Bellwether CONSULTING

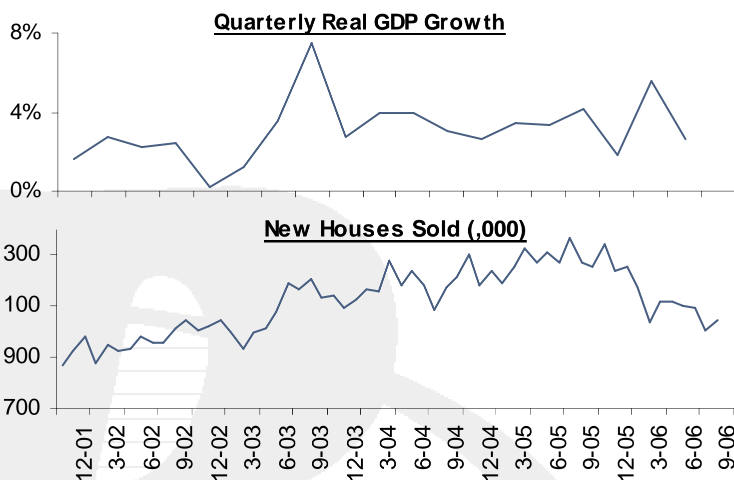
Your Quarterly Update on the Financial Markets
September 30, 2006

3rd Quarter

MARKET Recap

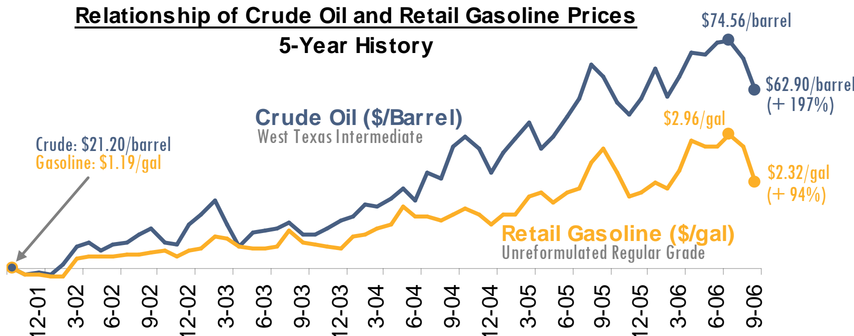
The Economy: *"Falling Crude Lubricates the Markets"*

The U.S. economy grew at a much tamer 2.6% annualized pace in the second quarter, finding more stable ground following a downward then upward distortion in the two previous quarters (driven largely by fallout from the 2005 hurricane season). The deceleration in real GDP growth was due primarily to downturns in personal consumption expenditures for durable and non-durable goods, equipment and software, and federal government spending, along with a large decrease in residential fixed investment; slowing growth was partly offset by a deceleration in imports, acceleration in personal expenditures for services, and an upturn in private inventory investment.



Real residential fixed investment declined 11.1% in the second quarter. Clearly a long-awaited deflation of the residential real estate bubble is well underway, and the effects are only beginning to make their way into lagging indicators like GDP. Residential real estate data are notoriously difficult to analyze because of reporting time lags and other inefficiencies; one of the better statistics is new home sales, which is a driver of home prices but, more significantly, a demand indicator for the huge industry surrounding real estate development. August brought a respite in the decline, with new home volume stabilizing month-over month, but volume of new homes produced has decreased 22% from the October 2005 high. Our sense is that prices have declined sharply as well, although this is difficult to objectively measure as non-cash incentives severely distort the pricing data. Ultimately, declines in home values may affect consumer spending; however in the short run, damage to the construction industry is likely to be the greater concern. We also have some concern that highly leveraged speculators owning multiple properties will be caught in a price squeeze and default, widening credit spreads.

Consumers have found solace from a somewhat surprising source – big oil. Prices of crude oil and retail gasoline fell steadily through the summer on more realistic weather expectations, less than anticipated demand, and an uneasy truce in the Middle East. To date threats of production cuts from Nigeria and Venezuela have failed to rally the crude markets (although we continue to watch these hot spots very closely). Despite a variety of theories to the contrary, data indicates that the variability of retail gasoline prices is primarily driven by volatility in world crude markets. Falling demand, rising inventories, and reduced expectations of volatility have driven down the price of crude. While oil is only one factor and other cost-related indicators such as labor cost have not moderated, cheaper oil has helped assuage consumer fears and steer the Federal Reserve away from further rate increases. Equity and fixed income markets responded accordingly.



Unsurprisingly, this data portends a period of slowness ahead (workers in the construction trades are already feeling the pinch in some regions). Relatively inexpensive oil could help moderate the slow-down significantly, but the U.S. economy will remain vulnerable to world events and "muscle flexing" by unfriendly oil producers. With GDP growing at a 2% pace or less, any price shock in the oil markets could quickly convert a soft landing into recession.

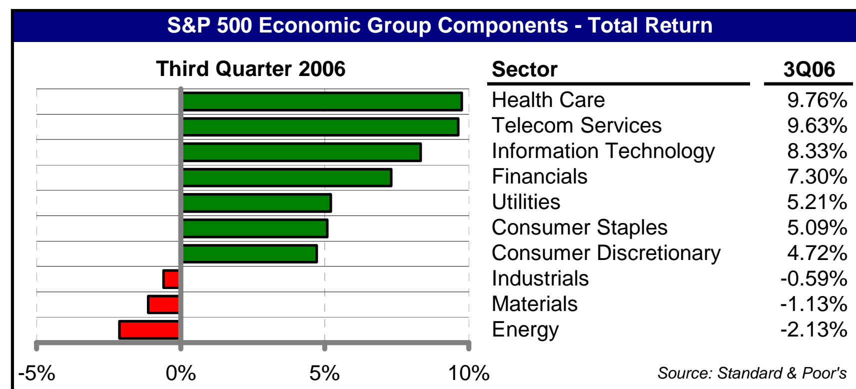
The U.S. Stock Market

After a second quarter that was best categorized as volatile, the third quarter ended with the stock market flirting with its all-time high buoyed by falling oil prices, falling interest rates and some unexpected positive news on corporate earnings. The Dow Jones Industrial Average closed the quarter at 11,679 after spending the final days of September near its record high close of 11,722 set in 2000. The S&P 500 was up 5.67% as the flight to quality within the stock markets that began last quarter continued through the end of September, with most sectors experiencing positive performance. The tech bellwether NASDAQ Composite participated in the up market, gaining 4.14% for the quarter.

Stock Indices - 3rd Qtr. 2006 Total Return			
Largecap Stocks		**Midcap Stocks**	
S&P 500	5.67%	Russell Midcap	2.11%
Russell 1000	5.06%	Growth	0.89%
Growth	3.94%	Value	3.53%
Value	6.22%		
		Smallcap Stocks	
Broad Markets		Russell 2000	0.44%
NASDAQ Comp.	4.14%	Growth	-1.76%
Wilshire 5000 FC	4.01%	Value	2.55%

Large-cap issues continued to ride the positive wave that began with last quarter's volatility. According to Lipper the average large-cap fund finished the quarter up nearly 5%. Investors' new-found conservatism has them focused on companies with strong market share, large cash reserves, and demonstrated dividend growth. As investors digest the latest economic news of a slowing U.S. economy, lower expected corporate profit growth, a slump in residential housing prices, and slackening consumer confidence, small- and mid-capitalization issues have fallen out of favor. Consensus is that the Fed has finished raising interest rates for the year; that, combined with falling energy prices, should produce the "soft landing" that investors are seeking. Investors seem to be taking a more defensive stance in their portfolios until market volatility cools down.

Value funds, again, fared better than their growth peers, however both sectors finished in positive territory for the quarter with the Russell 1000 Value and Growth Indices up 6.22% and 3.94%, respectively. Volatility and sector rotation in the market has not abated. Utilities, last quarter's darling, finished mid-pack this quarter (up 5.21%), while energy issues lagged all sectors as oil prices have fallen dramatically through the end of the quarter. Healthcare and telecom led all sectors for the quarter, both up well over 9%.


S&P 500 Economic Group Components - Total Return

Third Quarter 2006

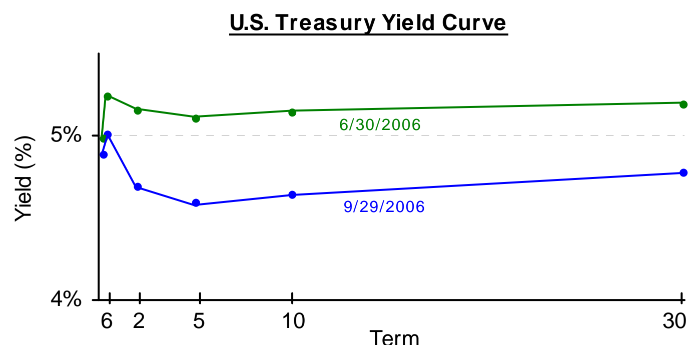
Sector	3Q06
Health Care	9.76%
Telecom Services	9.63%
Information Technology	8.33%
Financials	7.30%
Utilities	5.21%
Consumer Staples	5.09%
Consumer Discretionary	4.72%
Industrials	-0.59%
Materials	-1.13%
Energy	-2.13%

Source: Standard & Poor's

In the face of a slowing economy, corporate earnings are expected to show surprisingly robust growth. According to Zacks Investors preliminary 3Q earnings look solid, with median EPS surprises of 9.4%, and many firms reporting higher than expected earnings. Standard & Poor's estimates another quarter of consecutive year-over-year double-digit earnings growth. The anticipated third-quarter earnings of $21.53 per share, or $194 billion in aggregate, would represent a 14.3% gain over the $18.84, or $170 billion, reported for the same quarter of 2005. Earnings growth is attributable to many sectors, with six of ten contributing to the double-digit gains. S&P expects FY 2006 earnings growth to finish at around 13% led by energy and materials issues, due to the run-up in commodity prices over the year.

The U.S. Bond Market

With talk turning increasingly to chances of a recession, the markets breathed a collective sigh of relief in the third quarter when the Federal Reserve proved it had finally finished, or at least was willing to take a break from, tightening interest rates. In both the August 8 and September 20 meetings, the Federal Open Market Committee (FOMC) decided to keep its target for the federal funds rate at 5.25%, ending a tightening cycle that had lasted over 2 years and through an unprecedented 17 consecutive increases. The Fed's August 8 statement acknowledged that economic growth had moderated from earlier in the year "reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices." In the statements following both meetings, the Fed pointed to elevated readings on core inflation and noted the high prices of energy and other



Source: Bloomberg LP

commodities as having the potential to sustain inflation, but judged that "inflation pressures seem likely to moderate over time."

Bond yields ended the third quarter down across the curve, with the short end dropping 10 to 20 basis points and the mid to long durations falling about 50 basis points. The short end of the curve became more inverted, and on the whole the curve remained historically flat. As of September 29, only 8 basis points separated the 2-year and 30-year yields. Compared to the second quarter close, the third quarter ended with the 3-month bill down 10 basis points at 4.87%. In the last week of the quarter, the 10-year treasury hit a 7-month low with a yield of 4.55% on September 25 (the 10-year treasury is significant to consumers and corporations alike as the benchmark for borrowing). However, by the end of the quarter it rebounded slightly, closing down 51 basis points from the prior quarter close at 4.63%. The 30-year Treasury closed the quarter down 43 basis points to 4.76%.

Bond Indices - Total Return

Bond Index	3Q06
Lehman Aggregate	3.81%
Lehman Interm. Gov't	2.92%
Lehman Long Gov't	6.48%
Lehman Interm. Credit	3.67%
Lehman Long Credit	7.23%
Lehman High Yield	4.07%

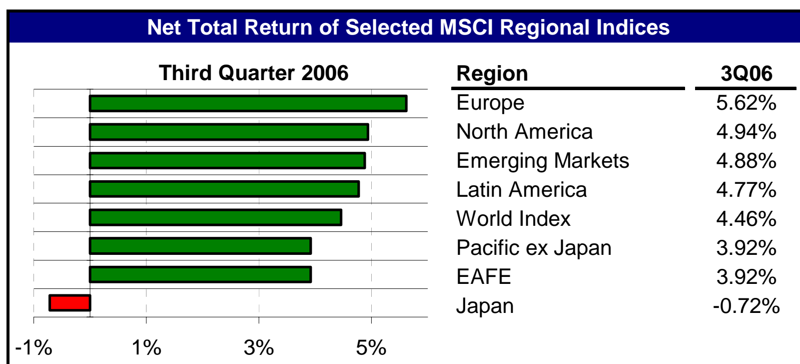
Not surprisingly, Fed comments that the economy was slowing and that inflation was moderating triggered a rally in the bond market in the third quarter. Returns were positive across all sectors at quarter-end, with the market experiencing rallies in most weeks throughout the quarter as investors anticipated then acknowledged the Fed non-actions and the causes for them.

Focus on interest rates and the declining housing market have brought mortgage-related issues into the spotlight. Experts have begun to wonder if declining home values will leave borrowers with enough equity to support their mortgages. Mortgage-backed securities, the largest sector in the bond market, would suffer considerably from any significant increase in default on mortgage payments. Purchases of mortgage-backed securities topped $1 trillion for the first half of 2006, according to industry sources, up 5% from the same period in 2005.

Overseas Markets

Global markets enjoyed some surprisingly robust results after last quarter's drop. Markets returned to form in most geographic sectors, although bigger Latin American markets have continued to underperform. Europe surged as a second consecutive quarter of positive economic news abounded, and North American markets also bounced back with solid performance on improving economic news.

In Europe, economic growth has been above expectations causing some confidence measures to moderate as the quarter closed. However, rising confidence has been apparent across many Euro Zone economies and GDP growth for the region is now estimated at 0.9% for the remainder of the year. In August, the ECB raised short-term lending rates by 25 basis points, the third such move this year, as the bank continues to attempt to corral inflation fears. In Germany GDP expanded at an annual rate of 3.6%. Employment in Germany rose 1.1%, annualized, with a corresponding increase in productivity at 2.7%, the strongest rate since 1998. The MSCI Germany Index was up 4.84% for the quarter. In France the INSEE, France's national statistical reporting agency, announced that its Composite Business Climate Indicator was unchanged at 107 in September from August but was 1.8% below its recent peak of 109 in April of this year. INSEE also reported economic growth in France in the second quarter was up by between 1.1% and 1.2% over the first quarter of 2006. The MSCI France Index was up 4.89%.



In Japan, as Prime Minister Koizumi prepared to step down, economic indicators are signaling a downturn after positive news in previous quarters. Corporate goods prices (wholesale prices) are on the rise and deterioration in consumer confidence in August indicates that the outlook for Japan's economy is becoming less optimistic. Corporate goods prices rose 0.6% from July to August and were 5.8% above August, 2005 with the main cause of the rise due to the prices of imported petroleum and metals. In July, the Bank of Japan's policy board raised its key interest rate by a quarter percentage point to 0.25%, ending the nation's five-year policy of keeping rates near zero percent. The policy shift, which had been widely expected, puts the rate above zero percent for the first time since March 2001, and may have cemented Koizumi's legacy as an economic reformer. The MSCI Japan Index was down -0.72% for the quarter.

Markets in China continued their stellar run. The yuan rose to its highest level since China ended a decade of fixing its currency's value in mid-2005. China's currency climbed 0.6% in September, the most since the link to the dollar was

dropped. It is widely believed that this rise is in response to U.S. Senators Schumer and Graham's pressure for trade sanctions on China if the yuan appreciation is not permitted to accelerate. As of the second quarter China's real GDP grew by 11.3% year-over-year, with continued acceleration in net exports and investment growth. The preeminent risk in China continues to be an abundance of banking system liquidity which, if unchecked, could lead to the bursting of a market bubble. The MSCI China Index was up 8.79% for the quarter.

Latin American emerging markets continued to moderate with some mixed performance. In Brazil good economic news in the form of inflation falling back toward targeted levels has allowed for some loosening of monetary policy. Brazil has taken advantage of heavy foreign exchange inflows over the past two years to retire external debt and clean up its public sector balance sheet. However, the country is beginning to feel the toll in the market as there has been very little investment in improving infrastructure in the country. The MSCI Brazil Index was down for the quarter -1.30%. Strong growth in Argentina continues to drive Latin America. According to the IMF, Argentina's economy is expected to grow by 8% this year. A recent IMF report urged Latin American governments, including Argentina, to prepare for worsening economic conditions as commodities prices decline, global interest rates rise and demand falls for riskier emerging-market securities. The MSCI Argentina Index was down -6.71% for the quarter. Mexico, Columbia and Peru drove Latin American markets during the quarter up 16%, 19% and 11%, respectively, on very strong commodities exports.

Focus On: *Life-Cycle Funds: A Lurking Fiduciary Challenge?*

Fiduciaries to retirement plan assets are charged by ERISA with the duties of prudence, loyalty, effectuation and diversification. While these obligations translate into many actions, one of the most important, and sometimes the most difficult to accomplish, is the responsibility to ensure that fees are reasonable for services rendered. Typically, plan sponsors seek to fulfill this obligation by understanding, benchmarking, and then negotiating fees.

Fees take on even more importance for ERISA fiduciaries when evaluating plan investments because, unlike future fund performance, fees can and should be known. Further, fees change rather infrequently and their direct impact on fund performance is clear and easy to compare from share class to share class, fund to fund, or product to product. All else equal, lower fees always mean better investment performance.

Fees paid out of plan assets should be:

- Reviewed & approved by a fiduciary,
- Allowed by law and terms of the Plan,
- Reasonable for services received, and
- Incurred for exclusive benefit of the Plan.

Bundled Platforms: Yesterday's Challenge

Plan sponsors have given much attention to fees over the years as plan structures and product lines have become increasingly complex and the fees paid by plan sponsors for products and services have become more obscured. Even prior to the Securities and Exchange Commission's probe into mutual fund companies' defined contribution plan payment practices in 2004, plan sponsors showed a keen interest in understanding the full relationship between platform providers and fund managers, including revenue sharing arrangements, to ascertain the true level of fees paid by themselves and participants. Through this process plan sponsors found that, while bundling retirement platforms with investment options and other services usually resulted in lower cost to the sponsors themselves, the arrangement made it quite difficult to figure out the actual fees associated with many of the bundle components. This in turn made it more difficult to benchmark and negotiate these fees. And finally, should a component of the bundle prove unsatisfactory, replacement was difficult. While plan sponsors' understanding of bundled arrangements and associated fees has improved over time, the ability to negotiate a satisfactory solution to an unsatisfactory component remains largely dependent on the amount of plan assets a sponsor controls.

Life-Cycle Funds: The New Bundle

And now a similar challenge to plan sponsor efforts to fulfill their fiduciary duties related to investment products in their retirement plans is lurking, with little industry discussion or debate to date. The challenge has come in the form of a much-heralded investment option: the target-maturity or life-cycle fund.

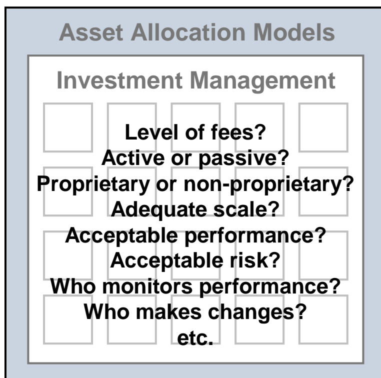
Life-cycle and target maturity funds are the next generation of balanced funds. They are a fund of funds with both equity and fixed income investments that automatically rebalance to maintain the stated asset allocation strategy. That strategy typically becomes more conservative as the fund approaches its target date. While these funds have been around since the 1990's, they have gained in popularity in recent years as the retirement industry grapples with the challenge of unengaged participants.

Attend any retirement industry conference and no doubt there will be much discussion about the benefits of these funds to plan participants. Participants, according to many industry experts, are largely incapable of or unwilling to choose what is considered to be an appropriate asset allocation, much less to rebalance their portfolios in response to market perform-

ance to maintain that strategy. Migrating an asset allocation strategy to take into account a shorter time horizon or changing risk tolerance is often neglected as well. With their "auto-pilot" features, many believe life-cycle solve some pretty big problems facing retirement plans. If they do, it is only in terms of participant behavior.

The Trade-Off

From a plan sponsor and fiduciary perspective, target-maturity and life-cycle funds can actually create new headaches if thought is not given to their structure and relationship within the investment fund line-up of the plan. Life-cycle funds can be added to a plan in two ways. The first is to use the existing investment options in the plan as the underlying components of the fund. In these cases, little additional fiduciary burden is added. The plan sponsor should already be monitoring fees (and performance) in these funds. If an issue occurs, the offending fund can be replaced in the plan, effecting the change in the life-cycle fund as well. Further, the charge to bundle the plan options into an asset allocation strategy is readily apparent, making it easier for the sponsor to determine if it is reasonable.



Each underlying investment fund as well as the asset allocation overlay must be assessed individually before the suite can be assessed as a whole.

However, when it comes to the suites of life-cycle mutual funds currently favored by many of the large platform providers, the fiduciary burden is actually significantly increased. In the case of life-cycle suites, the underlying component mutual funds are rarely stand-alone investment options in the plan, so they are additive to a plan sponsor's fee- and performance-monitoring obligation. With some platform providers using as many as 18 component funds, this is not an insignificant increase.

And, sorting through the life-style fund price tag is fairly complex and time consuming yielding many fiduciary questions for *each* underlying investment fund as well as the over-arching asset allocation strategy. To start, are the expense ratios of all underlying funds known and acceptable given their management or investment style (e.g., active versus passive, growth versus value, large cap versus small cap)? Are underlying funds proprietary or non-propriety? Is the least-expensive share class of any proprietary mutual funds being used? Do all the underlying funds have sufficient scale to produce reasonable expenses or is the suite being used to drive assets to a fund manager's unpopular or new (not to mention underperforming) funds? Is the charge for asset allocation known? Is it reasonable for what is likely a fairly static, automated strategy? Is there a hidden charge for recordkeeping? Each component of the life-style bundle must be fully measured and assessed, just as with any other bundled product or service.

And finally, just as in other bundled arrangements, plan sponsors' hands are somewhat tied when it comes to negotiating within life-style fund suites. Since the funds are sold as a package, the only recourse a plan sponsor has if fee (or performance) issues arise with one of the underlying funds is to replace the entire suite – a drastic action likely to be used in only the direst of situations. Take into consideration that many platform providers are using the addition of proprietary life-cycle fund suites as a trade-off for other platform or service considerations, and the plan sponsor is even further tied to the package, come what may. So while potentially solving one participant behavior problem, adding life-cycle funds in the form of proprietary suites is simultaneously creating other issues for plan sponsor fiduciaries: potentially expensive funds along with a diminished ability to resolve issues they are charged with and obligated to address.

Further Challenge Ahead

The U.S. Department of Labor recently released their proposed regulation relating to Default Investment Alternatives in conjunction with the Pension Protection Act. If passed as proposed, target-maturity and life-cycle funds will be one of the few choices for a plan's default investment that will give the plan safe harbor from legal action related to the default investment. Arguably, this will be an enormous incentive for plan sponsors to choose these funds as their plan's default option. While there may be benefits associated with giving participants an "auto-pilot" choice (or making it for them) that follows the tried and true principles of asset allocation, rebalancing, and strategy migration, the retirement industry and regulators alike have overlooked an important consideration: the additional fiduciary burden. Before hailing these funds as the silver-bullet solution to retirement-plan woes, perhaps some discussion and debate about the ways to deal with the additional fiduciary burden they create for plan sponsors is warranted, if only so plan sponsors understand the trade-off they are making.

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