Bellwether CONSULTING

Your Quarterly Update on the Financial Markets

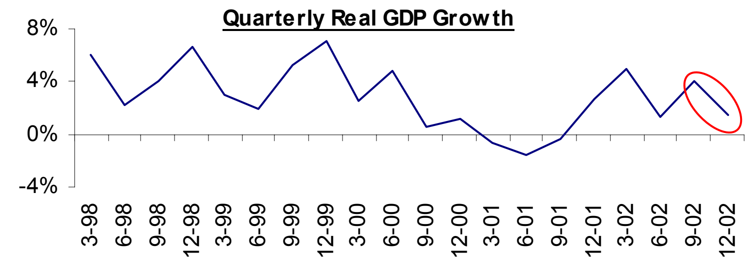
March 31, 2003

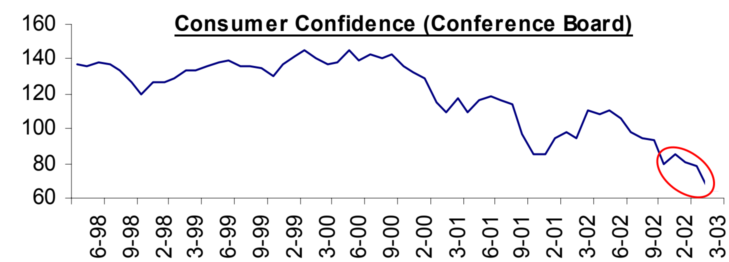
1st Quarter

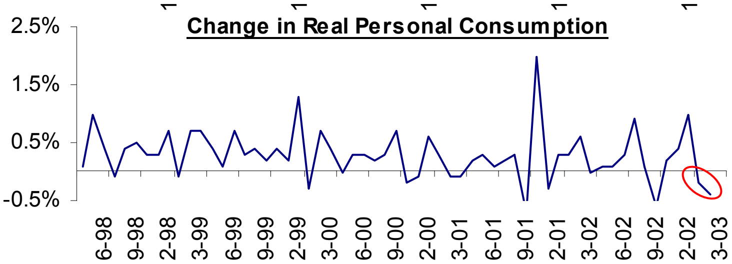
MARKET Recap

The Economy: *Weary consumers tap the brakes.*

Economic growth slowed to 1.4% for the 4th quarter of 2002, driven in part by an increasing trade deficit. The end of a 10-day dockworker strike on the west coast distorted the trade gap somewhat by generating a sudden flood of imports. Still the basic economic theme seems to remain centered on consumer spending. Consumer confidence indicators fell throughout the 1st quarter, approaching a 10-year low set in 1993. Of course the war in Iraq contributed to negative sentiment, but the longer-term trend is rooted in the bear stock market and business ethics crisis.



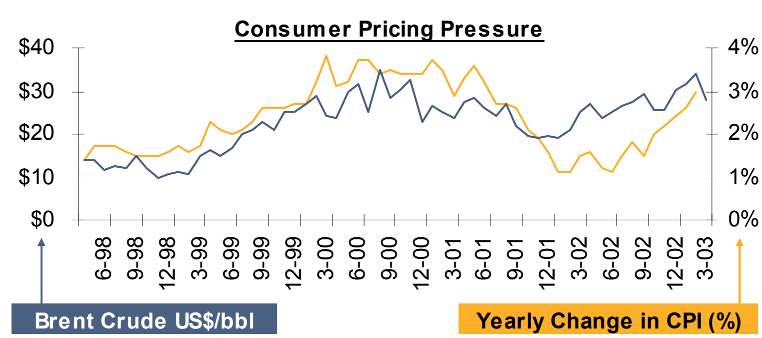




As noted in past issues, consumer spending has generally remained strong despite expressions of negative sentiment. Personal spending helped shorten the 2001 recession and curb its intensity as businesses cut back on investment spending. Nominal personal spending stayed flat last quarter while real personal spending (adjusted for inflation) fell in January and February, the first back-to-back decline in two years.

Rising oil prices contributed to a more inflationary environment, with Brent Crude approaching pre-recession price levels. The Consumer Price Index rose in lockstep with oil, although growth in the Core CPI (which excludes food and energy prices) remained modest at 1.7%. Businesses absorbed much of the indirect costs of rising oil prices, lacking adequate pricing power to pass increases on to consumers – a fact that does not bode well for prospects of increased business spending. Indeed the Purchasing Managers Index and Institute of Supply Management business index both fell in March while inventories contracted.

We do not expect short-term oil prices to hold at current levels, and in fact prices fell off in March on surging crude imports from Saudi Arabia. Longer-term however, unrest in other oil-producing regions such as Nigeria should keep oil in the spotlight. Other factors also support slowing consumer spending. Most notably, interest rates remained stable last quarter, and prospects of increased budget deficits will generate upward pressure on rates. "War deficits" also threaten to reduce the magnitude of tax cuts or other fiscal stimuli. For now the Fed is in neutral, leaving rates unchanged in March and choosing not to issue a bias statement. Even the Fed Governors are looking to the conclusion of hostilities for a clearer environment. Reduced uncertainty will likely buoy world stock markets, but in our view it will take more to prevent another recession and stimulate lackluster world economies.



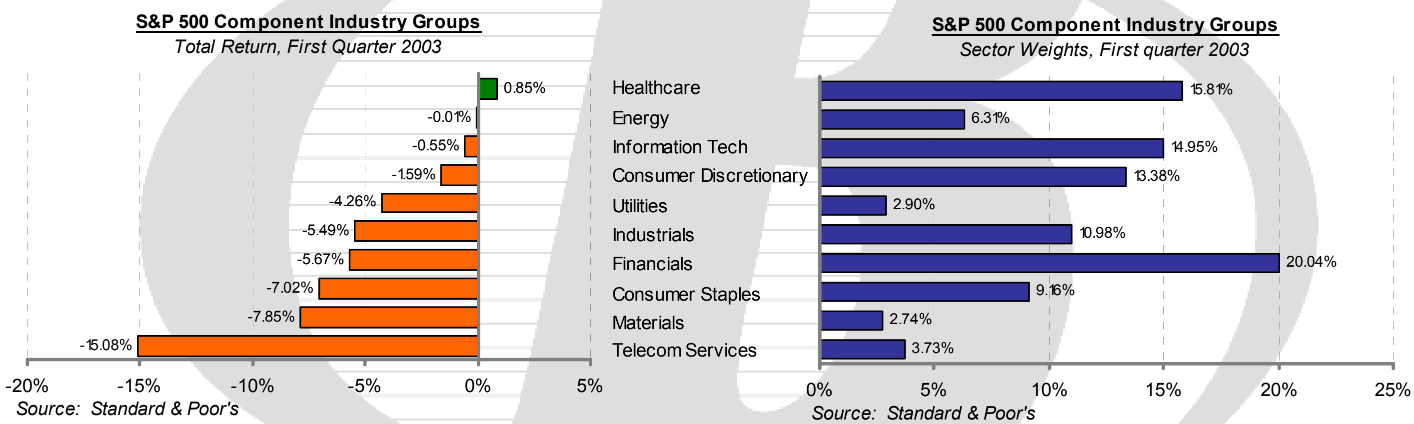
The U.S. Stock Market

Equity investors continued to suffer through another period of largely negative performance. The quarter opened with investors facing the familiar worries of a weak economy, accounting scandals, threats of terrorism, and uncertainty relating to the situation in Iraq. As the quarter progressed and the threat of war turned into reality, the impact on the markets intensified. Investors largely discounted business and economic fundamentals; instead it was the war that was the main market driver. Initial military successes and positive media coverage drove the equity markets higher, only to be reversed soon after by fears of a prolonged conflict. Despite significant volatility, trading volume was light for much of the quarter, as uncertain investors chose to stay out of the fray. The S&P 500 and the Dow closed the quarter with modest losses, at -3.15% and -4.19%, while the NASDAQ composite rose by 0.42%.

Stock Indices - 1Q 2003 Total Return

Large cap Stocks		**Midcap Stocks**	
S&P 500	-3.15%	S&P Midcap 400	-4.44%
Russell 1000	-2.94%	Russell Midcap	-2.37%
Growth	-1.07%	Growth	-0.02%
Value	-4.83%	Value	-4.06%
Broad Markets		**Small cap Stocks**	
NASDAQ Comp.	0.42%	S&P Smallcap 600	-5.80%
Wilshire 5000	-3.49%	Russell 2000	-4.49%
		Growth	-3.88%
		Value	-5.08%

All but one of the S&P economic sectors finished negative for the quarter. Returning 0.85%, Health Care was the best performing sector, buoyed by solid performances from biotechnology and managed health care stocks. Although losing 0.55%, information technology stocks had a relatively solid quarter, aided by strong performances from Yahoo (+46.91%) and Adobe (24.31%). Other stocks topping the winners list were Dynegy (+121.19%), Corning (+76.44%), Williams Company (+69.63%) and Starbucks (+26.40%). Major detractors from performance were Allegheny Technology (-53.45%), CMS Energy (-53.28%) and Andrew Corporation (-46.50%).



On the surface, corporate earnings growth numbers for 1Q03 are expected to look good. According to First Call, year-over-year earnings growth for stocks in the S&P 500 will be close to 11%; almost a percentage point higher than last quarter. However, much of the expected growth can be attributed to the energy sector, resulting from higher oil prices. Excluding energy, growth is about 4%, well below the 7.9% earned in 4Q02.

Another quarter of negative returns for stocks and positive returns for bonds contributed to the ongoing performance spread. On average, bonds (Lehman Aggregate Index) have performed better than the equities (S&P 500 Index) over the one-, three- and five- year periods. Equities still fare better over the ten-year period, but not by much (1.3%). Not surprisingly, cash has continued to flow into bonds. According to the Investment Company Institute (ICI), bond funds had an inflow of $19.6 billion in February, while equities had outflows of $11.1 billion.

Investors should be prepared for continued volatility in the market until the conflict with Iraq is resolved. At that time, it's likely a market rally will follow, although it is doubtful the rally will translate into a sustained recovery.

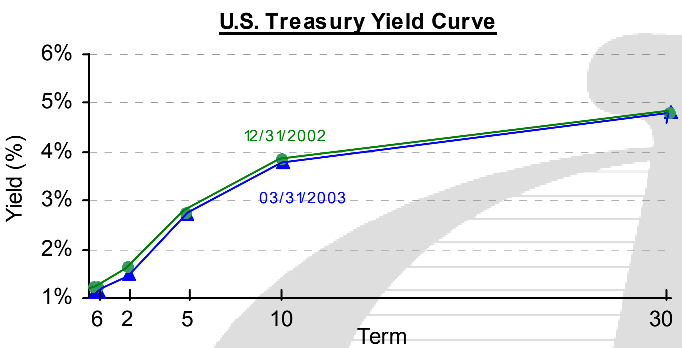
The U.S. Bond Market

The bond market continued to outperform equities in the first quarter, although the performance gap between the asset classes has narrowed. Once again, investors sought higher yields in the corporate sector even with the beginning of conflict in Iraq.

At the Federal Open Market Committee (FOMC) meeting on March 18, the Fed left the federal funds rate unchanged at 1.25% citing a high level of geo-political uncertainty including short-term oil prices and the outcome of the Iraq conflict. The Committee appears to believe that as those uncertainties lift, the monetary policy decisions made to date coupled with ongoing growth in productivity will provide support to economic activity sufficient to create an improving economic scenario. Spreads between the 2-year note and 30-year bond did not move significantly during the quarter, widening slightly to 333 basis points.

Bond Indices - 1Q 2003 Total Return	
Lehman Aggregate	1.39%
Lehman Interm. Gov't	0.93%
Lehman Long Gov't	1.49%
Lehman Interm. Credit	2.26%
Lehman Long Credit	2.90%
Lehman High Yield	7.61%

Performance of high yield bonds led all fixed income sectors for the quarter. Investors anticipating a short conflict after initial success rotated into higher yielding issues. The Lehman High Yield Index returned 7.61% for the quarter strongly outpacing its closest competition in the long credit sector. Ten year spreads between treasuries and high yields are running near 500 basis points.



While investors favored the safety of long government bonds in 2002, the start of 2003 has seen investors moving into the corporate credit sector, hungry for yield after three years of disappointing equity market returns and falling interest rates. After the accounting scandals of 2002, companies have focused on improving their balance sheets and paying down debt. This has had a positive effect, decreasing the credit risk in the corporate sector. But skittish investors are closely following developments in the Persian Gulf, standing ready for a flight to quality if it appears that the conflict will be prolonged. Corporate bond issuance contracted by 25% in 2002, with the expectation that this trend will continue into 2003. The impact of this contraction will be a reduction in supply and tightening of spreads, especially in lower credit quality issues.

It is clear that investor sentiment is being tempered by both political and economic factors, leading to a high level of market volatility. A successful war scenario should serve to help return markets to a semblance of normalcy, favoring economic data over war news as a driver of market performance. Wary investors will also continue to watch the Fed closely to gauge sentiment based on their approach to interest rates.

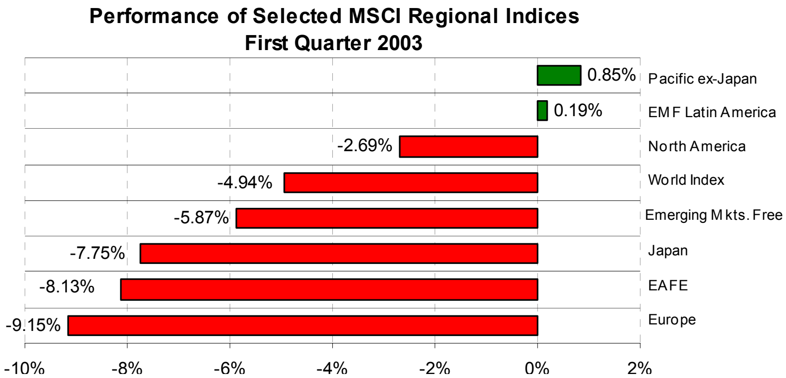
Overseas Markets

Global markets continued their lackluster performance for yet another quarter. Continuing economic strife across the globe has not improved the prospect of a recovery in any global sector as 2003 growth forecasts are likely to continue to trend sideways until the outcome of the Iraq conflict becomes clear.

The Eurozone saw a slackening in inflation early in the quarter coupled with an increase in the zone's manufacturing index, but most of the major geographic sectors in the region were still down for the quarter. Germany's woes continued as the economy is again in jeopardy of breaching deficit ceilings created through the euro currency treaty. Under the treaty, member countries must keep deficits below 3% of their GDP. Ironically, Germany was the country that pushed for the imposition of caps on deficits under the treaty. Economic growth is expected to be around 1.5% in 2003, an optimistic forecast given the 0.2% growth the country managed in 2002. The MSCI German Index was down 12.55%. France is in a similar position with slower growth projections for 2003 of 0.3% per quarter. Proposed tax cuts could potentially push France up against the same deficit ceiling issue facing Germany. Consumer confidence fell to 5 year lows during the quarter, helping to drive the MSCI France Index down nearly 11.5% for the quarter.

Stocks in Japan have shown no respite in their ability to continue falling. Prime Minister Koizumi installed Toshihiko Fukui as a new Bank of Japan governor late in the quarter. Fukui is exploring a target inflation rate as a short-term means of controlling falling asset prices in an attempt to create economic growth in the stagnant economy. Deflation is still a major issue as Japanese average wages fell 2.2% last year. The jury is still out on Fukui, in office only two weeks at the close of the quarter, but he is expected to take a cautious approach to investing in risk assets as a means of jumpstarting the economy. The MSCI Japan Index finished the quarter down 7.75%

Performance elsewhere in Asia was negative during the quarter. China, Asia's rising star, experienced a trade deficit early in the quarter, importing more goods than it exported. GDP growth is expected to be in the 7.5% range for 2003, down slightly from 2002, but still ahead of many of its regional neighbors. The MSCI China Index was down 1.77% for the quarter. With war being waged in Iraq, the geo-political focus has been shifted away from the North Korean issue, allowing South Korea some breathing room for economic growth, although the markets continue to suffer with the MSCI Korea Index falling over 17% for the quarter.



In Latin America regional volatility continues to persist, although there have been some positive economic developments. In Brazil, the country posted a 7.6 billion *real* budget surplus for February, helping surpass a 15.4 billion *real* target set by the IMF for the first quarter. All this good news translated into a 5.82% return in the MSCI Brazil Index. In Venezuela, oil production continues to come back on line, although oil workers remain on strike. The country was down over 9% for the quarter. Positive news in Argentina in the form of lifted restrictions on bank accounts was cause for the MSCI Argentina Index return of over 19% for the quarter.

Focus On: *Hedge Funds to the Rescue?*

Hedge funds have been back in the news lately; indeed, it's difficult to get through any investment journal without reading several articles extolling their virtues or reveling in their elegant mystique. Portfolio managers have been leaving traditional firms in a steady stream to open hedge funds, lured by hefty compensation and freedom from restrictive investment policies and regulation. The number of available funds has grown from several hundred to more than 5,000; simultaneously, minimum initial investments have dropped and Wall Street's considerable marketing machine is generating interest from new pockets of investors, including public pension funds and smaller corporate plan sponsors. Once the exclusive playground of the wealthy, more mainstream investors are getting into the act through hedge "fund of funds" products, which are already showing up in some 401(k) plans.

The reasons for looking at hedge funds vary, and we believe these products have a legitimate place in many institutional portfolios. For example, some hedge fund strategies offer the pension plan sponsor assets that may better match the return demands and risk characteristics of their plan liabilities, particularly for cash balance and other non-traditional benefit formulae. Hedge fund returns can also be attractive in an asset-only framework, where low market correlation leads to more efficient portfolios. Many endowment funds have benefited from low hedge fund correlation, particularly during the recent bear market.

Lately it's the allure of superior returns in a bear market environment that has caught the eye of pension sponsors and individual investors alike. Politically, hedge funds have become the "silver bullet" for investment woes. Many large government pension sponsors have led the way, offering a combination of hedge funds and shareholder lawsuits as the response to funding deterioration. Corporate CFO's are tired of explaining pension losses to investors and analysts, and we're all tired of tallying up losses on our savings plan statements.

Therein lies a real danger; remember last time that hedge funds were in the news? In 1998, the leading hedge fund Long Term Capital Management LP went from solvency to bankruptcy in a matter of weeks, destroying investor wealth by the billions and rocking world financial markets. Federal intervention and a coalition of investment banks were required to contain the situation. It was neither the first hedge fund meltdown nor the last, but it was noteworthy for its speed and severity. Silver bullets are great for killing werewolves, but you can also use them to shoot yourself in the foot. Careful study and due diligence really pays here. What is a hedge fund? The product defies tight definition, but generally they are loosely regulated investment portfolios, usually structured to avoid SEC registration requirements, that may invest in a very wide range of securities and derivatives. They typically allow for short-selling and leverage, to a much greater extent than a traditional investment product. Alfred Winslow Jones is widely credited with creating the first hedge fund in 1949, following a *long/short* strategy designed to capture returns from careful stock selection while canceling out much of the underlying stock market risk. By simultaneously buying stocks with favorable prospects and short-selling stocks with unfavorable prospects, this strategy seeks to achieve returns in both up-market and down-market conditions. While the strategy offers the potential for gains or reduced losses in bear markets, the investor gives up any underlying secular stock market growth, which is expected to be net positive over time. Fund managers often try to make up this gap by using leverage to enhance returns.

The term "hedge fund" follows from Mr. Jones' strategy; by using the otherwise speculative technique of short-selling (selling borrowed shares in the hope of buying them back later at a lower price), the fund manager hedges against downward market movement. Many of today's common hedge fund strategies follow from the equity long-short model, including market-neutral and alpha-transfer funds. While in isolation the techniques can be speculative and risky, in the hands of a skilled and disciplined practitioner overall risk can actually be reduced.

Not all funds follow this model. Over the past two decades, *arbitrage* and *macro* strategies became very popular. Arbitrage strategies seek to profit from small market pricing inefficiencies that occur from time to time. Popular strategies include convertible bond, mortgage, and merger arbitrage. In contrast, macro funds take large directional bets on global markets, currency rates, interest rates, and other economic factors. Both types of hedge funds tend to use much more leverage to deliver results.

Evaluating Hedge Funds

- **Policy Fit**
  What role would the HF play in your strategy? Does the candidate fund have clear and compatible objectives?
- **Theoretical Basis**
  Why should the fund's strategy work? Beware past performance and back-testing.
- **Leverage**
  How much is required? Why? Are there specific limits? How can they be changed?
- **Risk Control**
  Are big decisions subject to committee review before commitment? Who's on the committee and how much power do they really have?
- **Operations & Accounting**
  How much information will the manager disclose? How is the data accuracy independently verified?
- **Exit Risk**
  How long would an exit take? How many other investors are there, and what percentage of the fund would you represent?
- **Fees & Expenses**
  Are the fees (including performance fees) so high that any realized alpha is consumed?

Leverage is a key driver of hedge fund risk, because it can greatly magnify the impact of small mistakes by the manager. It was high leverage more than flawed underlying investment strategy that sank Long Term Capital Management. Lack of transparency and operational control can compound hedge fund problems; consider Beacon Hill Asset Management, a mortgage arbitrage fund that failed just last year. According to a complaint brought by the SEC, the firm committed fraud by reporting returns they knew or should have known were incorrect. This case serves as a reminder that, by its nature, "caveat emptor" rules the hedge fund marketplace.

It follows that no investor should consider hedge funds, regardless of past performance, unless they have the size and will to compel fund managers to follow strict risk control and reporting standards. That rules out smaller institutional investors, except through fund-of-fund structures where they rely on an investment manager for scale and due diligence capabilities. Using a fund-of-funds drives up fees and makes it more difficult to use hedge fund strategies for asset-liability management, but the approach is attractive for some investors.

Do hedge fund-of-funds have a place in employee-directed programs like 401(k) plans? Not in our opinion, at least not under today's loose regulatory framework. Hedge funds are designed for qualified investors, and lack much of the oversight and regulation provided by the Securities Act and Investment Company Act. The fund-of-fund structure may legally sidestep the requirements of these acts, but it does not sidestep the plan sponsor's moral and fiduciary obligation to provide suitable investment options for employee use.

By all means, institutional investors should consider the silver bullet. Proceed with caution, considering the risks, but think long and hard before handing the gun to your employees.

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