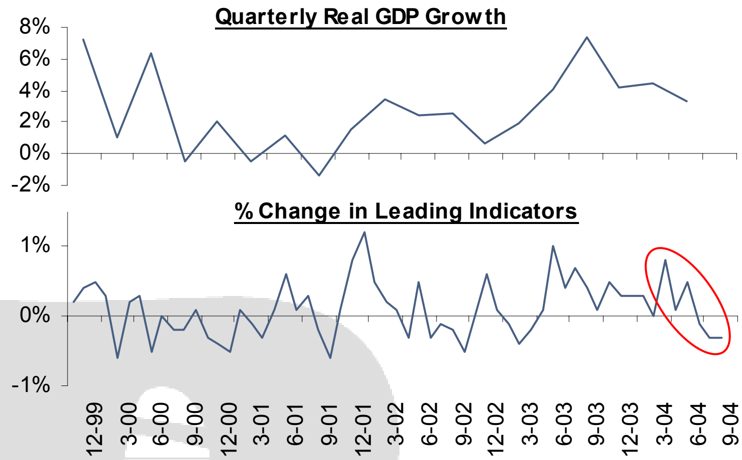
Bellwether CONSULTING

Your Quarterly Update on the Financial Markets
September 30, 2004

3rd Quarter

MARKET Recap

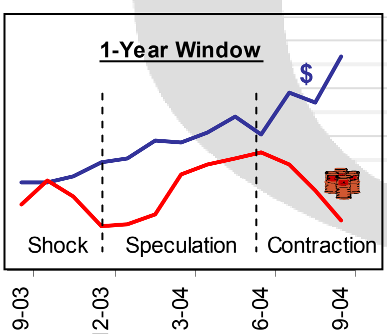
The Economy: *"Oil Prices Make the Slope More Slippery"*



Economic growth in the U.S. continued to slow through the second quarter. Gross Domestic Product growth came in at 3.3%, revised upward from previous estimates of 2.8% and by no means unhealthy. Through the third quarter the Fed continued a program of gradual rate increases, sticking to its thesis that growth prospects remain strong and factors causing second quarter weakness were largely transitory.

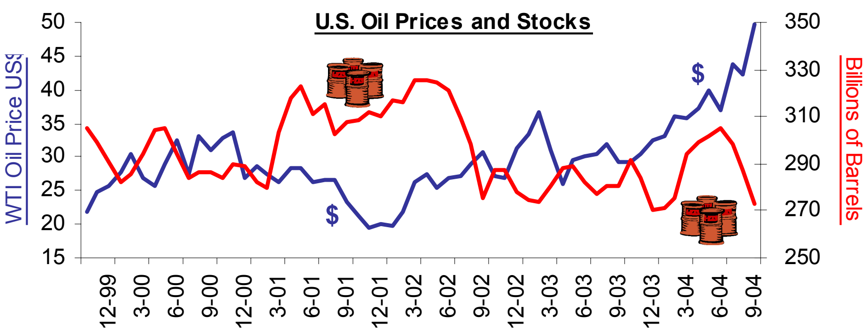
The bond market didn't buy it. Long-term interest rates fell by 40 basis points or more in the face of rising short-term rates; a flattening yield curve indicates that bond investors anticipate weakness ahead, as longer-term investors are willing to accept lower yields relative to short-term investors. The spread between Fed Funds and 10-year Treasury Bonds is one of ten components in the index of leading economic indicators, which fell in June, July, and August. Other leading indicators fell including consumer sentiment, evidenced by the Conference Board Consumer Confidence Index which fell in August and September.

Apparently stock investors were concerned as well; markets sold off last quarter despite respectable current earnings, suggesting low confidence in the sustainability of those earnings. As we've explored in past issues, rising factor prices (oil and other commodities, labor, capital) will place increasing pressure on profits, while foreign and domestic competition will make it difficult to pass along rising costs to the consumer. Indeed core inflation for the consumer remained in check last quarter, declining to 1.7% year-over-year through the end of August.



However producers and, to a lesser extent, consumers felt the pain of rising oil prices. The price per barrel for West Texas Intermediate crude rose 70% over the last year. For much of the year prices rose despite increasing supplies (shown in red, U.S. oil stocks not counting the Strategic Petroleum Reserve), an odd situation we attributed to fear-driven speculation.

In contrast we witnessed actual supply contraction through the third quarter which, coupled with seasonally high demand, drove prices above $50 per barrel briefly; as of 9/28 the spot price was $49.76/bbl. There were several good reasons, largely still "transitory" according to the Fed; the Yukos crisis in Russia, rebel activity in Nigeria, interruptions due to storms in the Gulf of Mexico, and so on. We tend to agree and believe supply shortfalls will correct without intervention, but the political implications of the timing need hardly be mentioned. Further, recent price spikes demonstrate how vulnerable the market is to a major supply contraction whether due to natural disaster, terrorist action, or political unrest.



All that said, there are some reasons to expect additional growth, albeit at a considerably slower pace than expected earlier this year. Industrial production activity appears robust at this time, and personal consumption expenditures for August did not decline. Without signs of inflation, we view the Fed's continued tightening as a means of gathering ammunition in the event of future weakness.

The U.S. Stock Market

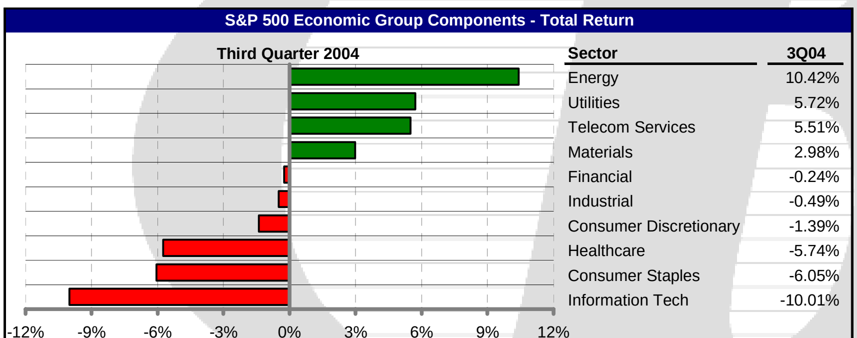
Equity markets took a hit in the third quarter with the major indices closing substantially lower. The Dow experienced the largest quarterly decline since the first quarter of 2003 (although it did close above 10,000 again by the end of the quarter) and the NASDAQ saw its biggest quarterly loss (-7.40%) since the third quarter of 2002. After posting gains in five previous quarters, the S&P ended the third quarter with a decline of 1.87%.

Stock Indices - Total Return
Third Quarter 2004

Largecap Stocks		**Midcap Stocks**	
S&P 500	-1.87%	S&P Midcap 400	-2.10%
Russell 1000	-1.81%	Russell Midcap	-0.84%
Growth	-5.23%	Growth	-4.33%
Value	1.54%	Value	1.74%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	-7.40%	S&P Smallcap 600	-1.37%
Wilshire 5000	-1.99%	Russell 2000	-2.86%
		Growth	-6.01%
		Value	0.15%

The biggest winners in the third quarter were energy-related stocks, gaining about 10% due to the run-up in oil prices. Consumer staples, health care and technology sectors all lost ground due to poor profit news. There was no clear leader during the third quarter among the three capitalization sectors. There was, however, a notable difference in style performance with value stocks outperforming growth stocks.

Wall Street closed out this bleak third quarter with mixed performance and earnings growth showing signs that it may taper off in coming periods. Until recently, earnings were quite favorable as companies in the S&P 500 posted four consecutive quarters of profit growth of more than 20%. Lately, however, growth in earnings, while still good by historical standards, has been deteriorating. A majority of U.S. fund managers surveyed in a September Merrill Lynch poll (as reported by the New York Times) believe profits will deteriorate in the coming months, and the consensus forecast for earnings growth for companies in the S&P 500 in the third quarter is 14.2%, down sharply from the second quarter. A slow-down in earnings growth, even if actual profits are growing, is generally considered to be a warning sign of poorer economic and business prospects.



Source: Standard & Poor's

Part of the earnings challenge is coming from oil prices. The impact of more costly oil most certainly will begin to show up in upcoming earnings reports. With oil prices reaching record highs during the third quarter, Wall Street is obviously worried that they will hurt economic growth and boost inflation. That being said, the low single-digit percentage declines in most key stock indexes in the third quarter likely do not fully reflect the surge in oil prices – price increases that have been viewed as temporary for two years. At some point the view that temporary factors are artificially boosting prices must be reconciled with supply and demand figures that just may justify current price levels.

On a brighter note, if history holds true the market may experience some upside from the coming presidential election. In a September article, Bloomberg News columnist John Dorfman observed that in the past 12 elections (1956 through 2000), stocks have advanced 10 times and declined 2 times. In his piece, Dorfman looked at the nine-week period from August 31 through Election Day in each of the past 12 election years and found that the majority of gains usually occurred immediately before the election in the first week of November. The positive trend generally continues through the month, with the average November return in the last 12 election years coming in at 1.65% (19.79% annualized).

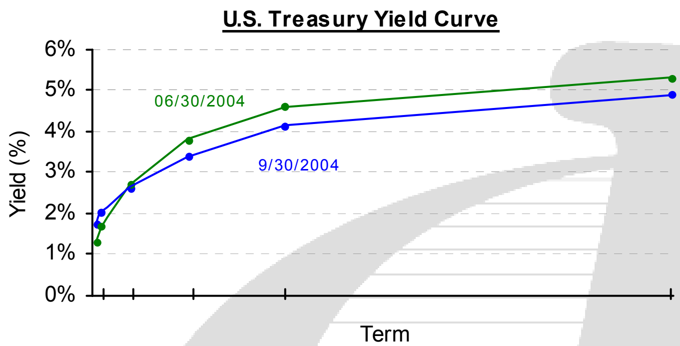
The U.S. Bond Market

As the third quarter came to a close, bond prices rose sending the yield on the 10-year Treasury to it lowest levels since April. The September 28 decline in yield on the 10-year Treasury to 3.96% elicited comment from all quarters since many believed this would be a year where longer-term rates rose while the Federal Reserve tightened monetary policy. The 10-year Treasury ultimately ended the quarter at 4.12%, down from 4.58% on June 30. Long duration treasuries have benefited from this yield movement as the Lehman Long Government Index finished up nearly 6.5% for the quarter.

Bond Indices - Total Return Third Quarter 2004	
Lehman Aggregate	3.20%
Lehman Interm. Gov't	2.26%
Lehman Long Gov't	6.42%
Lehman Interm. Credit	3.37%
Lehman Long Credit	7.19%
Lehman High Yield	6.13%

The Federal Reserve raised short-term rates two times in the third quarter (three times in three months), with an increase of 0.25% coming on September 21 and bringing the Federal Funds Rate on overnight loans between banks to 1.75%. Federal Reserve officials have made it clear that they believe short-term rates are too low to be sustainable, and that "significant cumulative policy tightening" is necessary for price stability and sustainable growth. Not surprisingly, along with the latest increase came the suggestion that the Federal Reserve will continue to raise short term rates gradually over the next year. With the continued, albeit weaker, economic growth, the Federal Reserve's raising of short-term interest rates would seem likely to eventually drive longer-term yields higher. However, rising oil prices and associated worries about slowing growth could mean lower rates in the near term.

Corporate bonds led all sector performance largely driven by demand from non-U.S. investors. While September was one of the most active months for issuance this year, net supply has experienced an overall general falloff in 2004. In addition, the bid for U.S. corporate bonds by non-U.S. investors has remained near the 7-year high. With net supply at its lowest annual run rate since 1998, strong demand from non-US investors has had a positive effect on spreads.



Source: Bloomberg LP

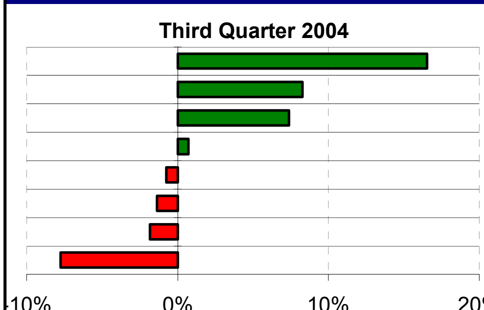
Rates on 30-year fixed rate mortgages declined about 0.50% during the third quarter, from around 6.25% to under 5.75%, keeping the housing market as strong as ever. (August housing construction figures were at 2 million homes, according to the Commerce Department.) If rates fall further and another wave of refinancing seems imminent, managers of mortgage portfolios will buy Treasuries or similar investments to hedge against potential losses in their portfolios, driving up prices. While this action offsets losses from taking on new lower rate mortgages, it will most likely send overall yields lower.

Overseas Markets

Developed global markets skidded again in the third quarter as the war on terror dragged on and the price of oil surged worldwide due to supply capacity issues. Latin American and Asian markets outpaced their European and North American peers whose markets are closely tied and surprisingly sluggish.

Performance in Europe was mixed as the MSCI Europe Index ended the quarter up slightly at 0.7%. Once again, the ECB left interest rates unchanged early in the quarter based on evidence that the sector was experiencing some level of economic growth while inflation remained relatively low at about 2.4%, but above ECB's 2% target level. Rising oil prices and flagging consumer demand have taken their toll in Germany. The Ifo Index, which measures the business climate in Germany, declined to 95.2 in September down from a high of 97.5 in January; the index has been down six times in the past eight months. The MSCI Germany Index was down 1.8% for the quarter. In France, structural issues continue to be a drag on the economy. Mounting healthcare costs, an inflexible labor market with unemployment hovering near 10.0% and a budget deficit which exceeds the EU's 3.0% of GDP threshold have contributed to the MSCI France Index's flat return this quarter.

Gross Total Return of Selected MSCI Regional Indices



Region	3Q04
Latin America	16.55%
Pacific ex Japan	8.28%
Emerging Markets Free	7.39%
Europe	0.73%
EAFE	-0.75%
World Index	-1.38%
North America	-1.84%
Japan	-7.75%

In Japan, structural issues dealt another setback to the economic turnaround experienced earlier this year. While many Asian markets have enjoyed strong returns, the MSCI Japan Index was down over 7.7% for the quarter. A recent IMF report on world markets forecasts GDP growth of 4.4% in 2004, above an earlier projected forecast, and raised next year's projected growth forecast to 2.3%. However, structural reform is still needed to support the sustained growth seen earlier this year. Japan's deficit, currently between 7.0% - 8.0% of GDP, threatens to put the brakes on growth. As the world's second largest economy, any global economic slowdown may have an impact on Japanese markets, but a slowdown in China may have a severe effect as their close proximity ties them together in the region. The IMF estimates a 10.0% decline in China's imports for domestic consumption would cut Japan's GDP by 0.5%.

In China, governmental intervention has sought to cool down the country's explosive growth. The MSCI China Index was up 7.2% for the quarter. To date the price controls and reserve requirements have had some effect and the orchestrated soft-landing seems to be coming to fruition. However, GDP growth estimates were still revised upward to 9.0% for 2004. Tighter lending and rising materials and labor costs should squeeze growth and corporate earnings heading into 2005. As the quarter closed and focus shifted to the upcoming G-7 meeting there has been increased pressure on China to allow the yuan to float versus other currencies.

Latin American markets performed strongest this quarter. The MSCI Latin America Index was up 16.5% for the quarter versus its 8.8% loss last quarter, an example of the volatility inherent in the region. As the quarter closed, Brazil's central bank increased interest rates for the first time since February 2003, saying that it hoped to rein in inflation without disrupting the country's economic recovery. The benchmark lending rate was raised to 16.25%. The MSCI Brazil Index was up 25.7% for the quarter. Strong exports to Argentina from Brazil prompted the former to impose a 21% import tariff on goods from Brazil. As the quarter closed, the head of Argentina's Central Bank was removed and replaced by Martin Redrado, who is thought to be less independent than his predecessor, Alfonso Prat-Gay. The IMF has also allowed Argentina a one-year extension to repay on its defaulted debt obligations. Even with all of the volatility, the MSCI Argentina Index was up 26.6% for the quarter.

Focus On: *Investment Policy – The Fiduciary Process Roadmap*

Clients and prospects often ask us about the necessity of a comprehensive investment policy statement. Should we have one? Why do we need one? Do we need to follow it? In jest, our response is that you wouldn't set out to drive across the country without a roadmap, would you? Sure, you could make it across by driving east or west, but you would have no idea whether the roads you were traveling on would get you to your destination or if there were obstacles that you needed to steer around. It's important that those entrusted with the stewardship of retirement programs know where they are going as well as having the ability to steer around trouble during the journey. An investment policy statement is a plan sponsor's roadmap for navigating the winding roads of investment management, helping to make sound investment management decisions and demonstrating prudent fiduciary oversight.

Investment policy statements for participant-directed plans (e.g., 401(k), 403(b), 457) vary slightly from those used for employer-directed pension plans. For participant-directed plans a policy covers investment education and advice for the participant while an employer-directed statement covers asset allocation with the goal of providing liability coverage. While differences between the structures of these policy statements exist, many of the sections such as investment selection and monitoring are similar. We focus here specifically on policy statements for participant-directed plans; look for a focus on employer-directed plans in a future article.

The law does not explicitly require retirement plan sponsors to have a written investment policy; however, if the DOL knocks on your door to perform an audit one of the first things they'll surely be asking for is your investment policy. There's no better way to demonstrate that a policy exists than to be able to produce a written version. According to the Profit Sharing Council of America, nearly 70% of plans currently have investment policy statements, up from around 54% just five years ago. Corporate meltdowns and the mutual fund scandal have shown the value of putting formal investment policies in place to help make decisions and to provide a measure of protection from fiduciary liability.

Now, to answer our clients' questions, yes, you should have an investment policy. Not only can it save you time by organizing thoughts and facilitating decision making, it also provides a framework to make decisions in the best interests of your plan's participants. You need one because it demonstrates sound fiduciary oversight of your plan and it takes much of the subjectivity out of investment decisions. Yes, if you've gone to the trouble of creating an investment policy, it's in your best interest to follow it. An investment policy should be a living document. The process for maintaining the statement is iterative; over time as your organization and participants change your investment policy statement should change to reflect your organization's then current needs and circumstances.

Now that we know we need an investment policy statement let's discuss the basic format for one. There is no one right way to structure an IPS, but there are some "must have" sections along with some additional information sections which can form the nucleus of a functioning policy statement. A good policy starts with an overview of the plan and the covered employees. Next, an outline of the plan's objectives should follow. Once the background and objectives have been stated, the policy should go on to outline the investment program itself covering topics such as investment categories and the availability of education or advice. Finally, the policy should

Key investment policy sections…

- Description of Eligible Employee Group
- Plan Objectives
- Investment Program Design (e.g. Choice and Education/Advice)
- Investment Categories
- Investment Selection & Monitoring Criteria
- Appendices: Current investment options and relevant benchmarks, current committee members

cover the investment selection and monitoring process. Additional information that can be included as appendices to the statement includes current listings of funds and corresponding benchmarks.

The plan overview should bring together the concepts of a description of the plan tied to the needs and circumstances of the covered employees. It does not need to be voluminous, but should briefly describe the demographics of the current employee population (age ranges, educational level, level of investment experience, different covered groups, etc.). The overview lays the foundation for the subsequent sections of the policy and the background information provided will be important in helping to make investment decisions in the interest of participants.

Once there is an understanding of the employee base a plan sponsor can begin to define the objectives of the plan. Objectives of the plan should cover in a specific manner how the sponsor hopes to achieve plan goals for the benefit of the employees described in the overview. For example, the objectives should cover the number of investment options that will be offered to participants and how much control participants will have over their accounts. This section of the statement should answer questions: will any type of education programs be available to participants to help with the investment selection and asset allocation process? Will the plan offer more sophisticated investment line-ups through a mutual fund or brokerage window? Will the plan be 404(c) compliant? The objectives should also describe plan administration and the information that will be provided to participants to allow them to monitor their investments.

A good policy statement…

- Creates a process that leads to prudent investment decisions
- Saves time and frustration by separating design decisions from tactical decisions
- Allows the plan sponsor to automate some processes (e.g. some monitoring functions)
- Provides a rationale for decisions and a basis for explaining them to participants

The investment program section of the statement should describe the types of investments to be offered and the structure of the program. For instance, will there be a single set of investments for all participants, or will the sponsor be offering a "tier" structure with a set of core investment options that cover the majority of employees and an additional set of investments for participants with more investment expertise? This part of the policy should cover broad investment categories offered rather than specific investment options and should remain flexible to add additional options at the sponsor's discretion when the need arises. Covering broad categories helps administratively with policy maintenance by not having to amend the policy every time an investment option is added to, or removed from, the program.

One of the most important sections of the statement is Selection and Monitoring. Here is where a plan sponsor defines the critical criteria considered when selecting an investment option for inclusion in the program and how the funds will be evaluated on an on-going basis. Criteria for selection and monitoring should reflect what a plan sponsor considers important based on the plan overview and should cover objective data such as performance versus benchmarks and peers, expense ratios, and portfolio characteristics. Subjective data that provides insight into the quality and stability of the management firm, among other things, should also be considered. Monitoring criteria should be objective and simultaneously loose enough so as not to be unduly burdensome. For example, some plan sponsors that we have worked with have wanted funds whose performance is always top quartile. While this is a noble aspiration, most fund managers do well to remain in the top 50% of their peer universe on an on-going basis. Using too strict of a performance hurdle can create the need for frequent fund changes and additional, unnecessary, fiduciary oversight. The monitoring section should also include a "watch list" for investments that do not meet a number of monitoring criteria. The monitoring criteria themselves should be closely linked to the selection criteria. This section should also include the process for removal from watch via improved performance or through a search and replacement.

Finally, addenda to the statement can include a list of current investments and their corresponding benchmarks, and the composition of an investment decision-making committee. A well-formed committee should bring together a number of senior executives from functional specialties (i.e., Human Resources and Finance) to help form and steer policy.

Once an investment policy is established it should not be changed very often. The policy should be reviewed at least annually to ensure that it continues to serve the sponsor's needs as a tool to make prudent decisions on behalf of plan participants. A good policy should seek to set forth processes to help make prudent decisions and should attempt to automate processes where appropriate (e.g. some of the monitoring process). It may look like a lot of work to create and maintain an investment policy statement; however, it will be time well-spent down the road as you are able to steer clear of the obstacles which face many retirement plan sponsors.

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