
CAPITAL MARKETS COMMENTARY FOR 2003

2003 was a year when the stock market and the economy accelerated to above average growth rates. The US economy posted strong real-growth gains during the year and corporate profits posted their best annual results ever. High rates of productivity growth were behind the success of the corporate sector as companies effectively leveraged the use of cost cutting and leading-edge technology to bolster output.

US stock prices moved dramatically higher during 2003 and posted their first positive annual result since 1999. Stock market gains were a result of several factors, including extraordinary real economic growth, record corporate profit gains, record low interest rates, low inflation and budding investor optimism.

In addition, the burden of supporting a global economic recovery appears to be lifting from the US consumer. Recent data and confidence indicators confirm that the global economic recovery is gaining momentum and broadening beyond US consumers not only to the US corporate sector, but also to other regions such as Japan, emerging markets, the UK and, to a lesser extent, Continental Europe.

Key global economies are starting to validate the positive signals that have been picking up for some time from prominent measures of economic activity and business confidence. GDP growth in the third quarter of 2003, for example, came in above consensus forecasts throughout the developed world. Recent monthly releases of the OECD Leading Economic Indicator series have also shown robust increases on a geographically diversified basis.

DOMESTIC EQUITY MARKETS

The domestic equity markets closed 2003 dramatically higher, and year-to-date returns for 2004 are giving clear indications that we are well on our way to recovery from the difficult down market we endured between 2000 and early 2003. Results for 2003 (about 28% for both the Dow and the S&P 500) are especially encouraging when we consider that the year included more corporate governance scandals, the discovery that many mutual fund companies were providing preferential treatment to large clients, and the ups and downs of our war against terrorism at home and abroad.

While most stock groups posted double-digit gains during the year, the NASDAQ composite of tech-related companies provided the largest single contribution to return in the broad market, as shown in the following table.

Index	Quarter	Performance (%)		
		1 Year	3 Years	5 Years
DJIA	13.4	28.3	1.0	4.5
NASDAQ	12.3	50.8	-6.4	-1.5
S&P 500	12.2	28.7	-4.1	-0.6

However, many of this year's high flyers still have not recouped from their losses suffered when the late 1990s technology bubble burst.

All S&P 500 indexes posted positive returns during the fourth quarter and for the year 2003, as shown in the following table.

S&P Index	<u>Performance (%)</u>			
	Quarter	1 Year	3 Years	5 Years
Large Cap – SP500	12.2	28.7	-4.1	-0.6
SP500 Barra Growth	9.9	25.7	-5.7	-3.5
SP500 Barra Value	14.5	31.8	-2.7	2.0
Mid Cap - SP400	13.2	35.6	4.8	9.2
SP400 Barra Growth	9.8	31.0	-0.9	6.5
SP400 Barra Value	16.5	40.2	10.5	12.1
Small Cap – SP600	14.8	38.8	8.1	9.7
SP600 Barra Growth	13.0	37.3	4.7	6.7
SP600 Barra Value	16.6	40.0	10.7	11.0

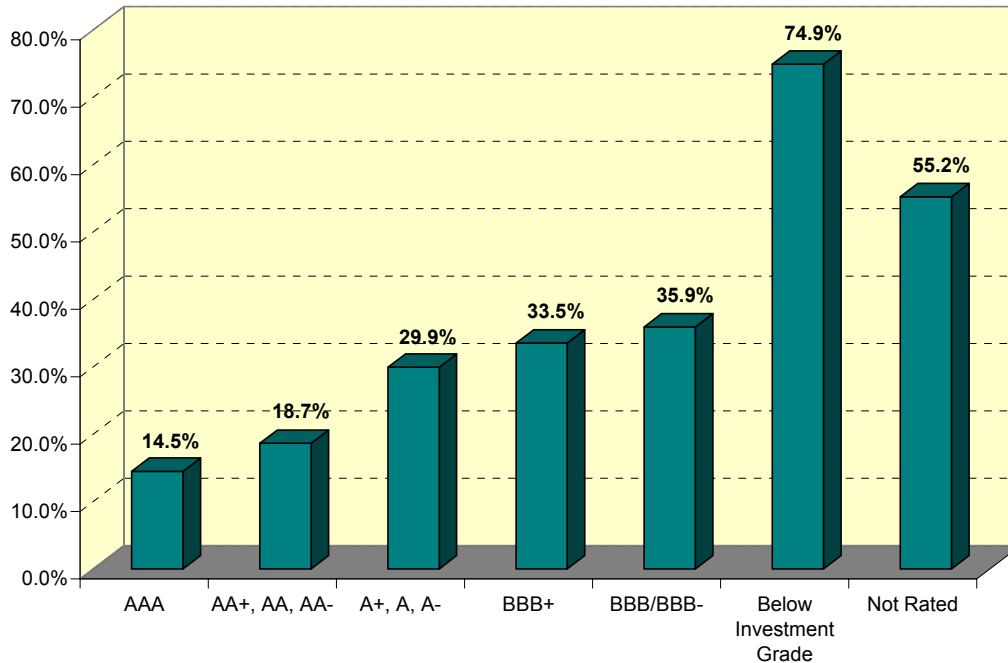
As shown above, market exposure in 2003 was beneficial regardless of style or sector. Small-cap stocks continued their performance leadership over their larger-cap counterparts. Small caps have outperformed large caps for five consecutive years, including each of the final three quarters of 2003. Meanwhile, value stocks outpaced growth stocks during the quarter even though both styles were nearly equal in performance for the year.

The largest gains during the year 2003 were in stocks that were bid higher by speculators. After a three-year bear market, investors concluded that the market had bottomed in the first quarter of 2003 and that the 2001-2002 recession had finally ended. Unlike the period from the end of the first quarter of 2000 until the fall of 2002, when investors sought refuge in high-quality companies with strong balance sheets, in 2003, investors went on a buying frenzy, seeking out the most beaten-down companies –low-quality speculative companies with low profitability and high debt. With strengthening economic news, investors rotated into low-quality companies that would most benefit by a firming economy. For the year 2003, including the fourth quarter, quality companies lagged –the worse the quality, the higher the performance –across all major indexes.

The market's emphasis on lower quality¹ companies, during the year 2003, is illustrated by the following chart:

¹ Approximately 29% of the weight of the S&P 500 Index is represented by companies that have a BBB+ or lower credit rating or no rating.

2003 S&P 500 Index Returns by Credit Quality

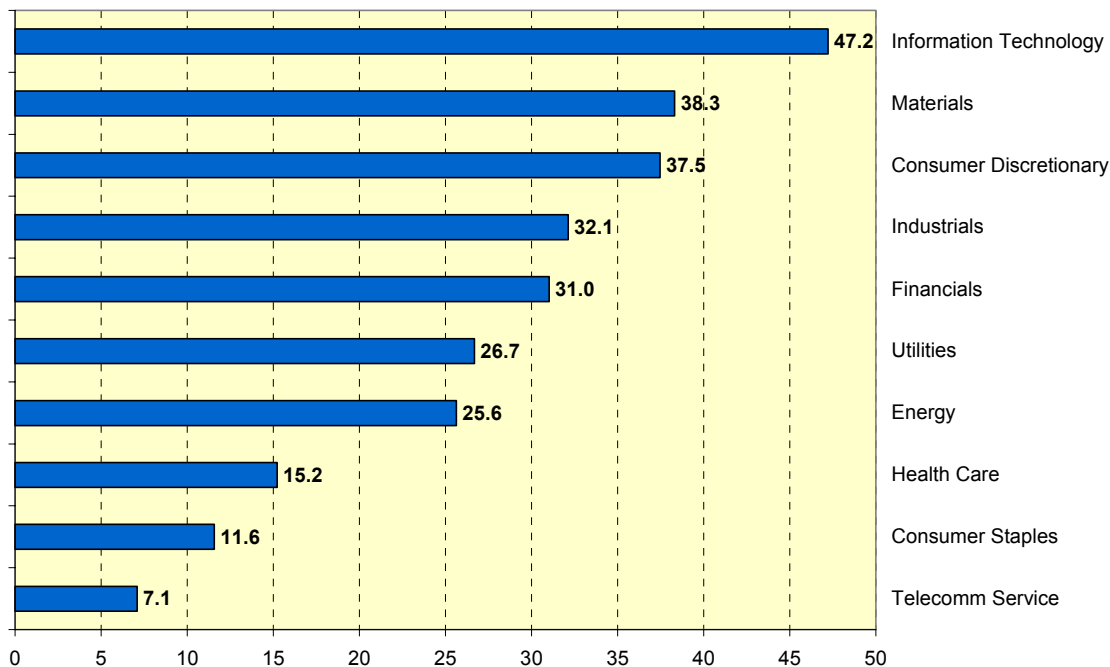


In the fourth quarter of 2003, the domestic equity markets provided strong returns, as represented by the performance of the S&P 500 (+12%), Dow Jones Industrial Average (+13%) and NASDAQ Composite Index (+12%). Reflecting a perceived recovery in the industrial portion of the economy, the strongest sectors in the S&P 500 in the fourth quarter were materials (+23%), energy (+15%) and industrials (+15%). The weakest sectors were utilities, consumer staples and health care, each considered classically defensive sectors and returned 8%.

For the full year, the domestic equity markets provided exceptional results: the S&P 500 returned 29%, the Dow Jones Industrial Average returned 28%, and the NASDAQ Composite Index returned 51%. The strongest sectors for the year in the S&P 500 were information technology, materials and consumer discretionary. The relatively weakest sectors were telecommunication services, consumer staples and health care. Essentially, in a recovery year, the cyclical sectors performed better than the defensive sectors.

The S&P 500 economic sectors performance for the year 2003 was as follows:

2003 S&P 500 Economic Sector Performance (%)

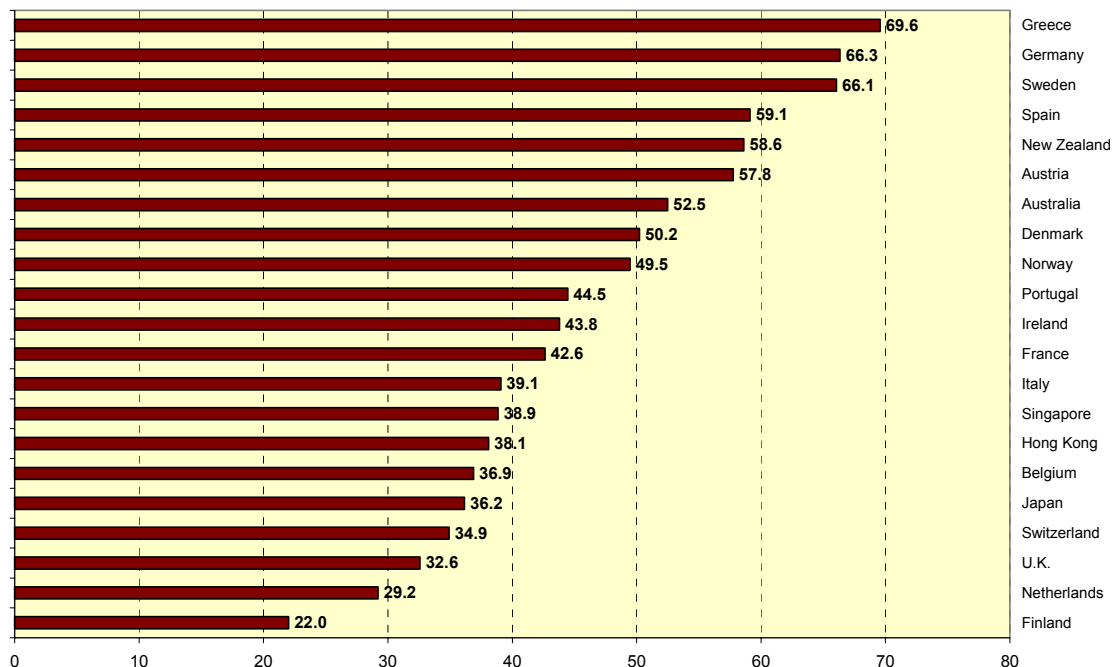


INTERNATIONAL EQUITY MARKETS

One of the most notable events during 2003 was the steady fall of the US dollar relative to other major currencies. The dollar fell over 20% relative to the Euro, nearly 11% relative to the Yen and over 22% relative to the Canadian dollar. The weaker dollar helped explain some of the recovery of real growth in the US economy (export sector). The weaker US dollar is driving the current account deficit. The US is now a huge net debtor (25% of GDP), which has shifted deflationary pressures to the Euro zone and Japan.

Non-US equity markets posted substantial gains during 2003 (outpacing US stocks) due to improving fundamentals, pre-2003 depressed stock prices and much stronger local currencies relative to the US dollar. The biggest gains to US dollar investors during the year were in Greece, Germany and Sweden. The markets that lagged during the year on a US-dollar basis were Finland, the Netherlands and the UK, as shown in the following graph.

2003 MSCI-EAFE Country Sector Performance (%)

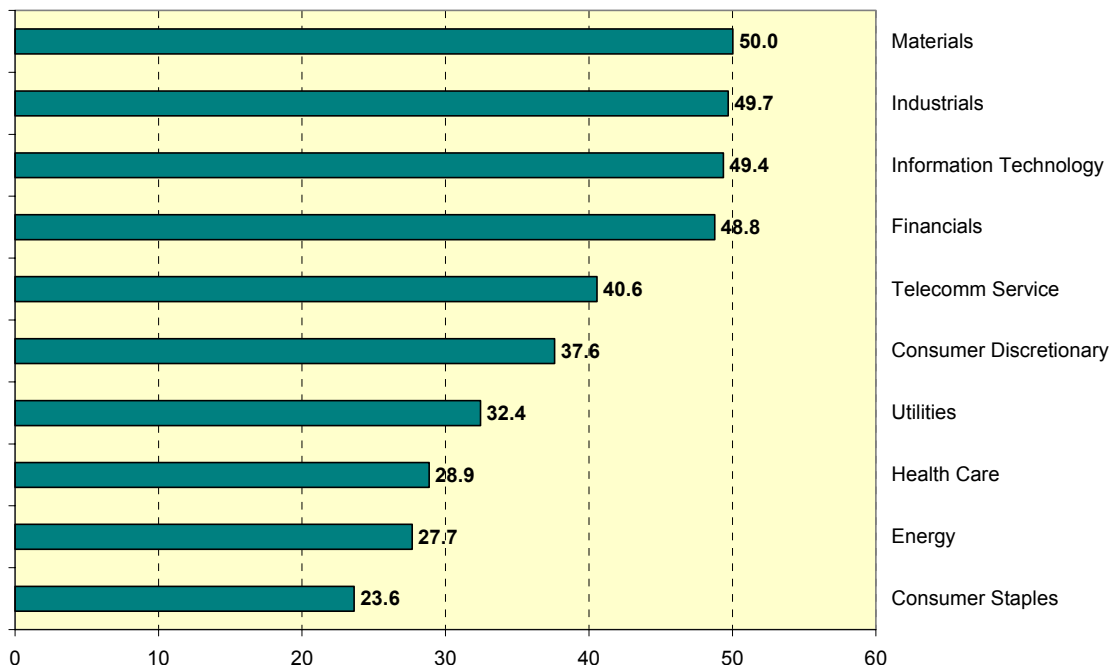


Investors were also drawn to emerging markets in 2003 by a number of fundamental economic factors, attractive valuations and the high cyclical nature of the asset class amid a global economic recovery. Moreover, emerging markets have proven to be strong performers relative to developed-world markets in recent years. As measured by the MSCI indices, emerging markets have outperformed developed markets for the past four years. In 2003, the MSCI Emerging Markets Free Index and the MSCI World Index (a leading benchmark for developed-world markets) rose 56% and 34%, respectively. Among the emerging world's major regions, Latin America was the best performer in 2003 (+74%), followed by Europe/Middle East/Africa (+56%) and Asia (+51%).

In the fourth quarter of 2003, the strongest sectors in the MSCI-EAFE were materials (+23%), energy (+21%) and financials (+19%). The weakest sectors were information technology (+10%), consumer staples (+12%) and industrials (+15%). For the year 2003, the strongest sectors in the MSCI-EAFE were materials, industrials and information technology while the relatively weakest sectors were consumer staples, energy and health care.

The MSCI-EAFE economic sectors performance for the year 2003 was as follows:

2003 MSCI-EAFE Economic Sector Performance (%)



December was a solid month that closed out a globally vibrant 2003 for both equities and fixed income.

FIXED INCOME MARKETS

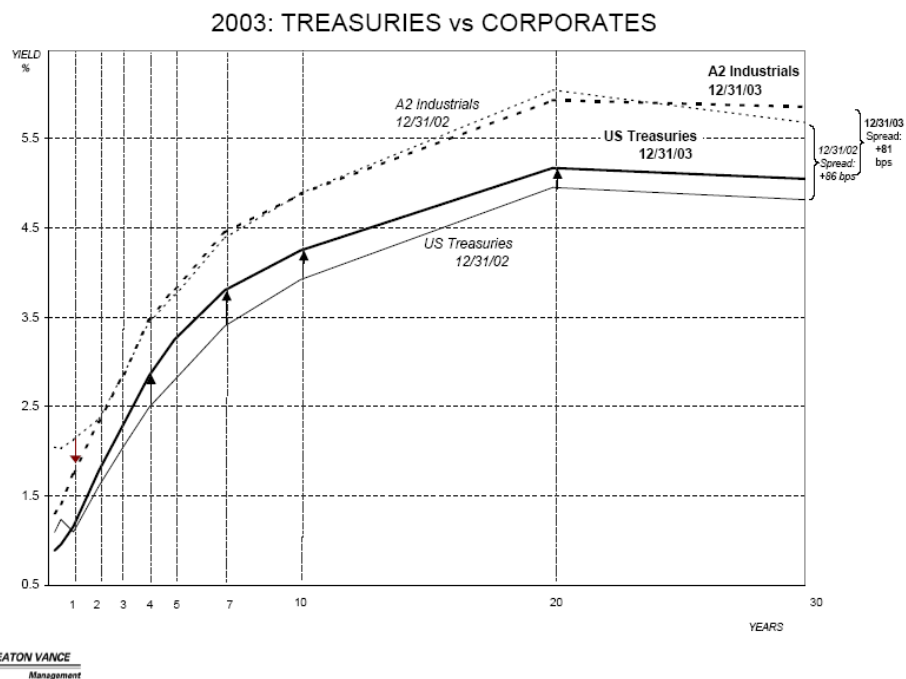
December performance saw Agencies, mainly FHLMC, prosper in every maturity sector as they recover from the bad press of recent months. FHLMC and BBB corporates were the clear performance winners versus all other investment-grade rating classes. The yield curve steepened as rates fell in the two to five year segment of the curve by 27 to 17 basis points. The swap curve also steepened with spreads relatively unchanged on the month. The big news continued to be the fall of the dollar versus the euro, yen and commodity currencies along with the further strength in hard and soft commodities. These developments are potentially big negatives for bond investors going forward.

For the fourth quarter, the bond market actually experienced negative price returns. However, the earned coupon allowed total returns in some sectors to be positive for the quarter and the year as a whole. The past year can be summed up in one sentence: *the more risk an investor took, the more they were paid in absolute returns with one major exception ... TIPS². The longer the maturity and the lower the rating... the higher the return.* This traditional pattern was upset by TIPS with an annual return of 8.4% which

² Treasury Inflation-Protected Securities (TIPS) were introduced in 1997 to provide investors with protection against inflation.

was superior to any A and higher rating for any maturity. TIPS perform well when interest rates go up as they did in 2003 and 1999. Spreads collapsed vs. US Treasuries in every credit and structured sector. Mortgage and Asset Backed Indexes also had decent returns of 3.4% and 3.2% respectively for the year, but lagged other sectors due to their higher quality and lower duration nature.

Rising inflationary expectations and slightly higher interest rates were the main culprits behind minimal returns in the Treasury bond market during 2003. Conversely, corporate bonds, specifically lower-rated bonds, posted sizable gains during 2003 as yield spreads for these issues narrowed sharply relative to Treasury yields, as shown in the following graph.



In the junk-bond sector, yield spreads narrowed over 6%, a reflection of the improving US economy and corporate profit picture. Investors who were willing to take risk were rewarded in the corporate bond market in 2003. Yield spreads on bonds are now at lows not seen since the mid-1980's, causing investors to reevaluate their risk-return going into 2004. With little spread compression left in the corporate bond arena, bond investors' greatest challenge lies in the yield curve and the ultimate movement and timing of interest rates.

The Fed's actions have far reaching consequences for the bond market. When the Fed began tightening in 1994, it resulted in the worst performance year on record for bonds. Treasury yields rose 200 to 350 basis points, decimating price returns in their wake. Today's market seems a bit better prepared than that of late 1993 when yields were nearly unchanged throughout the second half before surging in early 1994. Today, the 10-year Treasury yield is over 100 basis points higher than it was six months ago. To be sure, we are still at an impressive absolute yield of 4.25% which will certainly rise when

the Fed makes its inevitable move from a 1% Fed Funds rate to something closer to neutral, which historically speaking has been around 5%. Nonetheless, the Fed has said emphatically and frequently that now is not yet the time for higher rates. This should buy the bond market some relief at least for early 2004.

CAPITAL MARKETS OUTLOOK FOR 2004

2003 was a great year for investors with returns for most indexes exceeding 25%, breaking three consecutive years of negative equity returns. As the year began, expectations were quite low. Investors viewed 2003 cautiously due to continued uncertainty of a war with Iraq, a sluggish economy and talk of the risk of worldwide deflation. The markets were weak during the first quarter but began to strengthen just ahead of the major combat phase of the war, which was followed by a pick up in economic activity and a reduced risk of deflation. By the end of the third quarter, the strength in the economy was clearly evident as quarterly GDP grew at an 8.2% annualized rate, a 20-year high.

The modest rise in interest rates continued in the fourth quarter as bond investors anticipated a strengthening in the economy. While there remains much discussion as to the timing of a Federal Reserve rate hike, the ultimate direction of interest rates will be higher as the economy strengthens. Rising short-term interest rates will be a confirmation of a healthy economy, with negative implications for bond prices.

We continue to be optimistic about the economy and the stock market in 2004, but expect the pace of GDP growth to moderate. Investors should not assume that 2003 was the beginning of a new secular bull market. Stock valuations remain too rich and the secular decline in interest rates is over. However, reasonable real returns in stocks are probable over the coming year. The weak dollar will facilitate higher real growth, but will also place upward pressure on interest rates. A sustainable recovery in real economic growth will require a continuation of the improving job market.

As we have always emphasized in the past, future return expectations must be realistic. We will not make return predictions for stocks or bonds over the next 12 months, but continue to stand by our longer-term forecast (10-plus years) of stocks returning 7.5%-8.5% and the aggregate bond market returning 5%-5.5%. Relative valuations for small-to mid-sized quality companies are still attractive relative to large-cap companies. We feel the current performance leadership in this group will continue as the economy continues to grow and the job market continues to improve. We have also a slight bias to value over growth.

We expect the stock market in general to rise in 2004, but gains to level off later in the year. The upswing in profit growth has been cyclical, not structural. The massive financial stimulus from monetary and fiscal authorities has been the main driver behind the recent recovery, but we expect the effects of such efforts to wear off by mid-year. By the third quarter of 2004, we think the effects of both monetary and fiscal stimulus will be wearing off. Consumer spending will be compared with the strong growth of the third

quarter of 2003, and in our view, consumers will no longer have the benefit of refinancing and tax rebates to drive spending. A move to a more restrictive approach is possible once the November elections are over.

We expect international stocks to outperform US stocks, and emerging markets to outperform more mature international markets. The falling dollar may have short-term benefits for US economic growth, but if the fall is sustained, it could cause major economic damage outside US borders and have a negative impact on both stocks and bonds at home. A continued slide in the dollar also places pressure on higher bond yields, causing a potential negative reaction in both stock and bond prices. Conversely, a higher dollar relative to the Euro and Yen makes it less attractive for US buyers to purchase foreign products, thus leading to possible deflation in the Euro zone and deeper deflation in Japan.

The consensus expects interest rates to move higher during the later half of this year, with the Fed expected to raise short rates to a level of 2% by year-end. We believe the odds favor a trend toward higher interest rates over the next several years, and we expect a major impact on capital investment. Higher rates will make it difficult for investors to make money in bonds. Higher inflationary expectations and increased government borrowing will also feed the rate hikes.

Yield spreads have already narrowed dramatically, leaving little opportunity for return in lower-grade bonds. Despite the expectation of negligible returns in the bond market over the next year, we suggest that investors continue to diversify their bond holdings with exposure to short-to-intermediate high-quality issues and an emphasis on inflation-indexed Treasury securities and underweight Treasuries.

Finally, we have been strong advocates of using dividend-paying stocks as an alternative to cash and bonds for investors who need income and can tolerate the greater short-term volatility inherent in a stock portfolio. Our belief is that dividend growth is likely to be well above average for the next few years, thus we think the case for dividends is compelling, especially for investors with income requirements.