

# The PERAC Financial Bulletin

Financial Market Review, Third Quarter 2007



OCTOBER 2007 | NO. 35

“...A PERIOD OF GREAT VOLATILITY CAUSED BY AN  
HISTORIC MID-SUMMER CREDIT CRUNCH.”

## CREDIT CRUNCH

“...THE IMPORTANCE OF PROPERLY AND CAREFULLY  
ASSESSING RISK BEFORE LENDING MONEY OR MAKING AN  
INVESTMENT HAS MADE A LONG-OVERDUE COMEBACK.”

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If one just considered the beginning-to-end performance of the major stock and bond indices for the third quarter, one might conclude that it was a quiet summer that saw modest advances for both stocks and bonds. Underneath those numbers, however, was a period of great volatility caused by an historic mid-summer credit crunch.

Stocks began the quarter by surging to new highs but began to falter in late July when the far-flung problems relating to losses on sub-prime mortgages began to surface. Over weeks of fitful turbulence, the market declined almost 10% before rallying, first on the heels of the Federal Reserve's 50 basis point cut in the discount rate on August 16 and then after the Fed's surprise 50 basis point cut in the federal funds rate on September 18. Besides the credit woes, the markets also had to deal with oil prices reaching cyclical highs and the dollar sliding to new lows in the currency markets.

As a measure of the volatility during this extraordinary period, about half of the trading sessions between July 19 and late September featured swings of at least 1% in the S&P 500. In normal times, such volatility typically happens in about one of every ten sessions.

*"The Credit Crunch of 2007," an expanded commentary on the reasons for and implications of the summer's market turmoil, appears in the September issue of the PERAC Pension News.*

### EQUITY MARKETS

For the quarter, the broad market Dow Jones Wilshire 5000 rose 1.6% but, as usual, results were not uniform. Reversing a decade-long trend, large caps decisively outperformed small caps as the S&P 500 registered a total return of 2.03% while the Russell 2000 declined 3.09%. Contributing to this performance was the perception that large companies hold up better during uncertain economic times and that, by being more internationally based, they would benefit more from the falling dollar. Using these indices, large caps have also outperformed small caps by about 6% year-to-date.

In another reversal of a longstanding trend, growth decisively outperformed value both for the quarter and year-to-date.

Indicative of the tech sector's strength this year, the NASDAQ Composite was up 3.8% for the quarter and its year-to-date return of 11.8% exceeded the broad market's performance of 9.1%.

Among the S&P 500's ten sectors, energy (+9.39%) and information technology (6.12%) did the best during the third quarter, reflecting the rise in oil prices and the strength in technology, while consumer discretionary (-6.53%) and financials (-4.93%) fared worst, indicative of fears of an economic slowdown and substantial write-downs of loans and mortgage-related credit instruments by major banks.

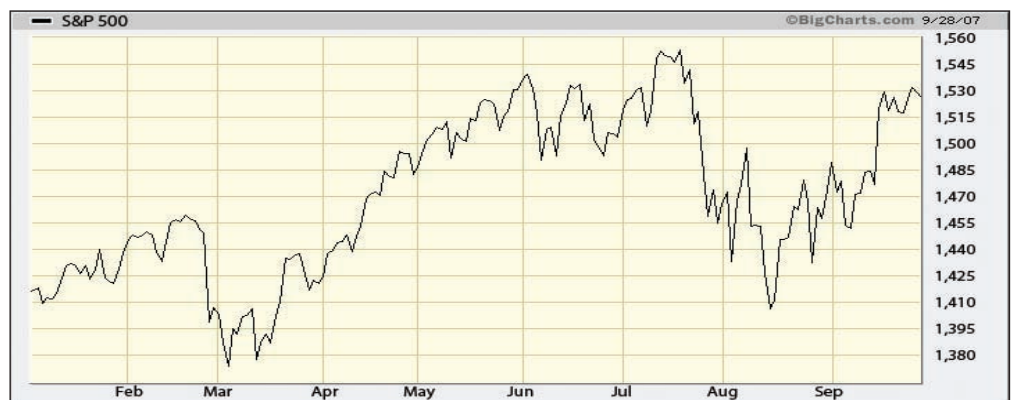
Among individual stocks in the Dow Jones Industrial Average, Procter & Gamble, United Technologies, IBM, Hewlett Packard, and Exxon Mobil rose 10-15% during the third quarter while Pfizer (-4.5%), JP Morgan Chase (-5.4%), Citigroup (-9.0%), WalMart (-9.3%), and Home Depot (-17.6%) suffered the largest losses. Among other stocks, Apple rose 26% to a new high after the successful launch of its iPhone.

The major stock indices have now risen in nine of the past ten quarters. Thanks to the Fed's actions, the market began the fourth quarter with a positive tone. While this month will mark the 20th anniversary of the Black Monday crash of 1987, other investors will take solace that the fourth quarter has historically been a good one for stocks.

#### Chart 1

##### S&P 500, 2007: Ups and Downs, But Up Overall

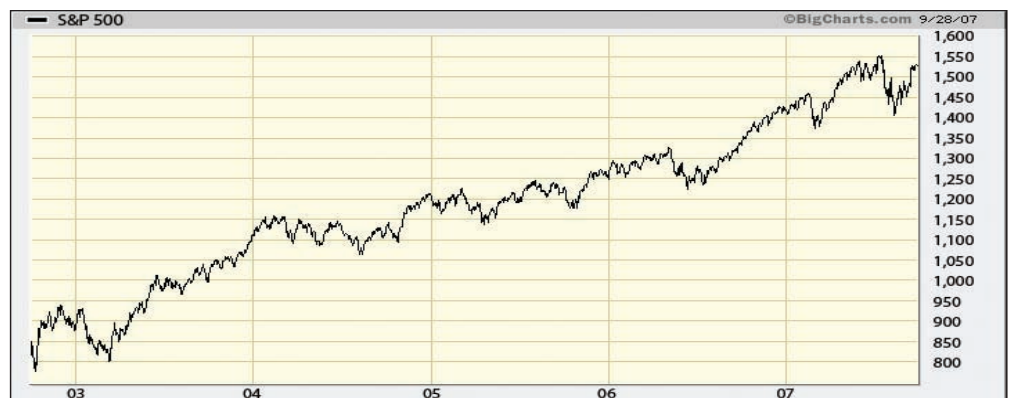
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#### Chart 2

##### S&P 500, Five Years: The Bull Market Continues

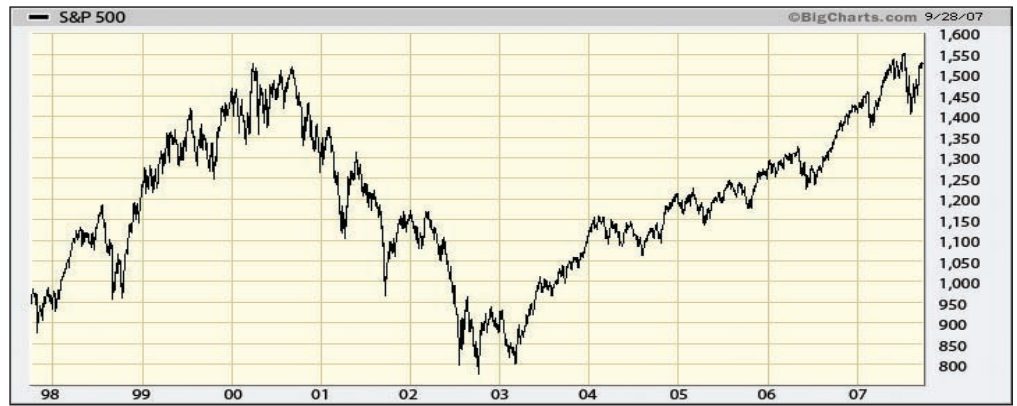
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### Chart 3

#### S&P 500, Ten Years: Reaching a New High

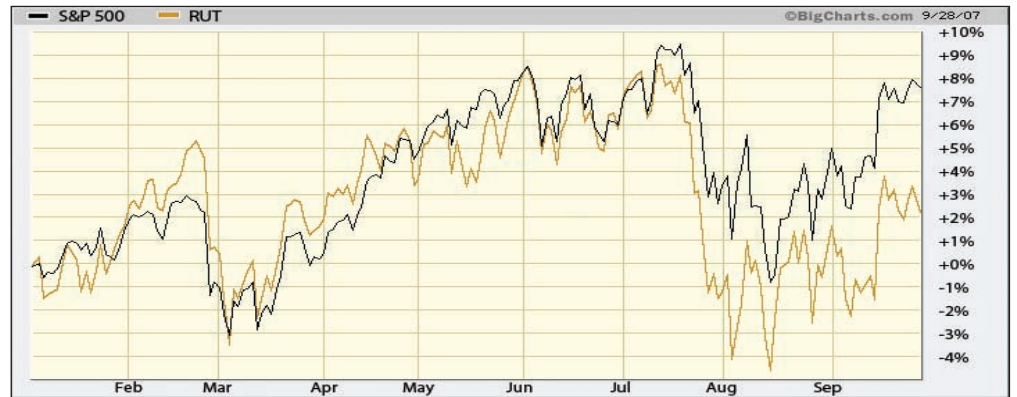
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### Chart 4

#### S&P 500 vs. Russell 2000, 2007: Large Caps Surge Ahead

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In general, global equity markets followed the ups and downs of the US. Demonstrating how interconnected global markets have become, securities tied to US sub-prime mortgages turned up in several foreign bank portfolios and investment funds. For the quarter, the MSCI-EAFE Index was up 2.18% while the Emerging Markets Index rose 14.42%. EAFE is up 13.15% year-to-date while Emerging Markets have surged 34.50%. Indicating the effect of the dollar's weakness, these respective nine month returns were 6.70% and 29.46% in local currency terms. For the trailing five year period, EAFE's annualized return of 23.55% handily outperformed the S&P 500, which had a 15.46% return over this time.

### BOND MARKET

It was also a tumultuous period for the bond market. Prices rose and yields declined on US Treasury notes and bonds as investors sought a flight to quality amid the burgeoning credit crunch, while other parts of the US credit markets actually froze as the problems in the sub-prime mortgage sector spread to the broader market. Investment grade corporate bonds held their own but, along with any securities and instru-

ments directly impacted by lower quality mortgages, high-yield "junk" bonds were severely impacted. Issuance of new junk bonds ground to a halt while outstanding issues lost considerable value relative to the investment grade market. The tone began to improve, however, after the Fed's dramatic September rate reduction, its first in four years.

Interestingly, while the yield on the 10-year US Treasury note declined from 5.034% to 4.579% from start to end of the third quarter, it actually rose after the Fed's September 18 rate announcement as investors began to fear that the lower rates might provide more stimulation than necessary to the economy and eventually lead to higher inflation.

### OTHER MARKETS

In contrast to the continuing weakness in residential housing and the turmoil arising from losses in mortgage-related investment products, commercial real estate has continued to perform well. Strong fundamentals in office, apartments, retail, and industrial space helped the NCREIF National Property Index continue to rise at an annualized rate in excess of 16% through the end of the second quarter. Publicly traded Real Estate Investment Trusts are still down

slightly for the year even after a positive third quarter, but the decline has been more of an expected correction after many years of strong performance than a reflection of weakened underlying fundamentals. For the trailing five-year period, equity REITs have registered an annualized return of 21.52%, compared to 15.46% for the S&P 500.

Composite returns from private equity and venture capital are not yet available but are expected to be positive. While the sharp summer slowdown in IPO issuance will affect the industry in the short term, the resurgence of tech stocks should help it in the long run.

### HEDGE FUNDS

Hedge funds were the subject of much press coverage during the summer credit crunch as a small number of funds suffered huge losses from untimely bets in sub-prime mortgages and a large number of funds with quantitative strategies suffered surprising (but, in most cases, temporary) losses when the market's turbulence played havoc with their models for a short time. Overall, the damage proved limited as most diversified funds of funds still have positive returns for the year despite modest losses during the quarter.

While many hedge funds were forced to reduce their leverage under difficult conditions during the summer crunch, the industry has emerged somewhat bloodied but unbowed. Composite performance numbers for funds of funds, while still positive for the first nine months of 2007, have lagged the returns of the stock market. Investors are not running for the exits, however, as asset growth is still reported to be positive although slowing. Nevertheless, after this summer's events, many hedge fund managers are re-examining their risk controls and the integrity of their quantitative models while many investors are more closely evaluating their hedge fund managers for their strategies, diversification, leverage, etc.

## OUTLOOK

With the credit markets regaining a sense of normalcy and the equity markets flirting with new records, all seems well once again with the major capital markets. If current trends persist, Massachusetts public pension systems have a very good chance of attaining their targeted rates of return this year. Nevertheless, basic questions remain. With the residential housing market remaining soft despite the Fed's rate reduction and with oil approaching new highs, will US consumer spending finally drop off and tip the economy into recession? Or will the Fed's aggressive action, derided by some as an unnecessary bailout of investors who made risky investments, eventually lead to higher inflation and its usually bad implications for the markets?

Whatever occurs during the fourth quarter and the months ahead, some basic lessons have been gleaned from the summer turbulence. Investors have been reminded about the importance and true meaning of liquidity, about some of the under-appreciated characteristics of many of today's financially-engineered investment products, including how they are rated and how they are valued, and about the danger of going too far in relaxing conventional lending standards. Above all, the idea that borrowing can be a path to riches has lost much of its cachet at the same time that the importance of properly and carefully assessing risk before lending money or making an investment has made a long-overdue comeback.

## TOTAL RETURNS | THIRD QUARTER, 2007

INDEX	THIRD QUARTER 2007	NINE MONTHS 2007
<b>US EQUITY MARKET</b>		
Dow Jones Industrial Avg.	+ 4.20%	+ 13.31%
Standard & Poor's 500 (Large Cap)	+ 2.03%	+ 9.13%
NASDAQ Composite	+ 3.80%	+ 11.80%
Wilshire 5000 (Broad Market)	+ 1.42%	+ 9.09%
Standard & Poor's Mid-Cap 400	- 0.87%	+11.01%
Russell 2000 (Small Cap.)	- 3.09%	+ 3.16%
<b>GROWTH VS. VALUE</b>		
Russell 1000 (Large Cap) Growth	+ 4.21%	+ 12.68%
Russell 1000 (Large Cap) Value	- 0.24%	+ 5.97%
Russell Midcap Growth	+ 2.15%	+ 13.35%
Russell Midcap Value	- 3.55%	+ 4.83%
Russell 2000 Growth	+ 0.02%	+ 9.35%
Russell 2000 Value	- 6.26%	- 2.70%
<b>INTERNATIONAL EQUITY</b>		
M.S.C.I. - E.A.F.E.	+ 2.18%	+ 13.15%
M.S.C.I. - Emerging Markets	+ 14.42%	+ 34.50%
<b>FIXED INCOME</b>		
Lehman Brothers Aggregate Index	+ 2.80%	+ 3.80%
Merrill Lynch High Yield Index	+ 0.30%	+ 3.40%
<b>REAL ESTATE</b>		
NAREIT - Equity Real Estate Investment Trusts	+ 2.59%	- 3.46%
NCREIF Property Index	+ 4.59%	+ 17.24%
	(Q2)	(Trailing 12 months)