Source: HFR, Standard & Poor's, Lehman Brothers

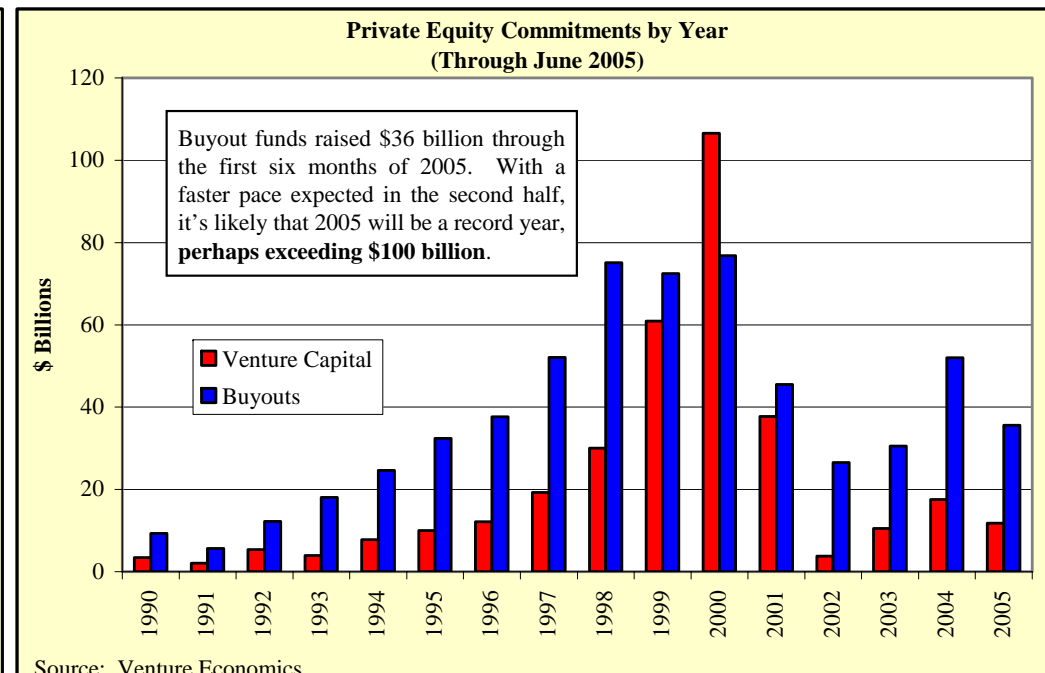
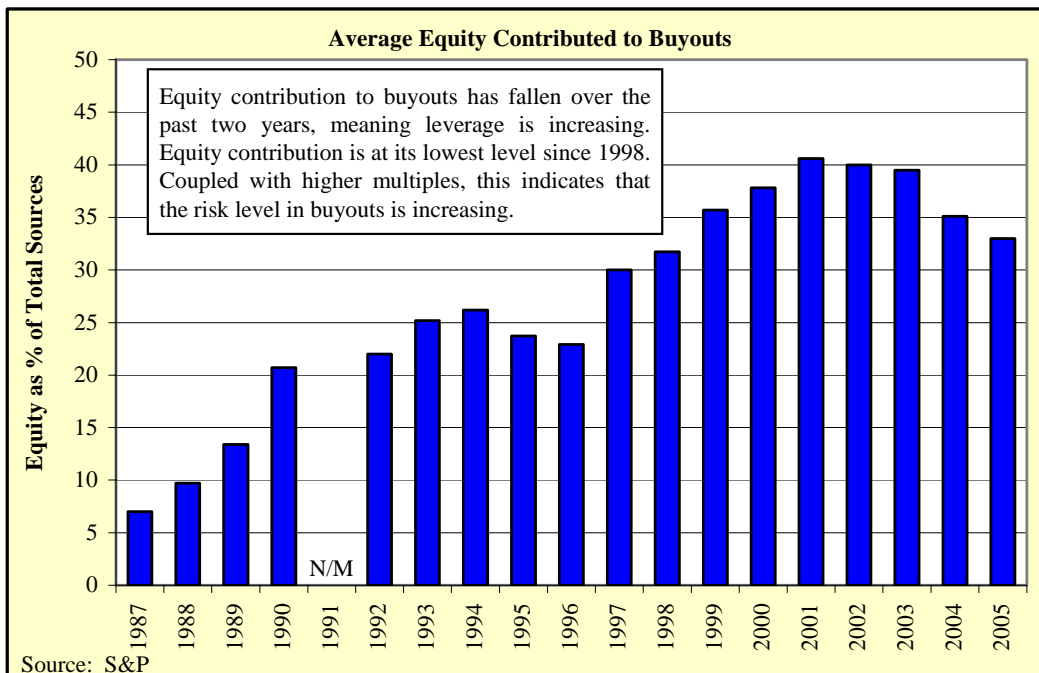
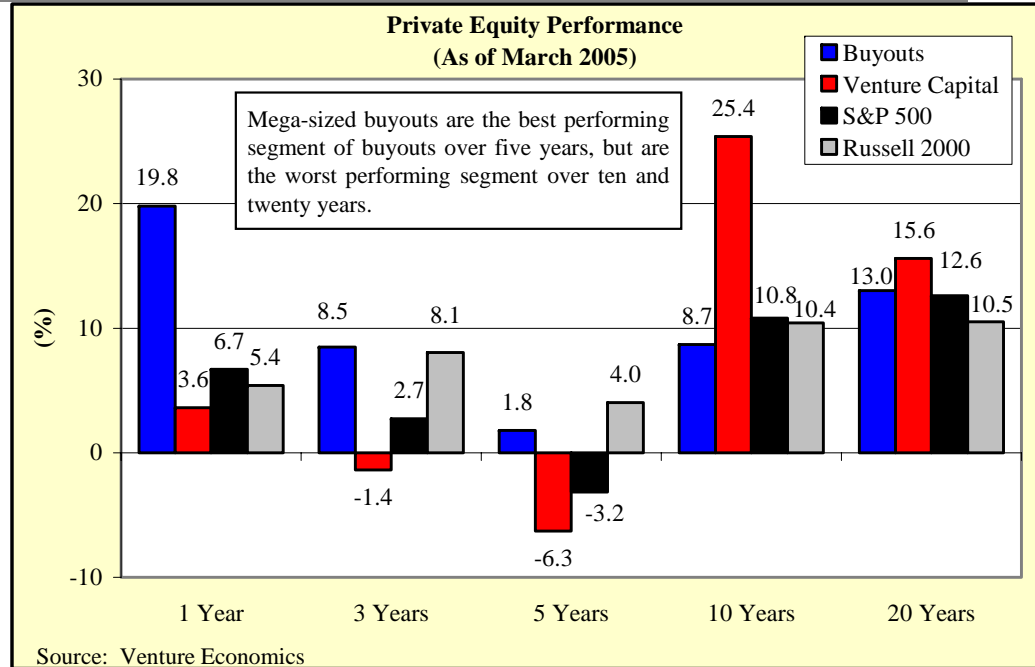
Quarterly Hedge Fund Asset Flows



Source: TASS

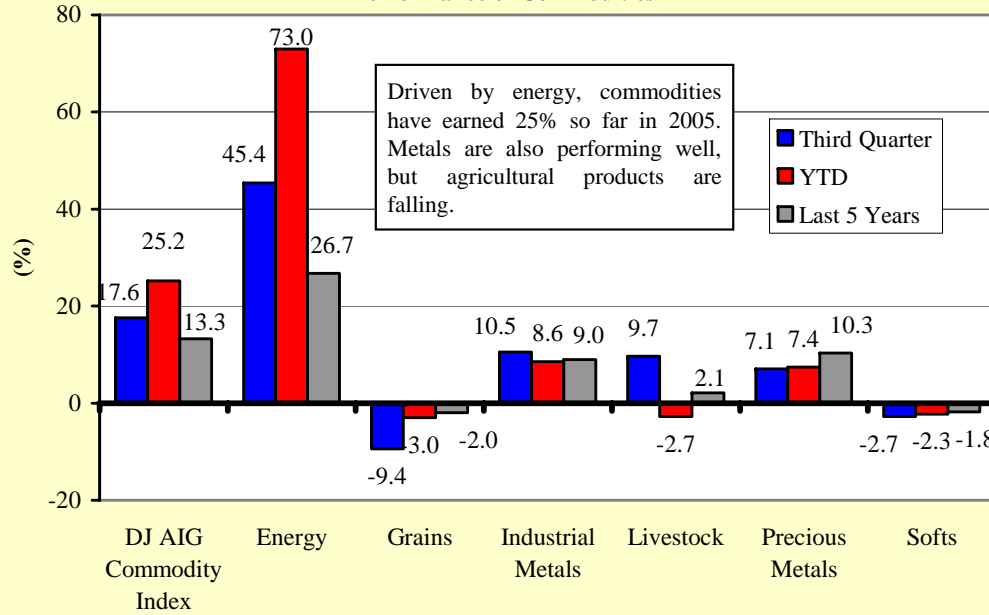
Buyout Funds Enjoy Strong Returns

- Buyout funds returned 20% for the year ended March 2005. Investments made from 2001 to 2003 when multiples were low on depressed cash flow are paying off handsomely. Buyout performance should remain strong as more gains from these investments are realized. Venture capital funds earned only 4% over the prior year due in part to a less active IPO market.
- Valuations are trending higher in buyouts, which raises concern over future returns. Average deal valuations have climbed to 7.1 times EBITDA in middle markets, up from 5.8 times in 2002.
- Fundraising continues to strengthen. 2005 will likely be a record fundraising year for buyouts. Venture capital fundraising could top \$20 billion for the first time since 2001.

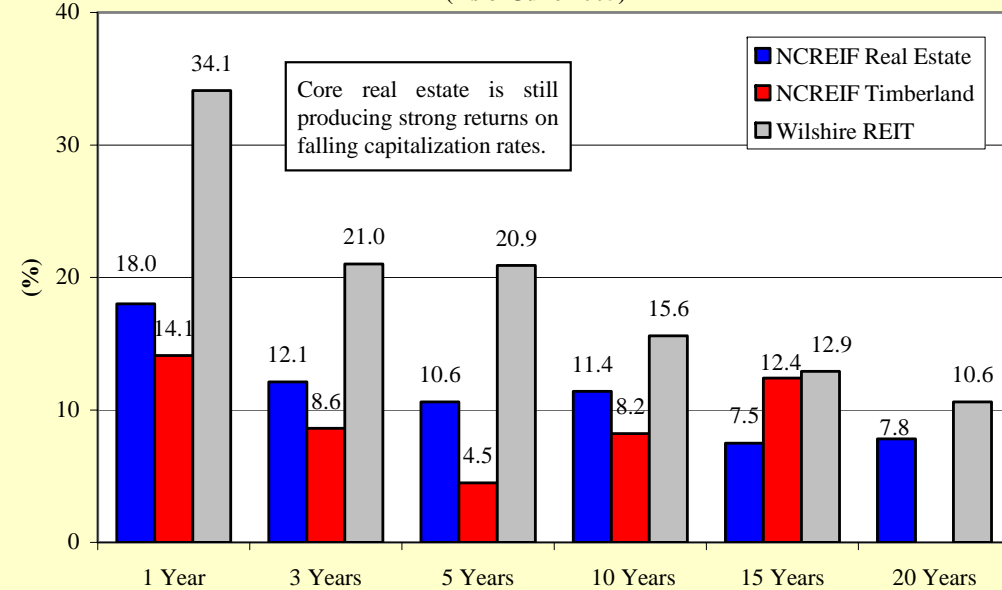


Natural Resource Investments Benefit from Energy

Performance of Commodities



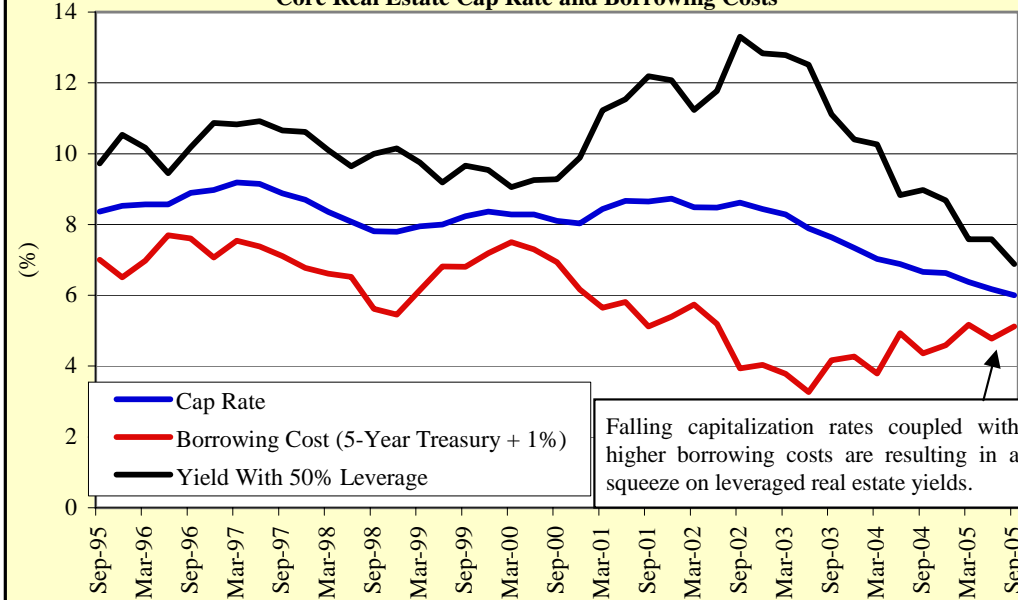
NCREIF Returns (As of June 2005)



Gold (Price Per Troy Ounce)

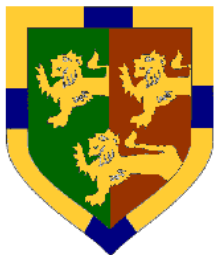


Core Real Estate Cap Rate and Borrowing Costs



Source: Bloomberg

Source: AEW



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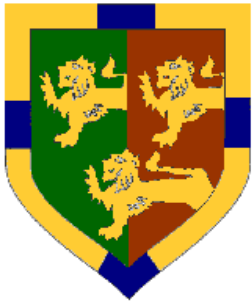
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