



New England Pension Consultants is an independent, full service investment consulting firm, providing asset allocation, manager search, performance evaluation and investment policy services to middle and upper market institutional investment programs. We service over 180 retainer relationships, representing assets in excess of \$270 billion.

We offer our market letters to provide insight into recent market conditions, and to assist your interpretation of investment results. We encourage your comments and feedback, as well as any inquiries you may have about our firm or our consulting services.

Market Thoughts

The third quarter of 2002 was one of the worst on record and the poorest for equities since the fourth quarter of 1987, when the Dow declined by over 500 points in a single day. Most global equity markets fell significantly as declining earnings, corporate accounting scandals, geopolitical uncertainty, mixed economic data and continued high valuations sent many investors, particularly individuals and foreigners, to the sidelines. The world's equity markets declined below the levels of post September 11, 2001, and apart from government bonds and certain hedge-fund strategies, few asset classes offered any respite.

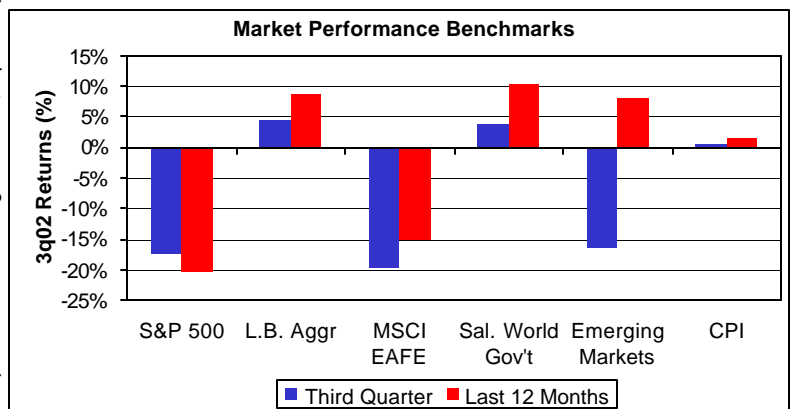
On the economic front, personal and corporate spending continued to slow in the third quarter. However, the service sector, the retail mortgage refinancing boom and an increase in government defense-related spending provided an economic safety net of sorts. Inflation in this slow growth environment remains in check, with prices increasing by just 1.5% year-over-year through September 30.

The recession is behind us, according to most economists, and it will prove to be one of the most moderate contractions in recent history (in marked contrast to the secular decline in equity valuations). The annualized 3.0% rate of GDP growth seen so far this year is in line with expectations and is consistent with recoveries from previous contractions. Jobs are being created, the housing market remains strong, thanks to the "wealth effect" of the refinancing boom, and the banking sector is in much better shape than in the last recession.

On the negative side, corporate earnings in the tech and telecom sectors continue to disappoint, as dwindling demand and overcapacity exact their toll. Our auto plants remain open and productive largely because domestic automakers are forgoing competitive profits by offering zero-percent financing. And a still-strong dollar makes foreign imports attractive to the consuming public while reducing overseas demand for our exports. Concerns mount over the strength of our recovery.

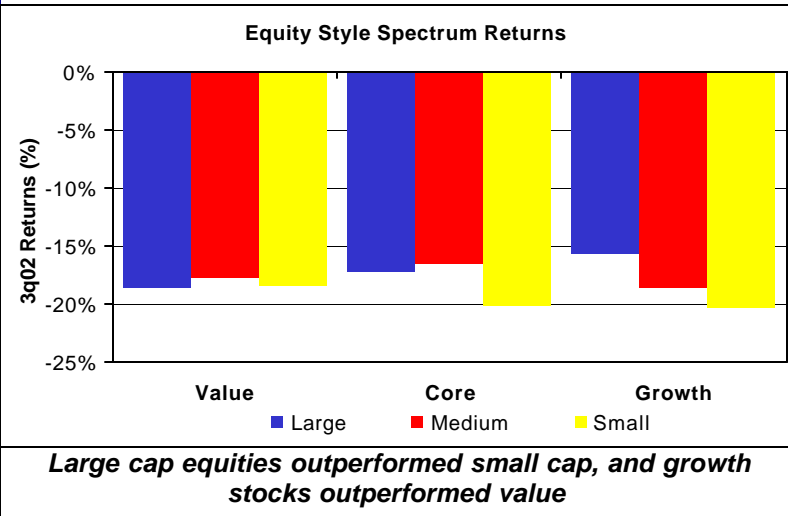
U.S. Equity Markets

In this challenging environment, the S&P 500 lost an eye-popping 17.3% in the third quarter (and has lost 42% of its value since the turn of the century, but 2.75 years ago). Over the last five years, the annualized return for the S&P 500 now stands at -1.6%, down a few light years from the 28.6% average over the last five years of the 1990's. Each of the S&P 500 economic sectors declined significantly, led by the telecom sector's 26.1% loss (on the heels of a 23.4% decline in the second quarter). Not to be outdone, the Nasdaq reached a six-year low on losses of 19.9% for the quarter and 39.9% year-to-



Emerging markets prevail as one of the best performing equity asset classes during the last twelve months

date. Telecom losses have eclipsed the losses of the dot.com sector, and now represent the biggest dollar loss to investors in U.S. history. The health care and consumer staples sectors saw the best relative returns, declining by only 7.5% and 10.6% respectively, reflecting their historically defensive nature in down markets.



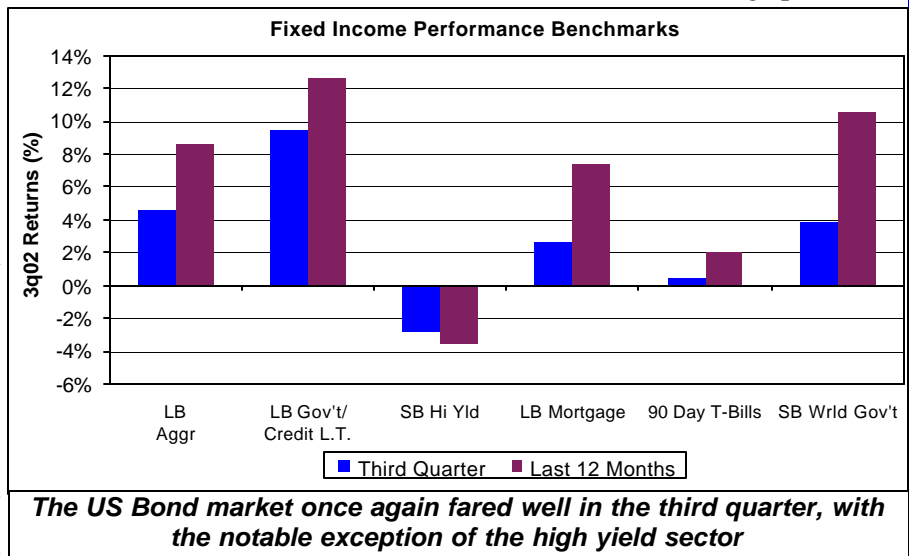
The real news for the U.S. stock market was the fact that foreign and retail investors have been exiting *en masse*. Foreign investors have been unnerved over our domestic accounting scandals and the declining dollar (down over 7% YTD) and many have sold out, believing that better investment opportunities await them at home. Retail investors have continued their time-honored tradition of buying high and selling low. In fact, most retail and 401(k) investors have seen substantially negative long-term returns (much worse than institutional investors), even with the significant price increases seen in the 1990s. Fortunately, institutional investors have for the most part kept their equity allocations in place through consistent rebalancing. Tellingly, many Tactical Asset Allocation managers have been increasing their

equity exposures recently, believing equities to offer better prospective returns than bonds.

Reversing a recent trend, large cap equities outperformed small cap, and growth stocks outperformed their value counterparts in the third quarter. Active management helped most equity investors, particularly in the small cap sectors, continuing the historic trend of outpacing relevant benchmarks as the markets correct and broaden-out following speculative run ups.

U.S. Bond Markets

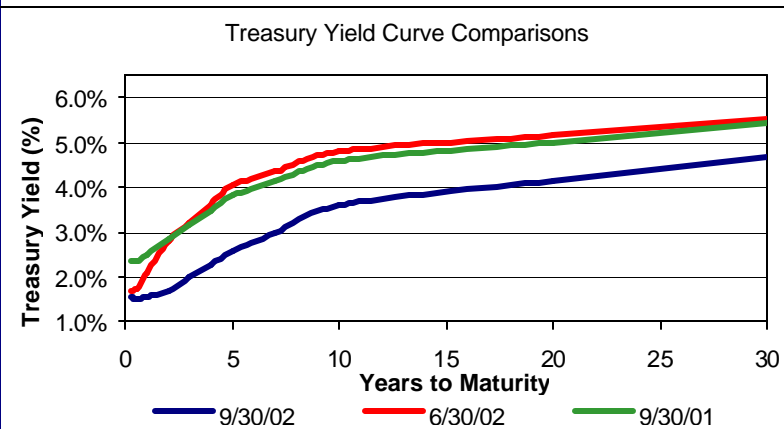
Offsetting some of the depressing news in the stock markets, the U.S. bond market once again fared well in the third quarter, with the notable (and continued) exception of the high yield sector. Treasury yields declined significantly for all maturities, despite the fact that the Fed left short-term interest rates unchanged. The decline in yields boosted the Lehman Brothers Aggregate Bond Index by 4.6% in the third quarter. Longer maturity, high quality bonds did even better. In fact, the Lehman Brothers Long-Term Government/Credit Index rose an astounding 9.4% in the third quarter, its best showing since 1989.



High quality corporates also performed well, but their below investment grade counterparts had a terrible quarter, losing 2.8% as measured by the Salomon Brothers High Yield Index, following an 8.5% decline in the second quarter. Returns were depressed by the demise of the telecom sector in general, and the WorldCom and Adelphia bankruptcies in particular. High yield premiums over comparable Treasuries rival those of the early 1990's, offering attractive opportunities to long-term investors. Many issues have seen their prices decline only because of their association with companies like WorldCom. There is a lot of guilt by association in the high yield bond sector right now.

International Markets

As mentioned earlier, foreign equity markets offered little protection to investors in the third quarter. Europe's telecom sector was also punished, stemming from the obscenely large sums paid to governments to develop wireless networks there. Record floods in central Europe further depressed the German markets, and virtually every country within Europe saw its economic fundamentals decline, many worse than the U.S. Fortunately, there are no overseas Enron's or WorldCom's thus far, and investors there have shown more faith in foreign accounting standards than those of the U.S., a remarkable mindset given the opacity of foreign corporate financial statements.



High yield premiums over comparable Treasuries rival those of the early 1990's

Japan has continued its 13-year equity bear market, with the Nikkei declining to 25-year lows. The deflationary environment there continues unabated, and there appears to be little political appetite for the necessary bank reforms. The decline in the value of the dollar relative to the yen has not helped matters any, as Japanese exports have seen their pricing power weakened by the stronger yen.

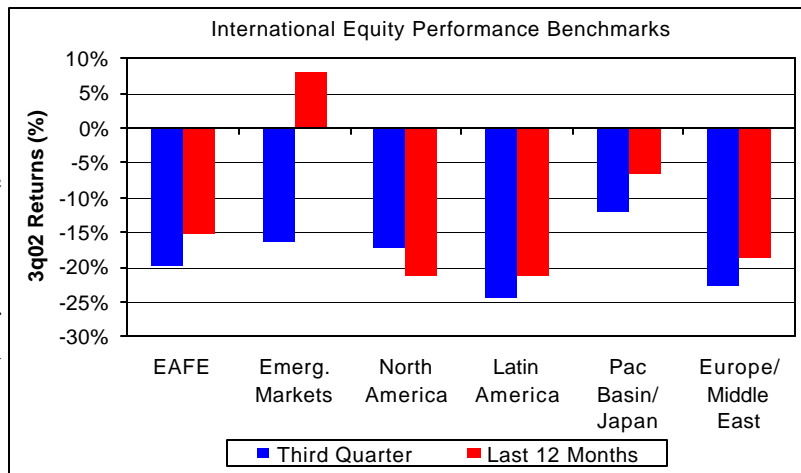
The dollar has also declined markedly against the Euro, reaching the psychologically important parity level of 1 euro/dollar (just as your correspondent was on his way to Europe in July). The dollar is still high by historical standards, and currency futures suggest that it could decline further in the coming months, further buoying U.S. overseas investments. Global bond portfolios (already performing well because of their high quality emphasis) advanced by 3.9% in the third quarter, following an increase of 11.6% in the second quarter, as measured by the Salomon Brothers World Government Bond Index. For the last year, global bonds have been the single best performing asset class, confirming their defensive role in investors' portfolios in equity bear markets.

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A Look Ahead

"Not a sprint, but a marathon", words that should be committed to memory by all serious investors. While the current bear market has been brutal in its own right, it also seems to be accelerating a trend towards "short-termism" that will likely end in tears for investors who have forgotten the importance (and necessity) of patience in the investment process. Where trends used to be measured in years, if not decades, many pundits today seem to think that a trend involves a minimum of two trading days where prices move in the same direction.



Foreign equity markets offered little protection to investors in the third quarter

That short-term emphasis is clearly inappropriate. Investing has always been an activity requiring a longer-term horizon. Those who have been most hurt by the recent sell-off are those that bought-in *during* the run up of the late 1990's and sold *during* the market's subsequent decline. Longer-term investors have earned returns very much in line with historic averages since the mid 90's, notwithstanding the 42% decline in domestic equities since January 2000. It's worth noting that thus far into October the S&P 500 has recovered over half of its third quarter losses.

Investors will never profit from short-termism, although during raging bull markets they may experience the illusion of success. Successful investors remain true to their long-term asset allocations, rebalancing when price declines (and advances) move their portfolios away from long-term targets. This helps ensure that investors systematically buy low and sell high, which is the *only* way to make money over the long run. By far the biggest risk faced by investors is that they

will be forced to “blink”, and not stick with their long-term plans.

Will the pain investors are currently experiencing ever end? The answer is “yes”. In the past, *every* period like the one we’ve endured recently has eventually been followed by a recovery. The rub (as always) has been predicting when salvation will come. An old adage does give us some comfort: the best cure for depressed securities prices is: depressed securities prices. There will be a point where future prospects for corporate America improve, and the price declines we’ve endured will translate into a significant buying opportunity. Our advice to our clients: stay the course. Rebalance back to target, and don’t be tempted to change long-term allocations at this point. This bear market will pass, just as surely as the equity bull market of the 1990s was destined to come to an end. Equities remain a very appropriate asset class for long-term investors, and there are many bargains to be found right now in the equity and high yield markets worldwide.

We’re less enthusiastic about investment-grade bonds. While they may continue to offer some short-term comfort as the equity and high yield markets find their bottoms, they are expensive at current yield levels and their long-term outlook is much less favorable. Historically low yields, an increasing federal budget deficit and a decreasing appetite for U.S. securities on the part of foreign investors mean that price decreases are more likely than increases over the long run. As mentioned earlier, most Tactical Asset Allocation managers have increased their weights to equities versus bonds, in part because of the relatively poor long-term prospects for government bonds.



Challenges remain for the equity markets, of course. Many stocks still appear to be overvalued, although earnings seem to be unusually depressed at this stage of the market cycle. To illustrate the uncertainty that remains in the market, consider the 13.6% five year consensus earnings forecasts recently published by I\B\E\S: aggressive, but not unreasonable from today’s depressed earnings levels. Should those estimates be realized and the market simultaneously regress to its long-term average 17X P/E multiple, stock prices would remain flat over the next five years. A sobering analysis. Because current price-to-earnings ratios for the markets as a whole remain above their long-term averages, we believe that it will be a stock pickers market for the next few years, and that the ability to generate alpha will become somewhat more important than was the case in the decade of the 1990’s. Intermediate to longer-term, we believe that as corporate earnings recover, stock prices will respond, although investors shouldn’t expect to see the types of returns experienced in the late 1990s.

The turmoil in the Middle East certainly does not help things. It’s contributing to what economists refer to as “risk ambiguity avoidance”. In the 1990-1991 Persian Gulf War we saw a similar phenomenon, only to be erased the day our armed force actually began their campaign. We expect a similar upward pressure on securities prices if and when the nature of our future military actions becomes less uncertain.

So much of what we have to report today is a direct result of the horrible acts of September 11, 2001. As the one-year anniversary of September 11 has just past, we’re reminded of just how precious life is. No one could have guessed that this nation would face so many challenges. And yet the resilience and ingenuity of Americans continue unabated, giving us hope for the promise of tomorrow. We at NEPC are grateful to have been able to work with so many wonderful people over the last 16 years, and we looking forward to sharing our investment insights with you in the future.