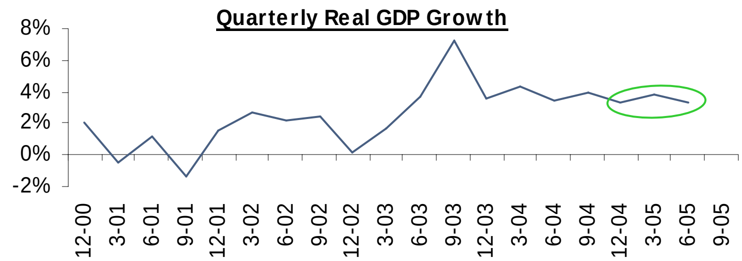
Your Quarterly Update on the Financial Markets
September 30, 2005

3rd Quarter

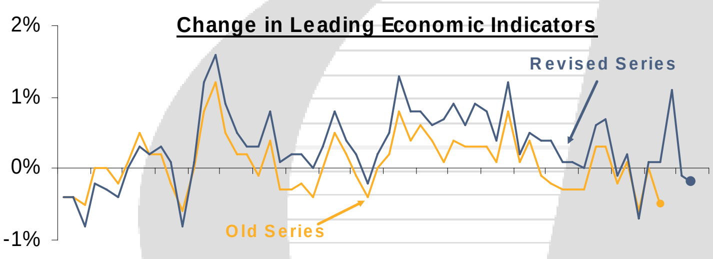
MARKET Recap

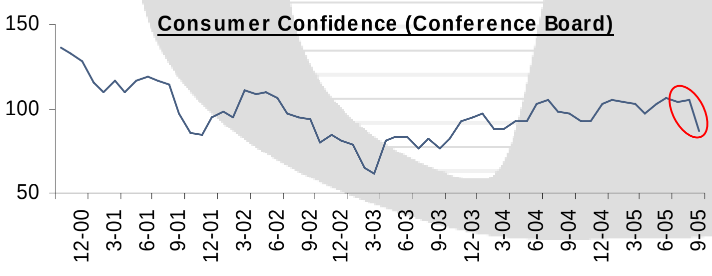
The Economy: *"Expectations of Slowness"*

The U.S. economy roared through the second quarter of 2005, maintaining a 3.5% growth pace that can only be described as healthy. The third quarter opened with a fairly widespread sense of optimism, manifest by speculation that a stable equilibrium between prices and growth had been achieved, the Fed would stop hiking rates, and we could all just relax. By August the optimism had predictably faded in the face of signals indicating slowing growth prospects and increasing inflation.



Prior to Hurricane Katrina, the Index of Leading Economic Indicators declined for two months running. Declines in this widely followed index were registered despite changes in construction methodology announced by the Conference Board effective in July. The most significant change is a modification to the way the yield spread component impacts the value of the overall index, such that the spread only contributes negatively to the leading index when the yield curve inverts. Recall from past issues that the yield spread is the difference between 10-year Treasury and short-term Fed Funds rates. Over the past five years, the change improves the appearance of the index in almost all periods (see the graph for a comparison of the old and revised index series). Changing the index in no way changes reality; we remain convinced that the shape of the yield curve is one of the most predictive indicators of future economic performance, and that a flat yield curve does not bode well for robust growth.





It's still too early to quantify the economic impact of Katrina and Rita, although we believe media speculation has been consistently too alarmist. One piece of data is available now; consumers clearly expect the storms to have a negative impact on the economy. The Conference Board's consumer confidence indicator fell sharply in September to 86.6, its lowest level in nearly two years, down from 105.5 in August.

It is difficult to separate the impact of Katrina from overall increases in oil prices witnessed in August; spot prices for West Texas Intermediate Crude were over $65 per barrel before the storm, driving the annual CPI run rate up to 3.6% (from 3.2%) in August. The Producer Price Index for finished goods also rose in July, up 1% with the core rate rising 0.4%; core producer prices were flat for August, but energy prices drove the overall index up 0.6%. Clearly energy-driven inflation is persisting, and signs of broader price inflation are present, maintaining upward pressure on interest rates.

Inflation will affect people directly as consumers, and indirectly as investors in companies with tightening margins. The question remains as to whether consumers and business purchasers now view increasing prices as transitory or long-term in nature. The longer an inflationary trend persists, the more likely it is that people will view it as long-term and adjust their expectations accordingly. If purchasers expect inflation to subside in the near future, they are likely to make only small changes in their buying behavior and rely on financing techniques to push through the problem. Once inflation expectations become long-term, people and businesses will alter their buying behavior, tightening their belts and substituting lower-cost goods and services. A slow-down is likely, outright recession is not if businesses are able to adjust their product mix quickly enough. Start cranking out the hybrids!

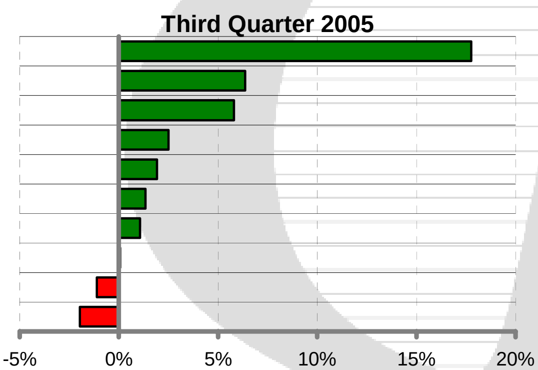
The U.S. Stock Market

Stock Indices - Total Return Third Quarter 2005			
Largecap Stocks		**Midcap Stocks**	
S&P 500	3.61%	S&P Midcap 400	4.88%
Russell 1000	3.95%	Russell Midcap	5.92%
Growth	4.01%	Growth	6.55%
Value	3.88%	Value	5.35%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	4.61%	S&P Smallcap 600	5.38%
Wilshire 5000	4.03%	Russell 2000	4.69%
		Growth	6.32%
		Value	3.09%

As September came to a close U.S. equity markets had survived an erratic, event filled quarter. The quarter began with some optimism that investors and the markets would be able to withstand the pressures of higher energy prices which had already started to escalate. In fact, both the S&P 500 and the NASDAQ rallied to four-year highs in August. Two major hurricanes battered the Gulf Coast in September and took their physical toll, driving crude oil and gasoline prices to heights never before seen in the United States. Fears of a slowdown in consumer spending in response to the volatility of energy prices came in the wake of both storms. The broader markets were able to absorb this impact and negative economic news including fears of a real estate market slowdown, evidenced by a 7.0% drop in mortgage refinancings and a 0.1% drop in housing starts, and falling consumer confidence, still managing to show positive returns. The Dow was up 2.86% for the quarter while the S&P 500 and NASDAQ gained 3.15% and 4.61%, respectively, primarily due to strong performance early in the quarter.

Alan Greenspan recently alluded to the market's "weathering" of the storms, both literal and figurative, stating that the U.S. economy's ability in recent decades to weather a series of shocks -- including the latest run-up in energy prices -- offered evidence of its increased flexibility. "That greater tendency toward self-correction has made the cyclical stability of the economy less dependent on the actions of macroeconomic policymakers, whose responses often have come too late or have been misguided," he said. However, given recent events, even the most optimistic of investors has been given reason to pause and reevaluate the response of the markets and their strategies. As the quarter wrapped up, consumer sentiment, consumer spending and personal income all dropped.

S&P 500 Economic Group Components - Total Return



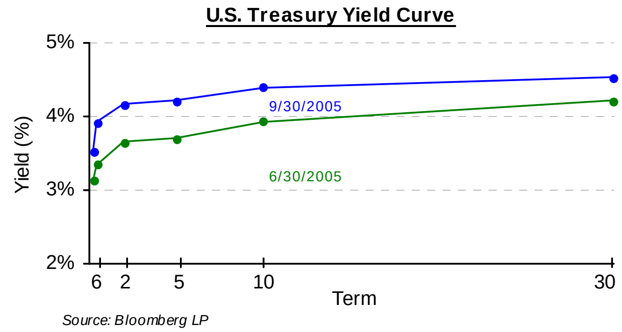
Sector	3Q05
Energy	17.77%
Utilities	6.37%
Information Technology	5.80%
Consumer Staples	2.51%
Industrials	1.92%
Materials	1.34%
Health Care	1.07%
Financials	0.07%
Consumer Discretionary	-1.11%
Telecom Services	-1.96%

Source: Standard & Poor's

Growth issues returned to favor during the quarter across all capitalization sectors, with mid cap and small cap issues continuing to outperform their larger peers. The P/E of the S&P 500 has remained relatively flat for most of the year at about 19, below its long-term average of 22 and well below its 10-year average of around 27. With oil prices piercing the $70 per barrel level and gasoline surging to over $3 per gallon in the wake of the storms, the energy sector again became the top performer of the S&P 500 as major gasoline distributors saw record profits with no discernable slackening of demand by U.S. consumers. S&P components ExxonMobil and Chevron ended the quarter up 11.0% and 16.5%, respectively. In line with economic data, the consumer discretionary sector fell to the second-worst performing sector as consumers were forced to decide between gasoline and other purchases. Investors, seeking reversion to mean growth levels, continue to participate in the market even as negative economic news might lead them to do otherwise. Since earnings growth is a trailing indicator we would expect to see a pullback in equities as investors come to terms with the strong possibility of inflation and the subsequent hit to corporate earnings growth.

The consensus forecast for third quarter profit growth stands at 17.8%, up from 15.1% at the start of the quarter, according to Thomson Financial. Upward revisions in earnings forecasts by street analysts stand in direct conflict with economic forecasts that had been predicting slower growth through the second half of the year even before hurricane Katrina. Discounting earnings from the energy sector, the S&P is still expected to show 11.0% earnings growth for the quarter, leading to the belief the impact of the storms and negative economic data has been minimal. However, at the start of the year analysts had predicted third quarter S&P earnings to be in the 15.0% range, so there is some evidence of a slowdown in growth. With the jury still out as the third quarter corporate earnings season begins, and expectations of strong earnings growth, any negative earnings surprises should have a significant impact on U.S. equity markets.

The U.S. Bond Market



The yield curve flattened a little more in the third quarter of 2005, moving up approximately 50 basis points for the shorter to mid-terms but only 32 basis points in the 30 year term, adding a fifth quarter to the flattening trend. Bond prices resumed their slide after a second quarter break, driving yields (which move inversely to prices) higher across the curve and past previous quarter closes for 2005 on the short to mid-range. The yield on the 3-month bill ended the quarter at 3.52%, closing in on the 4-year high of 3.55% reached on July 16, 2001. The 10-year Treasury, significant to borrowing by both corporations and consumers, ended the quarter at a yield of 4.38%; up 46 basis points from the June 30, 2005 close. The yield on the 30-year Treasury ended the third quarter at 4.51%; up 32 basis points from the second quarter. While rates increased across the yield curve, the continued flattening does nothing to alleviate the signals of a potential economic slowdown. (For more on "yield curveology," see the June 30, 2005 issue of our Market Recap.)

The Federal Reserve raised short-term rates for a tenth and eleventh consecutive time during the third quarter of 2005. The last increase of 0.25% came on September 20 and pushed the Federal Funds Rate on overnight loans between banks to 3.75%. This equates to higher rates on car loans and credit cards as well as on adjustable-rate mortgages for consumers. In the press release that accompanied the action, the Fed again echoed past indications it will continue with "measured" increases. The release pointed to "monetary policy accommodation, coupled with robust underlying growth in productivity" as "providing ongoing support to economic activity" despite the widespread devastation in the Gulf that may have "increased uncertainty about near-term economic performance." Adding that "core inflation has been relatively low in recent months and longer-term inflation expectations remain contained," the release acknowledged that "(h)igher energy and other costs have the potential to add to inflation pressures." One Federal Reserve member appears to be more worried about this matter than some of his colleagues. Jack Guynn, Atlanta Federal Reserve President, commented that he sees inflation risks as "elevated at the moment," adding that energy cost increases may impact not only some of the "headline measures" of inflation, but some of the core measures as well.

Bond Indices - Total Return

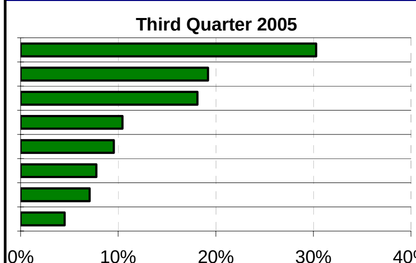
	3Q05
Lehman Aggregate	-0.67%
Lehman Interm. Gov't	-0.52%
Lehman Long Gov't	-2.63%
Lehman Interm. Credit	-0.52%
Lehman Long Credit	-2.61%
Lehman High Yield	0.93%

Concerns about inflation along with rising interest rates finally had the expected impact on bonds as they underperformed stocks across the board after faring well comparatively for the past few quarters.

Overseas Markets

Developed and emerging global markets were the darlings of the quarter, standing in stark contrast to U.S. domestic markets. Terrorist attacks in London, surging oil prices, the dead-locked German election and the continued specter of inflation could not daunt performance. Latin American emerging markets continue to shoot out the lights.

Gross Total Return of Selected MSCI Regional Indices



Region	3Q05
Latin America	30.28%
Japan	19.22%
Emerging Markets	18.11%
EAFE	10.44%
Pacific ex Japan	9.55%
Europe	7.78%
World Index	7.08%
North America	4.51%

Performance in Europe was strong in the north (France & Germany) and weak in the south (Spain & Italy). The European Commission's Business Climate Index moved into positive territory early in September for the first time since February. Although European politicians were hoping for a decrease in short-term rates, the European Central Bank held firm stating that the risk of inflation due to higher oil prices needed to be guarded against. Growth estimates in the Eurozone were decreased to 1.3% for the year from 1.6% in April. In Germany, a dead-locked election caused a decrease in the Ifo index of business sentiment after a surprise increase in September. However, economic sentiment in Germany has been slightly more optimistic with an increase shown in domestic orders. The MSCI Germany Index was up 9.7% for the quarter. In France, unemployment fell in August for the third month in a row. The high unemployment rate is believed to be one of the biggest factors holding back domestic consumption in France. Analysts believe that the creation of a new work contract focused on small businesses and adding public sector jobs does not reflect a true recovery in the job market, but the gains have helped the economy. The MSCI France index was up 8.3%.

In Japan, a mix of mostly positive economic data was digested by the markets and seemed to meet the approval of investors. In August, the unemployment rate fell to 4.3% from 4.4% a month earlier. The country's core consumer price index fell 0.1% year-over-year, equaling market expectations, with a slackening of deflationary pressures seen. Household spending fell 1.3% in real terms year-over-year as disposable income fell over 2% from a year earlier. Industrial production rose 1.2% in August after having not met the market's expectations earlier in the year. After a mostly lackluster year of performance for the Japanese markets the sector closed the quarter up over 19% with an optimistic outlook.

China continues to be a focal point in global markets with the undervalued yuan drawing the ire of U.S. policymakers. In July, China took a baby step toward revaluation when it allowed a nominal 2.1% appreciation in the yuan, producing a tiny gain of 0.2% versus the U.S. dollar after announcing that it would drop the yuan-dollar peg in favor of a basket of currencies. However, the flexibility that the end of the peg to the dollar was supposed to produce has been elusive. As the quarter closed, the U.S. announced it would stop pushing China to detail its timetable for reform, giving the Chinese Central Bank leeway to conduct exchange rate reform at its own pace. The U.S. and G-7 leadership have been concerned that China's dollar peg was limiting exchange market adjustments to the large U.S. current account deficit. Foreign exchange reserves in China increased by nearly $21 billion in August. The MSCI China Index was up 14.2% for the quarter.

Latin American markets again dominated global market performance. In Brazil, strong export growth, combined with low expected returns in developed markets has attracted foreign investment. As the quarter came to a close, the Brazilian central bank raised its 2005 forecast for the current account surplus to over $9 billion from $4 billion. At the same time it revised its trade surplus forecast from $30 billion to $38 billion. The MSCI Brazil Index was up 37.5% for the quarter. In Argentina, an increase in consumer spending is moving the economy toward its third year of expansion. The increase has caused inflation to accelerate to near 10% in August. The government still expects growth to come in at about 6% for the year after 2 consecutive years of growth over 8%. The MSCI Argentina Index was up over 49% for the quarter.

Focus On: *Hedge Funds – Does the Efficient Market Apply?*

Over the past fifteen years the hedge fund industry has grown from an estimated 300 funds in 1990 to 8,000 funds today. During this time, many sophisticated investors turned to hedge funds for outstanding returns from exposure to markets and strategies not available in other asset classes. Executing tactics like selling short, program trading, swaps, arbitrage, leverage, and using derivatives resulted in what seemed like magic: high returns with low risk.

Signs of an Efficient Market

- Large Number of Investors
- Random Market Information
- Rapid Buying and Selling
- Pricing Reflecting Implicit Returns and Risk

And it was great to be a hedge fund manager. Exemption from many of the rules and regulations imposed on other asset classes and little transparency in reporting allowed hedge fund managers to limit the imitation or duplication of successful strategies. Even the high fees, typically 1% but as high as 2% for management and 20% for performance, charged by these managers did not scare investors away. But with hedge fund investing becoming so prevalent that even some DC plans are considering it as an alternative asset class, can they continue to exploit market trends and exotic portfolio strategies like they did in the 90's? How long before an efficient market takes the magic out of hedge funds?

A Background in Efficiency

Anyone who has studied capital markets in even the most cursory manner is familiar with the Efficient Market Hypothesis. Evolved from the Ph.D. dissertation of Eugene Fama in the 1960's, the hypothesis lays out a number of assumptions that, when present as a whole, create an efficient market. These assumptions are:

- A large number of investors who seek to maximize their profits and analyze securities independently of other investors,
- New market information that arrives in a random fashion, essentially allowing equal access by all investors,
- Rapid buying and selling by investors reflecting new information and resulting in independent and random price changes, and
- Expected returns implicit in the current price of a security reflecting its risk.

If these conditions hold, it follows from the theory that expected investment returns are purely a function of risk. In other words, it is impossible to use information (including proprietary investment strategies) to "best the market." Understanding how this works is pretty simple. Say two securities with the same risk are offered to the market at different prices, Security A at $10 and Security B at $9. In an efficient market, large numbers of well-informed investors will choose to buy Security B, driving its price up. In fact, investors in Security A will probably sell their holding to purchase Security B, driving down the price of Security A. Ultimately, prices will reach equilibrium so that the same returns will be achieved by taking on similar risk.

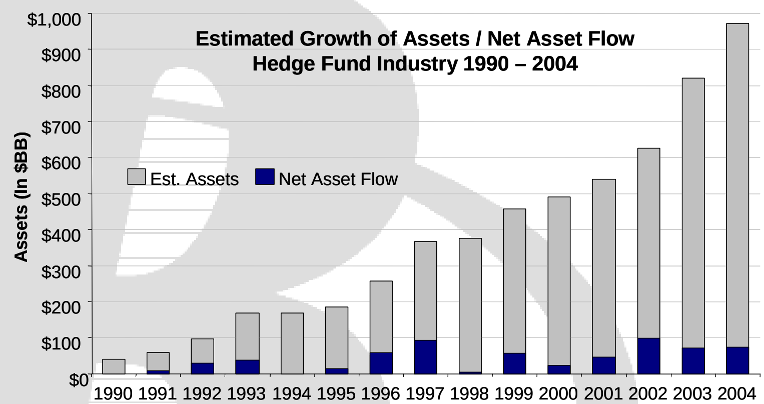
Efficient markets are generally considered to exist in three forms:

- *Weak Form*, where security prices fully reflect all *security market* information and technical analysis cannot be used to beat the market;
- *Semi-strong Form*, where security prices reflect all *public* information and neither fundamental nor technical analysis can be used to achieve above-market results; and
- *Strong Form*, where security prices reflect all information and not even insider information will benefit an investor.

It seems logical that in the real world, markets will never exist at the extreme of either complete efficiency or absolute inefficiency. Rather, as a market develops, it will become more and more efficient and above-average returns will be increasingly difficult to achieve on a consistent basis without taking on additional risk. How quickly and effectively a market becomes efficient really depends on whether the weak, strong, or semi-strong form of the hypothesis applies.

Heading Towards Efficiency

Ironically, investors must perceive an opportunity to exploit an inefficient market to start it on the road to efficiency. As initial investors profit in an inefficient market, more and more investors will seek to achieve the same results. This "herd mentality" will eventually satisfy the first condition of an efficient market: a large number of investors seeking to maximize their profits. Certainly the estimated $1 trillion of assets invested in hedge funds today would argue that a large number of investors are attempting to exploit this asset class.



Source: Hedge Fund Research, Inc., © HFR, Inc. 2005, www.hedgefundresearch.com

Inevitably (at least in the U.S.), as the number of investors grows, regulations and disclosure requirements will begin to be enforced resulting in wider accessibility of information at lower cost, the second criteria of an efficient market. Not surprisingly, developments in the hedge fund industry over the past five years are pointing to just that. The Hedge Fund Disclosure Act, introduced in 1999, seeks to require unregulated hedge funds to submit regular reports to the Board of Governors of the Federal Reserve System and make these reports available to the public. In fact, when approved by the House Banking Subcommittee on Capital Markets, the chairman noted that, "...the goal of the bill is simply to enhance market discipline and allow market participants to make better, more informed judgments..." In 2005 the SEC adopted a requirement for hedge fund managers to register under the Advisers Act and deliver disclosure statements specifically designed for hedge funds.

But even without these regulatory developments, the pressure created by increased investor demand guarantees that the strategies and access to markets that created the hedge fund magic will become increasingly more available. If everybody knows about them and everybody can invest in them, it is only a matter of time before hedge funds are subject to the same risk/return trade-offs as other asset classes.

Efficiency Ahead?

Recently, much press has been given to the topic of expectations for hedge funds. While many investors still recall the double-digit average returns and very low risk associated with the funds in the 1990s, recent performance hasn't been as good. The second quarter of 2005 generally saw flat returns, which combined with high fees resulted in overall losses and have led to questions about the sustainability of superior results. Other market analysts are pointing to the increasing correlation of hedge fund returns to returns for traditional stock indexes, and questioning the diversifying effect of the asset class. Perhaps most telling were recent comments by Tanya Styblo Beder, the head of Citigroup's single manager proprietary hedge fund unit (Tribeca). She predicted that "the nature of market trends is changing and it will become increasingly difficult [for hedge funds] to survive." As reported in CNNMoney, she commented that the role hedge funds are playing in rapidly spotting and profiting from mispricing opportunities is reducing the volatility of financial markets overall and ultimately making trading harder for the funds themselves. To us that sounds like a market becoming more efficient.

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