Bellwether CONSULTING

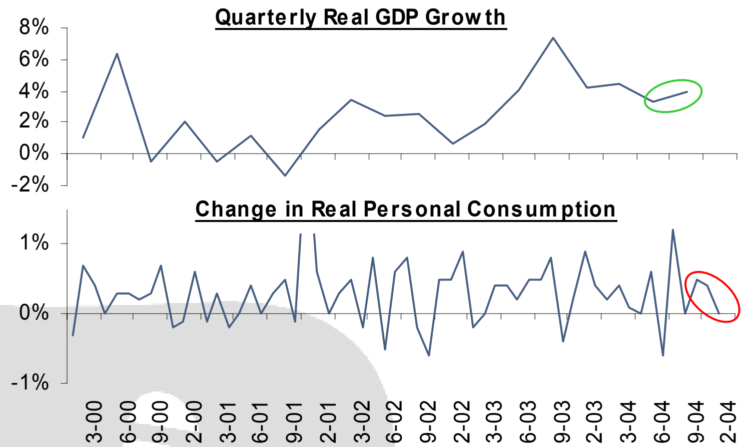
Your Quarterly Update on the Financial Markets
December 31, 2004

4th Quarter

MARKET Recap

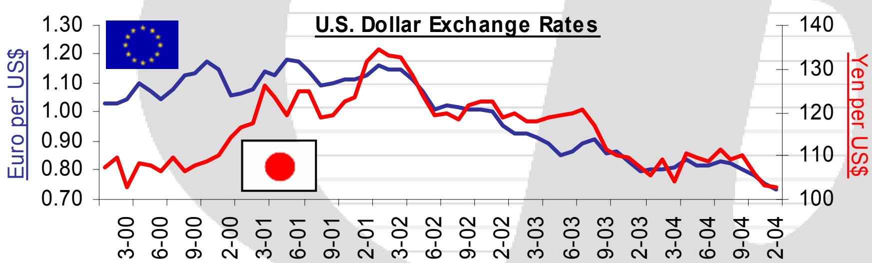
The Economy: *"Mind the Gaps"*

Real economic growth picked up modestly in the third quarter, increasing at an annual pace of 4%. The revised statistic provided a positive surprise and contributed to a significant fourth-quarter rally in equities, but further analysis reveals a mixed story.



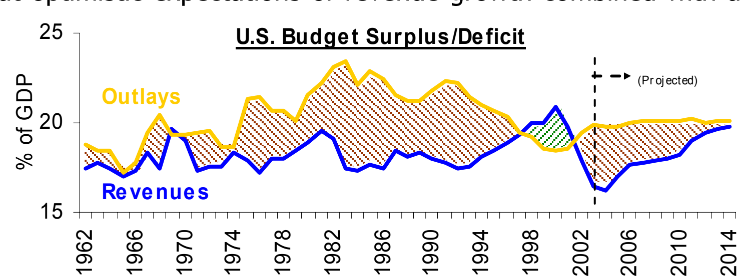
Personal consumption expenditures drove the increase in real GDP, reversing a mid-year slump despite high oil prices. Sales of computers were particularly strong, as was motor vehicle output; however, we remain troubled by Detroit's aggressive financing offers, which become increasingly expensive as short-term interest rates rise. The pace of imports also decelerated, contributing to GDP growth; recall that GDP (Gross Domestic Product) measures the value of goods and services produced in the United States, and so imports are subtracted from the figure. While encouraging, much of the positive story reversed in the fourth quarter. Personal consumption expenditures slowed in October and November, and the U.S. trade deficit widened to record levels triggering the dollar to resume its slide against other major currencies. It is too soon to draw any conclusions on holiday-related sales activity, but we maintain a cautious outlook.

Resolution of the U.S. election has spawned welcome discussion of two major, inter-related policy issues. The "twin gaps" represented by the fiscal budget deficit and current account trade deficit are historically addressed most effectively by second-term presidents, and the alignment of Congress and the President under one party represents a unique opportunity to effect change (for better or worse).



As with President Reagan at the start of his second term, it is apparent that a weakening U.S. dollar is part of the solution to the trade gap. A falling dollar benefits domestic manufacturers in both domestic and foreign markets, and may contribute to job and wage growth. Conversely U.S. consumers may face higher prices, and our trade partners (particularly in Europe) will face reduced demand. The risk with a weak-dollar strategy is that foreign governments will support the dollar by buying U.S. Treasuries until, under stress, they relent and the dollar falls too far, too suddenly. A coordinated strategy, though difficult to achieve, is likely to achieve better results for the global economy.

The budget deficit will prove a thornier problem. Congressional Budget Office projections show a gradually shrinking deficit over the next decade based in our opinion on somewhat optimistic expectations of revenue growth combined with a flat expense profile. Demographic demands from the Social Security program and potentially increasing current funding requirements due to privatization further erode our expectations of a balanced budget. Yet fiscal discipline is key to maintaining low interest rates, a condition precedent to growth in revenues. In testimony before the House Budget Committee last September, Fed Chairman Greenspan noted that "With the baby boomers starting to



retire in a few years and health spending continuing to soar, our budget position will almost surely deteriorate substantially in coming years if current policies remain in place." We are hopeful that both parties will seize this narrow window of political opportunity to attack the fundamental problems.

The U.S. Stock Market

Equity markets rose through the fourth quarter with the major indices closing substantially higher. Wall Street rallied from a 2004 low-point in October to a 3½ year high in the final weeks of the year. The markets benefited from generally good economic data and positive profit forecasts for 2005. While some may attribute the strong close, in part, to a "Santa Claus" rally, it seems more likely that continued attention to fundamentals drove the appreciation.

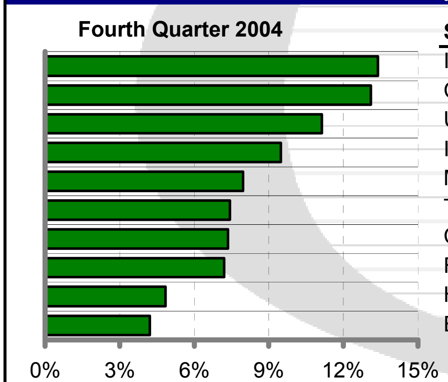
Stock Indices - Total Return

	4Q04	2004		4Q04	2004
Largecap Stocks			**Midcap Stocks**		
S&P 500	9.23%	10.88%	S&P Midcap 400	12.16%	16.48%
Russell 1000	9.80%	11.40%	Russell Midcap	13.66%	20.22%
Growth	9.17%	6.30%	Growth	13.94%	15.48%
Value	10.38%	16.49%	Value	13.46%	23.71%
Broad Markets			**Smallcap Stocks**		
NASDAQ Comp.	14.69%	8.98%	S&P Smallcap 600	13.00%	22.65%
Wilshire 5000	10.33%	12.62%	Russell 2000	14.09%	18.33%
			Growth	15.08%	14.31%
			Value	13.20%	22.25%

The best-performing sector in the fourth quarter was technology. (In fact, some mention is being made of the potential for technology stocks to finally come back into favor as industry leaders begin to figure out how to achieve long-term profits.) While no sector lost ground in the fourth quarter, energy and healthcare were at the bottom of the heap. Energy sector stocks were clearly impacted by the November and December decline in oil prices. The price of crude peaked on October 22 at $55.15 per barrel, but fell 21% by the end of the year.

Returns increased as investors moved down the capitalization ladder. Small-cap out-performed both mid-cap and large-cap sectors, although all sector returns were strong. Growth stocks made a comeback in the fourth quarter of 2004, out-performing value stocks in both the mid-cap and small-cap sectors.

S&P 500 Economic Group Components - Total Return



Sector	4Q04	2004
Information Tech.	13.39%	2.13%
Consumer Discretionary	13.11%	12.15%
Utilities	11.13%	19.60%
Industrials	9.49%	15.95%
Materials	7.97%	10.79%
Telecom Services	7.43%	15.98%
Consumer Staples	7.36%	6.04%
Financial	7.20%	8.23%
Healthcare	4.84%	0.24%
Energy	4.22%	28.77%

Source: Standard & Poor's

By ending on a strong note, the major market indicators posted annual gains in back-to-back years for the first time since 1998-99. While this is good news, all three are still below record levels: the Dow at -8%, the S&P 500 at -21%, and the NASDAQ at -57%.

Although it is rarely rewarding to try to predict the future, we're not above trying. The fact that the markets ended 2004 on a relatively strong note despite all the potential pitfalls (e.g., the war in Iraq, skyrocketing oil prices, a down-to-the-wire presidential election, a weakening dollar, and a record budget deficit, just to name a few), has encouraged many to be optimistic. With most of the threats carrying over into 2005 (except rising oil prices, which seem to have abated for now), again we believe it is rising interest rates that could pose the real problem for equity markets in 2005. As we pointed out last year at this time, markets are fundamentally driven by expectations of earnings and interest rates. Stock prices are depressed when higher interest rates reduce 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. Last year we predicted interest rate challenges that did not materialize. This is likely because rates remain close to historical lows despite the five Fed actions. However, with the Fed leaning toward further raises, we'll repeat our prediction that tightening monetary policy will be the biggest hurdle for stocks in the coming year.

The U.S. Bond Market

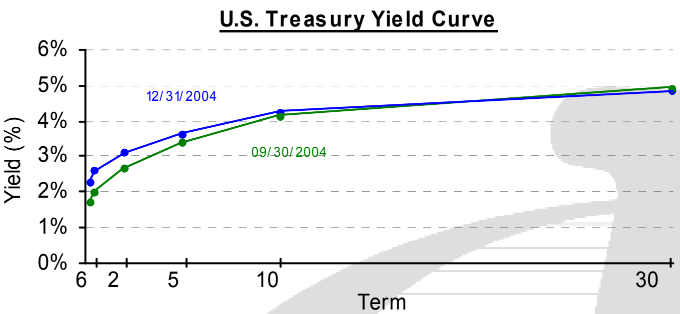
In the fourth quarter, bond prices fell across the curve, driving yields higher, except for the 30-year Treasury, which ended the quarter down slightly (0.07%) at 4.82%. The 10-year Treasury ended the quarter yielding 4.22%, higher than the third quarter close of 4.12%, but still lower than 4.58% on June 30. The Federal Reserve raised short-term rates two times in the fourth quarter (five times in six months), with the last increase of 0.25% coming on December 14 and bringing the Federal Funds Rate on overnight loans between banks to 2.25%.

Federal Reserve officials have once again made it clear that they plan to keep raising rates in the future, and the increases seem likely to continue to come in measured, quarter-point steps. Higher short-term rates are likely to cause some decrease in consumer spending through an impact to consumer loans like variable-rate credit cards, home equity lines of credit, and auto loans. However, as we saw last quarter, a Fed rate hike does not always have the expected impact to longer-term debt. In fact, the average 30-year mortgage has remained around 5.70% as of the end of 2004, down from 6.30% at the end of June; so while short-term rates went up by 1.25%, long mortgage rates have dropped by about 0.60%.

Bond Indices - Total Return

	4Q04	2004
Lehman Aggregate	0.95%	4.34%
Lehman Interm. Gov't	0.22%	2.33%
Lehman Long Gov't	1.57%	7.94%
Lehman Interm. Credit	0.77%	4.08%
Lehman Long Credit	2.96%	9.38%
Lehman High Yield	4.57%	11.13%

Spreads to treasuries on investment grade bonds were relatively unchanged from the third quarter. However, high yield spreads tightened over 0.25% across the board. High yield spreads have been narrowing for several years, but still have room to go before they reach their tightest levels historically. High yield performance led all fixed income sectors in total return for the quarter and the year. If rates rise through 2005, fixed income investors will likely turn to this sector in increasing numbers, able to seek out the higher returns due to the comforting trend of improving fundamentals.



Source: Bloomberg LP

Corporate issuance in 2004 topped previous records with investment-grade corporate bond sales coming in at $689 billion (compared to the previous record of $668bb in 2001) and high yield sales of $141 billion (compared to $138bb in 1998).

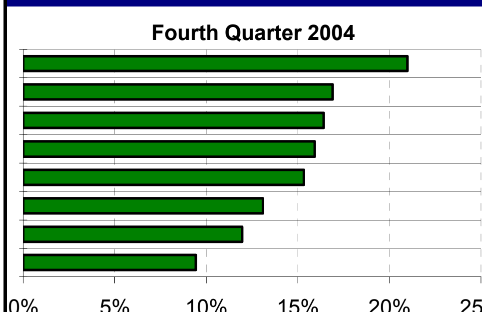
In contrast to expectations, bonds performed well in 2004, largely because the impact of the Fed increases on long rates was less than expected. That said, the close of 2004 saw most of the yield curve responding to Fed action in a more predictable manner. If this continues, one might expect bonds to diminish in attractiveness. However, with the Fed clearly telegraphing their actions, short-term rate increases may be fully priced into an efficient bond market.

Overseas Markets

Developed global markets surged during the fourth quarter as the price of oil moderated and positive economic news flowed through world markets. Emerging markets benefited from a global rise in commodity prices as China and America's appetite for raw materials remained strong.

Performance in Europe strengthened as several years of continued cost cutting led to corporate gains. Inflation in the Eurozone ended the year lower at 2.2%, but still above the European Central Bank's target of 2.0%. The ECB left its key interest rate unchanged at 2.0% for the eighteenth consecutive month in December even amid the euro's continued appreciation versus the dollar. In Germany unemployment rose to 10.8%, the highest level since 1998. While expected, sluggish growth in Germany has given rise to fears that the strong market performance experienced in 2004 will wane. The MSCI Germany Index was up 19% for the quarter. In France the budget deficit finished at 4.1% of GDP, well in excess of the ECB's 3.0% target. However, better employment and increasing consumer confidence coupled with decreasing energy prices and a weaker dollar contributed to better market performance in the sector. The MSCI France Index was up nearly 15% for the quarter.

Gross Total Return of Selected MSCI Regional Indices



Region	4Q04	2004
Latin America	20.98%	39.44%
Emerging Markets Free	16.89%	24.64%
Pacific ex Japan	16.40%	28.46%
Europe	15.92%	20.88%
EAFE	15.32%	20.25%
Japan	13.08%	15.86%
World Index	11.95%	14.72%
North America	9.43%	10.71%

In Japan the year ended with good news. The unemployment rate fell to 4.5%, the lowest level in the last five years. Simultaneously increasing output of electronic technology, steel and machinery used in the manufacture of semiconductors drove markets up. However, the good news was also tempered by a falling trade surplus as rising energy prices increased the cost of imports. The consensus for 2005 is that the economy will slow after strong GDP growth of 4.0% in 2004. The MSCI Japan index was up 13% for the quarter and 15% for the year.

The biggest global markets story in 2004 was China. With its rapidly expanding economy and appetite for raw materials driving growth, China's GDP grew over 9.0% for the year, far outpacing growth in most developed markets. Industrial production rose 14.8% year-over-year during the fourth quarter but fell from 15.7% the previous quarter. Exports grew 46% from the prior year as demand for Chinese-produced clothes and electronics goods increased; imports into China grew tremendously as well, rising 39% year-over-year, leaving a sizeable trade surplus. While this growth was exciting runaway inflation is a significant risk. Even given all of the positive news, the MSCI China Index finished up only 5% for the quarter and 2% for the year as fears of a hard economic landing and the possible easing of the yuan's tie to the dollar put downward pressure on shares.

Latin American emerging markets led performance globally benefiting from the surge in commodity prices for grains, metals and oil driven largely by demand from China. In addition, a relatively prolonged period of political and economic stability contributed to strong performance. In Brazil GDP growth was 6.1% for the year. Although unemployment remained relatively high at 10.6%, it ended the year lower than expected. Strong growth has kept the central bank busy as it has increased the benchmark lending rate to 17.75% to stave off inflation. The bank policy seems to be working as inflation for 2005 is forecasted to be just over 5.0% down from almost 6.5% in 2004. The MSCI Brazil Index was up 23% for the quarter and 36% for the year. Argentina continues to deal with its explosive debt issue, attempting to restructure outstanding debt payments to make good to the IMF. The IMF is owed over $14 billion and Argentina has nearly defaulted on payments a number of times in 2004. Given all of these problems the markets still performed well with the MSCI Argentina Index up 8% for the quarter and almost 26% for the year.

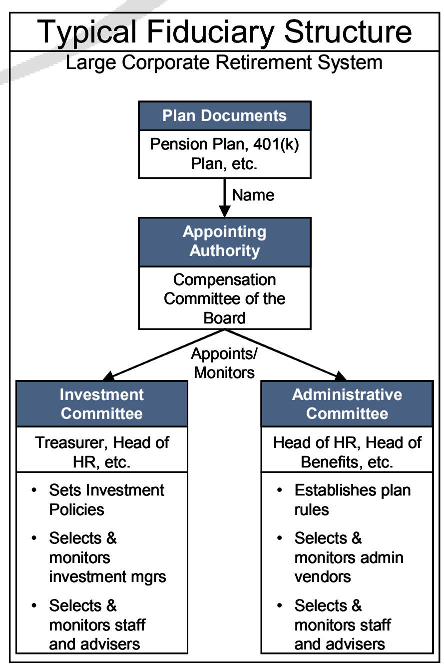
We expect global market performance to moderate in 2005, and we urge investors to keep a watchful eye on China, which will have an increasing impact on both developed and emerging markets.

Focus On: *Effective Investment Committees*

Managing money on behalf of other people is an awesome responsibility. Often, the relationship between a beneficiary and fiduciary is compared to the relationship between child and parent – due not to lack of knowledge or maturity on the beneficiary's part, but rather because of the degree of dependency involved. For a fiduciary relationship to be effective and sustainable, three burdens are imposed on the decision-maker: *technical competence, ethical intent,* and *formal structure*. These burdens are somewhat independent of each other, in that lack of one can lead to failure even when the other two factors are abundantly present.

We often find organizations with an abundance of talented staff and the best of honest intentions, but their retirement plans, endowments, and other pools of money suffer from neglect or inconsistent decision-making. Often the culprit is disorganization due to lack of formal structure; it is unclear who is in charge, and what the extent of their authority is. Turnover also contributes to the problem – without formal structure, confusion reigns after the departure of a strong leader, leading to poorly timed, non-strategic decisions. Ironically, some of the smartest analysts and strongest leaders eschew formal structure. That's a shame, because structure does not have to interfere with the decision-making process.

Establishing an effective committee leads to better decisions, because people act more decisively when comfortably within their authority. An effective committee cushions the portfolio and organization from personnel turnover, and over the long term enhances portfolio value. And yes, formal structure is a good fiduciary practice that helps tremendously if decisions are ever questioned or challenged.



For lack of a better term, we'll call the decision-makers for an institutional portfolio the *Investment Committee*. Regardless of the exact context (e.g., pension management, trust management, etc.), following a few simple principles in chartering, composing, and operating the Committee will lead to better results.

Committee Charter and Authority

The authority of an investment fiduciary flows from a governing document, which we'll refer to as the charter. For corporate and non-profit retirement plans, the plan document often serves this purpose; government-sponsored plans usually look to a specific statute or regulation at the state level; other institutional investors may refer to a corporate charter, trust document, or by-laws.

Specifying fiduciaries with authority to make decisions is the most important function of the charter. Three methods are common: naming individuals, naming functional positions, or naming an appointing authority. The latter method is generally best, and is most common in larger organizations, since an appointing authority can react to specific situations such as personnel changes without a rigid requirement to change the charter. Typically a board of trustees, board of directors, board-level committee, or combination of government executive/legislative functions serves as the appointing authority. The responsibility of the appointing authority should be narrowly defined since the individuals involved may not have the time or expertise required for specific investment decisions. However, if you have the power to appoint fiduciaries, you must see to it that the appointees perform their function. Therefore the investment committee should, at a minimum, provide the appointing authority with reports or minutes demonstrating that they are regularly discharging their duties.

A chartering document may impose procedural requirements on the appointing authority such as a minimum number of committee members or minimum qualifications. Specific investment objectives and restrictions are not uncommon either. We generally frown on imposing procedural requirements or investment restrictions within the charter, as it is better to allow the appointing authority or investment committee to establish these policies. However, it is very important to identify and faithfully follow any requirements or restrictions in the charter.

Finally, the charter often specifies the scope of the investment fiduciaries – if not, the appointing authority makes that decision. Corporations usually define scope by function, with a single investment committee governing investment matters for every plan the corporation sponsors. Foundations and endowments tend to take a similar approach. The committee may also handle administrative matters, such as formulating plan rules, hearing benefits appeals, qualifying donors, approving projects; larger organizations tend to allocate these functions to a separate committee, as the workload and technical competence required are quite different. Public-sector organizations are increasingly adopting a functional committee approach, although the less efficient method of having separate committees for every plan is still common.

Composition and Operation

The Investment Committee does not have to be particularly large to be effective. In fact, having more than five or so members can get in the way of effective decision-making. Having the right people is much more important; the best committees consist of a mix of relevant skill sets, including financial knowledge, an understanding of the needs and expectations of the beneficiaries, familiarity with operations, and some basic knowledge of applicable law.

For retirement plans in larger organizations, those skill sets typically span the Finance and Human Resource functions. There should be a designated chairman, preferably a senior officer of the organization (typically the CFO or VP of Human Resources). Having a senior officer chair the committee provides an appropriate level of seriousness, and turns the committee into a decision-making team. Decisions may result in moving around millions of dollars of other people's money; it is not an entry-level job.

Staffing the committee is very important; basic staffing functions such as preparing minutes or setting the agenda are often performed by committee members in smaller organizations, but it is very important to ensure that meetings are documented. If committee members cannot perform that function, staff resources are essential. Expert resources such as legal and investment counsel are also important, particularly if those skills are not present on the committee itself.

An investment committee does not need to meet very frequently, nor for very long, to be effective. The conventional wisdom is that committees should meet quarterly, and rely on staff for day-to-day operations. With strong staff support some organizations may find semi-annual or annual meetings more effective, depending on the scope of the committee and volatility of the investment portfolio. More importantly, the committee should develop written policy to govern each of the portfolios for which they are responsible. Written policy helps ensure that investment decisions are consistent with portfolio objectives, and that committee time is used most effectively.

While formal structure is often a weak area for fiduciaries, it is one of the easiest areas to evaluate and improve. Adhering to a formal structure centered on an effective investment committee requires discipline, but pays real dividends through better strategic decisions – a result worth achieving!

Tips for Effective Decision-Making

- Use a committee for investment decisions, not an individual
- Identify the chartering document, and review it for procedural requirements and constraints
- Name an appointing authority for the committee
- Provide the appointing authority with minutes or updates, so they know that the committee is actually functioning
- Define committee scope by subject matter (e.g., investment vs. administration) rather than entity (e.g., pension plan vs. defined contribution plan)
- Have a senior officer chair the committee
- Include a cross-section of functional skills on the committee
- Document committee meetings
- Form and maintain written policy for every plan or portfolio

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