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# RESEARCH REPORT

Spring 2007

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*In this report . . .*

- ✓ Complacency Abounds
- ✓ Will Spending Withstand the Housing Slump?
- ✓ Slowing Productivity Growth May Pressure Profit Margins
- ✓ Can the World Sustain Growth Rates if the US Slows?



## Overview

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### Executive Summary

- Despite the downturn from February 27 through March 5, global equity markets finished the quarter in positive territory. Domestically, the S&P 500 rose 0.6% and the Russell 2000 gained 2.0% during the quarter. In foreign markets, the MSCI EAFE index benefited from a weak dollar and returned 4.1%. Emerging market equities gained 2.3%.
- Investors continue to be willing to accept risk for very little incremental reward. Abundant liquidity and low volatility have encouraged risk taking. In particular, credit spreads on high-yield bonds remain near historic lows. We continue to recommend that investors look to reduce risk since it's not priced to be rewarded well in the future.
- Subprime mortgage problems added to the woes of an already struggling housing market. The potential losses from subprime mortgages should be bearable by our \$25 trillion financial market. More worrisome possibilities are that tighter lending standards will reduce the supply of buyers and resetting ARMs and foreclosures will increase the number of forced sellers. The combination of those two factors could have a negative impact on housing prices. Futures on the Case-Shiller Housing index are forecasting a price decline of 5% in 2007.
- Consumption growth has been boosted by rising home prices and expanding mortgage debt. With the housing market weakening, this will be difficult to maintain. Compensation growth will now be left as the key driver of consumption growth. Encouragingly, the jobs market remains strong. However, one concern is that business investment declined at an annualized rate of 3.1% during the fourth quarter of 2006. There is a strong relationship between business investment and employment growth.
- Wage growth and productivity growth have converged in recent periods. This has negative implications for profit margins. If there is a slowdown in the domestic economy, multinationals should be better positioned to maintain margins. This reinforces our recommended tilt to large-cap quality growth stocks.
- Many commentators argue that the rest of the world will be able to decouple from the US and continue to experience strong growth. If the US economy just slows and avoids a recession, there is cause for optimism. However, if the US enters a recession, the rest of the world is unlikely to escape unscathed. Emerging market equities would be especially vulnerable in such a situation because they are particularly sensitive to global growth and investors' high risk tolerance.
- Buyout funds have already attracted \$44 billion in commitments this year and invested over \$100 billion in the first quarter. It's hard to get excited about mega buyout funds due to the prices they're paying for companies. Hedge funds continue to maintain a strong appetite for risky assets. This degree of risk taking requires watching.



## Market Commentary

April 2007

Exhibit 1

Performance (%)					
	Jan. 1 to Feb. 26	Feb. 27 to March 5	March 6 to March 31	First Quarter	May 11 to June 13, 2006
S&P 500	2.5	(5.1)	3.5	0.6	(7.3)
Russell 2000	4.7	(7.7)	5.5	2.0	(13.2)
Wilshire REIT	9.0	(8.7)	4.2	3.7	(2.7)
MSCI Europe	4.6	(7.2)	7.0	3.9	(12.9)
MSCI Japan	6.9	(5.1)	2.0	3.5	(19.1)
MSCI Emerging Markets	3.3	(10.2)	10.3	2.3	(24.1)
Gold	7.6	(6.9)	3.7	3.9	(20.6)
Industrial Metals	4.1	(7.1)	10.7	7.0	(19.0)
Yen	(1.3)	4.2	(1.9)	0.9	(4.5)
Currency Carry Trade <sup>1</sup>	6.9	(8.1)	7.5	5.6	(3.2)

Although global equity markets turned in a solid quarter, it was a bumpy ride. The sell-off that began on February 27<sup>th</sup> caught investors by surprise. Equity markets in the US and internationally had been marching steadily upward since the third quarter of 2006. The S&P 500 was sitting on a 2.5% year-to-date return through February 26<sup>th</sup>. The index's decline of 3.5% on February 27<sup>th</sup> was hard to square with the news of the day.

The 9% plunge in China's market on rumors that the Chinese government might take steps to curb speculation was the apparent catalyst. Still, it's hard to believe that the sell-off in Shanghai alone would have caused such a reaction on Wall Street. Chinese shares had risen 94% since August 2006, so a 9% pull-back shouldn't have been too alarming. Analysts offered other explanations for the market's decline, such as Alan Greenspan's warning that a recession was possible, more bad news on subprime lending, and a

weak durable goods order report. However, none of these are satisfying explanations. Greenspan's warning made headlines the day before. News of the subprime mortgage problems had been trickling out since December, and they received much ink in early February. The durable goods order release, while discouraging, should not have had such an outsized impact.

As unsatisfying an answer as it is, perhaps it was Keynes' "animal spirits" exacerbating what should have been a minor sell-off. As we have pointed out in the past, risk premiums on global assets are remarkably thin. Any event that causes investors to focus more on downside risks (and there are many) can have an outsized impact, especially when markets are as frothy, and investors as complacent, as we find them today.

Following February 27<sup>th</sup>, the S&P 500 continued to trend downward the next five trading days as more woes in the subprime sector were revealed. The index reached a trough on March 5 with a total loss of 5.1%. While the loss on the 27<sup>th</sup> shocked markets, it was a mild downturn overall. Like the sell-off in May/June 2006, there weren't many places to hide among risky assets. Generally, the riskier an asset class, the greater the loss, suggesting that increased risk aversion played a significant role. The S&P 500 proved to be a *relative* safe haven among global equity markets, as we suggested that it might in last quarter's report. The Russell 2000 slid 7.7% from February 27<sup>th</sup> through March 5<sup>th</sup>, while the MSCI EAFE index fell 6.9%. Not surprisingly, the MSCI Emerging Markets index was punished the most, with a decline of 10.2%. REITs also suffered a steep loss. Still, riskier segments of the market held up much better than in 2006's downturn, which saw the Russell 2000 decline 13.2% and the MSCI Emerging Markets index tumble 24.1%.

Gold failed to live up to its reputation as a hedge, just as it did in spring 2006. It fell 6.9% during the downdraft, and industrial metals declined 7.1%. A currency carry trade proxy (long high-yielding currencies and short the yen) declined 7.5%. The yen, considered the primary source of funding for the carry trade, was the safe haven. It earned 4.2% during the downturn, as investors feared that increased risk aversion might lead to an unwinding of the carry trade. Credit spreads widened modestly. The option-adjusted spread on the Lehman High Yield index rose from 2.5% to 2.8%, taking it back to where it started the year.

As was the case in the late winter/spring sell-offs in 2004, 2005, and 2006, the losses were short-lived. By the end of March, the S&P 500 and other equity markets around the world recovered most of their losses, finishing the

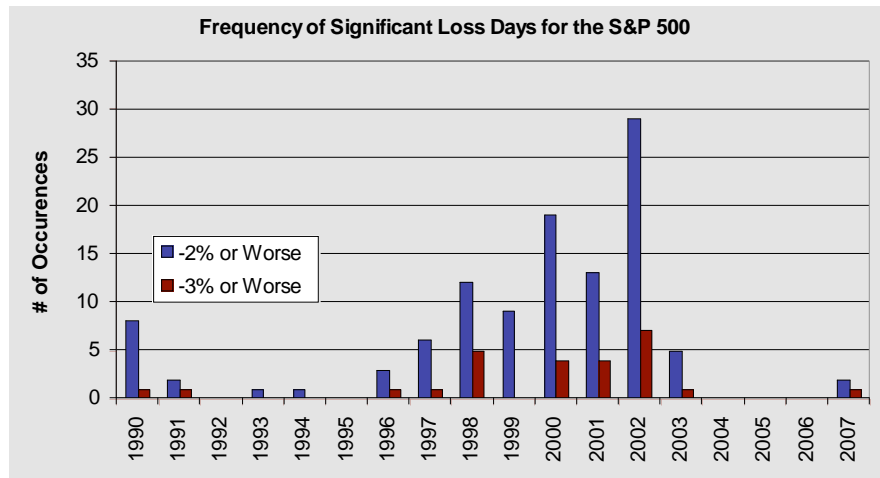
<sup>1</sup> Long: 25% Brazilian real, 25% Icelandic krona, 25% New Zealand dollar, 25% Turkish lira. Short: 100% Japanese yen. Source: Bloomberg

quarter in positive territory. Most indexes have surpassed their February 26<sup>th</sup> levels in April. The carry trade has also turned profitable again. With markets so easily shaking off their losses, this downturn may, unfortunately, have further emboldened investors.

### Is Volatility Back?

The first eight weeks of 2007 were remarkable for their lack of volatility. The S&P 500's annualized daily standard deviation was 7% for the first 37 trading days of the year, less than half its historical average. Given how low volatility has been recently, the steep decline on the 27<sup>th</sup> was surprising. Notably, the index's 3.5% loss was the first decline of more than 2% in nearly four years (950 trading days to be exact). It was the longest stretch between 2% declines in at least 50 years. (The index also suffered a loss of 2% on March 13<sup>th</sup>.) The lack of volatility recently is in stark contrast to the abnormally high volatility experienced early in this decade. In 2002 alone, the S&P 500 declined by 2% or more 29 times and by 3% or more seven times.

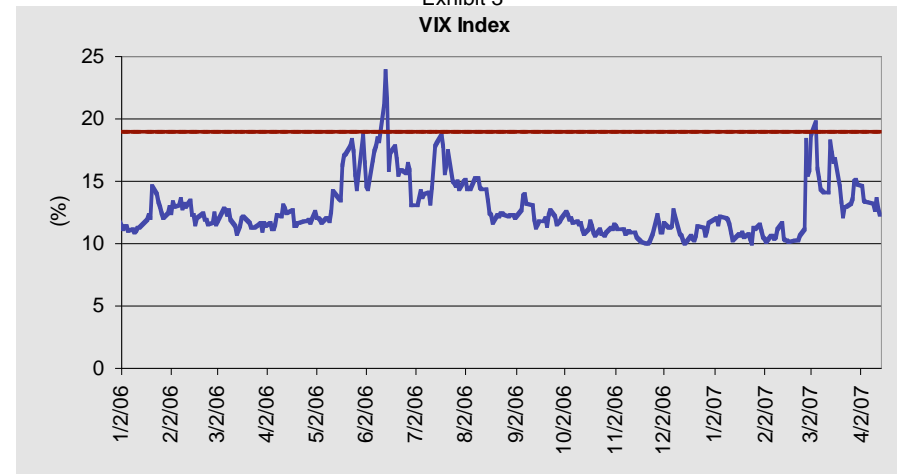
Exhibit 2



An indicator of the market's expectation for volatility is the VIX index. The VIX index measures the implied volatility in one-month option prices on the S&P 500. The higher the VIX index, the more it costs to buy portfolio protection. Since the volatility spike in spring 2006, the VIX index had been trending downward. On February 26<sup>th</sup>, it traded at 11.2, which was far

below the average level of 19 since 1990. The VIX rose sharply when the market declined on the 27<sup>th</sup>, increasing 64% to 18.3. It was the largest percentage move on a single day since the index's inception in 1990.<sup>2</sup> However, as the market recovered the VIX declined. By April 14<sup>th</sup>, it was back down to 12, suggesting option investors believe the short-term danger has mostly passed for the market. This seems to us overly optimistic, given the risks to the economy and, therefore, profit margins, raised by the slumping housing market. Nevertheless, until there is another event to test investors' confidence, we would not be surprised to see volatility remain low.

Exhibit 3  
 VIX Index

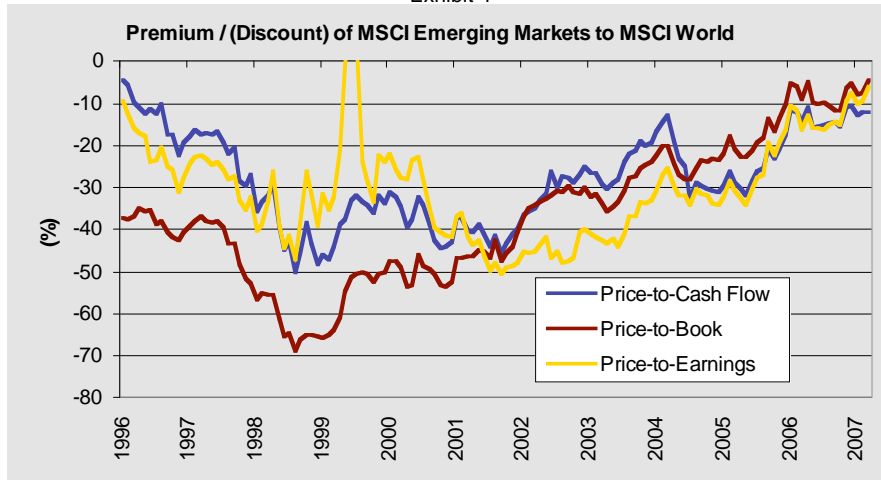


### Asset Class Convergence

As we have pointed out in past editions of this report, global asset class valuations are converging. Most of the valuation disparities that gave rise to the outperformance for globally diversified portfolios since 2000 have been corrected. Risk premiums for global assets continue to be emaciated, and there are few, if any, bargains. In fact, some of the best performing asset classes this decade, such as small-cap stocks, REITS, and emerging market stocks, are now among the most expensive. As a result, diversification away from domestic large-cap stocks won't be as beneficial in the future as it has been in the last seven years. We suspect it will be harder than ever to add value through long-only asset allocation tilts until an event occurs that creates new opportunities (by re-pricing securities).

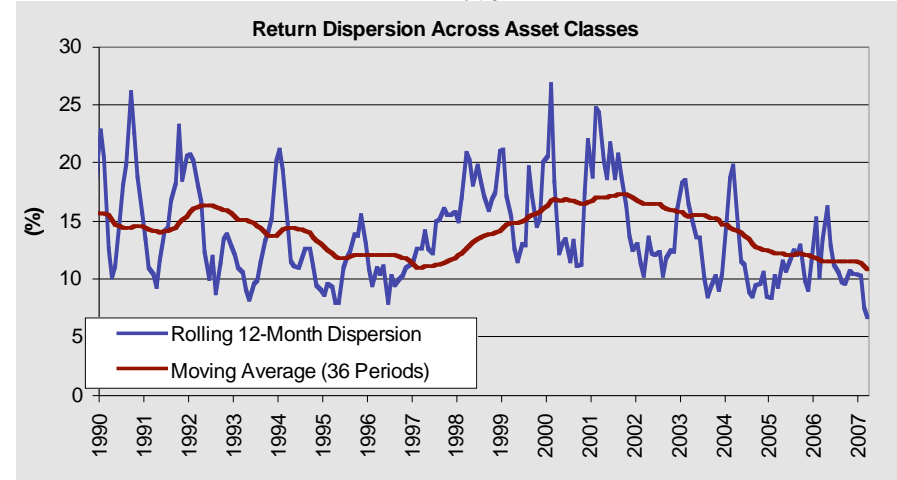
<sup>2</sup> The 7.1 point absolute move in the index was the ninth largest in a single day, but the eight larger moves were off higher bases.

Exhibit 4



One way to observe the dwindling potential to outperform (and underperform) from diversification and asset allocation tilts is to observe the dispersion of returns across equity and other risky asset classes. Exhibit 5 shows the standard deviation of returns across asset classes over rolling twelve-month periods. Low dispersion suggests low variability across asset class returns for a twelve-month period. As shown in the chart, dispersion has been trending downward over the last few years. The dispersion over the most recent twelve months was 7%, the lowest level in more than 30 years. A significant reason for lower dispersion is the low volatility environment. When asset volatility is below average, dispersion across assets tends to be below average. We suspect valuation convergence is also playing a role. With low dispersion, the benefits of making correct asset allocation calls are reduced. Furthermore, low dispersion reduces the benefits of rebalancing. Rebalancing is most effective when there is wide return variance across asset classes, affording more opportunities to sell outperformers to buy underperformers. A correction in global markets would increase dispersion and, perhaps, create new investment opportunities.

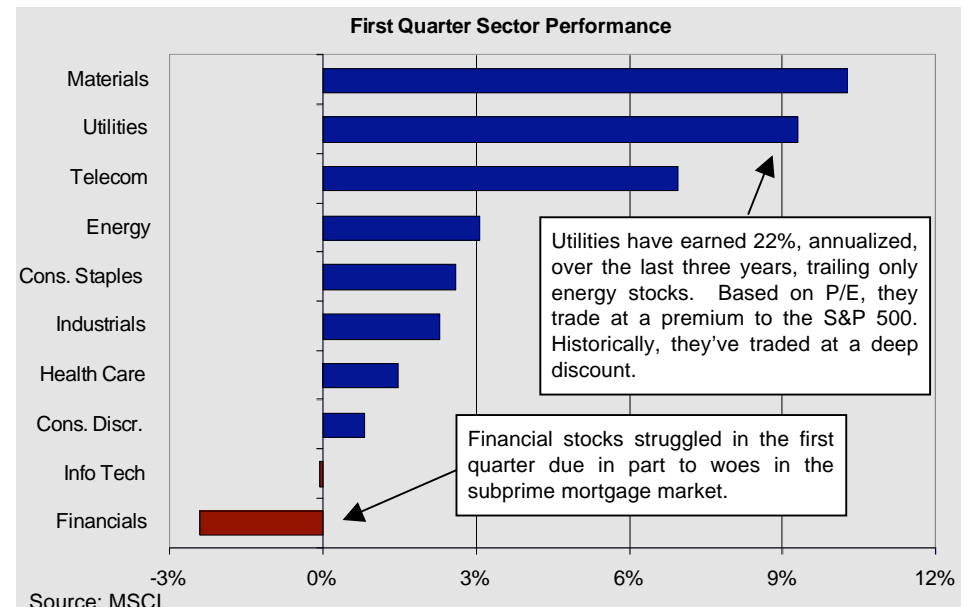
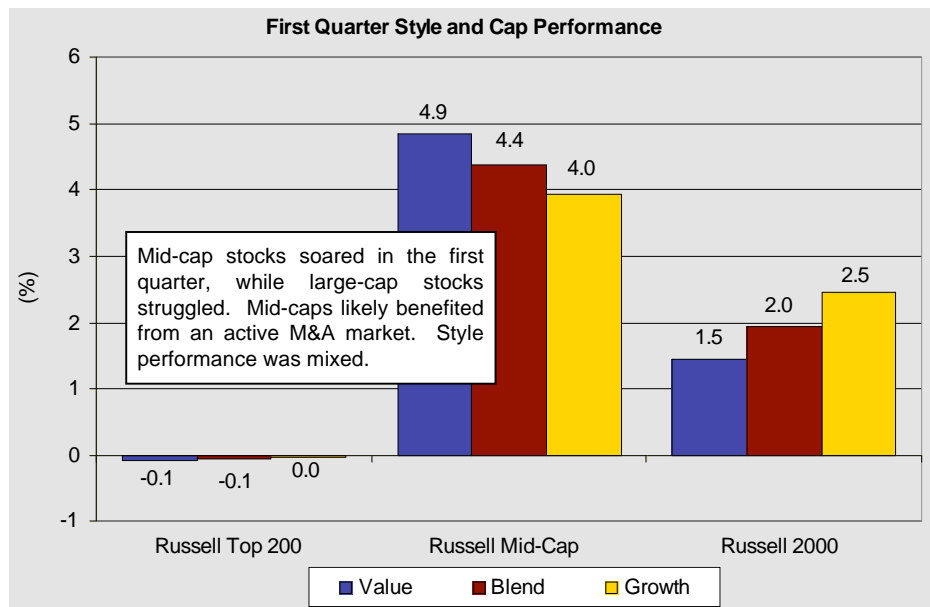
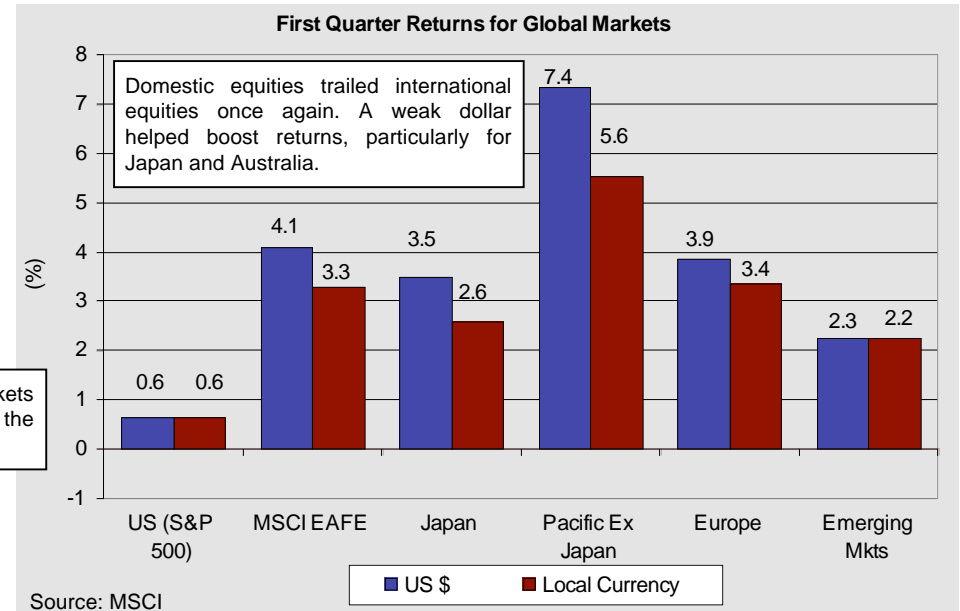
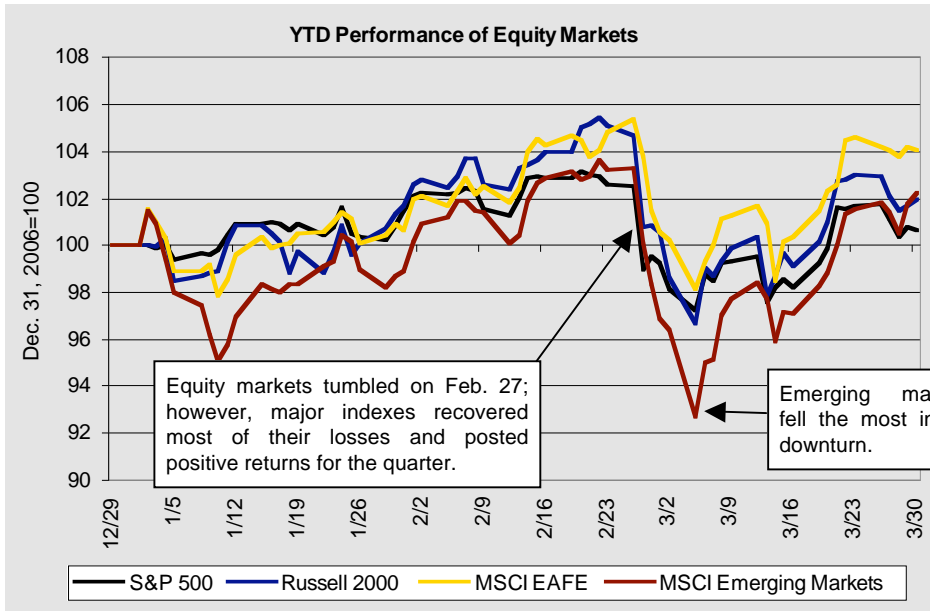
Exhibit 5



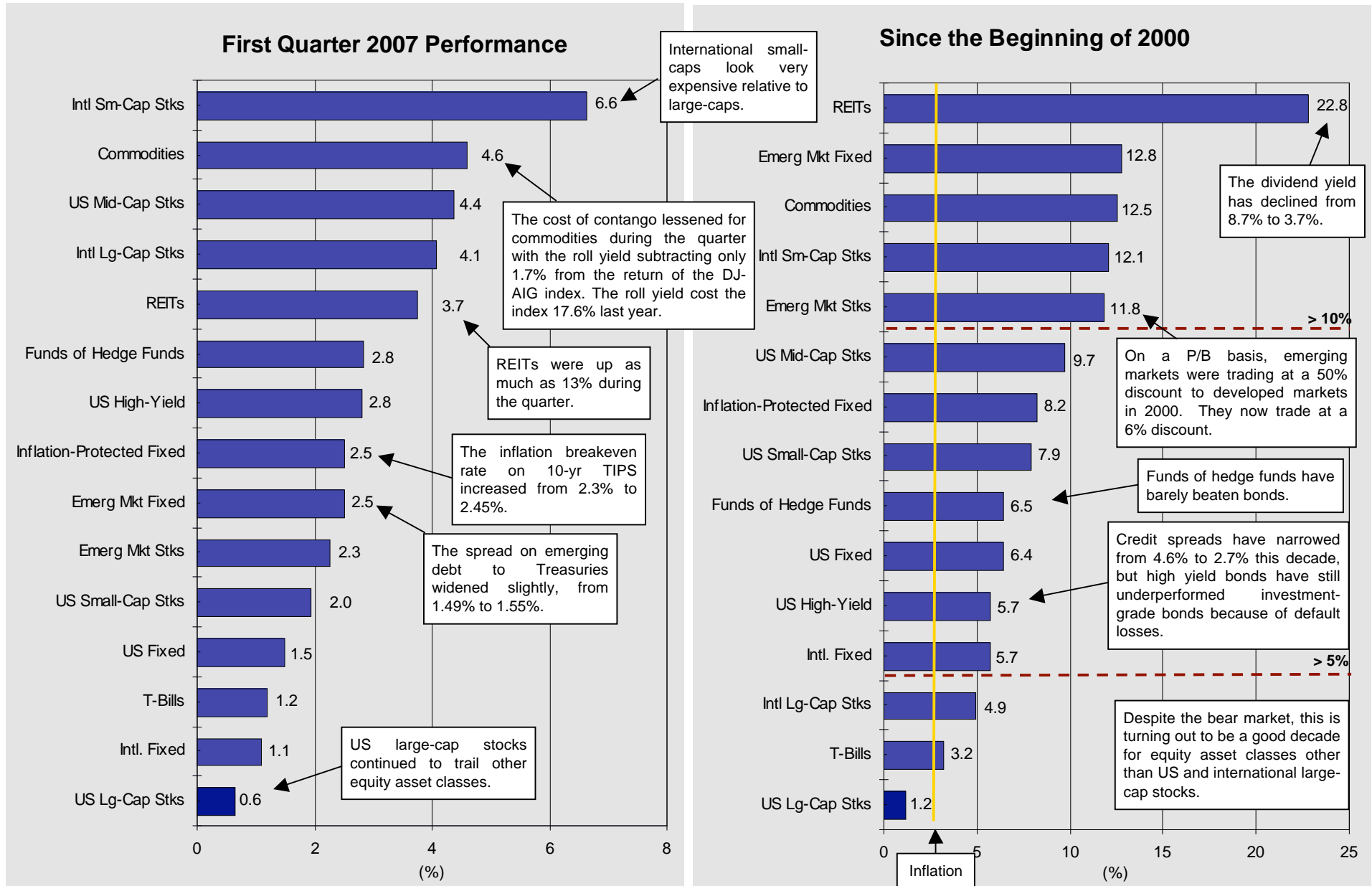
We still encourage broad diversification, and we continue to emphasize reducing risk at the margin. This means underweighting small-caps in domestic equity portfolios in favor of large-cap growth stocks, with a particular emphasis on high-quality growth stocks. Internationally, it may be time to trim tilts to emerging market equities in favor of developed large-caps. We are optimistic about the long-term prospects for emerging market equities, but they have probably run too far. In fixed income, this means steering clear of low-quality debt. Finally, we continue to recommend that clients diversify beyond traditional asset classes. While we acknowledge that there is reckless risk-taking in the alternatives space, we believe there are managers who can capture inefficiencies in markets and add value without accepting undue risk. If markets continue their march upwards, many moves towards risk reduction are likely to result in lower performance. Nevertheless, this does not seem to be a good environment in which to reach too far for returns.

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## Global Equities Finished a Volatile Quarter in Positive Territory

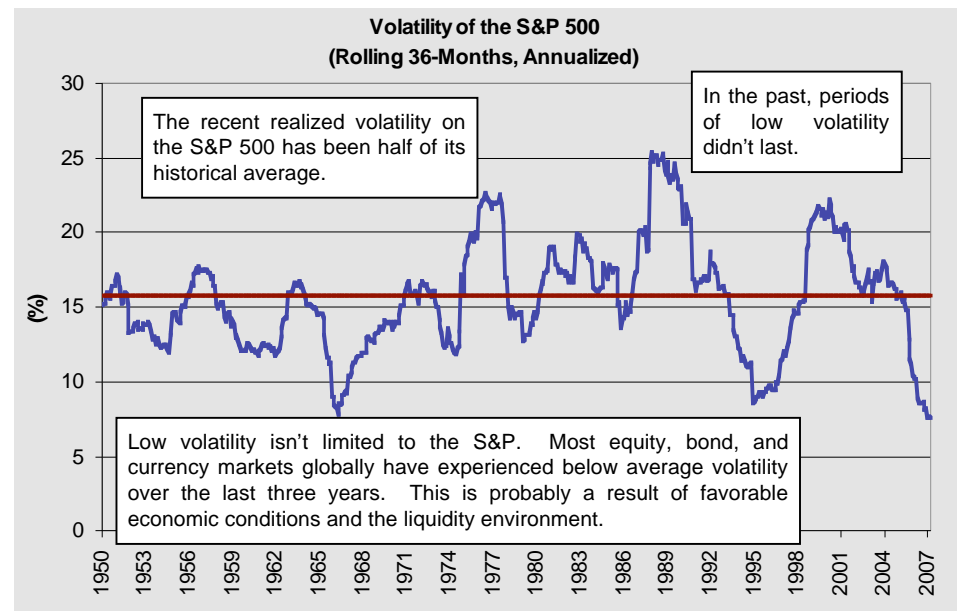
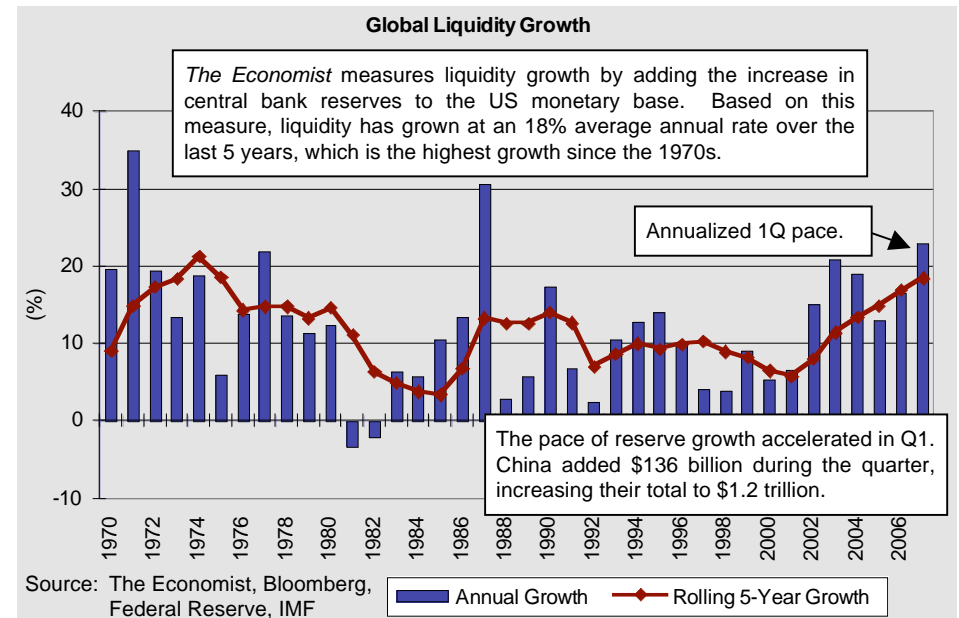


## Global Equities Finished a Volatile Quarter in Positive Territory (cont.)

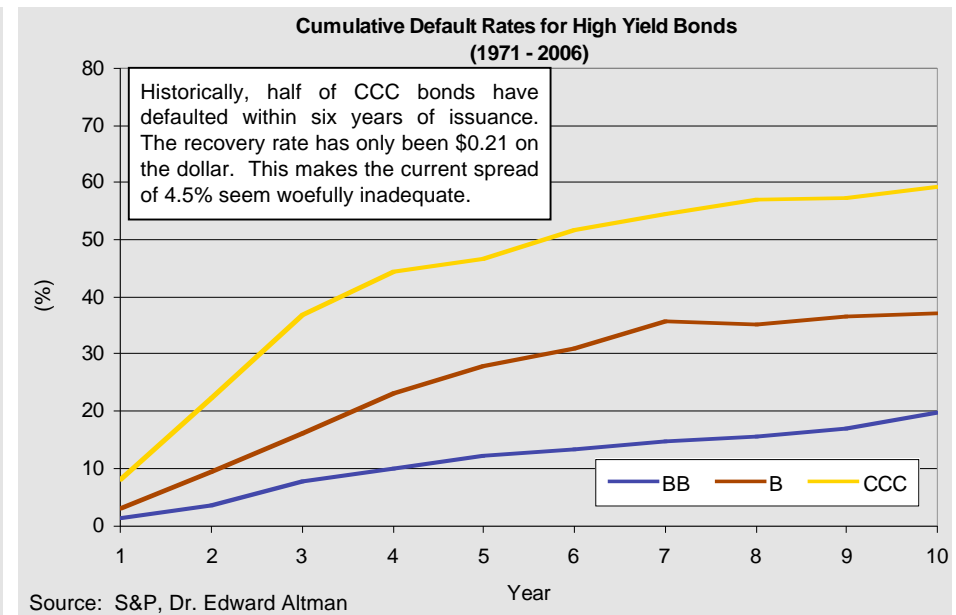
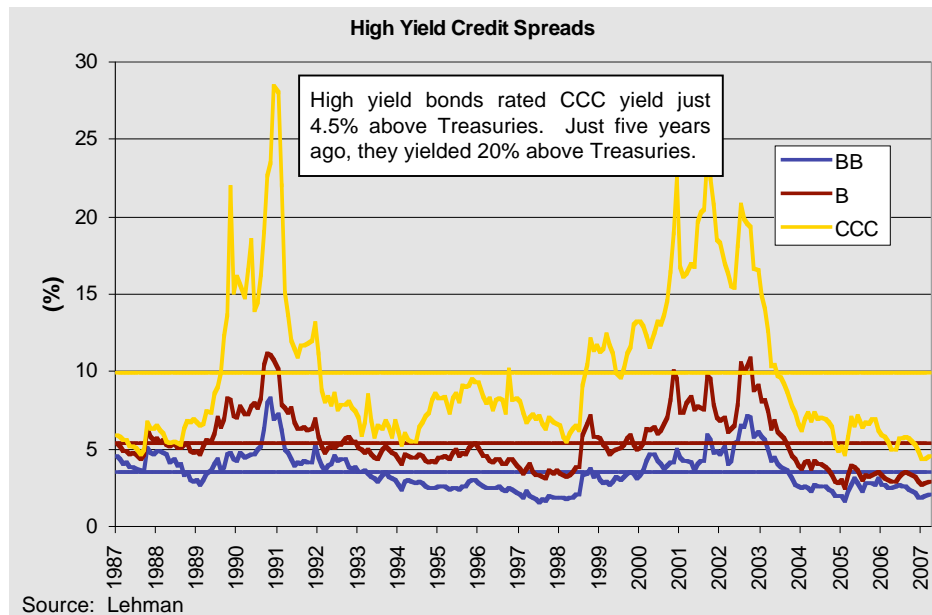
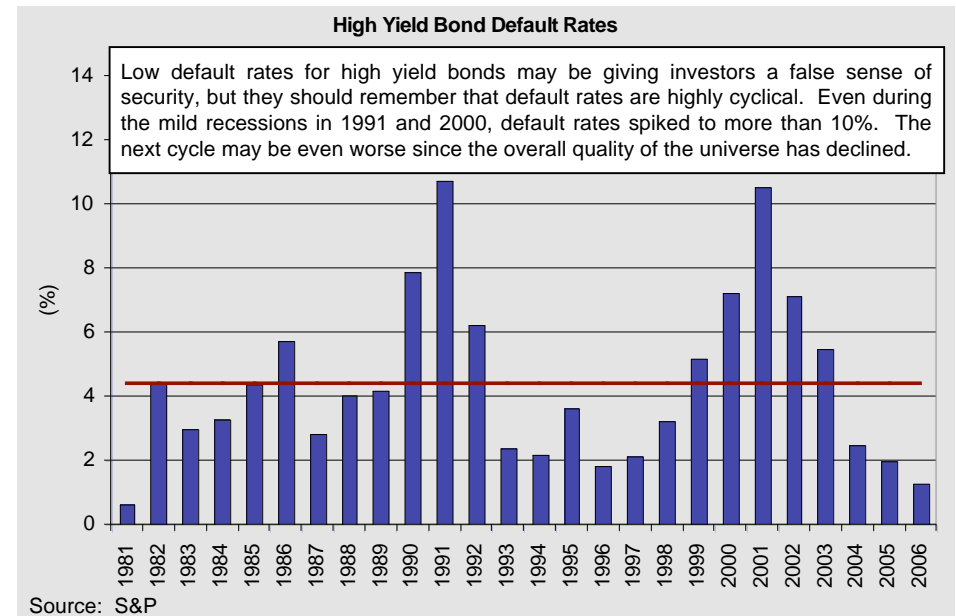
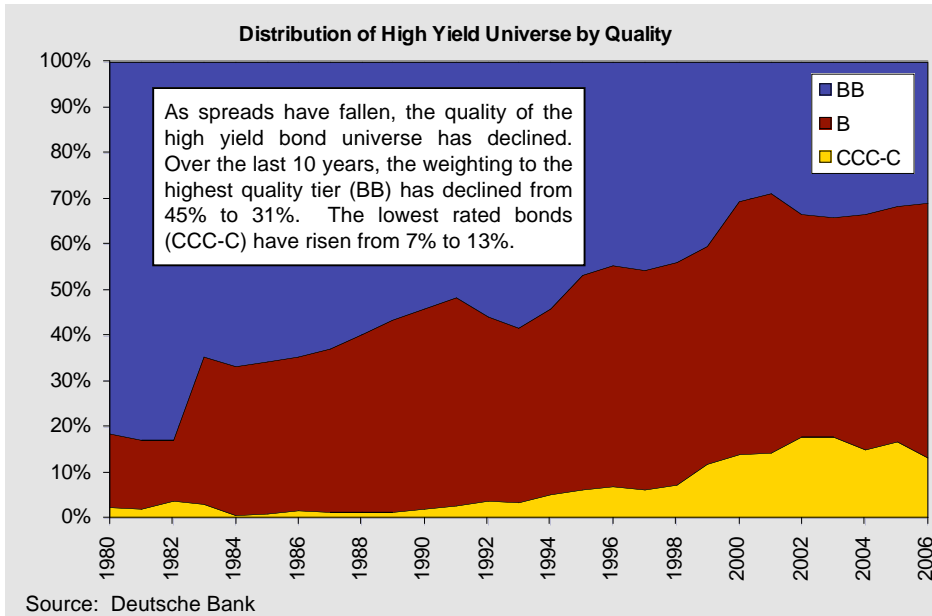


## Complacency Abounds

- Fears over subprime lending and concerns for its economic implications did not have a lasting impact on investors' risk tolerance. The brief period of volatility at the end of February and the beginning of March caused risk premiums to widen modestly, but in many cases, not enough to retrace the decline during the first part of the quarter. Investors are still requiring remarkably little reward to accept risk.
  - The liquidity environment continues to encourage risk taking. Foreign central banks are accelerating the pace of reserve accumulation, much of which flows into US bonds. This continual flow of money back into our bond markets has helped keep interest rates depressed, encouraging investors to reach for return.
  - The low volatility environment of the last few years has further encouraged risk taking. Volatility across global markets has generally been well below average since the beginning of 2004. While there have been spikes, such as in the first quarter and last spring, markets quickly calmed afterwards. Investors may be extrapolating the recent periods of low volatility into the future. History suggests caution; volatility has generally been mean reverting.
- Low risk premiums are most easily observed in high yield bonds and other yield-oriented investments (e.g., REITS and emerging market debt). High yield bonds offer just a 2.7% option-adjusted spread to Treasuries, half of the historical average. This spread is also slightly less than the cost of historical default losses (~2.9%), suggesting the risk premium on high yield bonds is negative if historical default trends return.
- Tight spreads on low quality credit have spilled over to equity markets. While stocks are not attractive on an absolute valuation basis, they are reasonably attractive relative to high yield bond spreads (especially if one assumes current profit margins persist). This has fueled the buyout boom. Buyout funds are paying very high prices for public equities, but lenders are assuming much of the risk, essentially selling buyout funds a cheap put option.
- It's impossible to say when investors' level of risk tolerance returns to more reasonable levels, but history has shown that periods of financial market complacency tend to end badly. A sharp slowdown in the economy is an immediate risk. An economic slowdown would test high yield bonds, which might finally bring the days of cheap credit to an end. We continue to recommend that investors look to reduce risk since it's not priced to pay much in the future.

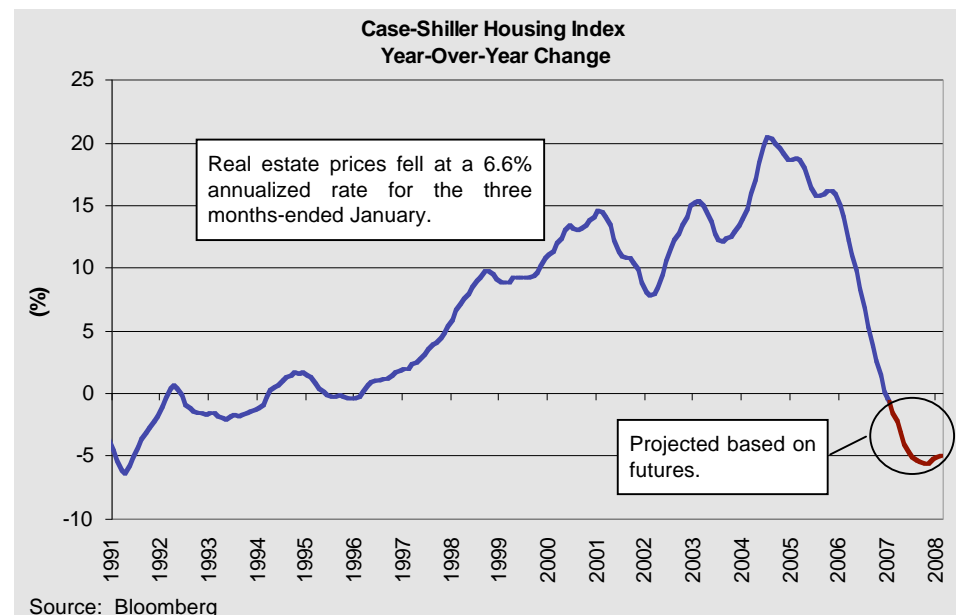
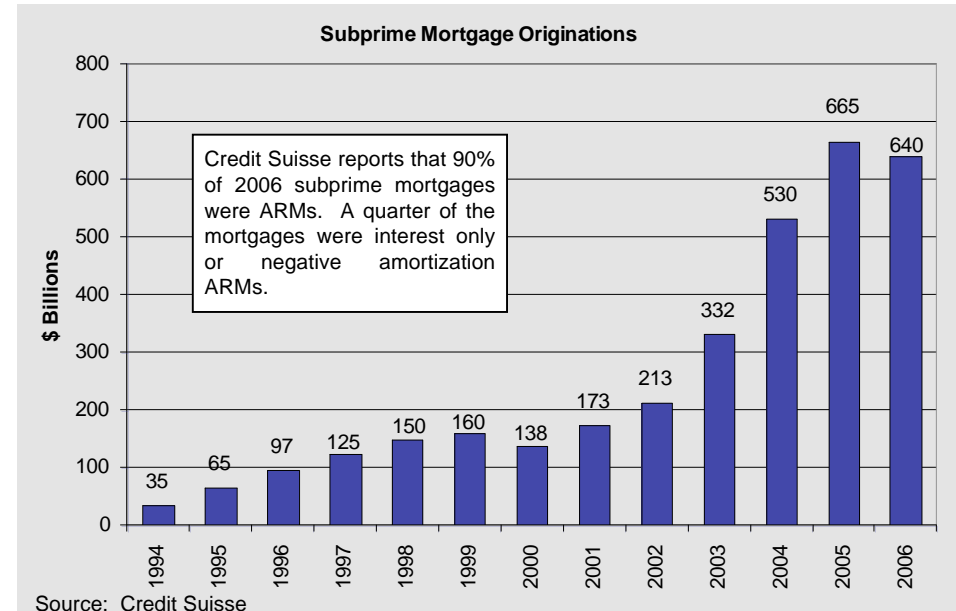


## Complacency Abounds (cont.)

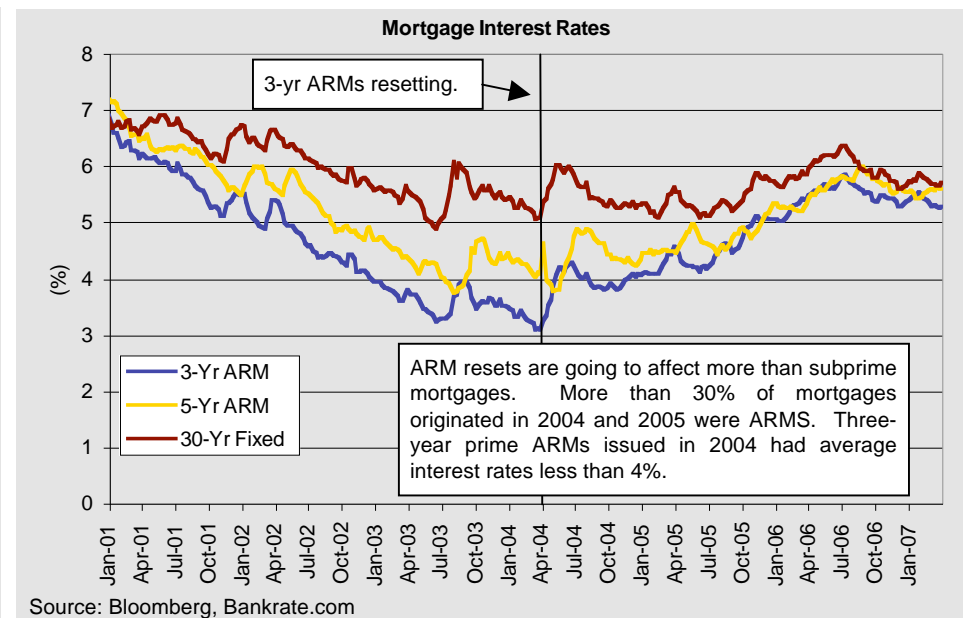
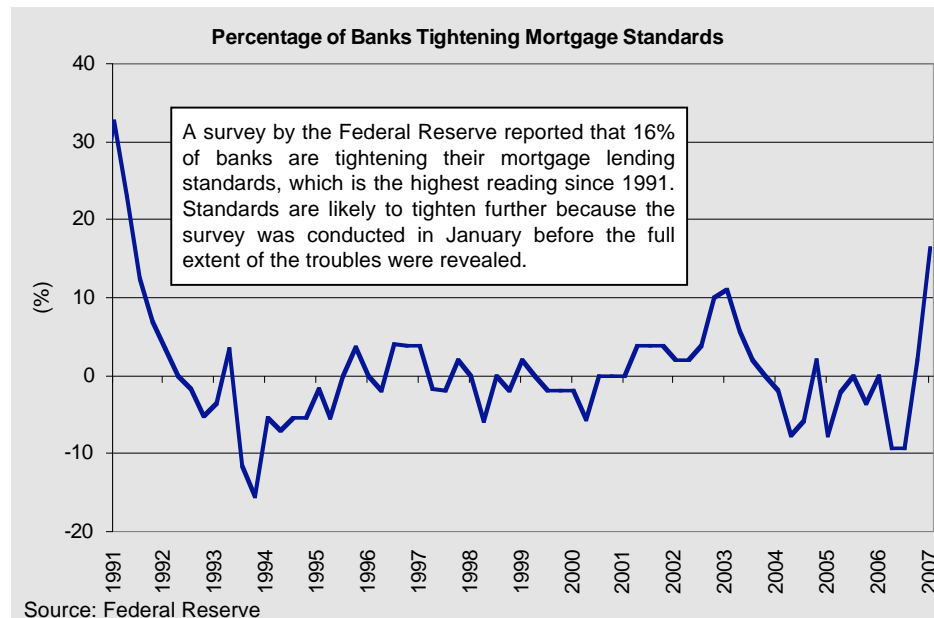
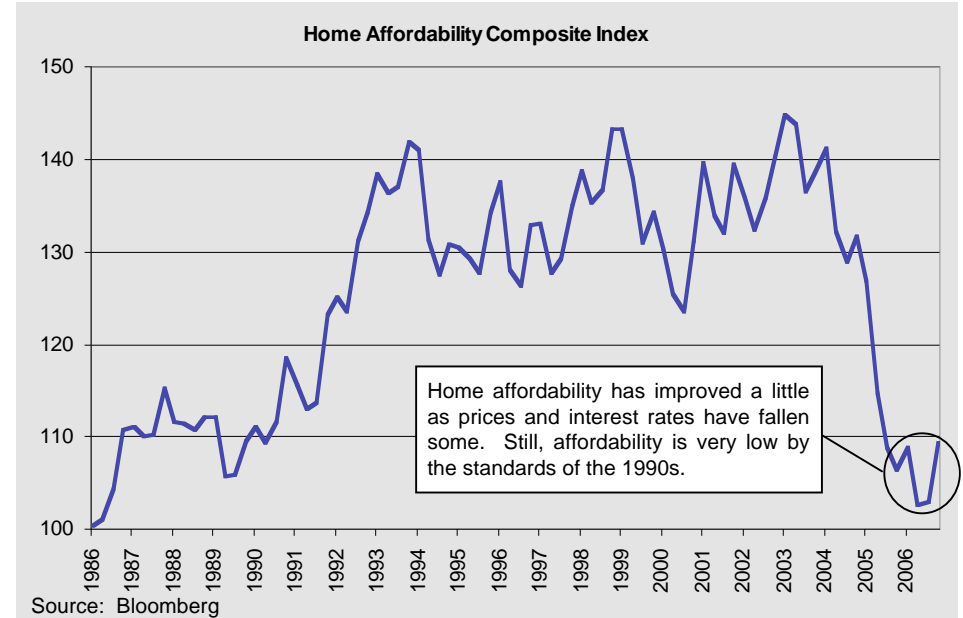
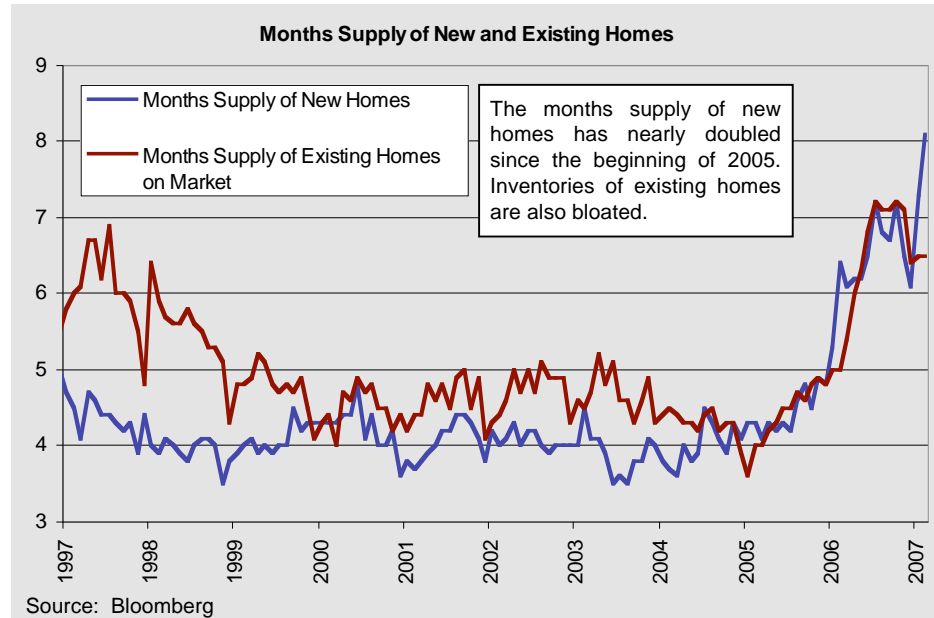


## More Troubles for the Housing Market

- Hopes that housing activity bottomed in the fourth quarter of 2006 were shattered with the troubles in the subprime mortgage sector. Subprime loans have been a large share of mortgage originations in recent years. Subprime mortgages represented about 20% of originations in 2006, totaling \$640 billion. A further 20% were “Alt-A” loans, whose quality is between subprime and prime. According to Lehman, subprimes comprise 15% of the aggregate mortgage universe, or about \$1.2 trillion, and Alt-A mortgages make up 7% (\$0.6 trillion).
- Most subprime loans are ARMs. Interest rate resets and the expiration of teaser rates are pressuring many borrowers. Subprime loans began to show signs of trouble in the second half of 2006 as delinquency rates began to rise. The delinquency rate rose from 11.7% in June to 13.3% by year-end. Delinquencies are expected to continue to rise in 2007.
- The fallout from the subprime woes remain to be seen. It’s already had a devastating effect on companies heavily involved in the business. A study by First American CoreLogic forecasted \$326 billion of defaults over the next few years with actual losses (net of recoveries) of \$112 billion. While significant, that should be bearable by our \$25 trillion financial market.
- The more worrisome impact is that it removes support from an already shaky housing market. Subprime and Alt-A borrowers will find it far more difficult to get loans as lenders tighten standards. Credit Suisse forecasts that tighter lending standards will eliminate 50% of subprime borrowers and 10% of Alt-A borrowers, which together represented 12% of 2006 buyers. In addition, resetting ARMs and rising foreclosures will likely increase the number of forced sellers.
  - The market for new homes is likely to continue to worsen. New home sales in January and February were 14% below the fourth quarter 2006 average. Economy.com estimates that there are 900,000 excess vacant units for sale, more than 4x the level at the end of 2005.
  - With fewer buyers and more sellers, housing prices will continue to come under pressure. According to futures on the Case-Shiller Housing index, home prices will decline about 5% in 2007. This, of course, has negative implications for consumer spending.
- There is some concern that this will cause a wider credit crunch. So far, there are few hints of that. Credit spreads widened modestly in reaction to the subprime news, but still finished the quarter below where they started. That could change if the worsening housing market causes a recession.

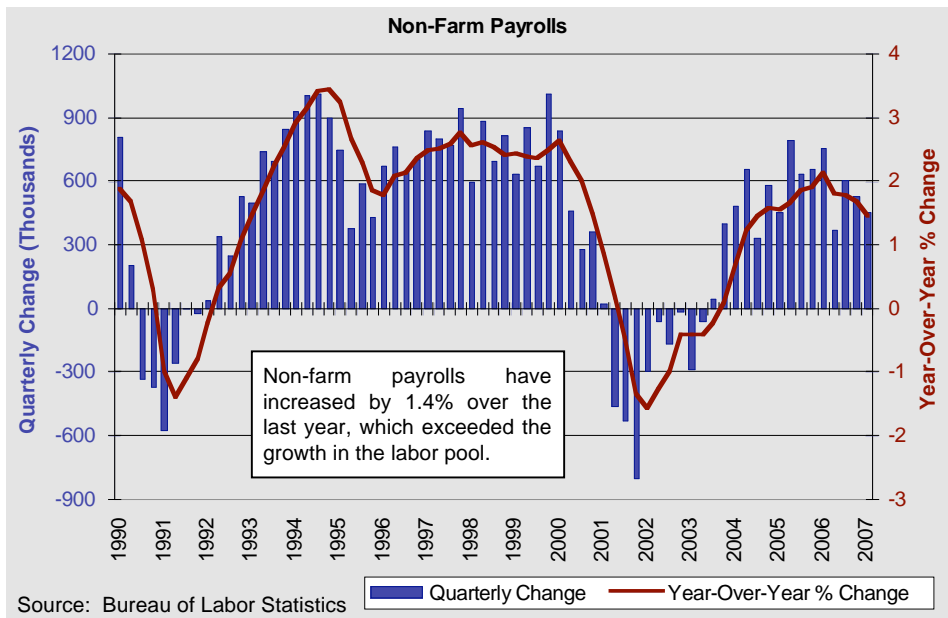
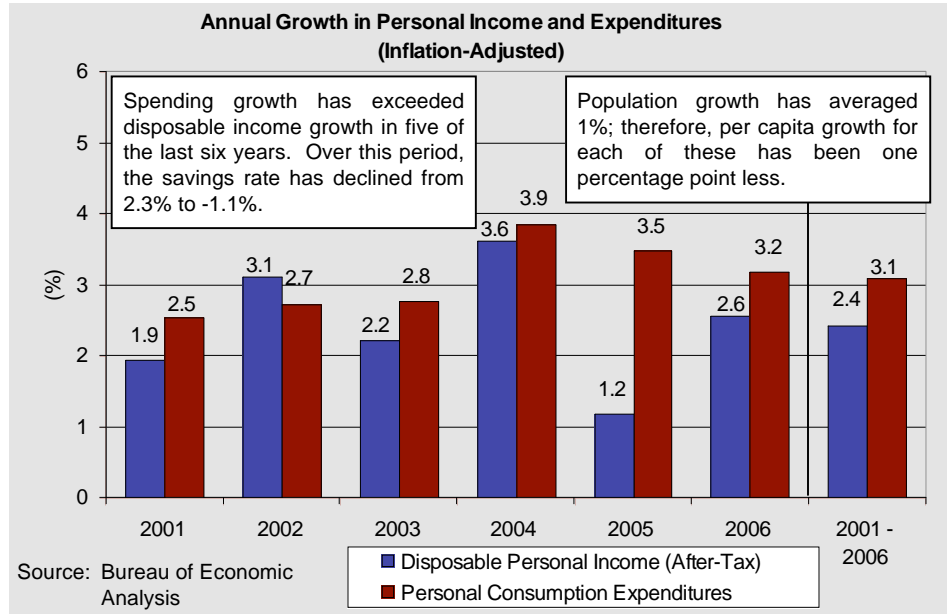


## More Troubles for the Housing Market (cont.)

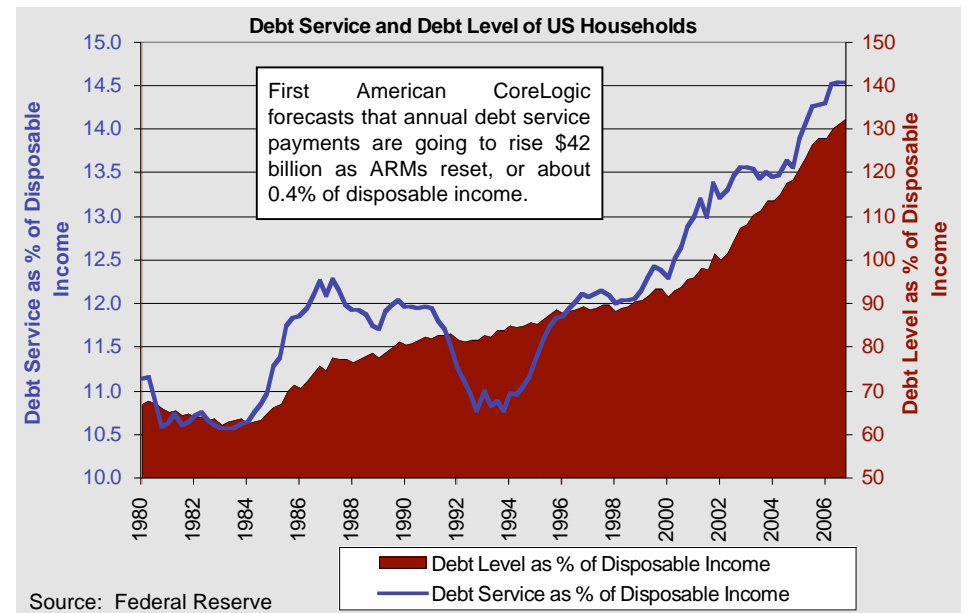
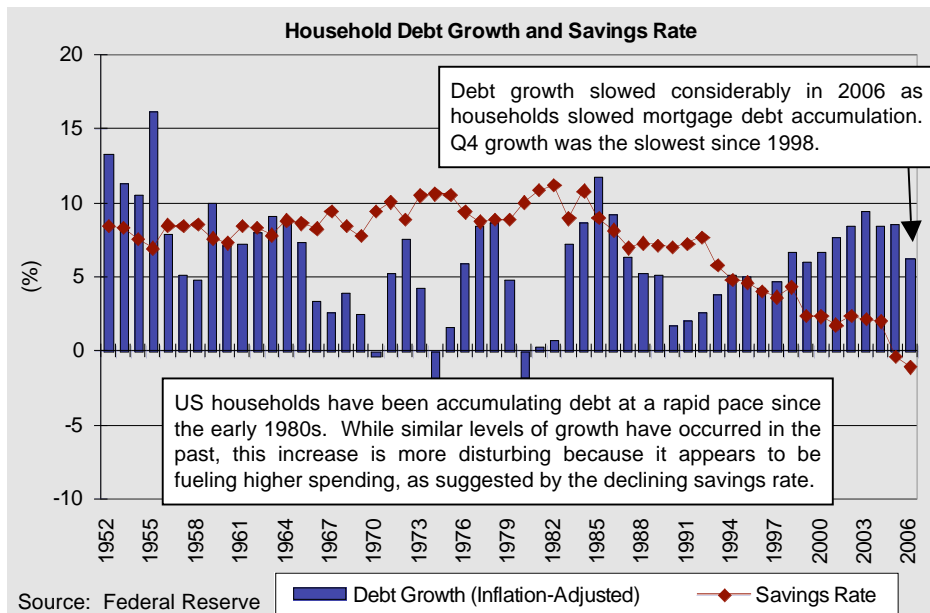
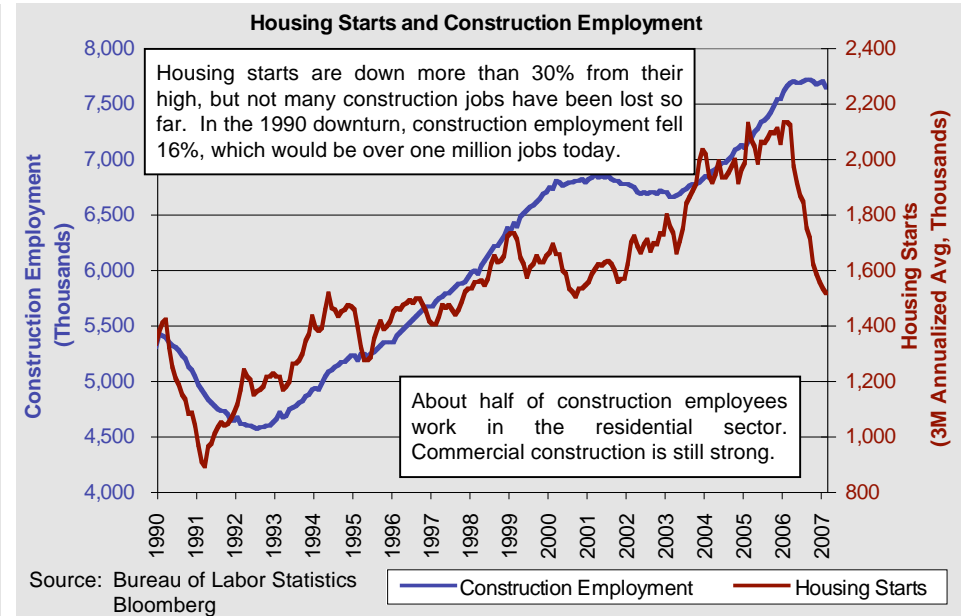
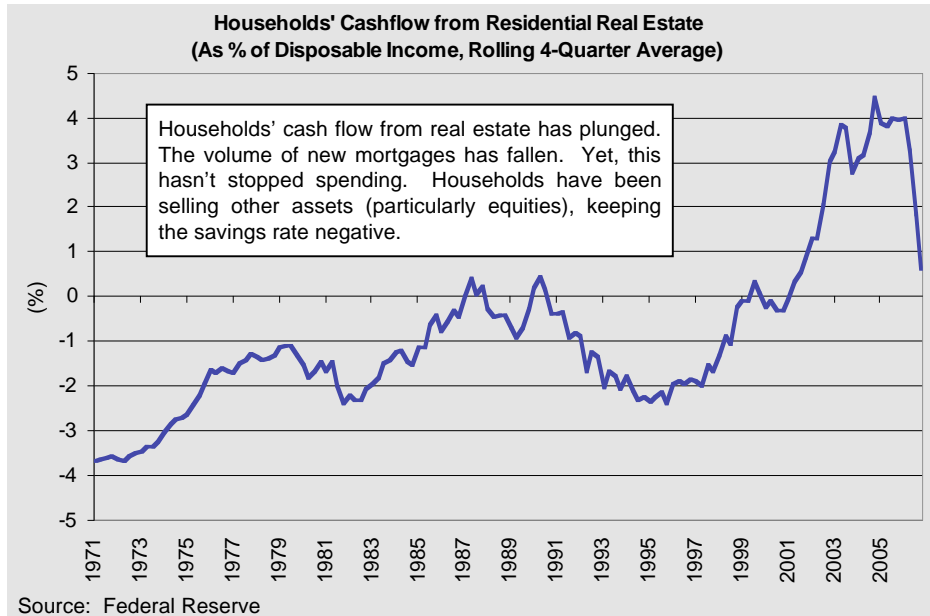


## Will Spending Withstand the Housing Slump?

- The economy grew at a 2.5% annualized rate in the fourth quarter of 2006, which resulted in a 3.3% growth rate for the full year. Personal consumption continued to grow healthily, posting a 4.2% annualized growth rate for the fourth quarter. Outside of personal consumption, the economy contracted, as residential investment continued its plunge in the fourth quarter (-20%). Surprisingly, business investment also contracted, falling 3.1%. Economists polled by Bloomberg expect first quarter growth to come in at 2% versus a 2.4% forecast going into the quarter. Despite the sorry state of the housing market, personal consumption expenditures probably increased by more than 3% in the first quarter.
- Economic growth has been driven largely by personal consumption growth. Consumption growth has been boosted by rising home prices and expanding mortgage debt. Since the beginning of 2001, real personal spending has increased by \$1.30 for every \$1 of growth in real disposable income, which has led to a negative savings rate. Over this period, the overall debt load has increased from 90% to 131% of disposable income. Now that the housing market has turned over, consumers are likely to finally buck the 16-year trend of declining savings rates.
- Compensation growth will now be left as the key driver of consumption growth. Encouragingly, the job market remains strong. The economy added an average of 152,000 jobs per month during the first quarter and the unemployment rate slipped to 4.4%. Wage growth was solid over the last year. Average hourly earnings were up an inflation-adjusted 1.2%. However, the job market will face headwinds. The downturn in the real estate market will likely mean significant job losses in construction and other real estate-related industries. In addition, if weak business investment persists, job creation in other industries is also likely to suffer (see page 14).
- Households need to build their savings rate back to more reasonable levels, particularly since baby boomers are approaching retirement. This means that consumption growth is likely to trail income growth in the coming years. Over the last decade, personal consumption has grown at 3.7% per year. Over the next decade, it's likely to grow at 2.5% or less.
- Most economists do not think the weak housing market will lead to a recession. The risks appear weighted to the downside, with a downturn in the jobs market and worse than expected declines in real estate prices representing the primary risks.

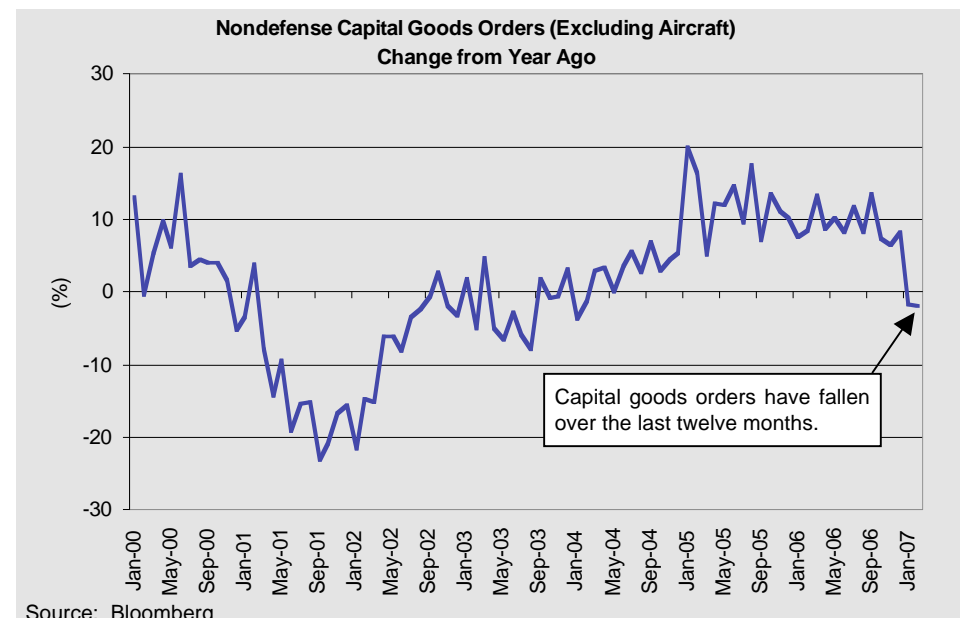
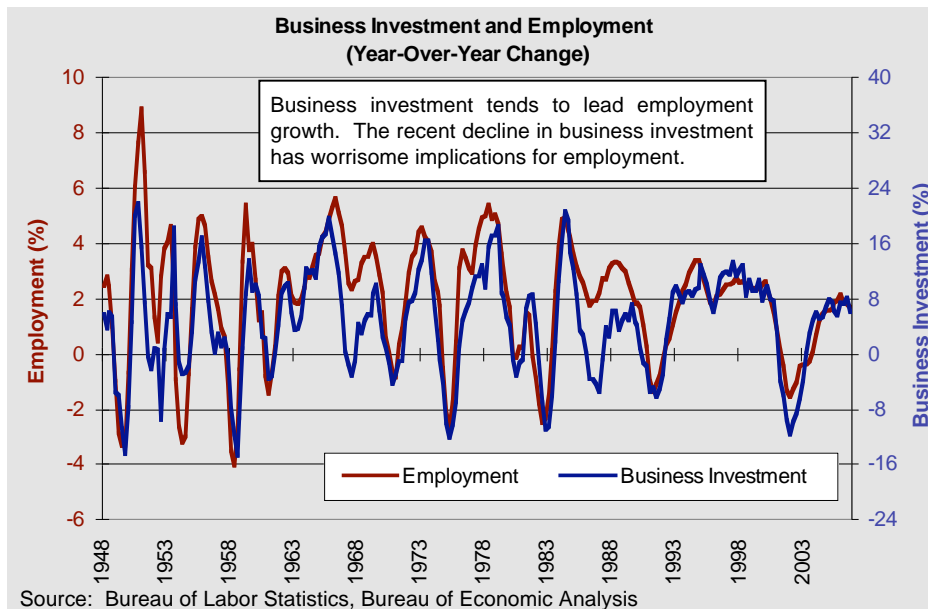
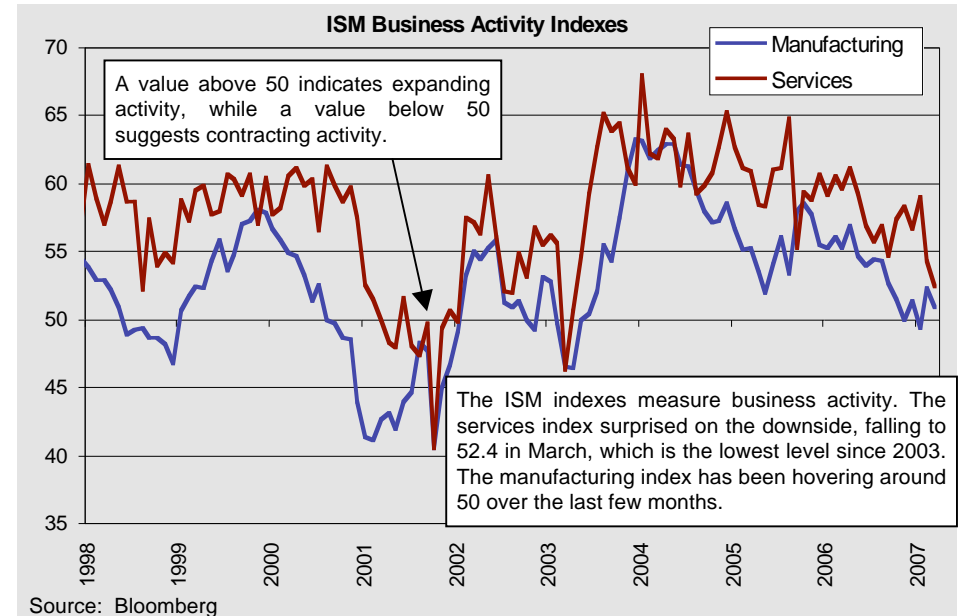


## Will Spending Withstand the Housing Slump? (cont.)



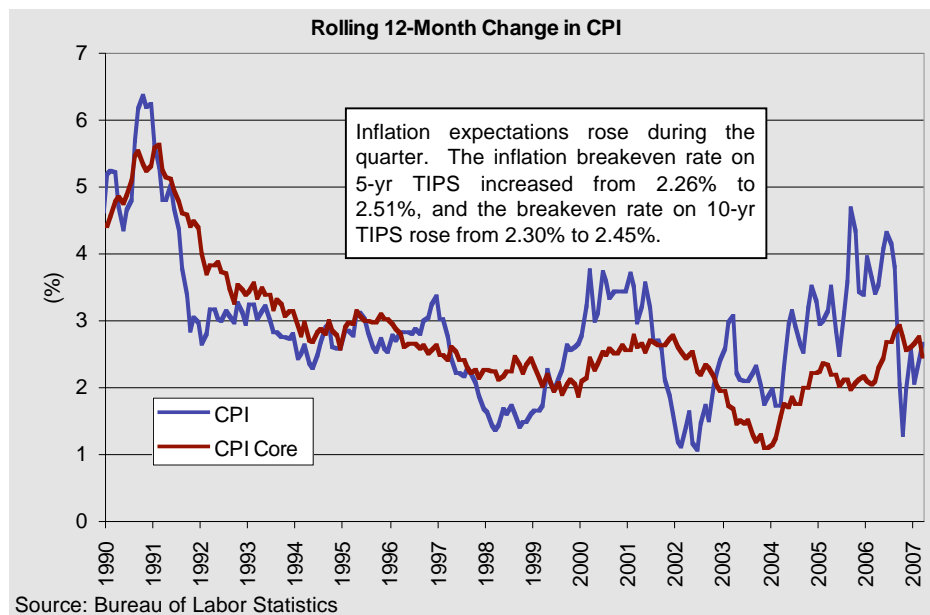
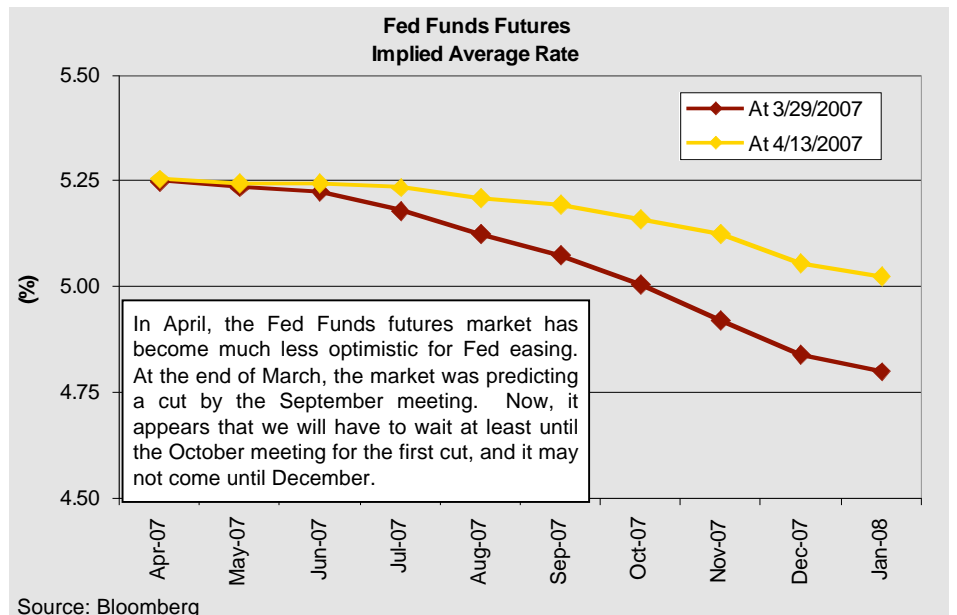
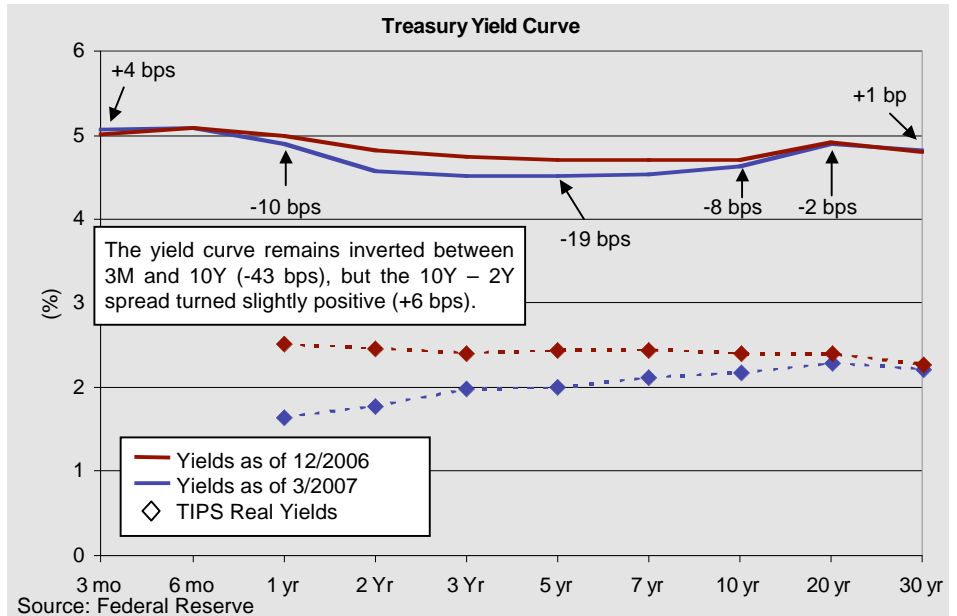
## Business Investment Faltering

- Most economists have been expecting consumer spending growth to slow. With record profits for US corporations, one hope has been that business investment will pick up some of the slack and help keep the economy growing strongly. That hope was dealt a blow with the fourth quarter GDP release. Business investment declined at a 3.1% annualized rate during the quarter. Based on weak durable goods orders in January and February, business investment may have declined again in the first quarter.
- As we noted in our 1Q 2006 report, it was hard to reconcile the need for businesses to increase their investment pace significantly if personal consumption growth was expected to decline. Nevertheless, the decline in investment in the fourth quarter was a surprise.
- Slowing business investment is a concern for the employment outlook. Not surprisingly, there is a strong relationship between business investment and employment growth. Hopefully, the recent decline in investment will prove temporary. However, if it persists, a recession becomes more likely because consumer spending growth is now more reliant on wage growth due to the fading wealth effects from housing.



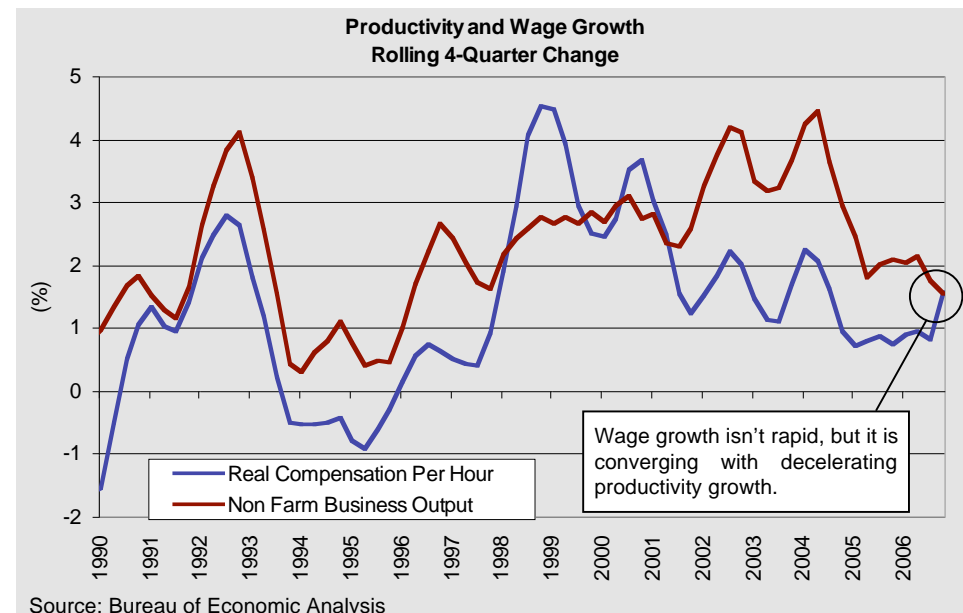
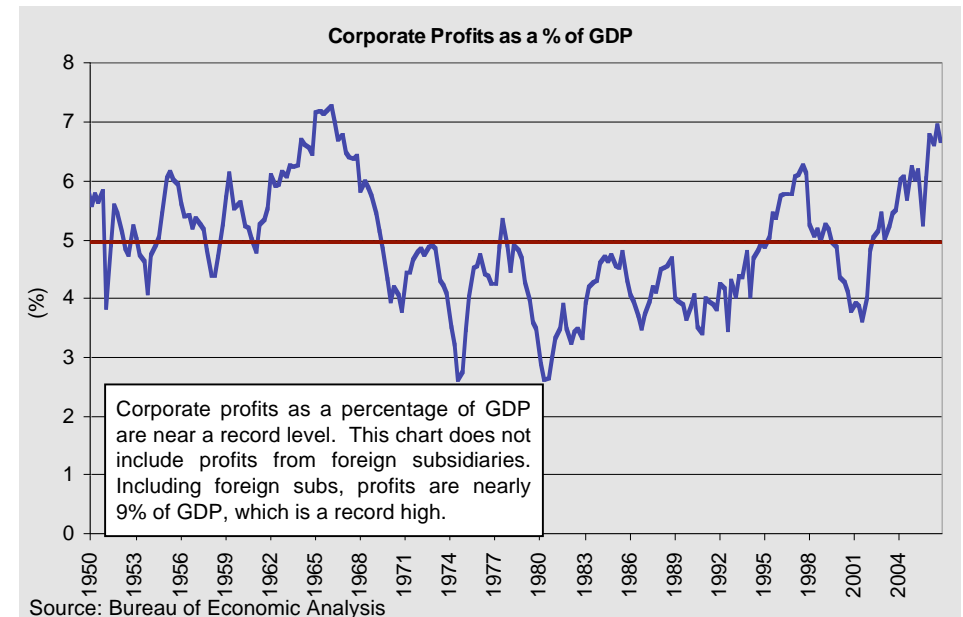
## The Fed Shifted to Neutral

- The FOMC left the Fed Funds rate unchanged at 5.25% during the first quarter. The statement from the March 25 meeting suggested that the FOMC switched its bias from tightening to neutral. Fed Funds futures didn't move much during the quarter. The futures market was already discounting the stated tightening bias, projecting that the next move to be a cut. However, Fed Funds futures predict that we're unlikely to see a cut until the fourth quarter.
- While the Fed changed its stated bias, officials are still making fairly hawkish inflation comments and minutes from the March 25 meeting reinforced their concern about inflation. Core CPI inflation remains stubbornly high at 2.5% over the last 12 months. The recent rise in energy prices will push the overall inflation upwards, as well.
- With conditions in the housing market deteriorating, it'll be interesting to see whether Bernanke's Fed will be as willing to provide ample liquidity to cushion falling asset prices as it was under Greenspan (the so-called "Greenspan put"). Low risk premiums suggest that markets believe the put is alive and well.

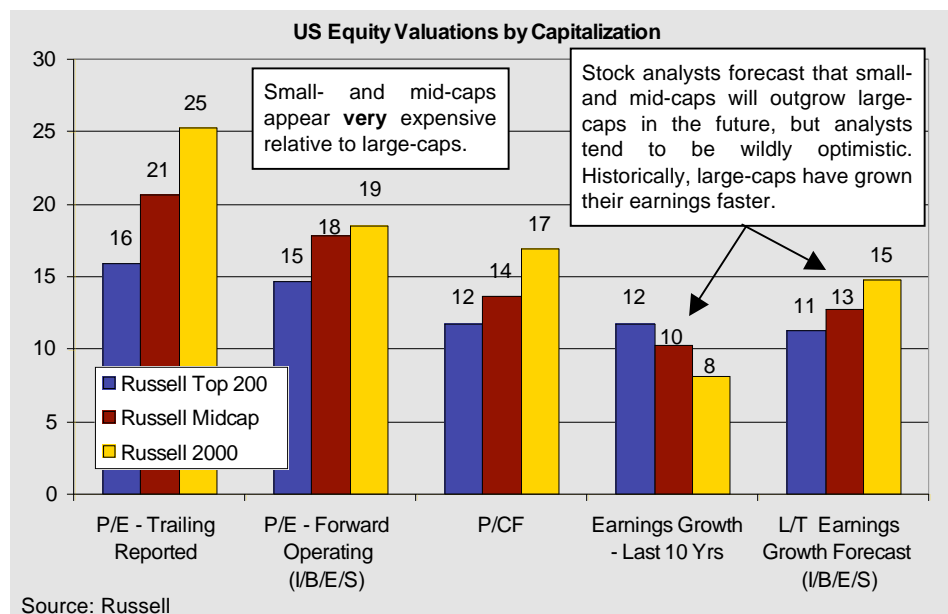
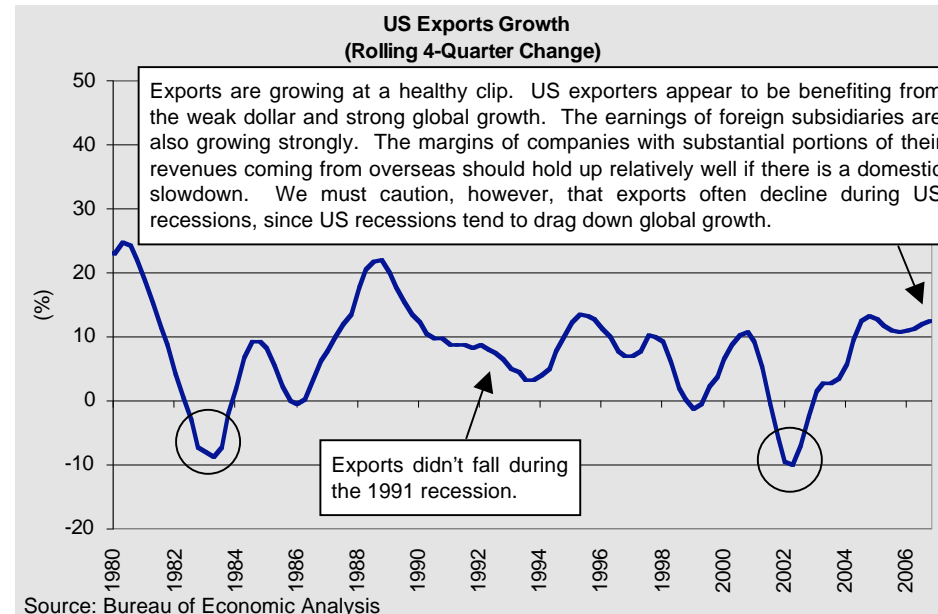
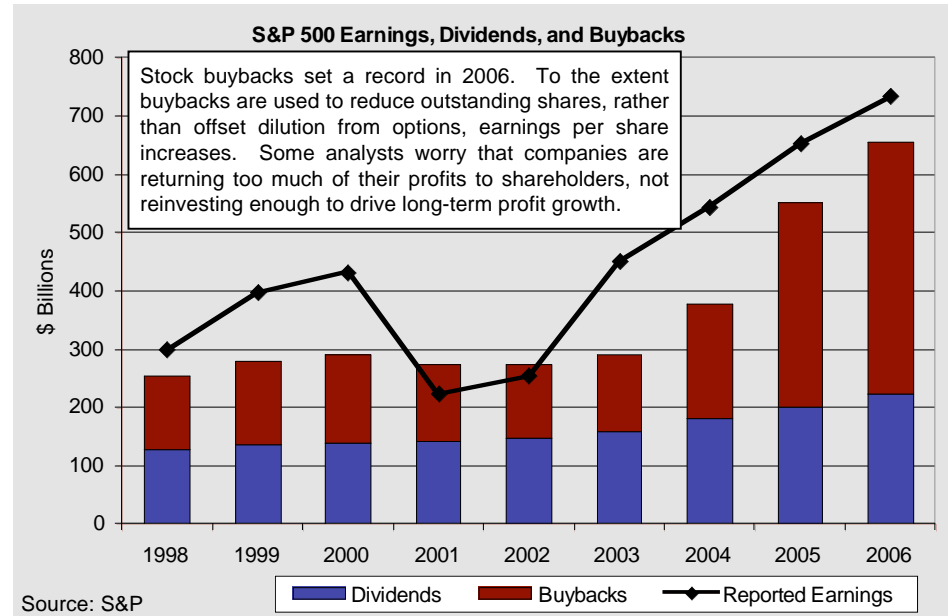
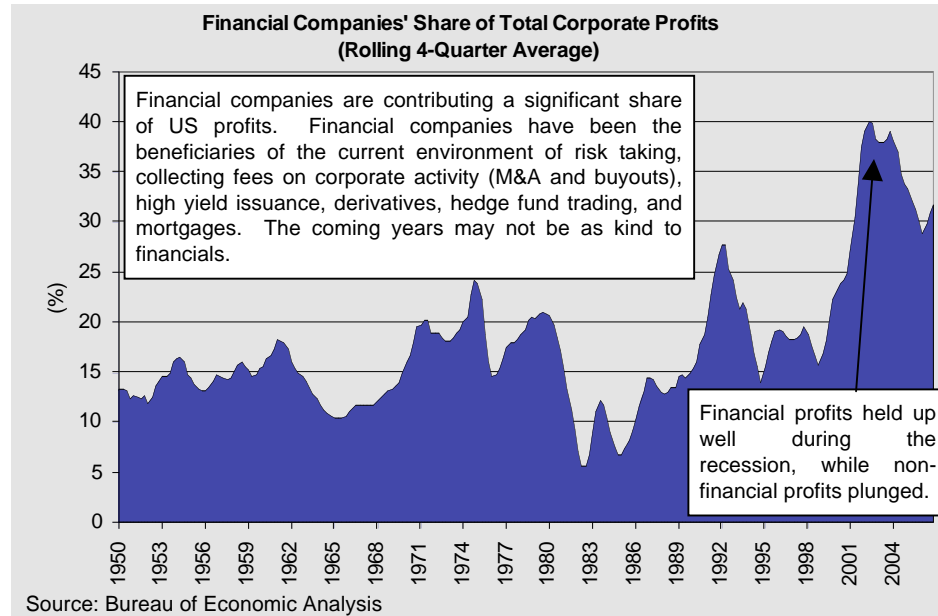


## Slowing Productivity Growth May Pressure Profit Margins

- Recent data suggest that the earnings boom may be coming to an end. The Bureau of Economic Analysis reported that corporate profits slipped 3% in the fourth quarter. Non-financial profits plunged 7%, while financial profits increased 5%. Still, year-over-year profit growth is very strong, showing a 15% increase at the end of 2006.
- A concern is the declining pace of productivity growth. It has been a significant contributor to profit margin growth since the recovery began in 2002. However, productivity growth has slowed over the last four quarters and is now at a 10-year low.
  - Corporations have been very successful in cutting costs, while growing output. Since the beginning of 2002 when profit margins began to rebound, productivity has grown 2.9%, annualized. Real compensation per hour only grew 1.4%.
  - However, corporations may not have much more fat to trim. Recently, productivity growth has been falling, while real compensation growth has been rising. Over the last four quarters, real compensation growth has matched productivity growth at 1.5%. This is an ominous sign. Not surprisingly, profit margins tend to decline when wage growth exceeds productivity growth. If the trend of lower productivity growth and higher wage growth persists, profit margins will come under pressure, particularly if the economy slows or enters a recession.
- A benefit of corporations' conservativeness in business investment in recent years is that profit margins should hold up better than usual if there is a recession. Profit margins tend to decline in periods of slow growth and particularly in recessions. A significant driver of the profit plunge in 2000/2001 was overinvestment in the late 1990s. With business investment restrained over the last few years, profits margins should not face as much downside risk over the short-term.
- If there is a slowdown in the domestic economy, multinationals should be better positioned to maintain margins. While it is open to question whether the world can completely decouple from a US slowdown (see pg. 18), the rest of the world seems certain to grow at a faster pace than the US. Furthermore, multinationals are better positioned to take advantage of cheap labor in emerging markets. This reinforces our recommended tilt to large-cap quality growth stocks. Many multinationals land in this category.

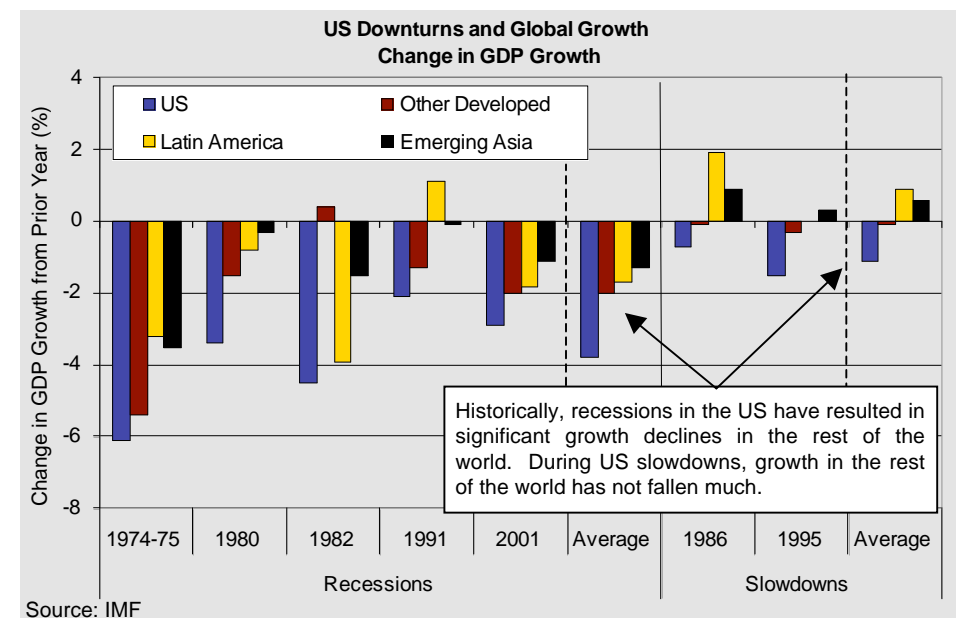
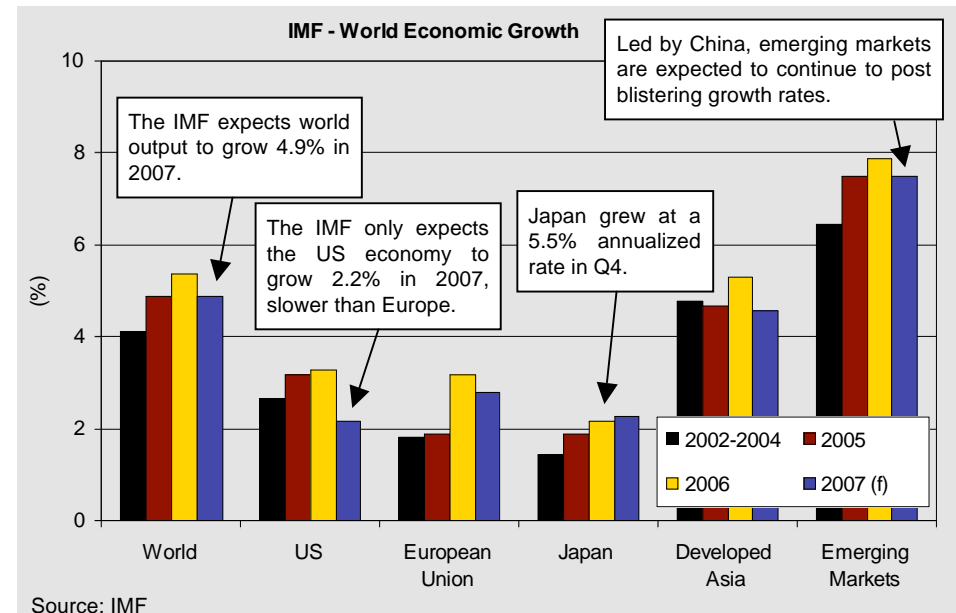


## Slowing Productivity Growth May Pressure Profit Margins (cont.)

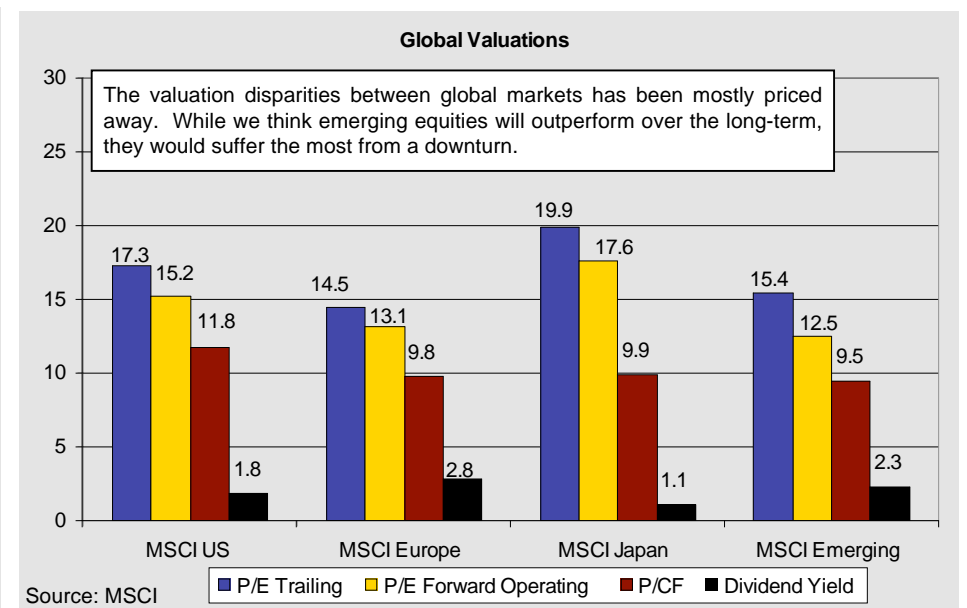
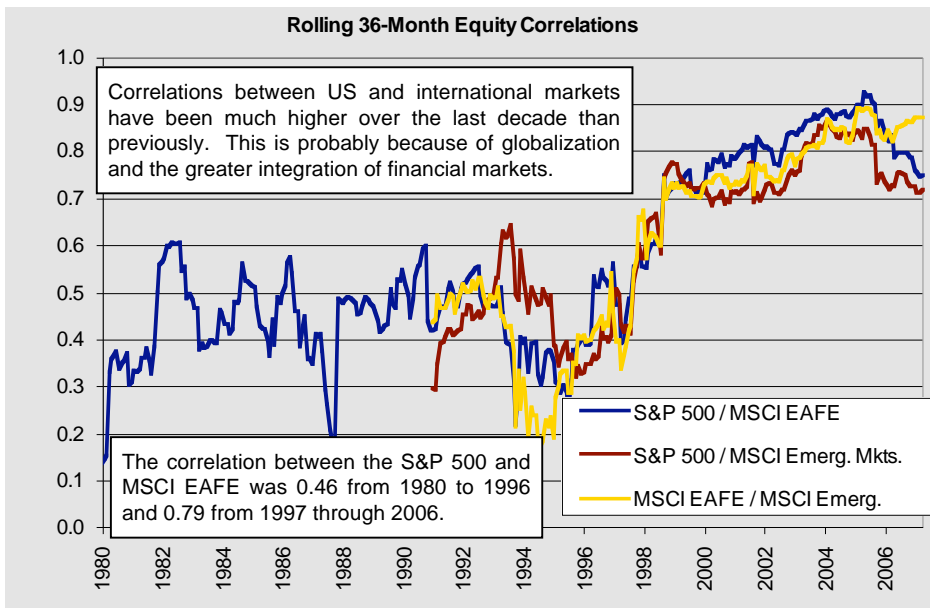
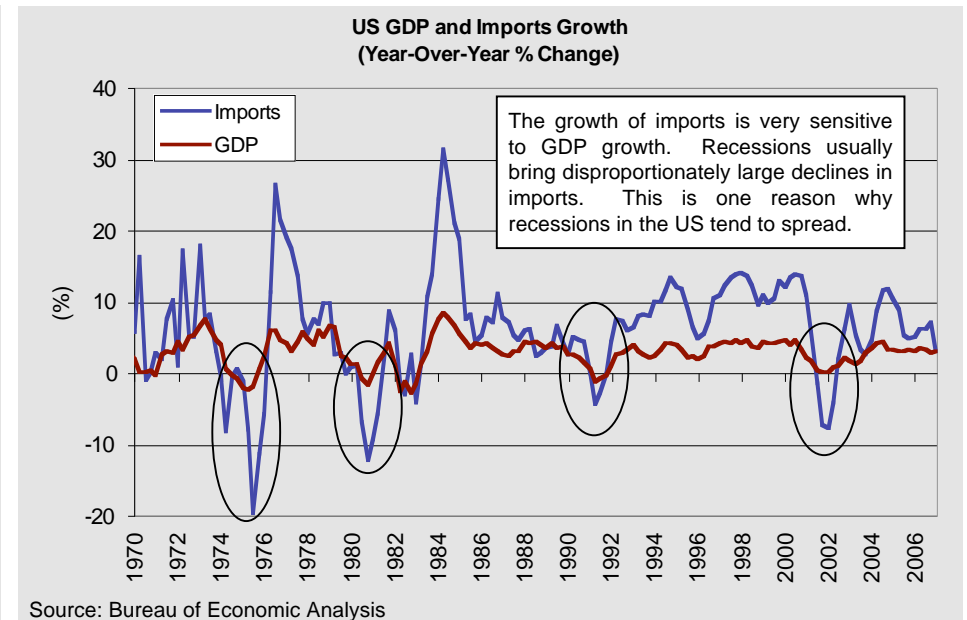
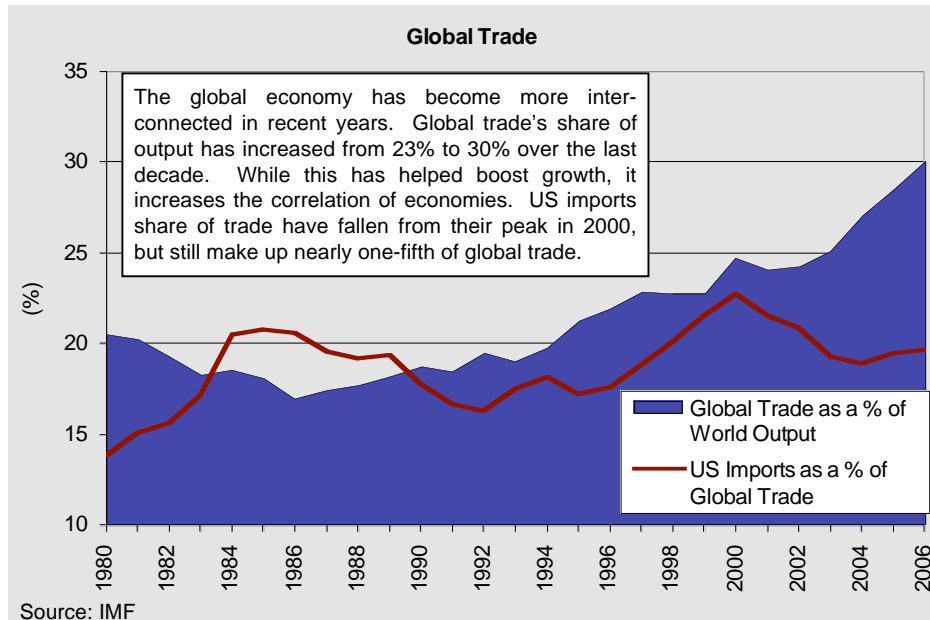


## Can the World Sustain Growth Rates if the US Slows?

- The US has played a central role in driving world economic growth in recent years. According to Morgan Stanley, US consumption grew at an annualized rate of 3.8% from 1996 to 2005, while consumption growth in the rest of the developed world averaged 2.2%. The appetite of US consumers for imports has helped fuel economic growth in emerging market countries. However, with the housing market cooling and a negative savings rate, it seems unlikely that consumers will be able to sustain their spending binge.
- Many commentators argue that the rest of the world will be able to decouple from the US and continue to experience strong growth. The economies of Europe and Japan are showing signs of stronger growth. Europe grew almost as quickly as the US in 2006, and its growth is expected to exceed that of the US in 2007. Japan's economy is also slowly turning around and with Japanese consumers sitting on a hoard of cash, there is potential for consumption growth to accelerate. Savings rates are very high in most emerging market countries, so there is also room for their consumers to increase spending. Increased consumption in local markets might be able to offset reduced US demand for imports.
- If US growth slows and avoids recession, there is cause for optimism. A recent IMF report showed that in two past US slowdowns, growth in the rest of the world did not slow. If that happens again, US imports should hold up reasonably well. China should continue to experience rapid growth and Europe and Japan might pick up some of the consumption slack. However, if the US enters a recession, the rest of the world is unlikely to escape unscathed. In past US recessions, global growth decelerated sharply as US imports declined, and there's little reason to believe it will be different this time since the global economy is even more tightly linked than in past recessions.
- While the global economy might be able to successfully decouple from the US slowdown, if the US equity markets suffer a correction, either because of a US slowdown or increased risk aversion, international markets are likely to follow. The valuations of global markets have converged with the US, so there is no longer a valuation cushion. Emerging market equities would be especially vulnerable because they are particularly sensitive to global growth and investors' high risk tolerance. In both the May/June 2006 sell off and the February/March downturn, emerging market equities fell more than US and other developed market equities.

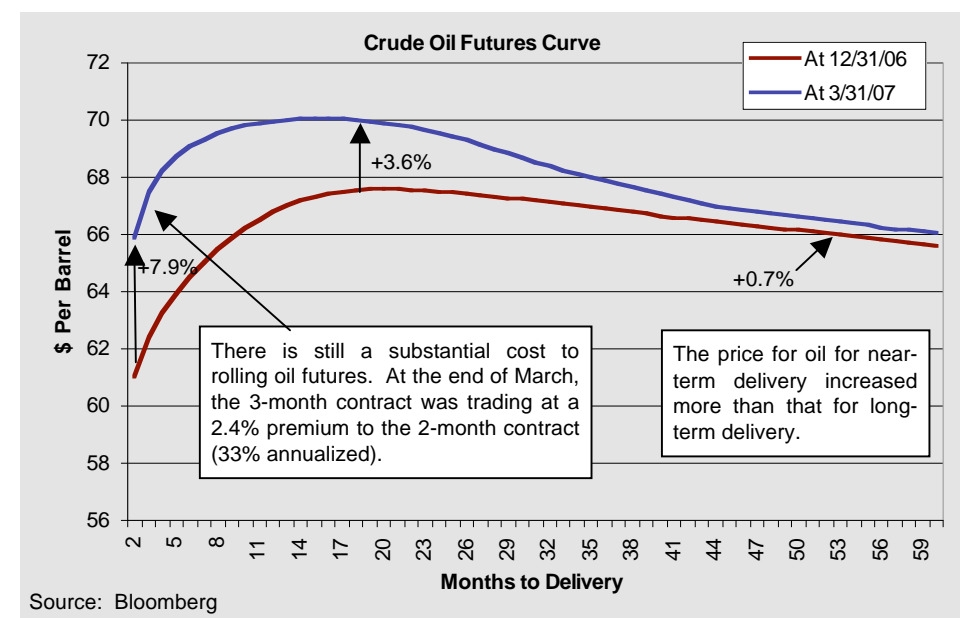
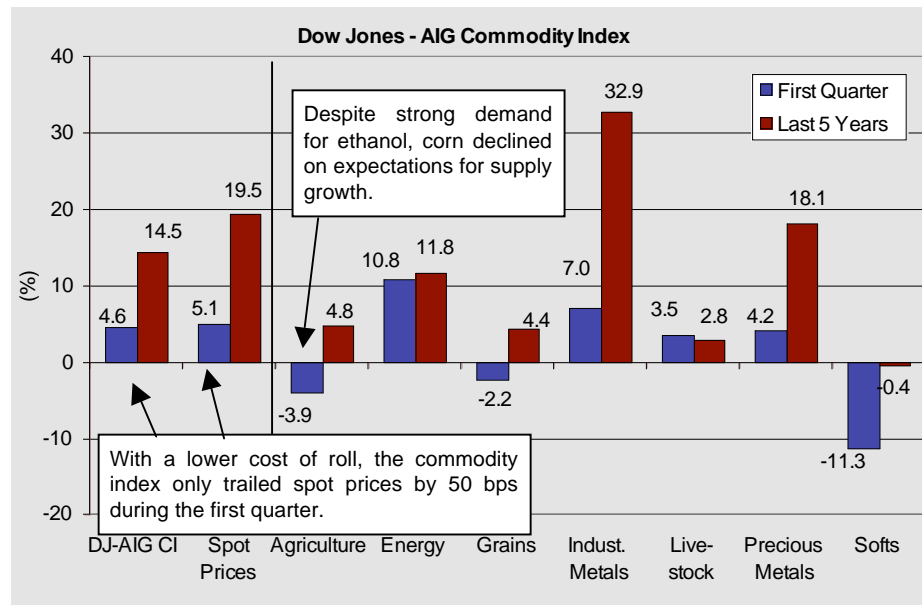
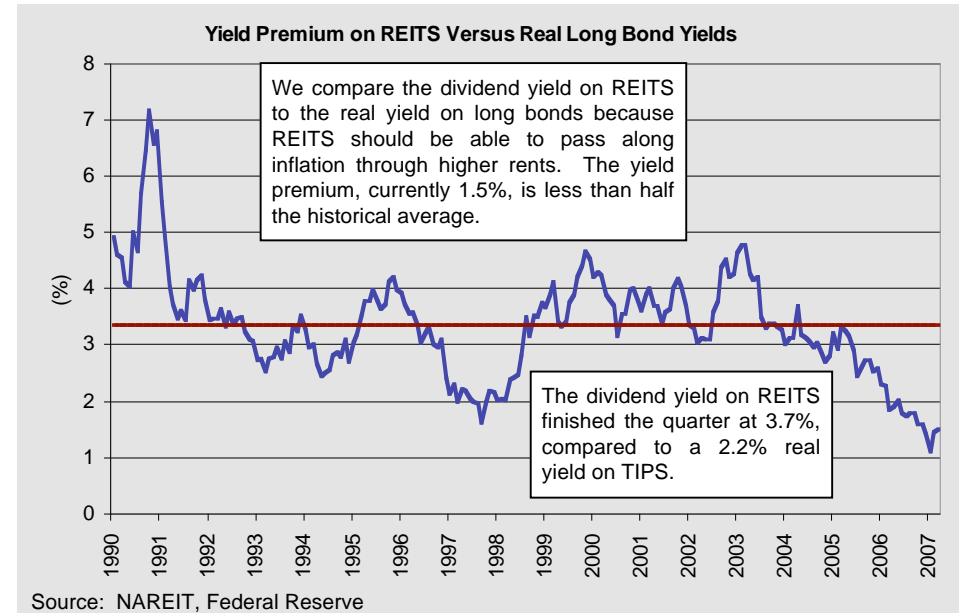


## Can the World Sustain Growth Rates if the US Slows? (cont.)



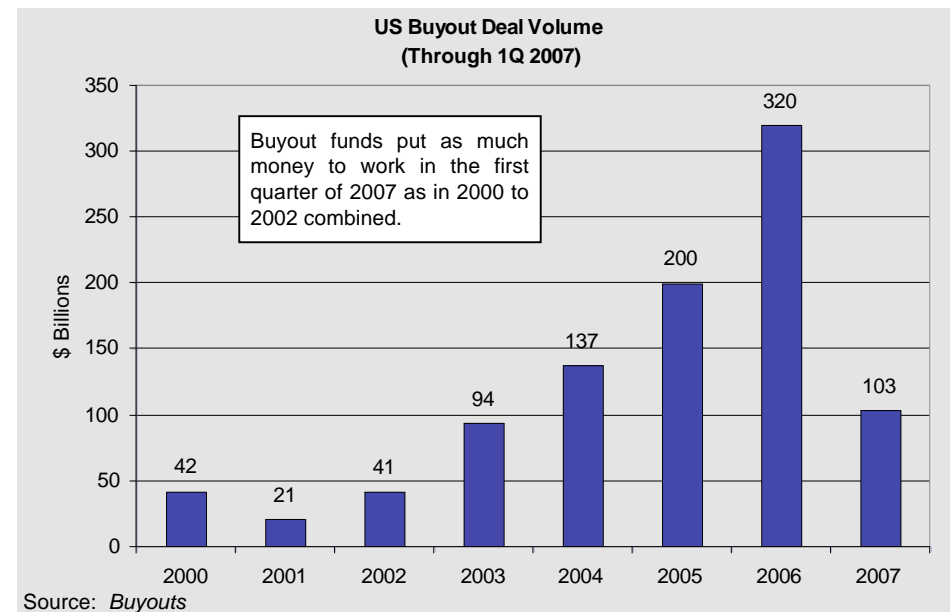
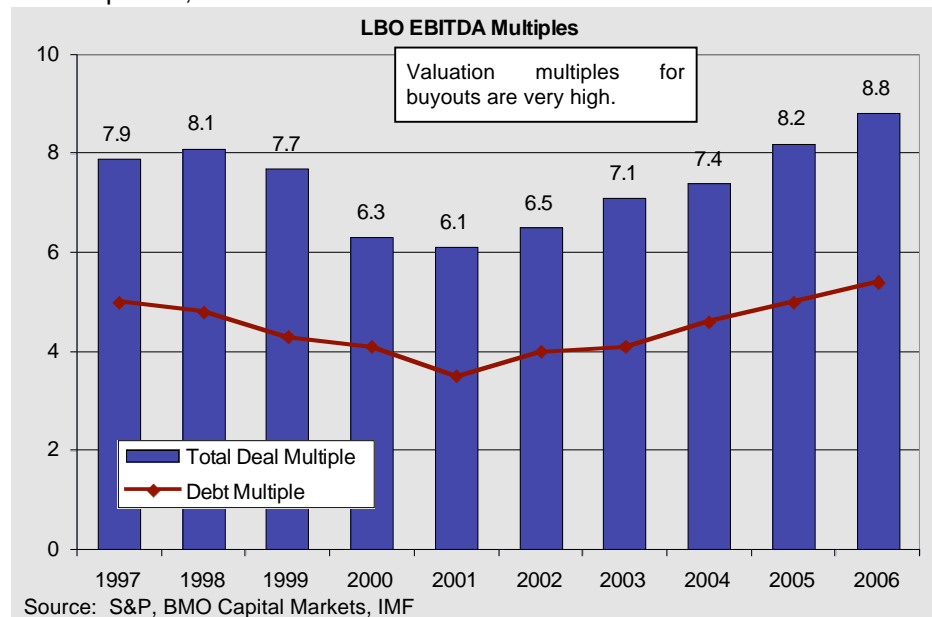
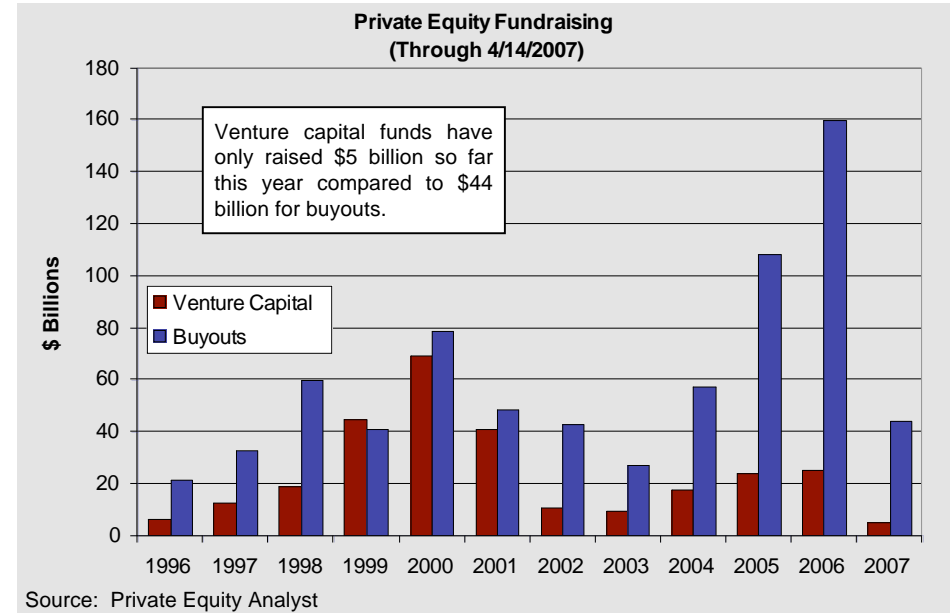
## Real Assets: A Volatile Quarter for REITS

- REITs had a rollercoaster ride during the quarter. The bidding war for Equity Office Properties helped push REITs up 13% for the year through February 7. REITs began selling off immediately thereafter. They were punished severely during the global market sell-off, losing 9% between February 27 and March 5. Still, REITs finished the quarter ahead 3.7%.
- Relative to private real estate, REITs appear appropriately valued. According to Green Street Advisors, REITs finished the quarter trading at their net asset value. Buyout activity reinforces that REIT valuations aren't far off their underlying assets. On an absolute basis, however, REITs (and private core real estate) appear very pricey. REITs yield just 1.5 percentage points above the real yield on long-term TIPS. This is just one more example of investors requiring very little reward to accept risk.
- Commodities had a solid quarter on the back of higher energy prices. Oil, natural gas, and gasoline all rose during the quarter. The DJ-AIG Commodity index gained 4.6%. The cost of contango was less during the quarter. The roll yield for the index was -1.7%, or -7% annualized, which was a significant improvement over the -18% roll yield in 2006.



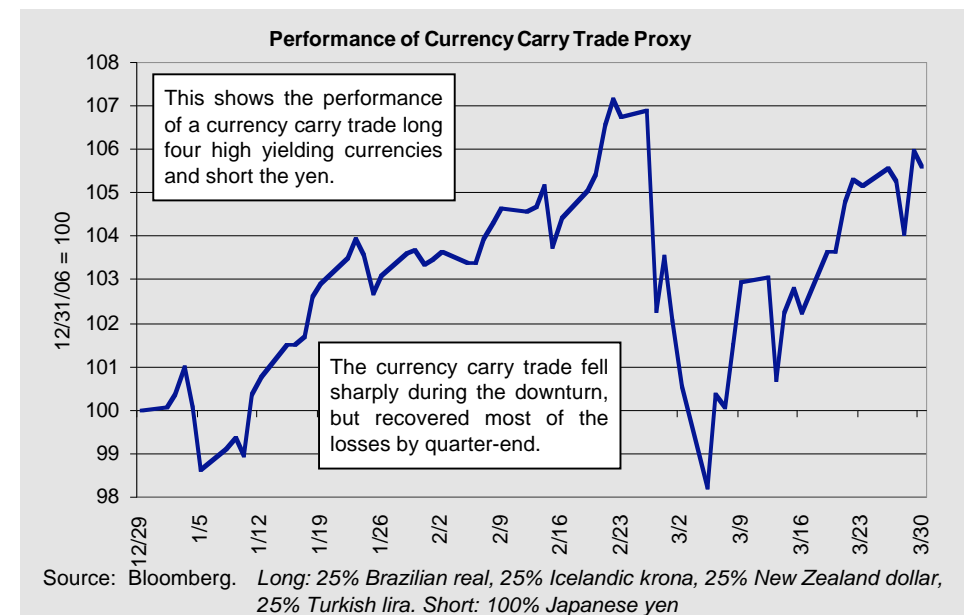
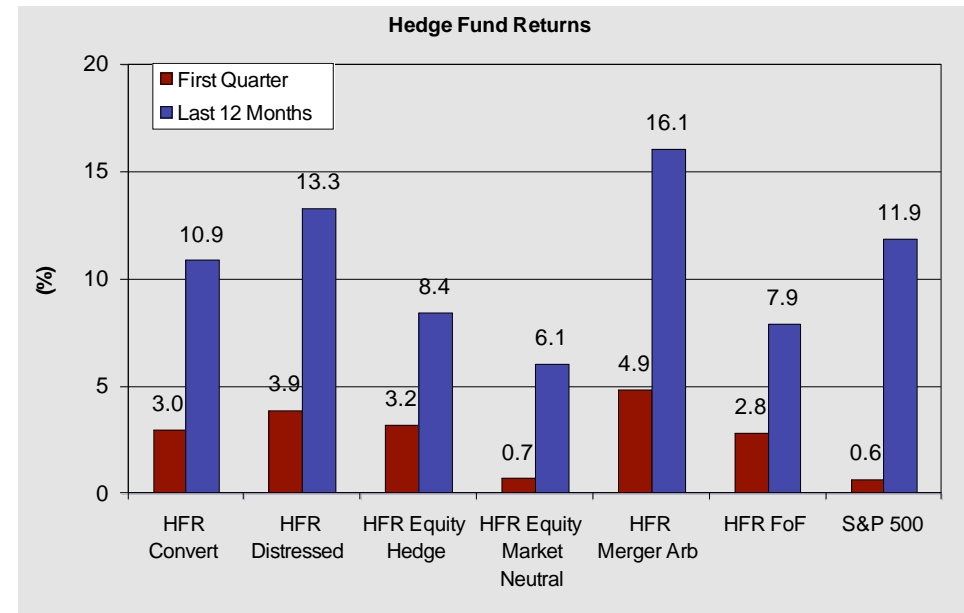
## Buyout Funds Put \$100B to Work in the First Quarter

- The pace of buyout fundraising continues to accelerate. Buyout funds have already attracted \$44 billion in commitments this year. Buyout funds are aggressively putting their war chests to work. Taking advantage of ultra cheap debt, buyout funds invested over \$100 billion in the first quarter. As one could surmise from the headlines, deals are getting much larger. *Buyouts* magazine reported that the average deal size during the quarter was \$1.3 billion, 75% higher than in the first quarter of 2006.
- Buyout funds are raising risky debt with light covenants to fund the deals. Half of the high yield bonds issued for acquisition financing in 2006 were rated CCC. Buyout funds are increasingly tapping the leveraged loan market to fund deals. It used to be that banks dominated the leveraged loan space. However, this debt is now mostly being purchased by investors, such as hedge funds, and packaged into CLOs (collateralized loan obligations).
- It's hard to get excited about mega buyout funds. Abundant, cheap financing are a positive because lenders are bearing much of the deal risk without much reward. Nevertheless, with the high multiples being paid for companies, we're concerned that realized returns won't be sufficient to



## Hedge Funds Emboldened

- Hedge funds turned in a strong first quarter with the average fund of hedge funds, as represented by the HFRI Fund of Funds Index, posting a return of 2.8%. A commentary on performance for the quarter would look very much like that for 2006. Event situations, particularly M&A activity, were the key drivers of performance. Additionally, migration into international and emerging equity markets helped boost returns. Convertible arbitrage also continued its rebound with another strong quarter.
- Overall, hedge funds appear to have weathered the volatility spike that occurred late February / early March. Such events are usually negative for the typical hedge fund. The timing of the volatility spike worked to mask its impact on hedge funds in two ways.
  - The losses incurred during the final two days of February were masked by the gains from earlier in the month
  - It appears to have been a very short lived correction as most markets have recovered most, if not more than, all of the losses. In the short-run, this event seems to demonstrate the vast liquidity that underlies the markets.
- Risk management programs appear to have worked well, perhaps giving investment managers more confidence to increase leverage further. A possible result of the short-lived correction is that hedge funds and the market alike have been emboldened.
- One early sign of such a phenomenon in the markets can be seen by looking at the carry trade, which appears to have recovered. In addition, all things with yield have rebounded. This can be observed in high yield currencies (such as the Brazilian Real) and high yield bonds (as evidenced by spreads on CCC rated debt). Increased risk appetite can also be seen in hedge funds willingness to fund buyout transactions through the leveraged loan market at slim spreads. This degree of risk taking requires watching.



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