Bellwether CONSULTING

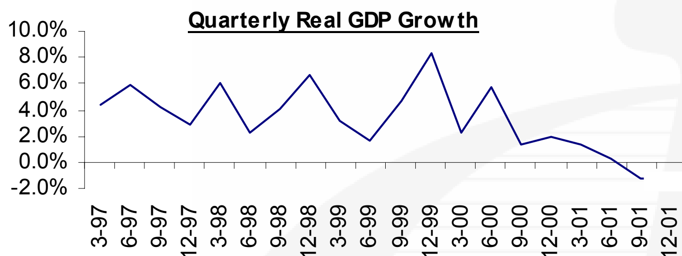
Your Quarterly Update on the Financial Markets
December 31, 2001

4th Quarter

MARKET Recap

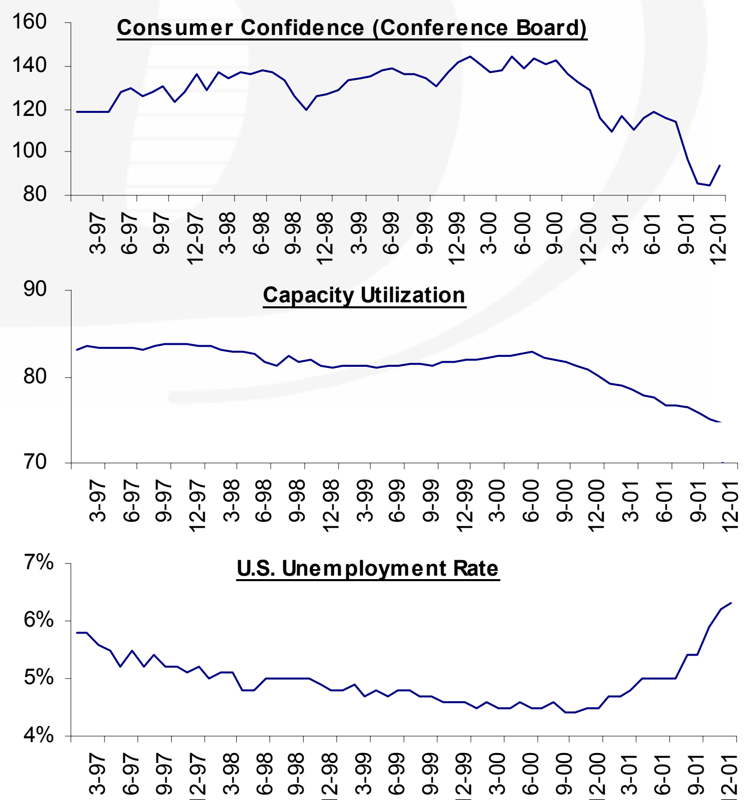
The Economy: *Signs of Recovery, Expectations of Slow Growth*

The recession of 2001 was statistically confirmed, as expected, with third quarter real GDP declining 1.3% after posting very modest 0.3% second quarter growth. All sectors of the economy suffered this quarter; businesses and consumers retrenched in preparation for war and economic uncertainty. Congress, President Bush, and the Federal Reserve responded with fiscal and monetary stimulus programs to cushion the blow and sow seeds of recovery. While efforts toward a broad-based fiscal stimulus package stalled in partisan debate, the government's initial response to the 9/11 attacks was in our judgment very effective, and we have confidence that lawmakers will work out a combination of tax cuts, unemployment relief, and deficit spending in the event conditions worsen. The Federal Reserve, largely insulated from partisan politics, acted decisively throughout the quarter, cutting the fed funds rate three times.



Sound crisis management by the government and generally good news on the war front has led many to believe the worst is over. Consensus expectations are for recovery and return to modest growth in 2002, and indeed several indicators provide hope. Consumer confidence (as measured by the Conference Board) fell to a five-year low in November, but rebounded sharply in December. Retail sales showed a similar pattern, falling by a record 3.7% in November but growing ahead of forecast levels through the holiday period.

Manufacturing was particularly hard-hit throughout the year. Orders for durable goods fell by 4.8% in November, but on closer inspection this was due primarily to the aircraft industry and related component manufacturers. Excluding the transportation sector, durable goods orders rose by 1.1% in November, following a 2.9% rise in October. Increased manufacturing activity is key to sustainable recovery; capacity utilization fell to a 10-year low in November, and manufacturers, financial services, and other firms continued to lay off workers (albeit at a slower pace). Unemployment, a lagging economic indicator, rose to 5.8% in December. This level represents a five-year high but remains relatively low by historical standards. We expect unemployment to continue rising well into 2002 as employers avoid increasing staff through overtime and productivity initiatives. Since the unemployment rate is highly newsworthy, expect to hear about it frequently in news reports and political



speeches, particularly as Congressional elections draw near.

While there are many risks out there, we remain optimistic for recovery in 2002 earlier than expected (probably in the Spring, with Summer confirmation). Most importantly, the basic factors of economic activity are pointed toward growth. We are awash in liquidity, with interest rates at historical lows (see last quarter's issue for a discussion of liquidity, available at www.bellwetherconsulting.net). Commodity prices remain low, especially oil, and manufacturing capacity and labor are underutilized. If we're right, it will soon be time to adjust policies. Look for the Fed, always watchful for inflation, to discontinue their program of rate reductions and begin increasing rates if signs of recovery continue. Also, please note that a return to economic growth does not portend a runaway bull market. Stock valuations are still quite high by historical standards, and it is unclear what long-term effects 9/11 will have on investor expectations and risk premiums.

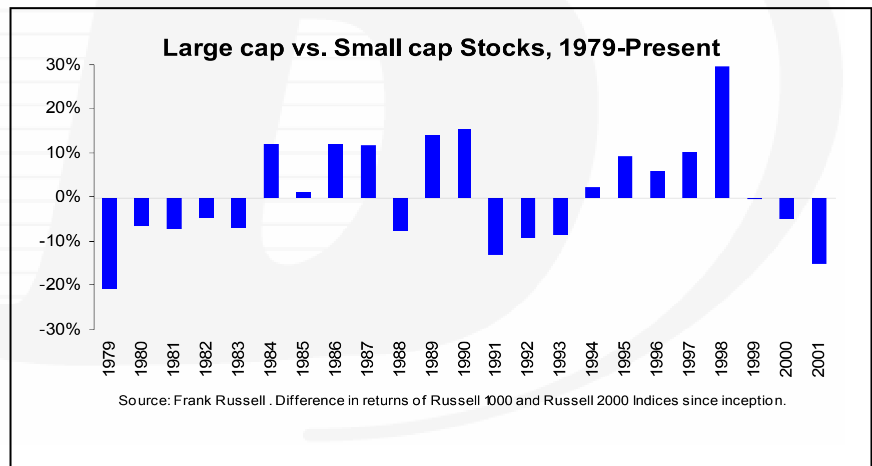
2002 Federal Reserve FOMC Meeting Schedule	
January 30	August 13
March 19	September 24
May 7	November 6
June 26	December 10

The U.S. Stock Market

The 4th quarter brought relief to U.S. equity investors, weary from a year of heavy losses. The market rally began after stocks hit lows following the September 11th attacks, and led to the best quarter the S&P experienced in 2 years. From September 21st, the S&P 500 increased 19%, the NASDAQ gained 37% and the Dow increased 22%. Gains were widespread - 80% of the stocks in the S&P 500 ended the quarter in positive territory. The strongest showing came from the technology sector, returning over 34%, followed by consumer discretionary (19%) and industrials (16%). The utilities and telecom services sectors were a drag on results, giving back 4% and 10.5%, respectively. The 4th quarter also showed signs of rebounding investor confidence, as equity mutual funds received $9.3 billion in net contributions in November. This reverses a two-month trend of net *outflows* (AMG Data Services).

Stock Indices - 4Q 2001 Total Return			
Large cap Stocks		**Midcap Stocks**	
S&P 500	10.69%	Russell Midcap	17.20%
		Growth	27.06%
Russell 1000	11.11%	Value	12.03%
Growth	15.14%	**Small cap Stocks**	
Value	7.37%	Russell 2000	21.09%
		Growth	26.16%
		Value	16.72%

Even with the recent rally, major market indexes ended 2001 down for the year. The S&P 500, NASDAQ and Dow indexes all posted losses for the 2nd consecutive year. Unlike last year, when technology issues dominated losses, most industries suffered in 2001. Only two economic sectors, consumer discretionary and materials, ended the year above water. Office Depot, Best Buy, AutoZone, and JC Penny were top performers, but in the end these sectors enjoyed only modest returns (under 2%). Despite the year-end bounce and stellar performance from names like Microsoft (+53%), Xerox (125%) and Nvidia Corp (+308%), the information technology sector closed 2001 with a 26% loss. Utilities were hit harder still, down 32%. Once again, small cap stocks fared better. Strong performance from value small caps overcame growth stocks losses and the Russell 2000 finished the year up 2.5%. Although a close call in 1999, 2001 marks the third year in a row small caps outperformed large caps.



Source: Frank Russell. Difference in returns of Russell 1000 and Russell 2000 Indices since inception.

S&P 500 Year-End P/E Ratios	
Dec-01	48.30
Dec-00	25.39
Dec-99	32.53
Dec-98	32.15
Dec-97	24.53

There are differing views about what prompted the year-end rally and much speculation on how long it will last. Optimistic investors look for 2002 to be a turn-around year. Others feel the recent rebound was a response to overselling in September, but are less confident about the future. These pessimists feel many stocks are still trading at rich prices relative to earnings, noting a 12/31 price-earnings ratio for the S&P 500 of 48. While economic recovery should revive corporate profits, growth in earnings would have to be very substantial to justify higher stock prices. At this point in time, we are in the latter camp. We anticipate economic recovery in the spring and but expect more modest equity returns, in line with historical averages.

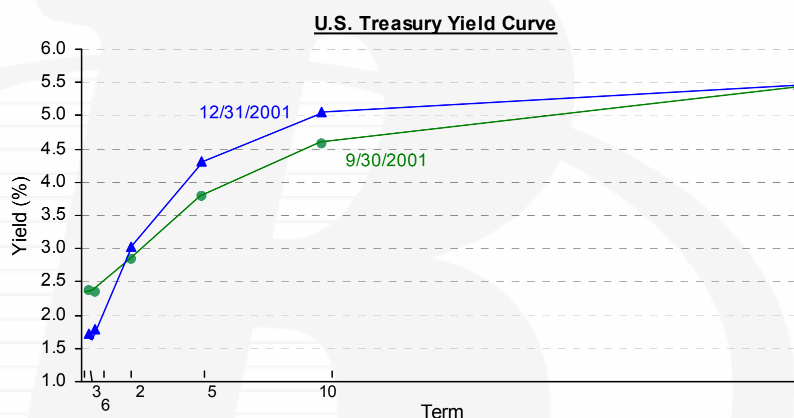
The U.S. Bond Market

The fourth quarter closed out a year of impressive gains for the credit markets, in which domestic bonds outperformed stocks for the second straight year. Performance came at a price, however, as the markets were characterized by significant volatility from eleven rate cuts by the Fed, the September 11 attacks, and Enron's record-breaking bankruptcy.

Bond Indices – Total Return	4Q	YTD 2001
Lehman Aggregate	0.05%	8.44%
Lehman Interm. Gov't	-0.14%	8.42%
Lehman Long Gov't	-1.86%	4.34%
Lehman Interm. Credit	0.35%	9.76%
Lehman Long Credit	2.59%	12.16%
Lehman High Yield	5.78%	5.28%
Lehman Global ex U.S.	-4.32%	-3.75%

After rallying for most of the year as the economy shrank and the threat of inflation eased, bond prices began to plunge in early November when signs of strength emerged in the U.S. economy. Investors began to worry that the Fed would stop cutting rates, and might even raise them this year. The late year sell-off cost investors a good chunk of their earlier gains. At the year's close, the yield on the 10-year Treasury note was at 5.02%, little changed from 5.11% at the beginning of the year, though it reached as low as 4.18% in early November. The shorter end of the yield curve steepened as the Fed cuts rates for the 11th time in 2001.

The spread on the 30-year and the two-year Treasury widened to 2.766 percentage points at October's close, when the Treasury Department made a surprise announcement that it would suspend sales on the 30-year bond. While the elimination of the 30-year bond had been discussed for some time, the surprise suspension and lack of a last auction in February 2002 distressed the investment community.



High grade corporates were the best performing sector during the year by a substantial margin, despite September11 and the Enron default. Treasuries gave back a lot of their performance in the November sell-off, while High Yield suffered from weaker equities and default concerns for most of the year.

Mortgage-backed securities started off 2001 well, then succumbed to a sizable supply and prepayment wave in the face of falling interest rates, as homeowners rushed to refinance their mortgages. Rates increasing at the end of 2001 were not enough to cut off the supply, so mortgages remain modestly cheap going into 2002.

The expectation of a quick recovery in the economy set off a rush into high yield at the end of 2001. Technology, Aerospace and Broadcasting were the strongest performing industries for the quarter, while the Food and Drug Retail, Services, and Super Retail led for the year overall. Worst performing for the year were Telecom, Air Transportation, and Textile/Apparel. New issuance rebounded in 2001 from the five-year low hit in 2000.

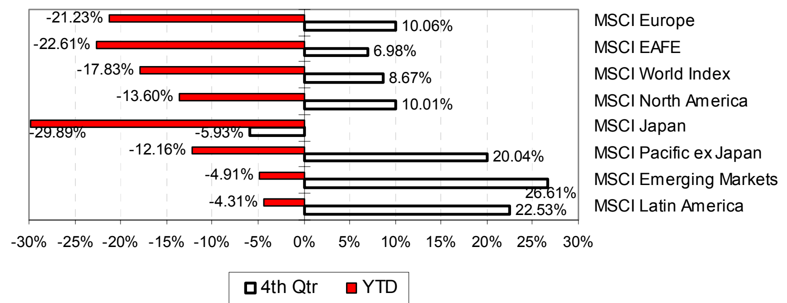
Overseas

International markets suffered through another tough year in 2001. The fourth quarter showed no respite for the sector as most of the world's major equity markets finished the year in the red. Many international sectors had a strong quarter, but the late rally failed to salvage the year.

In Europe, the technology sector led the region lower. In addition, industrials, services, telecom and media stocks all experienced double digit losses for the year. Due to its close ties to the U.S. economy, Europe experienced a similar economic slowdown, with rising unemployment and deteriorating consumer confidence. The European Central Bank lowered rates 100 basis points in the wake of September 11, and a total of 150 basis points for the year in an attempt to bolster the region. With inflation below the ECB's target rate of 2%, there may be room for additional rate cuts to help jump start the European economy. The introduction of the Euro combined with the ECB's ability to continue to lower interest rates should position Europe for a rebound in mid-2002.

In Japan, the economy continued to be haunted by its banking crisis, finishing down almost 6% for the quarter and nearly 30% for the year. Amid an unemployment rate that has grown to 5.5% and a large increase in bankruptcies, Japan's newly elected Prime Minister Koizumi failed to achieve his goals of sweeping economic reform. The economy has slumped on many fronts with

mounting job losses negatively effecting consumption. Retail sales fell nearly 5% for the year and housing starts and auto sales have begun to deteriorate as well. Many of Japan's largest companies have announced additional job cuts and facility closings which may only serve to worsen an already precipitous situation.



Elsewhere in Asia, the outlook is not as gloomy. South Korea, Thailand and Taiwan all posted positive performance for the year as financial reforms, increased trade with China and additional investment from foreign investors gaining confidence in the region pushed these markets higher.

Latin American markets suffered greatly with the collapse of Argentina's economy. The Merval, Argentina's stock market index, fell 29% as interest rates surged and the country defaulted on $132 billion of its international debt. High unemployment and limitations on access to deposits caused rioting in the country and forced the resignation of President Fernando de la Rua. The ripple effects were felt throughout Latin America as stock markets in Brazil, Chile and Venezuela dropped as investors lost confidence in the region. Brazil, which early in 2001 seemed poised for a strong year, continued to be plagued by an energy crisis and finished down almost 24% for the year. Mexico was able to side-step the issues that plagued the rest of Latin America as investors gained confidence in the country's ability to integrate with the U.S. economy. Consumer confidence was high and consumption moved the economy forward, strengthening the peso versus the dollar. With the continued close linking of Mexico to the U.S., look for the country to rebound along with the U.S. later in 2002.

Focus On: *Taking Stock of Retirement Plans in the Aftermath of Enron*

The collapse of energy giant Enron has brought to the forefront the debate over the amount of company stock that should be allowed in retirement plans. Long considered a risky investment practice, loading up on a single company's stock has proved devastating to employees in some 401(k) plans in 2001. As the value of company's shares plummeted, employees were left with drastically depleted retirement accounts.

At issue with Enron is also the inability of employees to sell their shares of company stock for a period of time, during which the price dramatically fell. The company asserts that the lockdown was the result of a long-planned change in plan administrators rather than the company's problems, and was limited to a two week period. Enron workers claim the freeze actually began a week and a half prior to that, on the day after the company disclosed at $1.2 billion reduction in shareholders' equity tied to complex partnerships it had set up. That disclosure sent its stock tumbling.

Beyond the dissent over the lockdown period, questions have arisen about breach of fiduciary duty over the retirement plan at Enron. If the officers were aware of financial problems with the company, then the rules of prudent investing would suggest the stock be removed as an investment in the retirement plan.

Typically in a 401(k) or similar retirement plan, the company matches employee contributions to a certain level. In many cases, employees can designate where the match is invested. At Enron, as with many other companies, workers who wanted to receive the company match in their retirement plan were required to take it in company stock. Enron prohibited workers from selling the stock until age 50.

The Enron situation has prompted the introduction of new legislation in both the Senate and the House in December which would place limits on the amount of company stock permitted in participant-directed retirement plans. Senators Barbara Boxer (Democrat, California) and John Corzine (Democrat, NJ) have called for an amendment to ERISA which would limit the amount of company stock an employee could have in their retirement account to 20%. In the House, Representatives Peter Deutsch (Democrat, Florida) and Gene Green (Democrat, Texas) introduced a bill that would limit employees' contributions into company stock in 401(k) plans to 10%.

Imposing legislative limits on the amount of company stock permitted in retirement plans is not a new concept. In general, retirement plans may not hold more than 10% of their assets in employer securities. An exception exists for 401(k) and similar plans. Therefore, in traditional pension plans, where the plan sponsor carries the investment burden, no more than 10% of assets can be invested in company stock. However, in 401(k) plans, there is no limitation, and the investing responsibility lies with the plan participant. It is the core concept behind participant-directed plans. Workers have the freedom to invest their money as they wish.

Many workers took advantage of that freedom during the 1990's, and 'won the lottery' by investing in a hot company stock in their retirement accounts while the stock posted record gains. These investment gains during a

stock's heyday made many workers rich. Not until the bear markets of 2000 and beyond have many workers faced the harsh realities of the risks associated with overexposure to a single stock.

In many 401(k) plans, employees are free to choose from a menu of investments, including diversified mutual funds as well as employer stock. Some Enron workers, instead of using their own contributions to diversify their retirement accounts among a reported 18 other investments, chose to invest primarily in the company stock. They bet all their savings on one horse, and while some won, many also lost.

While substantial shareholder losses were felt recently at a number of other well-known companies, only those where there are concerns over wrongdoing prompted such renewed interest in legislative limits. With the numerous unanswered questions surrounding the Enron failure, the situation should not be used to cloud the issue over whether to impose legislative limits on company stock in a participant-directed plan.

Key to the debate is that these retirement plans are *voluntary*. Workers choose whether to participate or not. We believe the imposition of limits on company stock or any other investment threatens the very essence of investor choice in participant-directed plans. Since workers choose to participate in the plan, they should also control how to invest their money, without any government intervention. Sound fiduciary practice and good employee education and communication programs from employers will ensure participants retain control over their money and have an awareness of investment risks.

Over-regulation would further complicate these heavily legislated and difficult to administer retirement plans. Companies offer retirement plans as a benefit to employees, albeit gaining a tax advantage for doing so. Imposing additional rules may discourage employers from offering such plans as part of their benefit programs.

Both bills contain diversification provisions which would allow workers to move out of company stock. In retirement plans that issue the company match in employer stock, participants are prohibited from moving out of the company stock for a substantial period of time. The Boxer-Corzine Bill would require that fully vested employees be allowed to diversify out of the stock the company contributes after 90 days. The Deutsch-Green bill would give employees the right to diversify out of company stock after three years.

We believe that diversification provisions for company stock are a good idea. In fact, we would encourage that no time limit be imposed on employees to exchange the company match issued in stock for another investment option in the plan. Employers would retain the right to issue the company match in stock, a benefit to them. Participants could then invest the match in any way they choose.

Beyond diversification provisions, there should be a greater focus on educating employees on the risks involved with investing in company stock. While many plan sponsors already do a good job with this aspect of employee education, mandating specific disclosures for company stock investments could potentially avert such disasters to workers' retirement savings that were experienced at Enron and a host of other companies whose stock price dropped dramatically this year.

Thoughts on Reform

DO:	DO NOT:
• Require that employees have the opportunity to diversify their company match out of company stock at any time	• Limit the amount of company stock employees can hold in their retirement account
• Require greater focus on employee education in company stock investments, mandating specific disclosures	• Limit the amount of employee contributions into company stock
• Explore new ways to protect employees during the 'lockdown' period	

The Enron situation also calls for service providers and plan sponsors to consider new and innovative ways to protect employees' savings during what is referred to as the 'lockdown' or 'blackout' period. This period of time when employees cannot conduct investment activity in their retirement accounts due to a change in plan administrators proved to be ill-timed for Enron employees, coming on the tail of devastating disclosures by the company.

Clearly, the Enron collapse and ensuing fallout is a startling reminder for retirement plan sponsors to the dangers of overexposure to one security and the need for good employee education and sound fiduciary management. However, Enron should not become the basis for a new set of rules that would restrict investor control over their own money. Retirement plans are voluntary; employees should then be free to choose their financial future.

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