Bellwether CONSULTING

Your Quarterly Update on the Financial Markets

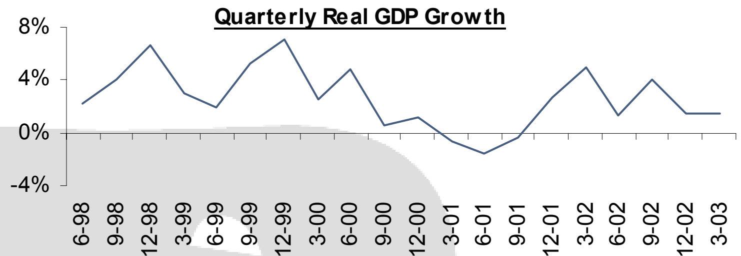
June 30, 2003

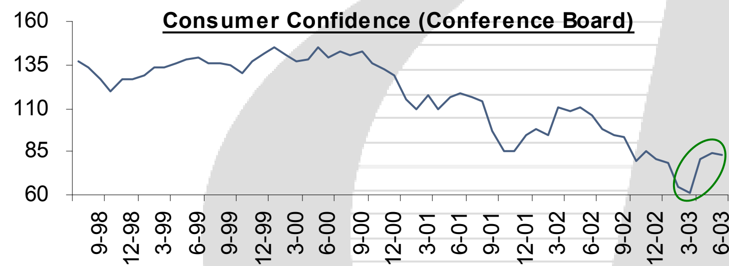
2nd Quarter

MARKET Recap

The Economy: *"Sentimental" Recovery Slow to Show Substance.*

U.S. first quarter growth came in flat at 1.4%, below consensus forecasts but in hindsight not terribly surprising given uncertainty over the war in Iraq. May and June brought a certain sense of relief, best expressed by rising consumer confidence and a surge in the U.S. stock markets. Emotionally, it's hard to deny a tremendous feeling of relief that war-related disaster scenarios have not played out and, while uncertainty remains, things could have gone much worse.

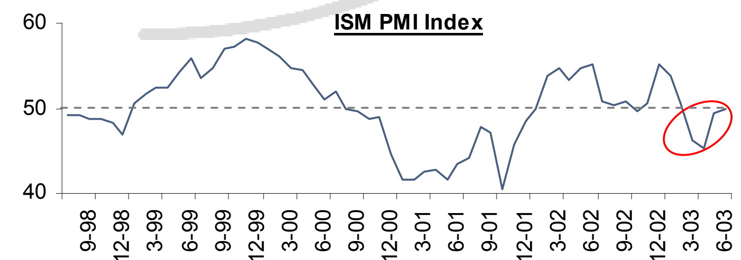


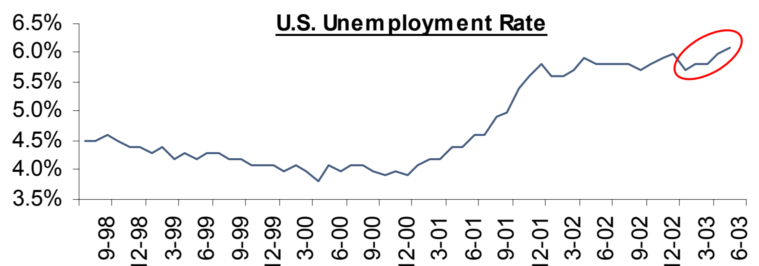


While the "man on the street" may express relief through confidence surveys and (for now) actual spending, business managers remain hesitant to increase production. The Institute of Supply Management's Purchasing Manager Index (PMI) was unexpectedly low at 49.8 for June. This widely followed leading indicator for the manufacturing segment tends to fluctuate in a historical range of 40 to 60, with values below 50 viewed as a signal of contraction. The June figure represents the fourth straight month below the benchmark level, suggesting that roots of sluggishness extend deeper than mere war jitters. Of course a healthy manufacturing segment contributes to employment which, in turn, supports consumer confidence and spending. Unemployment rose to a 5-year high in May, although a 6.1% rate remains quite modest by world and historical standards. While not a leading indicator, we expect increased attention on the issue of unemployment as presidential candidates prepare for election season.

The Fed continues to do its part to stimulate growth, voting on June 25th to reduce short-term rates to 1%, a level not seen since 1958. Little remains to be said about the much-anticipated cut. Perhaps more interesting is the resurgence of bullish hype from Wall Street leading up to the rate cut announcement and concurrent with the stock market surge. In our view one effect of the hype has been an overstatement of the risk of deflation, a general decline in price levels. The Fed has placed "corrosive deflation" in the right context by acknowledging it as a minor risk. Of more general concern is corporate America's ability to generate honest earnings that meet investor expectations – and support reinvestment that generates jobs and promotes business activity.

Until business executives demonstrate their own conviction in the recovery through spending activity, equity investors should remain cautious. Real recovery is likely to proceed at a slower pace than suggested by sentiment.



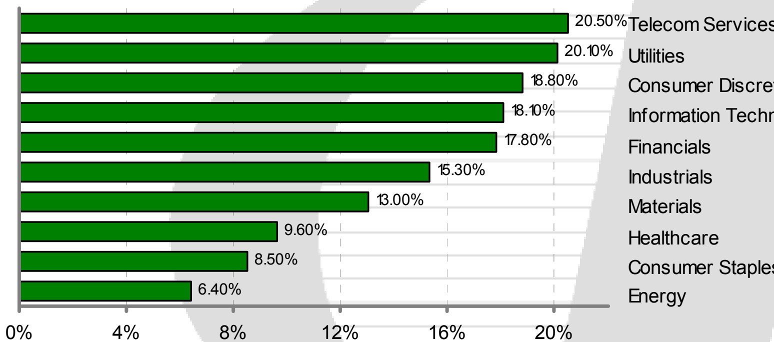


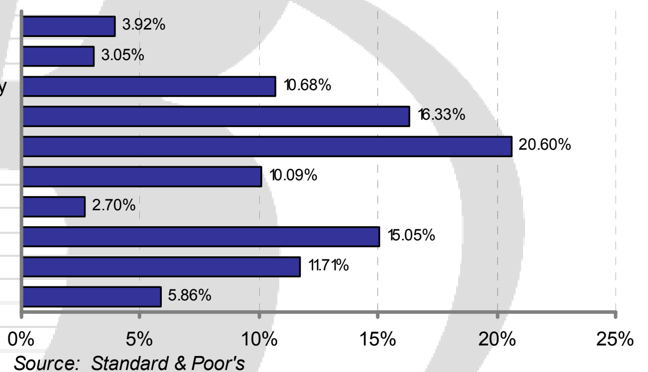
The U.S. Stock Market

Stock Indices - 2Q 2003 Total Return			
Large cap Stocks		**Midcap Stocks**	
S&P 500	14.89%	S&P Midcap 400	17.28%
Russell 1000	15.74%	Russell Midcap	18.26%
Growth	14.31%	Growth	17.86%
Value	17.26%	Value	17.90%
Broad Markets		**Small cap Stocks**	
NASDAQ Comp.	21.11%	S&P Smallcap 600	19.59%
Wilshire 5000	16.03%	Russell 2000	23.42%
		Growth	24.15%
		Value	22.72%

The wait for a turnaround in the equity markets seemed to pay off in the second quarter, with major stock market indices all showing gains. The quarter began triumphantly as the allied victory in Iraq dampened volatility and had investors buying into positive economic news. While volatility does continue to be a driver of investor activity, trading volume increased significantly as investors poured back into the markets. There was also resurgence in market breadth; 470 S&P 500 stocks were up for the period. The quarter ended with a Fed rate cut and even more investment dollars flooding back into the market as investors responded positively to the Fed attempt to continue the economic jump start. The S&P 500 and Dow closed the quarter with strong gains, while the NASDAQ composite rose by 21%.

All of the S&P 500 industry sectors finished positive for the quarter. Telecommunications was the top performer, up over 20%, as the sector has gotten past the worst of its accounting issues and is on more solid fundamental ground. The three top performers in the S&P 500 for the quarter were Avaya, Allegheny Technologies, and McDermott, up 196%, 117% and 107%, respectively. With only 30 stocks losing ground there were not many detractors; poorer performers included Tenet Healthcare, down over 30%, Ball Corp, down 20%, and HCA Inc, down 19%.





Corporate earnings growth numbers for the second quarter seem to be holding up well. According to First Call, the ratio of negative to positive earnings pre-announcements is running at about 2.0, down from 2.8 during the first quarter, with S&P earnings growth expected to come in the 8% - 10% range for the quarter. The financial sector seems to be the bright spot of the second quarter. First Call estimates expected growth for the sector to come in at 14%, well above the 12% forecast at the beginning of the quarter.

With positive economic news and continued strong performance in the equity markets, consumer confidence has begun to rise again and retail investors have started to re-enter the markets. Economic and job growth continue to remain slow and have the potential to short-circuit any sustainable recovery if improvement does not remain consistent; however at this time, equity markets seem prone to surge on any good news.

The U.S. Bond Market

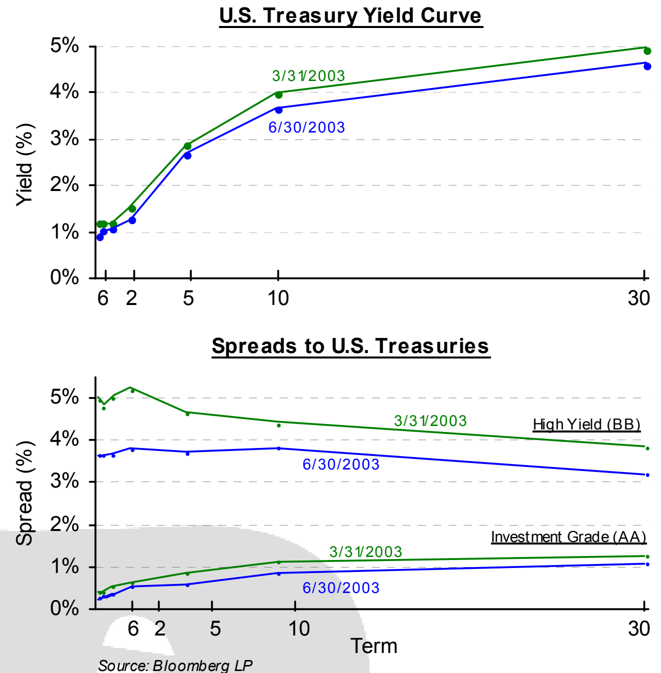
Bond Indices - 2Q 2003 Total Return	
Lehman Aggregate	2.50%
Lehman Interm. Gov't	1.69%
Lehman Long Gov't	5.10%
Lehman Interm. Credit	4.02%
Lehman Long Credit	7.49%
Lehman High Yield	10.11%

For once, bond and stock investors shared good performance. Predictably rates fell as expectations of Fed easing formed and were eventually confirmed. Notably yields on short- and long-term issues fell by roughly equal amounts (a parallel shift in the yield curve). Recent rate cuts have tended to produce a steeper curve, with short-term rates falling more than long-term. Comments by Chairman Greenspan, made in response to concerns that low rates have left the Fed without dry powder, helped force down long-term rates. The comments accurately reflected the Fed's array of tools to manage the money supply, including its ability to purchase longer-term bonds at the market. We believe the goal was both to allay fears about the Fed's potency and to force down rates – how much

weight to give each factor is anyone's guess.

Credit spreads narrowed for a second quarter running, benefiting corporate bonds and especially the high yield segment. Investor appetite for corporate debt was illustrated by General Motors' successful sale of the largest debt issuance for a U.S. company in history. Ironically, much of the proceeds from the $16.9 billion sale will be used to fund the company's pension plans, where liabilities have ballooned due to falling interest rates.

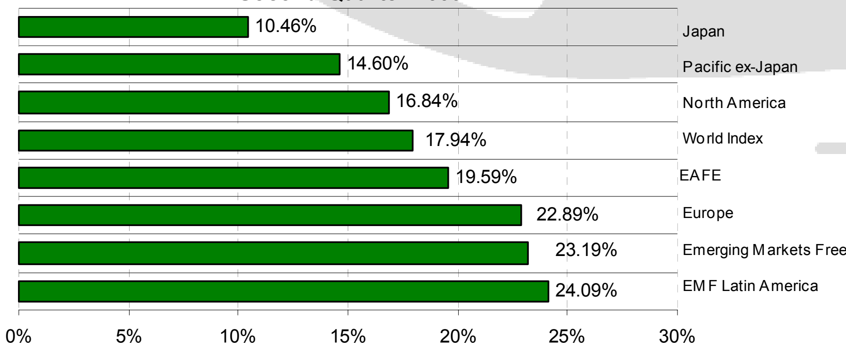
While investors in longer-term corporate debt continued to enjoy unprecedented returns, pension sponsors saw much of the quarter's stock market gains evaporate due to rising liabilities. Funding costs are likely to attenuate any recovery by placing continued pressure on economic earnings, even if legislative changes to pension accounting rules provide for relaxed funding requirements. We believe any such relief is not likely to be large due to concerns over PBGC solvency.



Overseas Markets

Global markets experienced a strong quarter for a change. The Eurozone saw a 0.50% (50 basis point) cut by the European Central Bank (ECB) to the key interest rate with the goal of continued economic stimulation. The ECB estimate is for inflation to remain steady at about 2% for the remainder of the year and possibly drop heading into 2004. This estimate seemed to bear out as inflation for May in the zone dropped down to 1.9%. Germany was especially in need of some positive, stimulative policy with unemployment hovering at nearly 11% and a deficit likely to exceed EU limits for a second straight year. Yet signs in Germany have been encouraging, as the IFO index, the index that tracks business climate, showed strong growth through June, rising to 88.8 from 87.6. The MSCI Germany Index was the top performer in Europe, gaining 35% for the quarter. In France, manufacturer confidence is on the rise with the expectation that the confidence index will show gains for the first time this year. Low interest rates and a recent weakening of the Euro vs. the dollar are significant factors driving the increase. The MSCI France Index was up 23%.

The Japanese market continues to struggle and lagged many of its Asian peers for the quarter. Falling wages and stock prices have led to a decline in savings among Japanese individuals. With savings assets falling for a third consecutive period the Bank of Japan left its monetary policy unchanged despite easing in the U.S. Rising stock prices and recent economic growth signs have taken some pressure off of the BOJ to make additional moves. The MSCI Japan index finished the quarter up 11%.



Other Asian markets, both developed and emerging, fared well for the quarter even given the SARS virus scare. Thailand's economy grew 6.7% in the first quarter compared with 4.0% a year ago. Positive signs of consumer spending and stronger exports helped performance and a 6% growth rate is expected over the next few years according to Prime Minister Thaksin Shinawatra. In Korea, GDP growth is now expected to be below the forecast rate of 4%. A potential strike by autoworkers at Hyundai also threatens. Even with negative news, the MSCI Korea Index was up nearly 31% for the quarter. Hong Kong and China were hard hit by the SARS virus. Both countries suffered from a slowdown in travel and tourism. As of this writing, the SARS epidemic seems to have mostly run its course, and the national stock markets finished up 7% and 17%, respectively.

Latin American markets posted the strongest quarterly performance seen in recent memory, with Argentina surpassing all other countries. Argentina underwent another leadership change as Nestor Kirchner replaced Eduardo Duhalde in May. Kirchner has been more effective in dealing with the IMF than his predecessor, and has been rewarded with a disburse-

ment of over $300 million in funds which had previously been delayed. Confidence in the market continues to grow. The MSCI Argentina index rose 25% for the quarter, its second strong showing in as many quarters. In Brazil, the quarter saw the real rise to its highest value in over 9 months with growing confidence in Lula De Silva's handling of the country. The MSCI Brazil Index was up 22% for the quarter.

Focus On: *Stable Value Products*

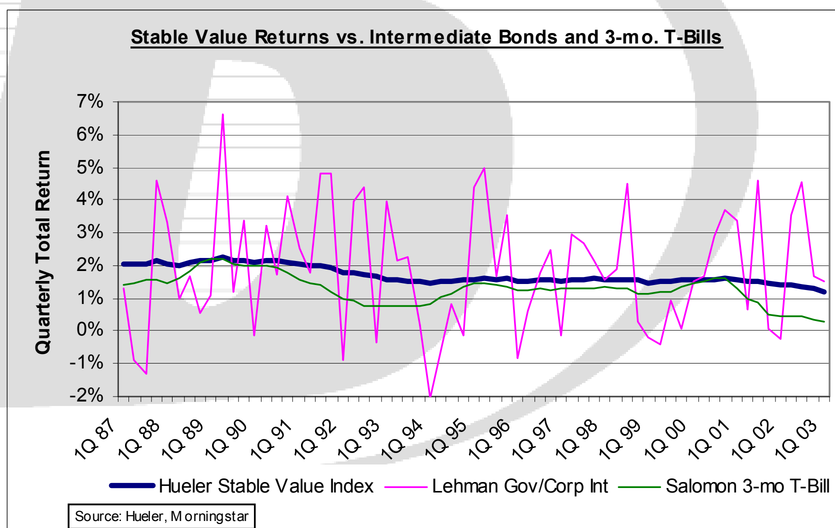
Market volatility over the last three years has left many investors smarting and asking where they can allocate assets without the threat of principal loss experienced in the recent market cycle. One safe haven is an asset class overlooked by many investors during the stock market boom of the mid 90's: *Stable Value*. It's an investment option that goes by many names: Fixed Income Account, Fixed Rate Account, and Stable Return Fund. While usually straightforward to participants, these products can be complex and difficult for plan sponsors to evaluate.

What is a Stable Value Investment?

Stable value investments are fixed-income type investments that can be compared to bank CD's in many respects; they are not mutual funds. Typically they are offered by defined contribution plans as a low volatility, conservative investment option. Historically, they have also been part of defined benefit portfolios used as a vehicle to help fund retirement benefits. Stable value investments provide consistent, predictable growth and higher rates of return without taking on significant market risk. Another feature gives investors access to their investment at book value, rather than market value. Often these investments are referred to as, or backed by, Guaranteed Investment Contracts (GICs). They are typically issued by insurance companies, and backed by the financial strength of the issuing financial institution.

How Do They Invest and Perform?

In order to credit investors with a guaranteed interest rate, issuers go to the market and purchase assets in anticipation of receiving some level of deposits and withdrawals. The assets are typically high-quality, fixed income investments such as U.S. Government Bonds. Commonly, funds have liabilities with duration in the 2 to 3 year range, supported by assets with duration of 3 to 5 years. (Duration is the average amount of time to return principal and coupon payments and is used to measure interest rate sensitivity). This is the secret behind stable value interest rates; by moving out along the yield curve issuers are able to offer yields in excess of money market funds while only taking on minimal interest rate risk, allowing them to credibly guarantee principal and interest.



Since the underlying investments have durations between three and five years, we would expect the performance of stable value products to be above money market funds in most interest rate environments (since money funds invest in assets with maturities of one year or less), and comparable to similar duration fixed income investments. The chart illustrates performance of stable value versus T-Bills (as a proxy for money market funds) and intermediate bonds. As you can see, long-term performance tends to be between bills and bonds, but with much lower volatility than bonds. One important thing to remember is that crediting rates tend to lag market interest rate movements in both directions. In an environment of increasing interest rates, stable value rates will trend in the same direction, up, but will do so more slowly than money market yields. Likewise, they will fall more slowly when interest rates are trending downward.

Investment Risks?

Even though investing in stable value provides protection and a guarantee of principal and interest, there are still risks to investing for both issuers and purchasers. Since contribution and withdrawal levels cannot be estimated with certainty and interest rates are subject to fluctuation, issuers of stable value products place liquidity restrictions on contract-holders and participants; the objective is to prevent scenarios that would force them to buy or sell assets in interest rate environments that could potentially harm investment returns.

Some common liquidity restrictions include "equity wash" provisions, market value adjustments and surrender charges. Each of these restrictions protects the contract issuer from the risk of harmful investment experience due to extreme cashflow fluctuations. Equity wash provisions require participants to make transfers into equity funds for a period of time to prevent arbitrage opportunities that may occur when other fixed rate products or similar "competing funds," such as money market funds or short term bond funds, are offered. Market value adjustments are charges that apply to withdrawals above a certain contractually fixed level. Normally a level of withdrawals is allowed at book value, with withdrawals in excess of the level allowed at market value. These charges account for the interest rate risk the issuer is taking in allowing additional withdrawals. Finally, surrender charges exist to protect the issuer from premature termination of the contract. Since the issuer has purchased assets in anticipation of its future liabilities, these charges also protect the issuer from interest rate risk due to sales of assets prior to maturity.

From a purchaser's perspective, the main risk to consider is the quality of the issuer guaranteeing the payments. Stable value investments are usually backed by the issuer's underlying credit worthiness. In the case of an insurance company, this often means that the company's general account, a portfolio of assets used to satisfy the company's liabilities and obligations to policyholders, backs the investment. It's critical for investors to gain a level of comfort with the issuer's general account and their ability to cover their liabilities. Another way to diversify credit risk is to invest in a GIC Pool, rather than in a GIC. A GIC Pool is a portfolio of GICs and high quality fixed income investments. This form of investment provides a purchaser with additional diversification since there are multiple providers of the guarantee rather than a single issuer's general account. The benefit is not free however; in addition to the cost of the underlying GICs, investors pay a management fee to the pool manager.

Stable Value Evaluation Points

- **Rate History**
  How have rates tracked the market?
- **Credit Quality of Issuer**
  What are the issuer's Moody's/S&P ratings for claims paying ability? Are you comfortable with the general account asset allocation?
- **Issuer Diversification**
  For Stable Value Pools is there adequate diversification among the underlying issuers?
- **Transfer Restrictions**
  Are participant and contract level restrictions onerous? Can participants transfer to non-competing funds without restrictions?
- **Termination Restrictions**
  Can the plan sponsor terminate the agreement with minimal cost and administrative burden? Is there a rate-lock period tied to an attractive new crediting rate?

Is It Right For Your Plan?

Stable value investments are good vehicles to provide plan participants an opportunity to diversify risk and build conservative portfolios. From a plan sponsor's perspective, the asset class should be considered as part of a "core" offering since it falls within the guidelines established in ERISA 404(c) for providing diversification from other asset classes, as long as liquidity restrictions are not too onerous. If you have overlooked stable value in the past, this may be a good time to consider it for your plan.

Legislative Update: *To Loan, Or Not to Loan?*

Complying with the Sarbanes-Oxley Act, last year's federal crackdown on lax corporate accounting practices, has left some 401(k) plan sponsors in a bit of a conundrum. Among the reforms on corporate governance and accountability is a provision prohibiting loans to executives. ERISA, on the other hand, requires that all plan participants be treated alike. Under the terms of ERISA, prohibiting loans to one group may preclude loans to all participants, eliminating a beneficial feature to many. Yet permitting plan loans to executives may violate Sarbanes-Oxley. Plan sponsors are faced with a dilemma – how to comply with one law without violating the other?

To provide some guidance on the issue, the DOL issued an advisory in April stating that plan sponsors could deny plan loans to executives without violating ERISA. Yet the Advisory fails to answer the pivotal question of whether a 401(k) plan loan constitutes a corporate loan, subject to the strict Sarbanes-Oxley provisions. While many experts believe that a plan loan is not a loan of corporate assets, and therefore not subject to Sarbanes-Oxley, there is no definitive answer. Until clarification becomes available, 401(k) sponsors are left to make their own judgment call.

For a copy of DOL Field Assistance Bulletin 2003-1, visit www.dol.gov/ebsa/regs/fab_2003-1.html. For more information on the Sarbanes-Oxley Act of 2002, refer to the 3rd Quarter 2002 issue of *Market Recap* at www.bellwetherconsulting.net or thomas.loc.gov.

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