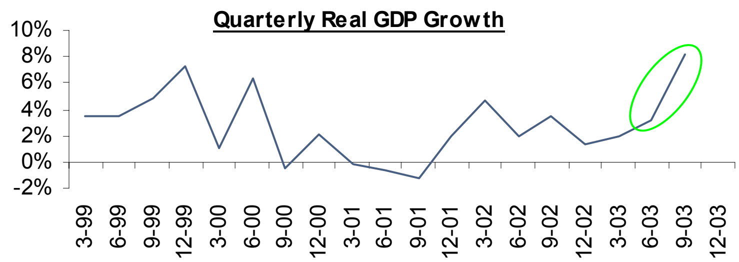
Bellwether CONSULTING

*Your Quarterly Update on the Financial Markets*
*December 31, 2003*

4th Quarter

# MARKET Recap

## The Economy: *Stage Set for Rising Rates.*

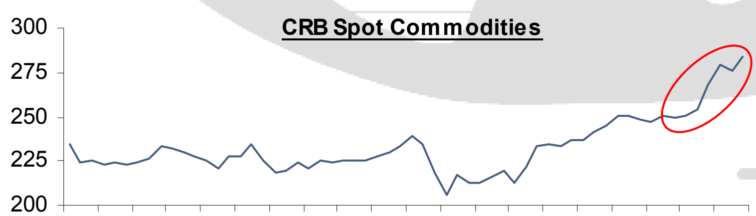


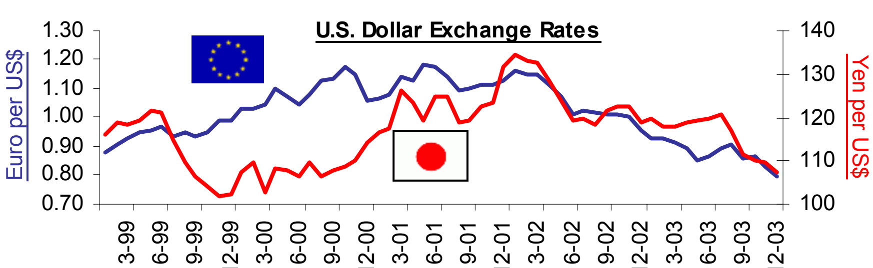

U.S. economic activity accelerated sharply in the third quarter, achieving a torrid 8.2% annualized pace in GDP growth. Personal consumption expenditures fueled the surge, driven by continued low interest rates. Economic growth for 2003 should come in around 4.3% according to economists surveyed by the Philadelphia Fed, a pace consistent with pre-recession activity levels. Consensus estimates for ongoing growth currently range from 4% to 4.5%. Unemployment declined for two consecutive months in October and November to 5.9%, another sign that the recovery has entered a more mature phase. While the recent "orange alert" serves to remind us that circumstances can change very quickly, most economists are now focusing on managing the secondary effects of a growing economy that is quickly advancing beyond mere recovery.

Consumer price inflation indicators have not yet registered any broad increases, although within sectors such as health-care and housing, inflation has become an accepted norm. On December 9th the Federal Open Market Committee left short-term rates at historically low levels but adopted a more balanced outlook, dropping previously emphasized comments on the risk of deflation. Although Fed governors have been quick to downplay inflation concerns, their statement is widely viewed as groundwork for a gradual shift toward tighter monetary policy.

Indeed, early warning signs are already present. Commodity prices rose sharply in the latter half of 2003, generating upward pressure on producer prices. Competitive forces have largely precluded companies from passing along the increased cost, but profit margins cannot be squeezed indefinitely. The U.S. dollar depreciated to 5-year lows against the Euro and Yen, increasing the cost of imported goods as the U.S. trade deficit simultaneously widened. Finally, measures of other key production factors (e.g., unemployment, plant capacity utilization) show that we are beginning to take up the economic "slack" generated by the recession. Under the influence of powerful monetary and fiscal stimulus, we believe inflation may quickly become a problem.

But inflationary signals have been present, without broad inflation, for the better part of 2003. Why has inflation remained so very dormant? In part, because raw material is a relatively small and decreasing component of the cost of finished goods in the modern economy. The decreasing unit cost of labor, caused both by increased productivity and overseas migration of skilled jobs, has been a major factor in mitigating price increases. It is also fair to point out that a falling dollar carries with it a number of beneficial effects, such as making U.S. exports more competitive and shifting demand for intermediate goods to U.S. manufacturers.




The stage is set for tighter monetary policy and higher rates, but only gradually so. While the Fed has kept short-term rates firmly anchored, yields on the 10-year Treasury bond rose 0.75% in the second half of 2003. Ultimately, the Fed is likely to increase short rates, even in an election year; but prior to that dramatic event, we anticipate gradual tightening through open market activities.

# The U.S. Stock Market

Stocks rose sharply through the fourth quarter on improving earnings. Broad-market indices gained approximately 12% for the quarter and finished the year up nearly 30%. Smallcap stocks outpaced largecaps and value strategies outperformed growth strategies for the quarter, while midcap and smallcap growth strategies outperformed for the full year.

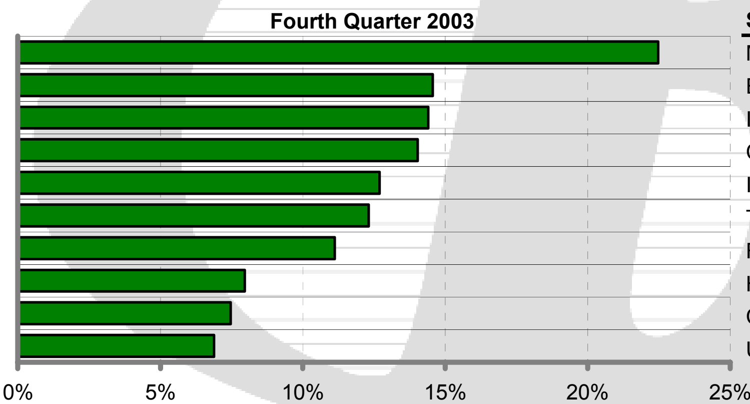
**Stock Indices - Total Return**

| | 4Q03 | 2003 | | 4Q03 | 2003 |
|---|---|---|---|---|---|
| **Largecap Stocks** | | | **Midcap Stocks** | | |
| S&P 500 | 12.18% | 28.69% | S&P Midcap 400 | 13.19% | 35.62% |
| Russell 1000 | 12.26% | 29.89% | Russell Midcap | 13.97% | 40.06% |
| Growth | 10.41% | 29.75% | Growth | 12.16% | 42.71% |
| Value | 14.19% | 30.03% | Value | 15.22% | 38.07% |
| **Broad Markets** | | | **Smallcap Stocks** | | |
| NASDAQ Comp. | 12.30% | 50.77% | S&P Smallcap 600 | 14.78% | 38.79% |
| Wilshire 5000 | 11.92% | 29.44% | Russell 2000 | 14.52% | 47.25% |
| | | | Growth | 12.68% | 48.54% |
| | | | Value | 16.37% | 46.03% |

Quarterly leadership came from the basic materials sector, on continued rising commodities prices. Information technology stocks made the greatest contribution for the full year; tech giants Intel and Texas Instruments announced higher than expected sales in December, extending their gains to over 90% on the year. However, good performance could be found in most every sector on improved sales and earnings. Estimates from Thomson Financial indicate that S&P 500 companies may have fully recovered their earnings capabilities, exceeding reported net income for 2000.

Trying to predict stock market direction is always perilous, but the festive New Year's environment compels us to give it a try. Setting aside the great unpredictables such as terrorism, markets are fundamentally driven by expectations of earnings and interest rates. It's widely held that we are facing a rising-rate environment for 2004, a fact that should depress stock prices by reducing the present value of future earnings. Rising rates also threaten the ability of companies to generate earnings, by increasing the cost of debt financing for consumers and businesses.

**S&P 500 Economic Group Components - Total Return**



*Source: Standard & Poor's*

| Sector | 4Q03 | 2003 |
|---|---|---|
| Materials | 22.47% | 34.76% |
| Energy | 14.56% | 22.39% |
| Industrial | 14.41% | 29.74% |
| Consumer Discretionary | 14.03% | 36.09% |
| Information Tech | 12.69% | 46.55% |
| Telecom Services | 12.31% | 3.28% |
| Financial | 11.12% | 27.92% |
| Healthcare | 7.97% | 13.31% |
| Consumer Staples | 7.47% | 9.23% |
| Utilities | 6.89% | 21.10% |

Reported earnings have increased, predictably, as the economy has recovered from recession; concurrently, the price-to-earnings ratio of the S&P 500 has fallen to about 28 times trailing earnings, a level last seen in the fourth quarter of 1998. Back then, that level was historically high, and the Fed began a program of interest rate increases. The market defied conventional wisdom by climbing into the rising rate environment, earnings multiples expanded into the 30's, and the "bubble" was born. We believe sustainable earnings growth is not likely to be sufficient to offset the further contraction in P/E multiples we *should* see due to rising rates, so we are relatively bearish on stocks. Whether this scenario plays out depends largely on whether the market at large has learned the harsh lessons of the past few years. Investors should be particularly cautious if P/E multiples fail to contract on news of rising rates.

# The U.S. Bond Market

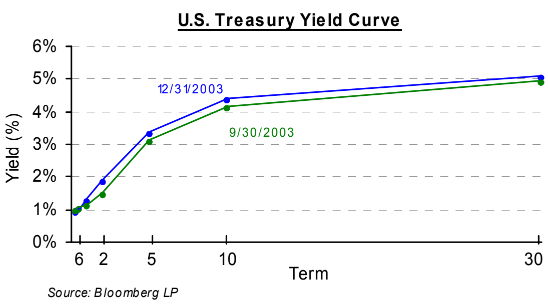
As 2003 came to a close the bond market again lagged the stock market as signs of positive economic news and profit growth drove investors into equities and away from fixed-income. The Federal Reserve continued its holding pattern on further easing during the quarter keeping the Fed Funds rate at 1% with a neutral bias for future moves. For now, the Fed continues to signal a policy of keeping interest rates low to spur continued economic growth.

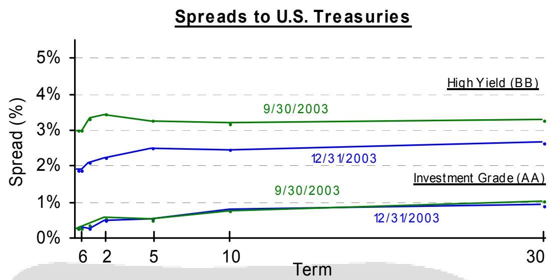
**Bond Indices - Total Return**

| | 4Q03 | 2003 |
|---|---|---|
| Lehman Aggregate | 0.32% | 4.10% |
| Lehman Interm. Gov't | -0.20% | 2.29% |
| Lehman Long Gov't | -1.14% | 2.61% |
| Lehman Interm. Credit | 0.39% | 6.91% |
| Lehman Long Credit | 0.83% | 10.43% |
| Lehman High Yield | 5.91% | 28.97% |

High yield spreads continued to narrow sharply, although investment-grade corporate spreads were more stable; corporate spreads are at their narrowest point in the last 5 years. Along with narrower spreads, a reduction in default rates has also helped to revive investor interest in corporate credit.

The U.S. Treasury market has suffered with the turn-around in the economy. With speculation that an improving economy, strong consumer confidence and manufacturing gains will spur inflation and cause the Fed to raise interest rates next year Treasuries have lost the allure of the past three years. Yields on the ten-year note are up over 30 basis points for the year and 75 basis points since mid-year, translating into falling prices.




High yield bonds continued to show strong performance and, once again, led fixed-income sector performance. As we saw last quarter, lower-quality issues were the stellar performers in the sector. A record of more than $27 billion flowed into high yield mutual funds in 2003 as spreads in the sector narrowed by nearly 450 basis points (4.50%) during the year.

The market seems to be of mixed opinion regarding Fed moves in 2004 with some investors believing that the Fed will delay raising rates as the rate of economic growth won't be enough to spark inflation. Others, however, expect a move of as much as 50 basis points (0.50%) by mid-year if growth continues to be robust. We look for signs of moderate inflation to spur the Fed into raising rates by mid-year.

# Overseas Markets

Global markets had another strong quarter of performance, generally outperforming U.S. stocks. The MSCI EAFE Index was up over 17% for the quarter and nearly 40% for the Year. Latin America was the best performing region as both Brazil and Argentina experienced strong growth on exports with expectations of continued strong performance and a decreasing need for additional borrowing.

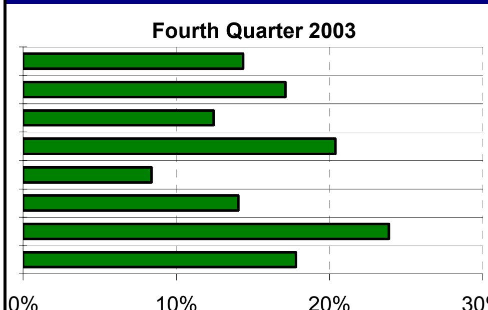
Europe had a strong quarter of performance with the MSCI Europe Index up over 20%. In the Eurozone, the European Central Bank continued to leave interest rates unchanged. The stock markets in France and Germany, the largest economies in the region, were up 22% and 31%, respectively. In Germany, while unemployment remains high, industrial production increased over the year with the expectation that strong growth will continue well into 2004 and unemployment will begin to slow. In France, where 2004 budget increases are still expected to surpass the 3% EU limit, signs of economic growth are also apparent. Unemployment in France dropped unexpectedly to 9.6% at the end of the quarter, an encouraging sign that companies are beginning to take on additional staff. The IMF expects growth in France to accelerate to over 2% in the coming year.

In Japan there are definite signs of economic strengthening. The MSCI Japan Index was up over 8% for the quarter and over 36% for the year as better job prospects appeared and downward-spiraling prices began to stabilize. Although there are some positive signs for the economy, Japanese business leaders remain cautious about growth prospects. A survey of some of the largest companies in Japan showed that executives believe the economy will be very slow to improve but that faster U.S. economic growth, better corporate earnings in Japan, and improving capital spending will help.

Growth in China this year fueled much of the Asian economic growth. The Chinese government estimates that 2003 growth will come in at around 8.5%, more than doubling the growth of the world's other major economies. Growth in the third quarter alone was 9.1%. Chinese exporters got help from increased demand in the U.S. for Chinese goods. The MSCI China Index was up over 34% for the quarter and 87% for the year.

Latin American markets also finished the year strong. In Brazil, strong exports of soy beans, steel and auto manufacturing and a surge in its trade surplus drove the economy. The MSCI

**Gross Total Return of Selected MSCI Regional Indices**




| Region | 4Q03 | 2003 |
|---|---|---|
| World Index | 14.37% | 33.76% |
| EAFE | 17.11% | 39.17% |
| North America | 12.44% | 30.13% |
| Europe | 20.38% | 39.14% |
| Japan | 8.38% | 36.15% |
| Pacific ex Japan | 14.05% | 47.03% |
| Latin America | 23.86% | 73.66% |
| Emerging Markets Free | 17.81% | 56.28% |

Brazil Index was up 38% for the quarter and over 115% for the year as the *real* gained over 23% for the year, strengthening against the dollar. Argentina, likewise, saw astonishing improvement, up 27% for the quarter and 101% for the year. Argentina is still struggling against its 2001 bond default, but was granted a slight reprieve during the quarter as they were granted a 90 day extension for repaying a private U.S. creditor $725 million. In addition, investment in the country was up over 30% this year.

# Focus On: *Mutual Fund Scandals.*

For years investors have trusted in mutual funds under the presumption that the funds and investment managers were treating them fairly and putting their interests ahead of their own. Mutual funds were one of the few investment products available to small investors that provided some "fair" chance of upside. Now it appears this presumption was premature. No financial event in 2003 was more significant, or identifiable, than the scandal that rocked the mutual fund industry.

## What Happened?

September began with New York Attorney General Eliot Spitzer announcing actions against four companies – Bank One, Bank of America, Janus and Strong Capital – for providing a sweetheart deal to a hedge fund, Canary Partners. The deal allowed the managers at Canary to make trades into and out of funds after trading hours, providing quick profits at the expense of long-term investors. Since this story broke the scandal has only widened as it seems a new fund company or manager is implicated on a weekly basis for having traded improperly in their own accounts, or allowed select clients to buy/sell after hours, or for giving incentives to steer clients toward certain products. Focus is also being given to "soft-dollar" arrangements which provide additional compensation to mutual fund providers in the form of research and other items in return for doing increased business with a particular firm – e.g. running trades through a firm.

Abuses such as stale-pricing are unique to the mutual fund industry. Rapidly buying and selling fund shares to take advantage of stale prices of foreign shares is called "stale price arbitrage". U.S. funds that buy foreign shares are priced at the end of New York trading, well after foreign markets close. If a significant news event occurs in the interim that will move foreign market prices, market-timers trade on the stale price, then quickly exit the position pocketing arbitrage profits. These profits come at the expense of other long-term investors in the fund, who are essentially selling shares to market timers at the low price, and buying shares again at a higher price the next day, or vice-versa. Market-timing is an old problem, and many fund companies have been taking positive steps to curb abuses; unfortunately, other fund companies have been using the opportunity to market-time as an inducement to sell more shares of their funds.

## What Are The Implications?

The allegations and abuses that have been brought to light have served to undermine investor trust and confidence in the industry. As a plan sponsor there are a number of serious issues to be concerned with: the risk of mass redemptions hitting a fund, poor fund performance due to staff losses and inattention, and participant perceptions of mismanagement.

**Fund Scandals – Principal Risks**

- **Run Risk**
  Risk of negative consequences for investors due to large or rapid redemptions.
- **Management Risk**
  Risk of poor ongoing performance due to staff defections or loss of focus.
- **Perception Risk**
  Risk of losing the satisfaction and confidence of plan participants.

In a run scenario many investors seek to redeem their shares simultaneously, forcing fund managers to liquidate large positions to cover redemptions. Managers that are forced into quick liquidations run into a number of difficulties that may impact fund investors. Market liquidity is the primary concern. Smallcap, high yield, foreign, and specialty funds are particularly susceptible to liquidity issues, since there may not be sufficient market capacity to execute the sales quickly, or the sales themselves may cause market prices to move. Liquidity issues are less of a problem with large cap funds which have size and scale to absorb large liquidations. A run on a fund can also impact fund expense ratios; expenses are likely to rise as the fees are spread over a smaller asset base hurting the remaining investors. Rising fees have the potential to become a serious problem for the plan sponsor, since a primary fiduciary duty is to control costs for the benefit of participants. Finally, prospectus provisions may allow a manager to delay redemptions, or deliver securities in lieu of cash, since large redemptions are potentially injurious to fund investors; such actions lead to substantial operational and communications problems for the plan sponsor. Factors increasing the negative impact of a run include small fund size, or a high percentage of fund assets belonging to a small number of retirement plans or other large institutional investors.

Poor fund performance as a result of the on-going investigations is another issue to be on the watch for. Fund performance may be impacted by key staff losses. Portfolio managers and key analysts may be looking to leave a "tainted" firm creating a performance issue as the staff with the most experience for a particular fund leave, creating a talent gap. The allegations and negative publicity can also cause staff to take their eye off the ball, creating performance issues as managers miss key investment opportunities in order to deal with issues confronting the firm.

Finally, participant perception is a concern. Participants read the newspapers and watch television, and are particularly attuned to issues that affect their financial future! As situations such as this develop it is important to keep a finger on the pulse of what participants are thinking. Participant action can spiral into a run scenario and can end up tying a plan sponsor's hands if a delayed redemption occurs. Keeping in touch with participants can head off potential litigation in the case of problems with redemptions, or prevent the plan sponsor from having to make hasty or imprudent decisions to assuage a few vocal participants. After all, the whole purpose of a benefit plan is to generate employee satisfaction, leading to better recruiting and retention. If employees are stressed out and concerned about the security of their retirement savings, it may be time to change funds – even if you are otherwise comfortable with the status quo.

**Do…**

- Use your investment policy statement
- Continue to monitor funds/managers
- Review all funds, implicated or not
- Remain vigilant and ask questions
- Communicate with participants
- Seek expert assistance if necessary
- Document the process

**Don't…**

- Make hasty or imprudent decisions
- Wait for guidance from regulators
- Assume your provider or fund family is watching out for the plan's best interests
- Cut corners on due diligence work for a replacement fund.

## What You Should Be Doing…

Whether or not your plan offers a "tainted" fund, the recent mutual fund scandals serve as a valuable reminder of the importance of routine performance review and solid governance processes. Plan sponsors have a fiduciary duty to act with prudence in regards to the investments offered within their retirement plan. Especially in light of the current environment, a plan sponsor should regularly review and evaluate the mutual funds held within their plan. If the plan provides for any investments in funds which have been implicated, the plan sponsor should evaluate whether to continue offering the fund as part of the retirement program. There is risk in either inaction or rash action; the plan sponsor's best defense, and best route to a quality program, is a deliberate process.

There are a number of factors to consider when evaluating a manager for retention or replacement. If your plan contains a fund from one of the implicated firms, the first thing you should do is place the fund on a "watch list" pending further review. Next steps include both objective and subjective review factors. You should consider the facts that caused the fund or company to come under regulatory review. Was it an isolated incident confined to one or two employees or was it a broader "corporate culture" issue? If it was an isolated incident the fund may not need to be removed from the platform, but merely kept on "watch" for a prudent amount of time until a level of comfort with the steps management has taken to improve the process is achieved. If, through a review, it is found that the issues are wider spread or that an ethical violation has occurred the fund should be kept on the watch list and a search for a replacement should commence. If factors are present that indicate higher than average run risk an appropriate review of the fund should be conducted to ensure that the investment is still prudent. Finally, keep open communication lines with participants to gauge their thoughts and feelings on the issues.

When interviewing potential replacement candidates ask whether there are any agreements that exempt any class of investors from market timing restrictions. Also, ask for a description of the steps that have been taken to ensure that all shareholders are treated equally regardless of size. Remember, there is risk involved with the decision to change a fund. The potential replacement fund could be the next one implicated in the scandal, causing additional work and issues. You need to be sure that you've followed a prudent process and clearly documented all research and reasoning for making any changes.

As with any issue that confronts plan sponsors, you should be taking both a critical and long-term view of what has happened and the impact to the plan. Rely on the investment policy statement if there is one. If not, this is a good time of year to review the plan and put a policy in place. Above all, remain vigilant and focused on your fiduciary duties.