Bellwether CONSULTING

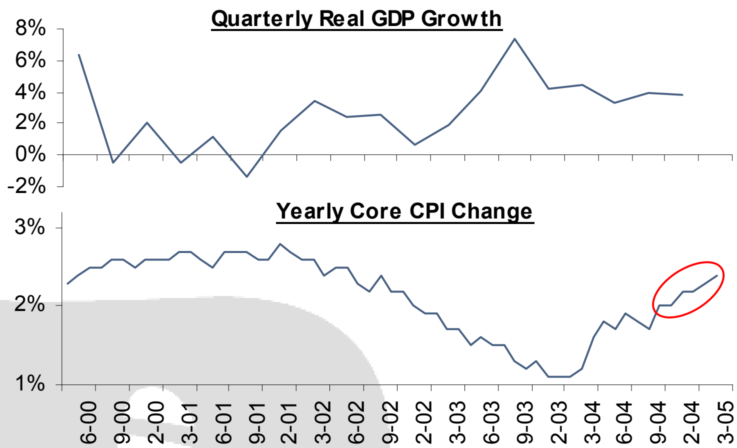
Your Quarterly Update on the Financial Markets
March 31, 2005

1st Quarter

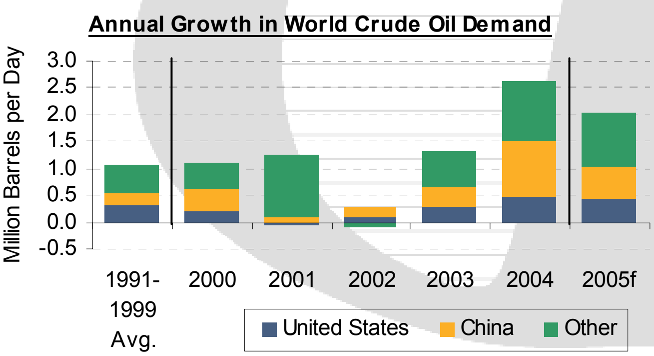
MARKET Recap

The Economy: *"Inflation, Evidently"*

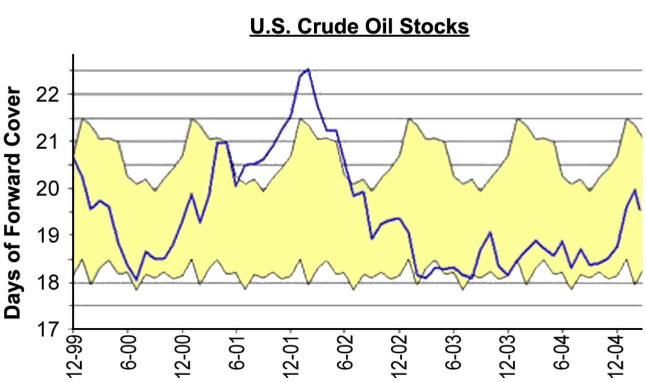
U.S. economic growth for the fourth quarter came in at 3.8% annualized, slightly softer than the 4.0% consensus estimate but healthy nevertheless. A certain sense of pessimism persisted throughout January and February as oil prices continued to climb and speculation of accelerating Fed tightening increased. The yield curve flattened and twisted in response to the first of two 0.25% rate increases (February 2nd); as we've previously discussed, a flattening yield curve is one of the more accurate predictors of slowness. Preliminary data and projections contributed to a more optimistic March, with many economists predicting more rapid growth, rising payrolls, and tame inflation. Indeed the bond market's response to the March 22nd rate hike reflected this optimism, with long rates increasing in lockstep with Fed Funds.



Alas, a spate of news in the final week of March leads us back to the same concerns as before. Non-farm payrolls increased by 110,000 in March versus 213,000 expected; the core CPI inched up to a 2.4% pace for February; and consumer confidence fell back to December levels after a surge in January, according to the Conference Board. Rising oil prices have been cited as the cause for each bit of bad news. We maintain a thesis that factor prices will drive economic results in the intermediate term (see the 3/31/2004 issue of <u>*Market Recap*</u> for a more complete discussion). While we believe that inflationary pressures span many critical production inputs today, oil prices are always worthy of analysis and present the most visible example of a more general problem.



The Administration's efforts to increase supplies have largely met with success; crude inventories topped 315 billion barrels in March, a level last seen in 2002 after OPEC opened the spigots in response to a worldwide recession. However, demand for oil outstripped increases in supply on a worldwide basis but particularly in China. In fact, demand growth in 2004 far exceeded the government's projections, and will likely exceed 2005 forecasted levels based on 3.5 – 4.0% GDP growth forecasts.



Source: U.S. DOE, Energy Information Administration

When adjusted for expected demand, current inventories are not robust. As illustrated in the Crude Oil Stocks chart, current U.S. supplies expressed on a forward cover basis (inventories at time "t" divided by refinery inputs at time "t+1") have been running at the lower end of the normal range – represented by the yellow band, which displays one standard deviation around the 5-year average. Supply pressure moderated in January, but only reached average levels and subsequently contracted. That fact, coupled with speculative trading, drove the price of crude oil to levels over $50 per barrel throughout March. Of further concern, U.S. refinery production exceeded 90% of capacity in March, a foreboding statistic as demand for gasoline begins its seasonal climb.

Note that the price of oil has always been volatile, and therefore one cannot predict economic performance based solely on oil; however, we see pricing pressures in all factor markets except labor, and even the cost trend of labor production is no longer falling rapidly. The slow increase in consumer prices (ex. food and energy) suggests that pricing power is rising, and that the impact of inflation may be more evenly shared between the bottom lines of consumers and corporations.

The U.S. Stock Market

Equity markets were mixed over the course of the first quarter but most major indices closed down. Record-setting crude prices and rising interest rates spurred concerns about inflation and challenged the stock market, as did lower corporate earnings growth and fears that the quality of corporate earnings has begun to deteriorate.

Stock Indices - Total Return
First Quarter 2005

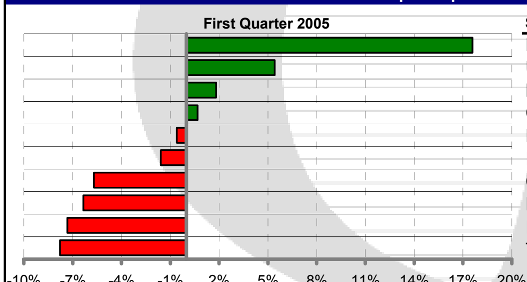
Largecap Stocks		**Midcap Stocks**	
S&P 500	-2.15%	S&P Midcap 400	-0.40%
Russell 1000	-1.91%	Russell Midcap	-0.25%
Growth	-4.09%	Growth	-1.67%
Value	0.09%	Value	0.78%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	-7.95%	S&P Smallcap 600	-2.07%
Wilshire 5000	-2.39%	Russell 2000	-5.34%
		Growth	-6.83%
		Value	-3.98%

Mid-cap was the best performing capitalization sector, although returns were nothing to write home about. One notable change from prior quarters was that the performance of the large-cap sector, though negative, exceeded that of the small-cap sector, reversing a seven-quarter trend. A sustained shift in market leadership to the large-cap sector could be a sign of decelerating profit cycles. Value stocks made a comeback, beating out growth stocks where performance was dragged down by heavy weighting in technology stocks, one of the worst-performing sectors.

Energy stocks climbed out of the cellar to become the top-performing sector, buoyed by record crude prices. Utility funds benefited to a lesser extent. Other sectors did not fair as well. Financial stocks suffered from concerns about rising interest rates, as did the consumer discretionary sector. Bottom-of-the-heap performance by telecom and technology sectors drove a steep drop in the NASDAQ Composite.

As noted above, corporate earnings growth slowed after several quarters that were mostly in the double digits. With a general consensus that it will be more difficult for companies to maintain these growth rates in 2005 (earnings growth for companies in the S&P 500 is projected to be a moderate 6%), some companies may be tempted to look to more aggressive accounting to meet prior estimates and sustain the strong trends. However, with scandals still fresh in investors' minds, quality of earnings may be just as important to investors as the level of earnings.

S&P 500 Economic Group Components - Total Return



Sector	1Q05
Energy	17.58%
Utilities	5.42%
Materials	1.82%
Consumer Staples	0.68%
Healthcare	-0.60%
Industrials	-1.59%
Consumer Discretionary	-5.69%
Financial	-6.36%
Information Tech.	-7.34%
Telecom Services	-7.78%

Source: Standard & Poor's

One way to measure earnings quality is by the spread between a company's operating earnings and GAAP (generally accepted accounting principles) earnings. A larger spread indicates lower earnings quality, because GAAP earnings include charges for things like restructuring, financing, layoffs, and other events expected to be one-time charges. Since these charges are not included in operating profits, analysts consider operating profits a better indicator of future earnings even though they tend to be lower than GAAP earnings. The earnings spread in the fourth quarter of 2004 was 22.3% according to Standard & Poor's. An acceptable spread level is usually considered to be 12% - 18%, and the spread was 11.5% in the fourth quarter of 2003. While the earnings spread is nowhere near the record level of 74.9% set in the fourth quarter of 2002, it could be the beginning of a trend that investors will want to watch as companies report their earnings in 2005.

The U.S. Bond Market

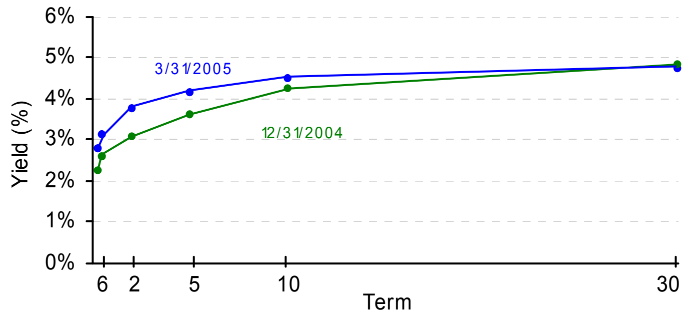
The first quarter of 2005 was a virtual repeat of the fourth quarter of 2004, with the yield curve flattening even more. Bond prices fell across the curve driving yields higher, except for the 30-year Treasury, which ended the quarter down a slight 7 basis points at 4.75%. The 10-year Treasury, a bellwether rate for everything from mortgages to corporate bonds, ended the quarter at a yield of 4.48%, up from the previous quarter's close of 4.12%, but still down from 4.58% on June 30, 2004.

Bond Indices - Total Return

	1Q05
Lehman Aggregate	-0.48%
Lehman Interm. Gov't	-0.68%
Lehman Long Gov't	0.59%
Lehman Interm. Credit	-1.17%
Lehman Long Credit	-0.66%
Lehman High Yield	-1.61%

The Federal Reserve raised short-term rates two times in the first quarter (seven times in nine months), with the last increase of 0.25% coming on March 22 and bringing the Federal Funds Rate on overnight loans between banks to 2.75%. As with the past five actions, these increases were not surprising. The big change this quarter came in a new stance by Federal Reserve policy-makers after the March 22 meeting, when they indicated their view that "pressures on inflation have picked up in recent months."

U.S. Treasury Yield Curve



Source: Bloomberg LP

Industry experts continue to agree there will be more increases by the Fed in 2005, and their year-end 2005 predictions for the Federal Funds Rate have been revised up to a range of 3.5% – 4.0%. If the Federal Funds Rate reaches 3.5%, the 10-year Treasury note could be yielding above 5% by the end of the year, a challenging prospect for current holders of these notes.

As the quarter came to a close, strong inflation indicators caused the market to wonder if the Fed would forego its "measured steps" for something larger, say, 0.5%. Fears of accelerated tightening contributed to the falling bond prices as well as to widening spreads on riskier assets. But regardless of the magnitude of Fed moves, consistently rising borrowing rates will become a hurdle to strong stock market performance in 2005 as they dampen profit growth and reduce liquidity.

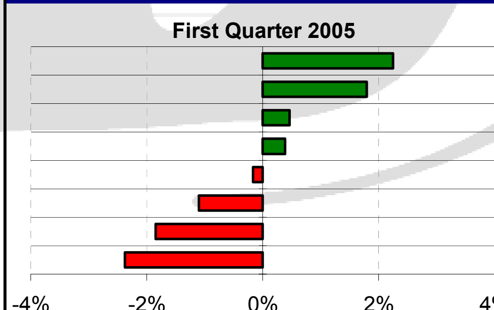
Corporate bond spreads widened in the last month of the quarter climbing to a five-month peak and reversing a two-year trend of narrowing. Overall, corporate spreads widened by 0.12%, with the average corporate bond yielding 0.93% more than Treasuries, which, according to Merrill Lynch, is the widest spread since October. Spreads on junk bonds have increased by nearly 0.70% to 3.52% over Treasuries, and high yield bonds showed a loss on a total return basis.

Overseas Markets

After a strong finish in 2004, developed global markets moderated during the first quarter of 2005 as oil price volatility and the specter of inflation combined to dampen performance. Emerging markets continued to fare better than their developed counterparts, especially in Latin America where favorable IMF treatment in Argentina and strong economic growth in Brazil has helped bolster performance.

Performance in Europe was mixed and moderate with as many markets in the red as in the black. Surprisingly, inflation in the Eurozone edged down slightly in February; the markets remain concerned that the ECB will increase short-term rates in the near-term, although consensus estimates indicate that tightening will occur later in the year. In Germany, the IFO Index of business sentiment fell to 95.5 in February after two months of consecutive increases, and far below the consensus estimate of an increase to 96.7. The March IFO survey is expected to show continued weakness due to higher oil prices and the negative impact due to appreciation of the Euro. The MSCI German Index was down 2.3% for the quarter. France continues to be hampered by a stagnant labor market. The central government is considering allowing tax-free withdrawals from pensions as consumers have been forced to tap savings due to low income growth. Consumption in the sector did surprise to the upside in January, but expectations are that this will moderate going forward. The MSCI France Index was up 1.8% for the quarter.

Total Return of Selected MSCI Regional Indices



Region	1Q05
Latin America	2.25%
Emerging Markets Free	1.80%
Europe	0.46%
Pacific ex Japan	0.38%
EAFE	-0.17%
World Index	-1.10%
North America	-1.85%
Japan	-2.37%

Japan continues to send mixed messages to the markets. In March, fourth quarter 2004 real GDP was unexpectedly revised upward against a consensus downward expectation, leading many to believe that the sector had turned the corner. However, other data such as flat household consumption, increasing inventories, and negative net-exports paint a less pretty picture. Much of the economic recovery over the last few years has been export-driven which should concern investors when looking at net-export numbers. Department store sales also recorded sub-par performance, down over 8% year-over-year. The MSCI Japan Index was down 2.4%.

The Chinese market continues to intrigue the world. 2004 saw China's economy overheating with a rapidly expanding economy and unbridled appetite for raw materials driving strong GDP growth of 9.5%. To contrast that, first quarter growth in 2005 is expected to slow down to 8.8%! A slowdown in investment and the agricultural sector is expected to help temper the growth rate. Last year there was much talk of engineering a soft-landing and easing the yuan's tie to the dollar. However, recent comments from China's policymakers seem to indicate that they will neither raise interest rates in the near-term, nor allow the yuan to float. There may be some cause for concern as China's CPI rose 3.9% in February, a much sharper increase than expected. After raising interest rates 27 basis points last year, policymakers may need to intervene more strongly to curb growth. The MSCI China Index was down 0.4% for the quarter.

Latin American emerging markets continued to lead global performance as prices for natural resources remain high, driven mostly by growth in demand from China. Argentina recently completed a debt-swap negotiation on $102 billion of sovereign debt, which effectively allows creditors to recover about 30 cents on the dollar. While Argentina has stuck to its guns regarding the deal, the IMF is investigating whether or not the country conducted negotiations "in good faith" when arriving at a settlement. Growth in the sector is expected to slow this year as fiscal and monetary stimuli injected into the economy over the last few years are expected to run out of steam. The MSCI Argentina Index was up 13.2% for the quarter. In Brazil, inflation seems to be the overriding theme. Tighter monetary policy has pushed the interest rate up to 19.25% in the country in an attempt to ease growth. With seven rate increases since September, economists are speculating that the central bank has finished boosting borrowing costs for the year. The MSCI Brazil Index was up 4.2%.

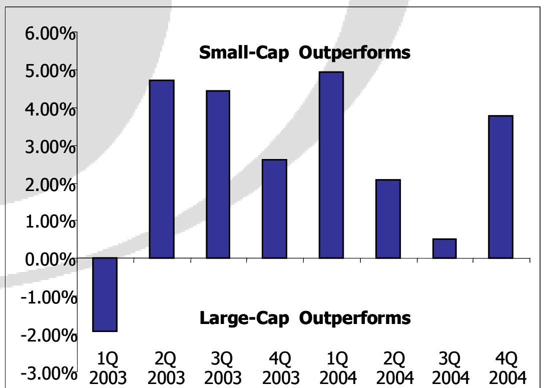
Focus On: *Fund Capacity - When the Party's Over*

Over the past few months we have been involved in a number of searches for small cap managers, and found the pickings to be slim. With small-cap stocks out-performing large-cap stocks for a fifth consecutive year in 2004, investors have flooded small-cap managers with both retail and retirement plan contributions and pushed many funds to capacity, closing them to new investors and making the replacement process more difficult than usual.

While conventional wisdom tells us to hold well-diversified portfolios when investing for the long-term and that asset allocation strategies require only fine-tuning and occasional rebalancing, the lure of a "hot" market segment is irresistible to many investors. Whether it was dot-com stocks in the late 90's or bio-tech stocks right after, as news about an outperforming market segment hits the papers investors flock to that sector, giving rise to what many investment managers consider a desirable problem - running out of capacity.

A Particular Problem for Small-Cap Funds

One of the biggest challenges for small-cap managers is the limit on the fund's percentage of outstanding stock shares of any particular issue. In terms of absolute dollars, it takes less trading to impact the price of a small-cap stock than a mid-cap or large-cap issue. This is because there is generally less trading volume by number of shares and by dollar amount in small-cap stocks. A manager that holds enough of a particular stock to influence the price must be very thoughtful about any action with that stock. Should he ever want to trim the position, he can't sell too much without driving down the price. By overweighting the portfolio to a stock, he makes it less responsive to the market. To avoid that risk, he must keep positions reasonable in size. So while the absolute percentage diversification guidelines for small-cap portfolios may be in the same range as those for larger-cap funds, the dollar limits will be smaller for small-cap funds.



Source: Standard & Poor's. Difference in returns of S&P 500 and S&P Small-Cap 600 Indices.

To illustrate this point, let's say a small-cap manager wanted to purchase shares of Coldwater Creek (CWTR), a multi-channel retailer of women's apparel with a market cap of $1.1 billion. According to Yahoo Finance on March 31 at 10:42 a.m., the trading volume in this stock was 43,344 shares. With CWTR trading at $18.28 per share, the dollar volume of trading in CWTR was a little over $790,000. In contrast, the trading volume for IBM on March 31 at 10:39 a.m. was 852,700 shares. With IBM trading at $90.70 per share, the dollar volume of trading in IBM was over $77.3 million or over 97 times that of CWTR. Add to this that IBM's market cap of $148.1 billion is almost 135 times that of CWTR and it becomes clear that compared to IBM, it would take a very small investment in CWTR to influence its price.

Well-performing companies offer another challenge to small-cap managers. If a manager is to stay true to capitalization targets, he must divest of stocks just as the fundamentals he based his purchase on really start to pay off. In a way, the better his picks are, the more frequently he'll be looking for a replacement holding. And as outlined above, while that "good pick" is growing but still below his capitalization threshold, a small cap manager must always be monitoring his fund's position to ensure it doesn't comprise too large a percentage of that company's outstanding shares.

Implications of Nearing Capacity

It's no surprise that the recent run-up has closed many funds to new clients; according to Morningstar, 24 small-cap mutual funds closed in 2003 alone. But what happens to a fund as it approaches capacity? First off, the cash position may start to increase. In trying to balance diversification constraints with the fundamentals of good stock picking, not to mention the time it takes to research and make a good pick, the management team may simply feel they cannot find acceptable purchase targets fast enough. Holding more cash will impact overall return, potentially dragging down the total return in a fund that had solid performance.

When Funds Near Capacity

- Cash Position Increases
- Response to Market Changes Slows
- Expense Ratios Increase
- Discipline Loosens
- Fund Begins to Close to Certain Investors

The fund will probably also become more sluggish in its response to changing market conditions as it nears capacity. This is not surprising since the larger a fund is, the greater the amount of assets that need to be traded to move the portfolio. A small-cap manager may be forced to spread trades out over several days or even weeks due to lack of market liquidity.

A third effect is increased expenses, both direct and indirect. For example, mutual fund expense ratios have three components: management fees, distribution (12b-1) fees, and other expenses. Distribution fees are usually fixed. Management fees are likely to gradually decrease with increasing fund size. But as a fund nears capacity commissions, which are passed directly on to the fund as part of "other expenses," are likely to increase and drive up the expense ratio. However, this alone understates the full effect of trading costs. Other costs including market impact (buying market liquidity), timing cost (seeking market liquidity), and opportunity cost (failure of market liquidity), grow as a fund nears capacity and the size of the fund impacts execution. These costs do not appear in the quoted "expense ratio" for the mutual fund but, as with other expenses, directly reduce total return.

Finally, fund management may start to loosen its discipline, expanding the pool of stock picks in terms of market cap, style characteristics, or other criteria previously fundamental to the portfolio strategy. This can result in significant style drift over time. That "small cap growth" fund that rounded out your asset allocation strategy can easily become a "mid cap blend" fund in the face of capacity limits.

What's an Investor to Do?

When performance or style purity suffers due to capacity constraints, the choices are simple in theory: find a replacement fund or accept the problems, perhaps making other portfolio adjustments to compensate. However, when a sector stays hot, all of the most popular products will either close or risk performance/style degradation. With fewer and fewer choices open as replacement options, investors may opt to accept the devil they know. As long as the absolute performance shortfall is not too great, it may pay to wait until sector rotation occurs and more high-quality choices become available.

Depending on the circumstances, style drift may be more or less tolerable. For participant-directed retirement plans using an asset allocation or advice model, for instance, tolerance to style drift may be low. Participants in the plan utilizing the model are relying on statements made about general exposure to market segments. As a component fund drifts in style, segment exposure produced by the allocation model is skewed from stated targets and the allocation tool becomes less effective. This creates a strong argument in the minds of many plan sponsors for replacing the offending fund. However, if the fund is one of several offered in its segment, style drift may be more tolerable since there are other offerings from which to choose. Whether tolerance is low or high, if a drifting fund is retained, any performance benchmark associated with the fund should be updated to more appropriately reflect the new style of the fund. Depending on how things have changed, a custom benchmark may need to be constructed.

Another option, of course, is to consider a newly opened fund or an "emerging" fund manager. In this case the challenge will be to find some type of track record on which to assess the management team and investment strategies. Funds previously managed at another firm may provide the history needed to make a case for the manager. A third option is to consider a different product structure; for example, larger retirement plan sponsors might consider collective trust funds or separate accounts as an alternative to mutual funds; since fewer plans have the scale required to make these product forms worthwhile, more capacity may be available.

Regardless of actions taken in response to a fund experiencing style drift, or bad performance, for that matter, good fiduciaries will inform plan participants of any change in a fund's strategy and any implications the change has for the retirement plan (e.g., changes to the asset allocation model). Communication should be simple, direct, and focused on the impact to participants in a format that is easily accessible to all.

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