

## Good But Not Great

2004 was a good year for the economy and the capital markets. Oil prices shot up to \$50 a barrel and inflation fears were fanned, yet the economy shrugged it off. GDP rose 3.1% in the fourth quarter, resulting in a gain of 4.4% for the year, the best performance since 1999. *see page 11*

## Election Cycles Ups and Downs

The **S&P 1500** (+9.62%), pushed by consumer discretionary, technology and utilities, turned in its best quarter of the year. Stocks of all sizes advanced, with small capitalization stocks maintaining their dominance. Large value outdid large growth for the quarter, while small growth trumped small value. *see page 2*

## Bond Market Holds Steady

In the fourth quarter the **Lehman Aggregate Index** advanced 0.95%. Corporate bonds returned 1.32%, 90 bps more than Treasuries with a similar duration. The high yield rally extended into the fourth quarter, despite the year's record level of new issuance and negative mutual fund flows. *see page 4*

## Strong Demand Spurs Real Estate

High investor demand for stable income-producing assets continued to attract massive capital flows into real estate. The one-year return for **NAREIT** was 31.58%, topping all other asset class investment options in 2004. The private real estate market, as measured by the **NCREIF Total Property Index**, advanced 4.69% for the quarter and 14.52% for the year. *see page 9*

## International Markets Beat the U.S. Again

For the third consecutive year, **EAFE** (+20.3%) beat the **S&P 500** (+10.9%), helped by a strong fourth quarter showing of 15.3%. After nearly two years of positive news, Japan's economic recovery showed signs of faltering. Emerging markets, with an impressive 17.3% showing in the fourth

quarter, recorded its first back-to-back yearly gain since 1992-93. *see page 6*

## Weak Dollar Lifts International Bonds

In the fourth quarter, the **Citigroup World Government Bond Index ex-U.S.** rose 10.64% in dollar terms, but just 2.15% in hedged terms. The **JPMorgan EMBI+ Index** moved 5.11% higher for the eighth positive return in the past nine quarters. The European bond market rocketed higher with the **Citigroup EMU Government Bond Index** gaining 12.51% in U.S. dollar terms, thanks in most part to the soaring euro. *see page 8*

## Private Equity Market

The fourth quarter solidified the marked turnaround that began this year on all fronts in the private equity market. A total of \$84.8 billion and 280 funds were raised in 2004—up from \$49.3 billion and 197 funds in 2003—ending a precipitous three-year decline. Portfolios saw valuation increases and significant distributions primarily from buyout holdings, but also from venture capital funds. *see page 10*

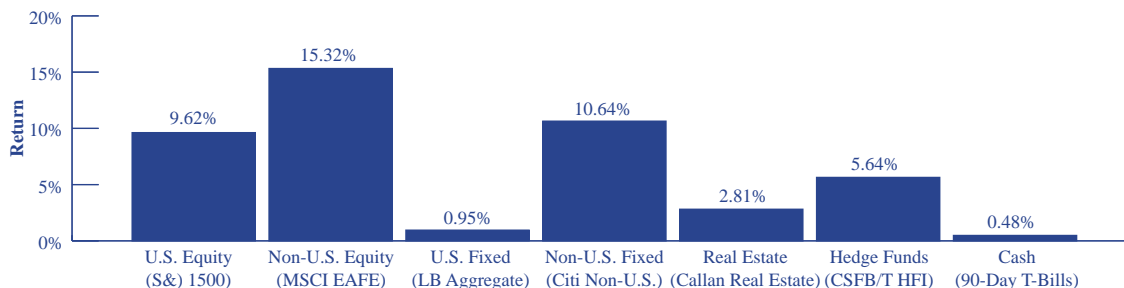
## Hedge Funds Advance As Fog Clears

The **Callan Hedge Fund-of-Fund Database** gained 4.06% last quarter, after all fees. Among the strongest strategies, *Long/Short Equity* jumped 7.42%. As credit spreads tightened further to historically low levels, *Distressed* managers gained 6.59%. *see page 10*

## A Solid Ending Makes the Year

World markets turned around in the fourth quarter, posting solid gains across the globe. With an average international allocation of 16%, the median public plan fared the best, up 7.67% for the quarter. With slightly lower international allocations, corporate and endowment/foundation plans advanced 7.63% and 7.64% in the median case, respectively. *see page 12*

Broad Market Returns – Fourth Quarter 2004



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## Election Cycles Ups and Downs

Food for thought... Since 1926, there have been 20 presidential elections, and the fourth quarter of the election year has produced an average quarterly gain of 4.26%. During periods of regime change (there were eight), the S&P 500 was up an average of 2.38%. When the incumbent party remained in the Oval Office, the market rose by an average of 5.52%. This would argue that the U.S. equity market reacts favorably when the incumbent party (regardless of affiliation) stays in office, and supports the position that markets dislike uncertainty and change.

The fourth quarter results back this position as the **S&P 1500** (+9.62%) turned in its best quarter of the year, pushed by consumer discretionary, technology, and utilities.

Stocks of all sizes advanced, with small capitalization stocks maintaining their dominance. The **S&P Small Cap 600** rose 13.00% and the **S&P MidCap 400** was up 12.16%. The **S&P 500** (+9.23%) was the laggard for the quarter.

Consumer discretionary (+13.78%), supported by continued consumer spending growth, led the S&P 1500's 10 economic sectors. Technology (+13.65%) was a close second. Utilities (+11.58%), despite a decline in oil prices, continued to climb as both TXU Corp (+35.97%) and Exelon (+21.28%) had double-digit returns.

Industrials (+10.73%) rose as both capacity utilization and industrial production grew. Leading the charge were Tyco (+16.89%) and UPS (+12.94%).

Rising commodity prices did not seem to hurt materials (+9.31%), with both DuPont (+15.20%) and Dow (+18.37%) surging.

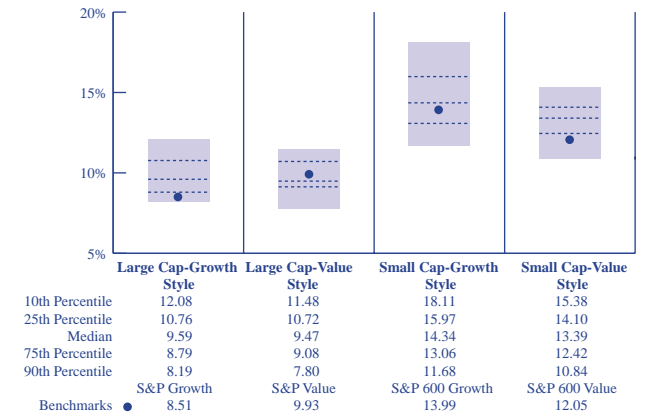
Telecommunications (+8.14%), with continuing merger buzz around cell phone companies, had another healthy quarter. Financials (+8.31%) were boosted by the large money center banks, including Citigroup (+10.19%) and BankAmerica (+9.49%). AIG (-3.3%) lagged as the company became a target in the growing insurance pricing scandal. Consumer staples (+8.21%) were hurt by poor holiday sales expectations at Wal-Mart (-0.44%) and would have been worse without support from Altria (+31.44%).

Energy (+4.46%) was a mixed bag as oil prices fell from record highs. Integrated oils (+3.93%) were hampered, while refiners (+15.64%) benefited from rising gasoline prices and an expected heating oil shortfall in the Northeast.

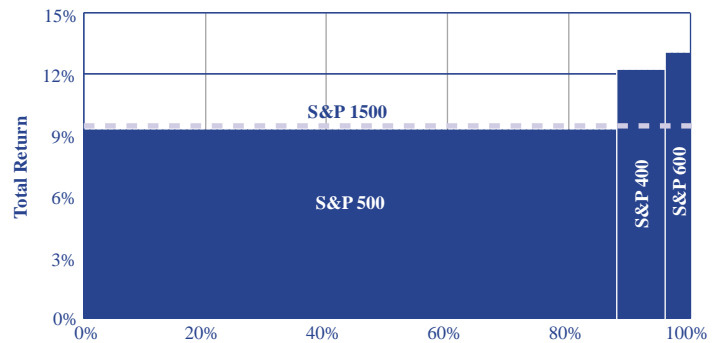
Health care (+5.90%) was also up, but continued to suffer from concern over Vioxx and other high profile prescription drugs. Worries over both Celebrex and Lipitor hurt Pfizer (-11.57%). This decline was offset by gains from Johnson & Johnson (+13.12%), Amgen (+12.92%) and Abbott Labs (+10.82%).

Based upon the S&P/Barra style indices, large value stocks outdid large growth stocks this quarter, while small growth trumped small value. To compare value and growth, S&P and Barra divide the capitalization indices evenly by price-to-book, creating subsectors of growth and value-oriented stocks. Among smaller stocks, the **S&P/Barra Small Cap Growth Index** climbed 13.99%, compared to an increase of 12.05% for its value counterpart. In the large stock arena, positions were reversed, with the **S&P/Barra Value Index** rising 9.93%, while its growth counterpart was up 8.31%.

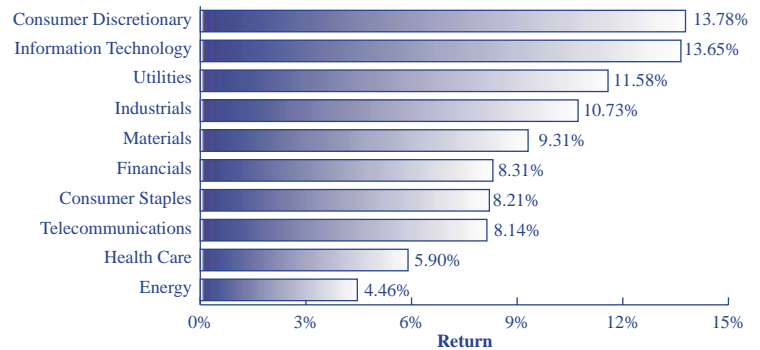
## Callan Style Group Returns – Fourth Quarter 2004



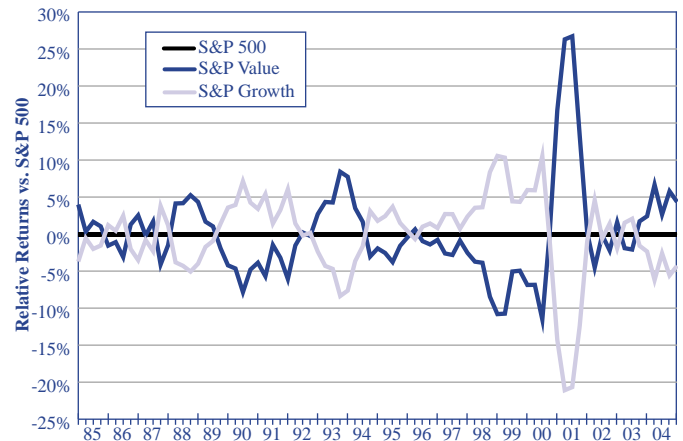
## Capitalization Sector Performance – Fourth Quarter 2004



## Economic Sector Performance – S&P 1500 Fourth Quarter 2004



## Rolling One-Year Relative Returns vs. S&P 500



## U.S. EQUITY

Style Median and Index Returns\* for Periods ended December 31, 2004

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
<b>Large Cap Equity</b>						
<i>Large Cap–Broad Style</i>	9.47	11.34	3.28	-1.08	12.74	11.79
<i>Large Cap–Growth Style</i>	9.59	7.08	-0.16	-7.22	11.57	11.50
<i>Large Cap–Value Style</i>	9.47	14.63	6.30	4.66	13.36	11.97
<i>Aggressive Growth Style</i>	13.02	10.13	2.86	-5.46	11.51	12.97
<i>Contrarian Style</i>	10.35	15.18	7.80	8.43	14.02	12.55
<i>Core Style</i>	9.31	10.15	3.36	-1.66	12.74	11.71
<i>Yield Style</i>	8.87	14.18	7.52	6.88	13.19	11.46
S&P 1500	9.62	11.78	4.46	-1.07	12.30	—
S&P 500	9.23	10.88	3.59	-2.30	12.07	10.94
NYSE	10.85	14.71	7.08	2.85	12.68	11.26
Dow Jones Industrials	7.56	5.27	4.71	0.69	13.10	12.16
<b>Mid Cap Equity</b>						
<i>Mid Cap–Broad Style</i>	12.61	17.29	10.26	8.20	14.77	14.23
<i>Mid Cap–Growth Style</i>	13.56	12.28	3.15	-5.05	12.71	13.94
<i>Mid Cap–Value Style</i>	12.21	19.23	12.31	14.29	15.49	13.99
S&P Mid Cap 400	12.16	16.48	10.53	9.54	16.10	14.67
<b>Small Cap Equity</b>						
<i>Small Cap–Broad Style</i>	13.75	17.45	10.93	9.69	14.89	14.55
<i>Small Cap–Growth Style</i>	14.34	12.16	5.01	0.14	12.70	13.16
<i>Small Cap–Value Style</i>	13.39	22.99	17.56	18.18	17.15	15.46
S&P Small Cap 600	13.00	22.65	13.27	11.60	14.29	12.56
Russell 2000	14.09	18.33	11.48	6.61	11.54	11.09
NASDAQ	14.86	9.14	4.21	-11.42	11.69	11.84
<b>S&amp;P 1500 Sectors**</b>						
Consumer Staples	8.21	8.71	3.88	0.96	10.76	10.89
Consumer Discretionary	13.78	14.41	8.47	2.57	11.80	11.08
Industrials	10.73	18.67	5.55	2.09	12.85	10.70
Energy	4.46	32.24	15.16	11.63	14.95	11.42
Materials	9.31	16.70	13.50	7.03	8.66	8.52
Information Technology	13.65	2.21	-2.25	-16.56	10.55	11.49
Utilities	11.58	23.38	5.42	6.54	9.97	8.33
Financials	8.31	11.93	9.31	9.33	18.31	15.38
Telecommunications	8.14	19.82	-5.84	-15.11	—	—
Health Care	5.90	3.31	-1.16	2.90	—	—

<b>U.S. Equity Index Characteristics as of December 31, 2004</b>					
	S&P 1500	S&P 500	S&P 400	S&P 600	Russell 3000
Cap Range	69–385,376	749–385,376	344–9,408	69–4,894	4–385,234
Number of Issues	1,500	500	400	600	3,012
% of S&P 1500	100%	88%	8%	4%	—
Wtd Avg Mkt Cap	\$80.5B	\$91.5B	\$3.5B	\$1.2B	\$75.1B
Price/Book Ratio	2.9	3.0	2.6	2.5	2.9
P/E Ratio (forecasted)	16.6	16.4	17.4	17.3	17.1
Dividend Yield	1.6%	1.7%	1.1%	0.8%	1.6%
5-Yr Earnings (forecasted)	12.2%	12.0%	13.6%	12.7%	12.3%

\* Returns less than one year are not annualized.

\*\* Returns prior to 1Q03 are based upon Callan Broad Market's sector returns.

## Bond Market Holds Steady

The bond market exhibited resilience throughout the fourth quarter—as it did most of the year—despite modest expectations, Fed tightening, lofty energy prices, a growing economy, and a depreciating dollar. While the price of bonds defied expectations on the long end of the curve, yields on the short end of the curve trended upward, following the Fed's lead. In the fourth quarter, the **Lehman Aggregate Index** advanced 0.95%, as the increase in short-term interest rates eroded 23 bps from the index's yield. For the year, the index produced a coupon-like 4.34% return, as long yields ended the year almost exactly where they began.

During the fourth quarter, the Federal Reserve continued its well-telegraphed gradual increase of short-term interest rates. The Fed increased rates by 25 bps twice during the quarter, ending the quarter with the Fed funds' target rate at 2.25%. In response to the Fed's actions, two-year and three-year Treasury yields increased by 46 and 37 bps over the quarter. The market, through futures contracts, is predicting that the Fed has not completed this tightening cycle. As of year-end, the market is predicting another 100 bps of Fed tightening will occur during 2005.

Long-term interest rates were not affected by this anticipated increase in short-term rates. Instead, robust demand for U.S. bonds by foreign investors, coupled with expectations of tame inflation and modest GDP growth, kept long-term yields stable. The 10-year Treasury ended the quarter at 4.22%, 10 basis points higher than at the beginning of the quarter, and within three basis points of where it began the year. With the increase in short rates and the decrease in long rates, the yield curve flattened by another 53 basis points over the quarter. At the beginning of 2004, 325 basis points separated two-year and 30-year Treasury yields. By the end of the year, the amount of extra yield earned by investing in a 30-year Treasury, as opposed to a two-year Treasury, dropped to 1.76%.

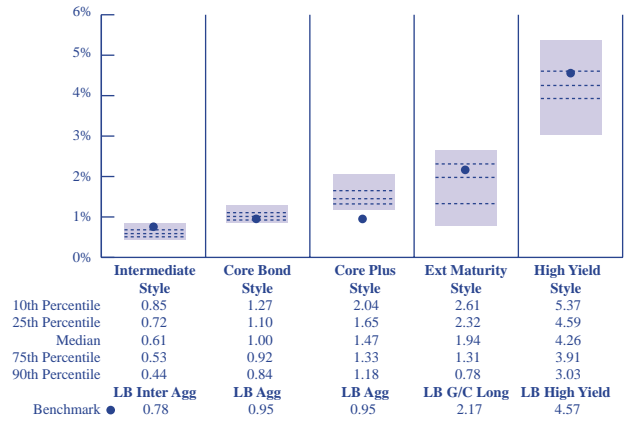
Fixed rate mortgages exhibited strength over the quarter, generating a return of 1.26%. Low interest rate volatility, low swap spreads, and a low supply of fixed rate mortgages helped produce the market's 84 bps of excess return over Treasury bonds. Asset Backed Securities and Commercial Mortgage Backed Securities had another solid quarter as the global search for yield spurred demand for low duration spread product. The two markets produced excess returns of 31 bps and 41 bps, respectively.

A quick resolution to the U.S. presidential election, as well as increased foreign appetite for U.S. corporate debt, helped support the credit market during the quarter. For the quarter, corporate bonds returned 1.32%, 90 bps more than Treasuries with a similar duration. Lower quality spread products continued to outperform higher quality peers, with BBB rated bonds producing 1.2% in excess returns over the quarter.

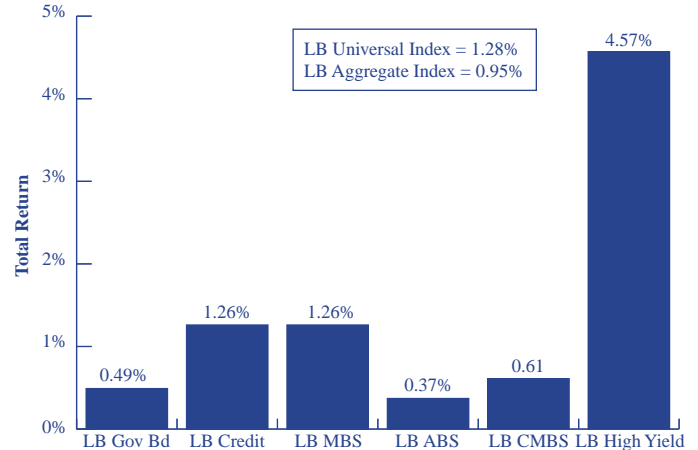
The high yield rally extended into the fourth quarter, despite the year's record level of new issuance and negative mutual fund flows. The high yield market (especially CCC-rated debt) continued to perform well, propelled by declining default rates, increasing corporate profitability, and a healthy equity market. Due to the relatively low cost of issuing high yield debt, below investment grade companies issued an unprecedented \$158 billion in debt throughout the year.

Unhedged international assets also extended their rally during the quarter, as the dollar dropped 8.2% versus the euro. In light of the strong performance produced by non-index sectors, the median core plus manager exceeded the return produced by the median core bond manager by 47 bps during the quarter.

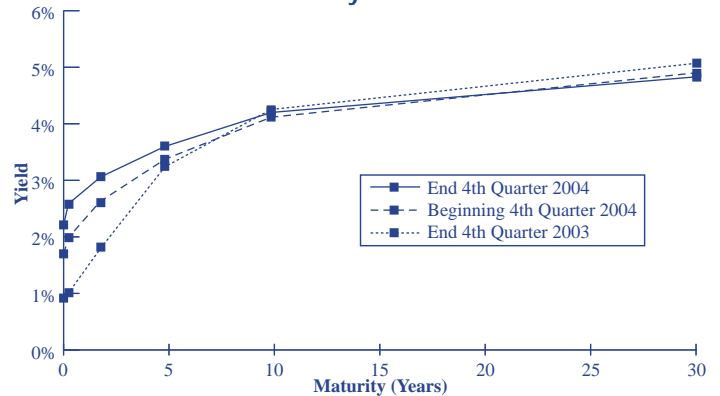
## Callan Style Group Returns – Fourth Quarter 2004



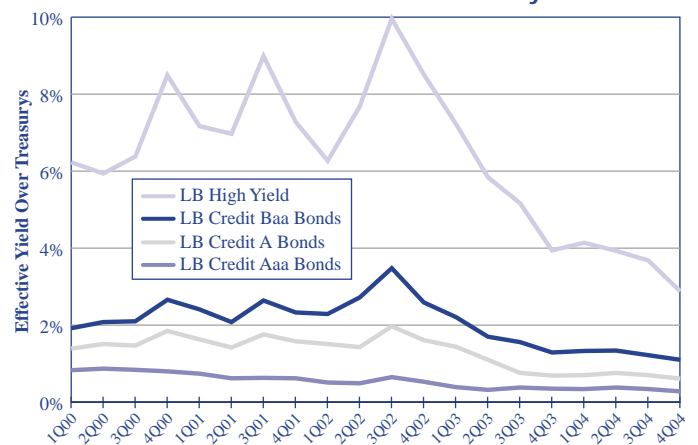
## Sector Performance – Fourth Quarter 2004



## U.S. Treasury Yield Curves



## Effective Yield Over Treasuries



**U.S. FIXED INCOME**  
**Style Median and Index Returns\* for Periods ended December 31, 2004**

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
<b>Broad Fixed Income</b>						
<i>Core Bond Style</i>	1.00	4.48	6.28	7.87	7.84	7.90
<i>Core Bond Plus Style</i>	1.47	5.23	6.87	7.95	8.30	8.51
LB Aggregate	0.95	4.33	6.19	7.71	7.72	7.70
LB Govt/Credit	0.80	4.19	6.59	8.00	7.80	7.77
LB Govt	0.49	3.48	5.70	7.47	7.46	7.48
LB Credit	1.26	5.24	7.80	8.62	8.40	8.35
Citi Broad Investment Grade	1.00	4.48	6.22	7.74	7.74	7.75
<b>Long Term</b>						
<i>Extended Maturity Style</i>	1.94	8.17	9.36	10.73	9.96	9.61
LB Govt/Credit Long	2.17	8.56	9.68	10.46	9.72	9.25
LB Gov Long	1.57	7.94	9.02	10.22	9.62	9.12
LB Credit Long	2.96	9.38	10.57	10.61	9.70	9.32
<b>Intermediate Term</b>						
<i>Intermediate Style</i>	0.61	3.31	5.66	7.22	7.21	7.39
LB Intermediate Aggregate	0.78	3.74	5.65	7.23	7.32	7.38
LB Govt/Credit Intermediate	0.44	3.04	5.69	7.21	7.16	7.25
LB Gov Intermediate	0.22	2.33	4.70	6.57	6.75	6.93
LB Credit Intermediate	0.77	4.08	7.01	8.05	7.91	7.94
<b>Short Term</b>						
<i>Defensive Style</i>	0.21	1.67	3.35	5.38	6.07	6.51
<i>Active Cash Style</i>	0.41	1.39	2.40	4.06	5.08	5.47
<i>Money Market Funds (net of fees)</i>	0.33	0.80	0.92	2.45	3.77	4.05
ML Treasury 1-3 Year	0.02	0.91	2.83	4.93	5.71	6.03
90-day Treasury Bills	0.48	1.33	1.42	2.95	4.11	4.39
<b>High Yield</b>						
<i>High Yield Style</i>	4.26	10.55	11.67	7.45	9.20	10.71
LB High Yield	4.57	11.13	12.22	6.97	8.13	9.45
ML High Yield Master	4.46	10.76	11.68	7.32	8.45	9.62
<b>Mortgage/Asset-Backed</b>						
<i>Mortgages Style</i>	1.17	4.73	5.78	7.46	7.88	8.03
LB MBS	1.26	4.70	5.48	7.14	7.56	7.56
LB ABS	0.37	3.00	5.16	7.19	7.11	—
LB CMBS	0.61	4.10	7.90	9.30	—	—
<b>Municipal</b>						
LB Muni	1.25	4.48	6.44	7.20	7.06	6.99
LB Muni 1-10 Year	0.62	2.92	5.29	5.91	6.06	—
LB Muni 3 Year	0.18	1.78	3.71	4.78	4.97	5.37

**U.S. Fixed-Income Index Characteristics as of December 31, 2004**

Lehman Brothers Indices	Yield to Worst	Modified Adj. Duration	Average Maturity	% of LB G/C	% of LB Aggregate
LB Aggregate	4.38	4.34	7.09	100.00%	100.00%
LB Govt/Credit	4.09	5.22	7.77	100.00%	60.49%
Intermediate	3.78	3.66	4.38	78.81%	47.67%
Long-Term	5.22	11.02	20.41	21.19%	12.82%
LB Govt	3.75	4.87	6.82	59.00%	35.69%
LB Credit	4.58	5.74	9.15	41.00%	24.80%
LB Mortgage	4.91	2.86	6.20	—	35.08%
LB Asset-Backed	3.80	2.58	2.93	—	1.37%
LB Commercial Mortgage	4.34	4.59	5.47	—	3.06%
LB Corp High Yield	6.76	4.70	8.34	—	—

\* Returns less than one year are not annualized.

## International Markets Beat the U.S. Again

For the third consecutive year, **EAFE** (+20.3%) beat the **S&P 500** (+10.9%), helped by a strong fourth quarter showing of 15.3%. The long-awaited pullback in oil prices led the energy sector to a weak 8.7% performance. After several high profile drug recalls, pharmaceuticals trimmed health care to an 8.3% return. European stocks (+16.0%) edged out Japanese equities (+13.1%), but the big winner once again was emerging markets (+17.3%). The dollar continued to weaken, dropping 9.4% versus the euro and 7.6% against the yen.

### Europe

European investors remained apprehensive in the fourth quarter despite the rising market (+16.0%). The euro surged another 9.4% and began to draw the attention of policy makers, who feared that the currency's strength would undermine global export competitiveness. The drop in oil prices encouraged investors to rotate out of that sector and into financials and telecommunications, which helped balance the currency worries. Pharmaceuticals also struggled, contributing to the health care sector's "paltry" 8.7% return for the continent. Stocks in the United Kingdom (+12.6%) lagged the returns but still stayed in positive territory, thanks in part to the a strong pound, that climbed 6.1% against the dollar. The British economy showed early signs of slowing after a long round of rate hikes earlier in the year, leading investors to believe that rates had finally peaked.

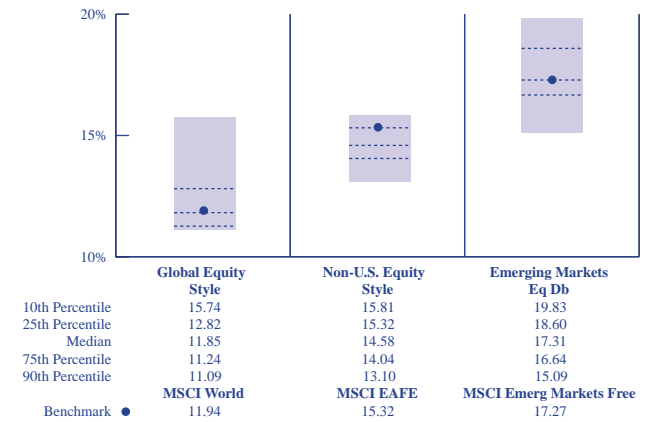
### Asia

After nearly two years of positive news, Japan's economic recovery showed signs of faltering. The government downgraded its assessment of the economic conditions, while the rising yen began to impact the revenue outlook for exporters. Japanese stocks lagged the EAFE benchmark with a 13.1% return, with the yen's strength contributing 8.0% of that figure. Despite the unsettling economic news, the best performing industry in Japan was commercial banks, rocketing 28.2% higher as a result of improving balance sheets. Elsewhere in the Pacific Basin, New Zealand (+15.1%) and Australia (+20.1%) soared on the heels of seemingly unstoppable commodity prices, with the currencies following the local equity prices higher. Mining stocks, in particular, were major beneficiaries of the continued bull market in metals prices, as investors remained concerned about capacity shortages.

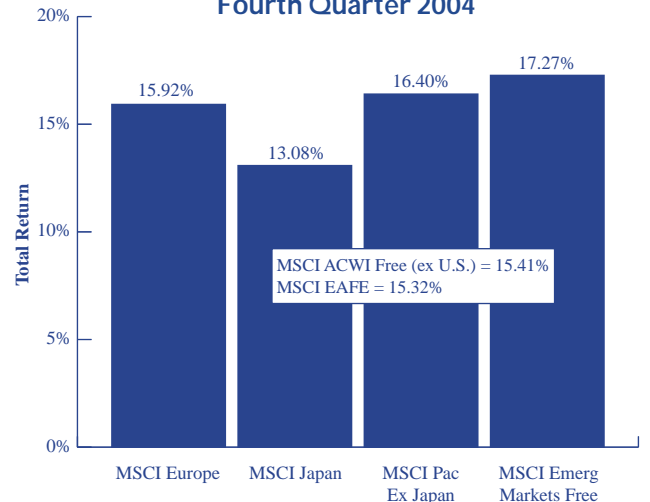
### Emerging Markets

Emerging markets continued their winning ways with an impressive 17.3% showing in the fourth quarter, bringing the return for 2004 to 25.95%. This was the first time this asset class had back-to-back yearly gains since 1992-93, and it was the fourth consecutive year emerging markets beat the developed markets. Cyclical led the way, with particular strength in retailers (+41.9%), financials (+26.4%), and telecommunications (+23.4%). As had been the case for two years, investors continued to prefer the smaller and riskier countries, such as Colombia (+33.6%) and Jordan (+33.5%). In Latin America, strong economic growth lifted Brazil (+23.2%) and Mexico (+22.6%). In the Asian region, China climbed just 5.5%, as investors feared the government would step too hard on the brakes. Taiwan (+13.3%) and Korea (+16.0%) were bolstered by investor demand for technology companies, but other economic concerns prevented them from climbing higher than the broader index.

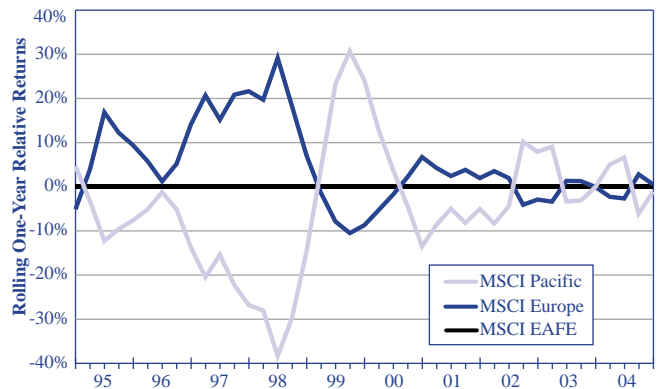
## Callan Style Group Returns – Fourth Quarter 2004



## Regional Performance (based on US\$) Fourth Quarter 2004

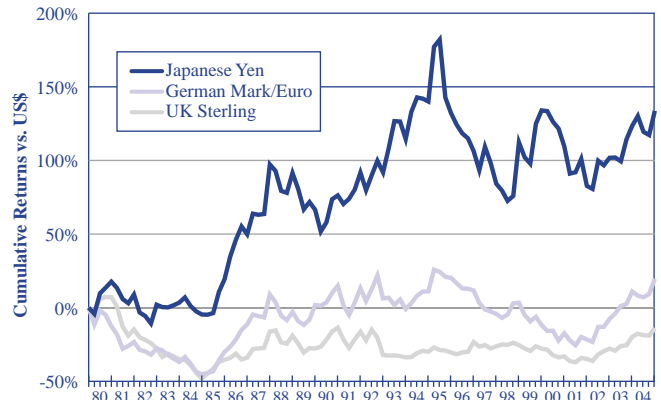


## Rolling One-Year Relative Returns vs. MSCI EAFE US\$



## Major Currencies vs. US\$

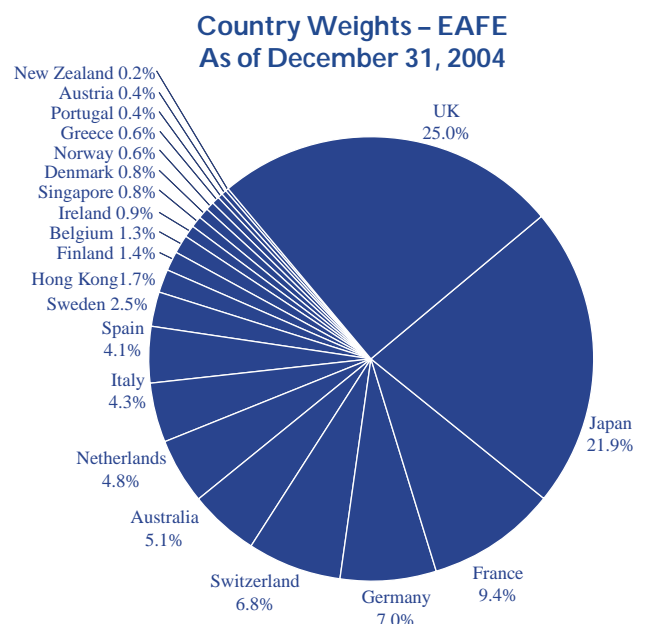
### Cumulative Returns over Last 25 Years



**INTERNATIONAL EQUITY**  
**Style Median and Index Returns\* for Periods ended December 31, 2004**

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
<b>International Equity</b>						
<i>Global Style</i>	11.85	14.90	7.96	0.33	10.01	10.01
<i>Non-U.S. Style</i>	14.58	18.87	11.90	-0.37	8.66	8.29
<i>Core Style</i>	14.56	18.80	12.27	-0.43	8.47	8.46
<i>Small Cap Style</i>	16.51	29.91	22.99	7.09	12.19	7.90
MSCI EAFE–Unhedged	15.32	20.25	11.89	-1.14	5.62	4.23
MSCI EAFE–Local	6.83	12.67	0.06	-4.92	4.88	2.55
MSCI EAFE Growth Index	15.15	16.12	8.78	-6.03	3.15	1.90
MSCI EAFE Value Index	15.49	24.33	14.96	3.69	7.97	6.48
MSCI World–Unhedged	11.94	14.72	6.95	-2.45	8.09	6.59
MSCI World–Local	8.11	11.32	1.82	-3.98	7.93	5.77
MSCI AC World Free ex-U.S.–Unhedged	15.41	21.36	13.56	0.02	6.03	4.81
MSCI AC World Free–Unhedged	12.31	15.75	8.08	-1.79	8.19	7.02
<b>Pacific Equity</b>						
<i>Pacific Basin Style</i>	14.25	18.71	13.73	-4.32	2.09	4.24
<i>Japan Style</i>	12.26	18.23	13.84	-4.97	3.81	2.68
<i>Pacific Rim Style</i>	14.05	17.57	16.69	2.44	3.21	8.46
MSCI Pacific–Unhedged	13.96	18.98	14.33	-3.72	-0.66	-1.06
MSCI Pacific–Local	6.38	14.04	4.71	-4.57	-0.68	-3.09
MSCI Japan–Unhedged	13.08	15.86	12.21	-6.45	-2.34	-2.75
MSCI Japan–Local	5.13	10.78	3.37	-6.43	-2.07	-4.93
<b>Europe Equity</b>						
<i>Europe Style</i>	15.68	19.61	10.61	0.88	12.63	10.74
MSCI Europe–Unhedged	15.92	20.88	10.98	0.06	10.54	9.17
MSCI Europe–Local	7.06	12.24	-1.71	-4.93	9.18	8.19
<b>Emerging Markets</b>						
<i>Emerging Markets Database</i>	17.31	26.36	24.63	6.78	6.75	11.38
MSCI Emerging Markets Free–Unhedged	17.27	25.95	22.77	4.62	3.30	8.86
MSCI Emerging Markets Free–Local	9.25	16.45	16.65	5.05	8.14	27.93

Country	Total	Local	Currency
Australia	19.77%	10.68%	8.22%
Austria	29.25%	18.10%	9.44%
Belgium	18.12%	7.93%	9.44%
Denmark	10.74%	1.15%	9.48%
Finland	16.71%	6.64%	9.44%
France	14.88%	4.97%	9.44%
Germany	19.34%	9.04%	9.44%
Greece	33.25%	21.75%	9.44%
Hong Kong	11.26%	10.90%	0.33%
Ireland	19.43%	9.13%	9.44%
Italy	23.20%	12.58%	9.44%
Japan	13.08%	5.13%	7.56%
Netherlands	16.39%	6.35%	9.44%
New Zealand	14.49%	7.13%	6.87%
Norway	17.35%	5.58%	11.14%
Portugal	12.64%	2.92%	9.44%
Singapore	7.05%	3.81%	3.14%
Spain	25.29%	14.48%	9.44%
Sweden	16.25%	6.12%	9.55%
Switzerland	14.36%	4.14%	9.81%
UK	12.61%	6.14%	6.10%



\* Returns less than one year are not annualized.

## Weak Dollar Lifts International Bonds

In the fourth quarter, the **Citigroup World Government Bond Index ex-U.S.** rose 10.64% in dollar terms, but just 2.15% in hedged terms. Bolstered by moderating expectations of tight monetary policy and a persistently weak U.S. currency, momentum in the global bond markets carried over from the previous quarter. The dollar sank 6.6% overall against the currencies in the international bond benchmark.

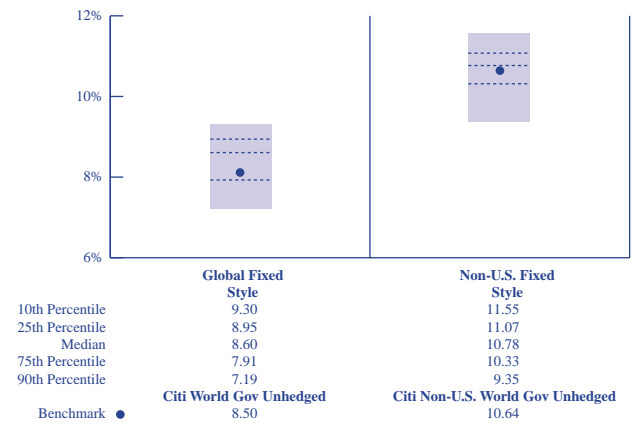
### Europe

The European bond market rocketed higher in the fourth quarter, with the **Citigroup EMU Government Bond Index** gaining 12.51% in U.S. dollar terms, thanks in most part to the soaring euro. Monetary policy remained steady, with long rates dropping considerably on declining inflationary expectations. The euro strengthened dramatically against the dollar with a 9.40% rise. The story in the United Kingdom was similar, with the bond market surging 9.32% in hedged terms. Signs of economic moderation and continued strength in the pound sterling (+6.10%) led investors to reduce expectations for future tightening.

### Japan

The Japanese government bond market climbed 8.10% higher in dollar terms, but just 1.03% in local terms, as the strengthening yen

## Callan Style Group Returns – Fourth Quarter 2004



gained 7.56% in value. The yield curve was nearly unchanged as investors waited for clearer economic news to emerge.

### Emerging Markets

The **JPMorgan EMBI+ Index** continued to rally in the fourth quarter, moving 5.11% higher for the eighth positive return in the past nine quarters.

## INTERNATIONAL FIXED INCOME

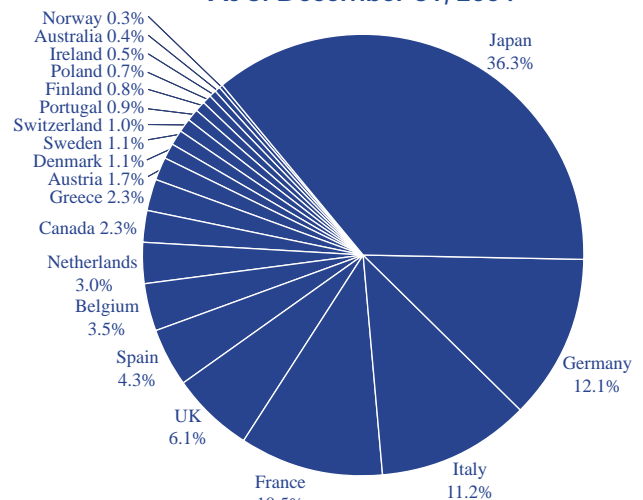
### Style Median and Index Returns\* for Periods ended December 31, 2004

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
<b>Global Fixed</b>						
<i>Global Style</i>	8.60	10.62	15.73	9.32	8.41	9.00
Citi World Govt–Unhedged	8.50	10.34	14.86	8.79	7.60	8.28
Citi World Govt–Local	1.66	4.84	5.02	5.61	6.91	7.42
<b>Non-U.S. Fixed</b>						
<i>Non-U.S. Style</i>	10.78	12.45	18.26	9.40	8.27	9.35
Citi Non-U.S. World Govt–Unhedged	10.64	12.14	17.48	8.78	7.33	8.66
Citi Non-U.S. World Govt–Local	1.98	5.17	4.77	4.95	6.76	7.48
<b>Europe</b>						
Citi Euro Govt Bond Index–Unhedged	12.51	16.21	23.31	13.63	—	—
Citi Euro Govt Bond Index–Local	2.80	7.65	7.03	6.88	—	—
<b>Emerging Markets Fixed</b>						
JPM Emerg Mkts Bond Index Plus	5.11	11.77	18.05	13.55	15.05	—

### Return Attribution for Non-U.S. Govt Indices Fourth Quarter 2004

Country	Total	Local	Currency**
Australia	10.32%	1.94%	8.22%
Austria	12.46%	2.76%	9.44%
Belgium	12.46%	2.76%	9.44%
Canada	8.72%	2.93%	5.63%
Denmark	12.46%	2.71%	9.48%
Finland	11.78%	2.14%	9.44%
France	12.40%	2.70%	9.44%
Germany	12.30%	2.61%	9.44%
Greece	12.35%	2.66%	9.44%
Ireland	13.07%	3.32%	9.44%
Italy	13.01%	3.26%	9.44%
Japan	8.10%	0.50%	7.56%
Netherlands	12.24%	2.55%	9.44%
Norway	13.52%	2.14%	11.14%
Poland	22.69%	4.56%	17.33%
Portugal	11.96%	2.30%	9.44%
Spain	12.50%	2.80%	9.44%
Sweden	12.98%	3.13%	9.55%
Switzerland	13.23%	3.11%	9.81%
UK	9.32%	3.03%	6.10%

### Country Weights – Citigroup Non-U.S. Govt As of December 31, 2004



\* Returns less than one year are not annualized.

\*\* Derived from MSCI EAFE data.

## Strong Demand Spurs Real Estate

Real estate won more converts in 2004. High investor demand for stable income-producing assets continued to attract massive capital flows. The demand was especially rewarding to owners and sellers of well-leased, core assets, which created lofty appreciation gains. Capitalization rates have been compressed to a point where many institutions have been forced to shelve new investments or lower return expectations.

Public real estate markets closed out the year with a bang, returning 15.23% for the fourth quarter, as measured by the **NAREIT Equity Index**. The one-year return for NAREIT was 31.58%, topping all other asset class investment options in 2004. The private real estate market, as measured by the **NCREIF Total Property Index**, advanced 4.69% for the quarter and 14.52% for the year.

In the fourth quarter, the retail sector continued to outshine all other real estate asset type classifications, both publicly and privately. Despite widespread expansion by key retailer chains, the sector has maintained strong absorption. The success of retail is being driven by strong consumer spending and higher rental income. The public sector, as measured by the Regional Mall slice of NAREIT, rose 7.62% for the fourth quarter, bringing the year-to-date return to a healthy 45.01%. The private retail sector, as measured by NCREIF, gained 7.83% for the quarter.

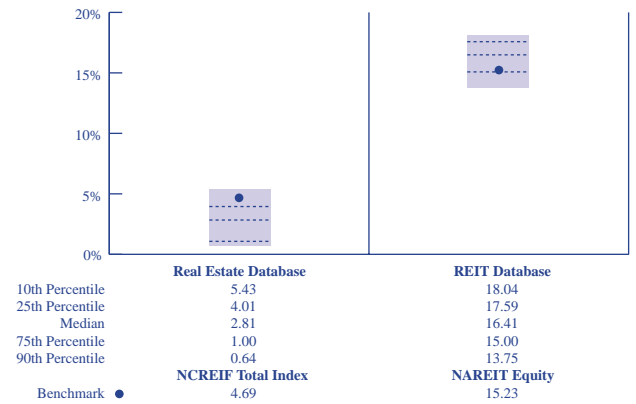
Capitalization rates have reached historical lows in 2005. Tenant demand remains positive and vacancy rates are showing improvement in all asset types as of year-end. As the nation's economy begins to shift from a consumer-led expansion to a business-led expansion, the expectation is that business-driven property types, such as office and industrial, will benefit in the long-term.

### Overall Capitalization Rates

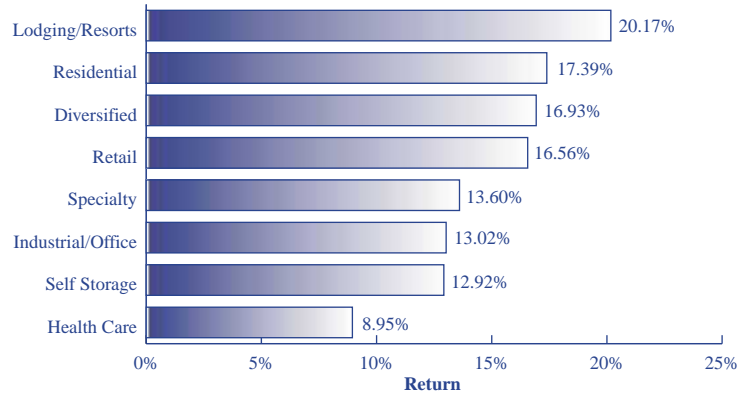
Sector	4th Quarter 2004	One Year Ago
Industrial	8.12%	8.51%
Apartment	7.01%	7.45%
CBD Office	8.40%	9.02%
Suburban Office	8.73%	9.50%
Strip Shopping Center	8.10%	8.84%

Source: *Korpacz Real Estate Investor Survey*®  
Rates based on unleveraged, all-cash transactions.

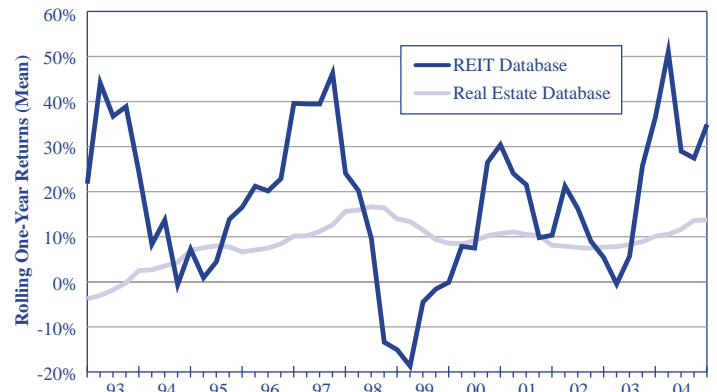
## Callan Style Group Returns – Fourth Quarter 2004



## NAREIT Equity Sector Performance – Fourth Quarter 2004



## Rolling One-Year Returns



## REAL ESTATE

### Style Median and Index Returns\* for Periods ended December 31, 2004

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
<b>Private Real Estate</b>						
<i>Real Estate Database (net of fees)</i>	2.81	11.65	9.29	9.20	10.27	7.51
NCREIF Total Index	4.69	14.52	10.03	9.91	10.87	7.10
<b>Public Real Estate</b>						
<i>REIT Database</i>	16.41	34.57	24.69	23.39	16.94	14.92
NAREIT Equity	15.23	31.58	23.27	21.95	14.81	13.25

\* Returns less than one year are not annualized.

## Private Equity Market

The fourth quarter solidified the marked turnaround that began this year on all fronts in the private equity market. During the year, portfolios saw valuation increases and significant distributions, primarily from buyout holdings, but also from venture capital funds. The investment pace of private equity funds into new company investments also picked up, with a record year for buyouts and a vigorous rate for venture capital funds. In the second quarter, tenured general partners began to return to the market to raise new funds. As seen in the table below, a total of \$84.8 billion and 280 funds were raised in 2004—up from \$49.3 billion and 197 funds last year—ending a precipitous three-year decline.

Looking to 2005, we expect continued momentum in the market, to a point where overheating will begin to be a concern. The fundraising environment will be booming. It is widely expected that the private equity industry will see its first \$10 billion partnership. Pricing for both buyout and venture capital transactions is increasing at a surprisingly rapid pace. The capital markets are quite liquid, which fosters both entry and exit activity in private equity, but also leads to more competition and rising valuations.

Please see our upcoming issue of *Private Markets Trends* for more in-depth coverage.

Funds Closed January 1 through December 31, 2004			
Strategy	# of Funds	\$ Amt (mil)	%
Venture Capital	115	14,870	17.5
Acquisition/Buyouts	90	46,217	54.5
Subordinated Debt	17	4,348	5.1
Distressed Debt	9	7,698	9.1
Other	15	5,594	6.6
Fund-of-funds	34	6,023	7.1
<b>Totals</b>	<b>280</b>	<b>84,750</b>	<b>100.0</b>

Source: *The Private Equity Analyst*

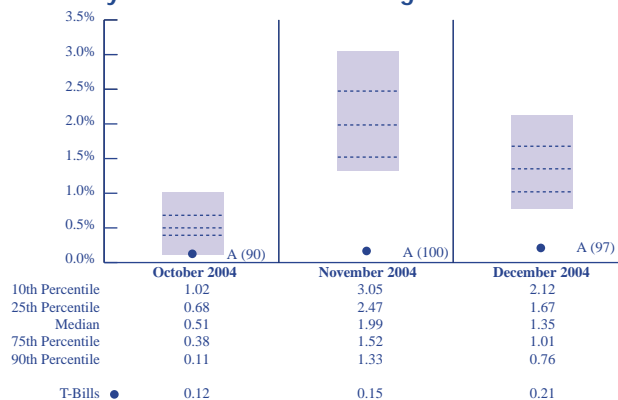
## Hedge Funds Advance As Fog Clears

Given the uncertain markets leading up to Election Day, hedge funds struggled to generate meaningful returns. However, when the election results became apparent, the investment environment rewarded traders betting on equity, credit and other systematic risks. Representing broadly diversified programs of hedge fund strategies, the median manager in the **Callan Hedge Fund-of-Fund Database** gained 4.06% last quarter, after all fees. For the year, the median manager netted 6.98%, or 5.65% above the risk-free rate.

Representing an asset-weighted universe of individual hedge funds, the **CSFB/Tremont Hedge Fund Index** climbed 5.64% last quarter, net of fees. For the year, the index rose 9.64%, significantly outperforming Callan's Hedge Fund-of-Fund Database. This unmanaged composite's strong performance was primarily due to higher allocations to long-short equity or otherwise beta-driven managers.

Among the strongest strategies last quarter, *Long/Short Equity* jumped 7.42%. Although these long-biased, bottom-up stock pickers trailed the S&P 500 (+9.23%) last quarter, the average manager beat the S&P 500 for the year (+11.57% vs. +10.88%, respectively). As credit spreads tightened further to historically low levels, *Distressed* managers gained 6.59%.

Monthly Net Returns: CAI Hedge FoF Database



## ALTERNATIVE INVESTMENTS

Style Median and Index Returns\* for Periods ended December 31, 2004

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
<b>Convertibles</b>						
<i>Convertibles Database</i>	5.72	7.31	7.41	4.73	12.01	11.43
CSFB Convertible Securities	5.37	6.92	7.93	1.62	10.46	10.25
<b>Absolute Return Strategies</b>						
<i>Hedge Fund-of-Funds Database</i>	4.09	7.12	6.63	8.38	12.52	11.74
<i>Market Neutral Equity Style</i>	0.23	2.66	3.26	3.47	6.02	8.36
CSFB/Tremont Equity Market Neutral	1.15	6.50	7.00	9.01	11.58	—
CSFB/Tremont Long/Short Equity	7.42	11.57	8.80	4.84	14.36	—
CSFB/Tremont Event-Driven	6.93	14.45	11.22	10.47	12.83	—
CSFB/Tremont Convertible Arb	1.48	1.98	6.20	11.51	11.64	—
CSFB/Tremont Fixed-Income Arb	2.90	6.85	6.84	6.97	7.48	—
90-Day T-Bills	0.48	1.33	1.42	2.95	4.11	4.39
<b>Other Alternative Investment Benchmarks</b>						
VE Post Venture Cap Index	20.28	19.61	6.10	-13.77	8.69	11.16
GS Commodity Index	-10.79	17.28	23.20	13.77	10.84	8.22
MLM Managed Futures Index	-0.66	3.52	1.90	4.98	7.08	7.14

\* Returns less than one year are not annualized.

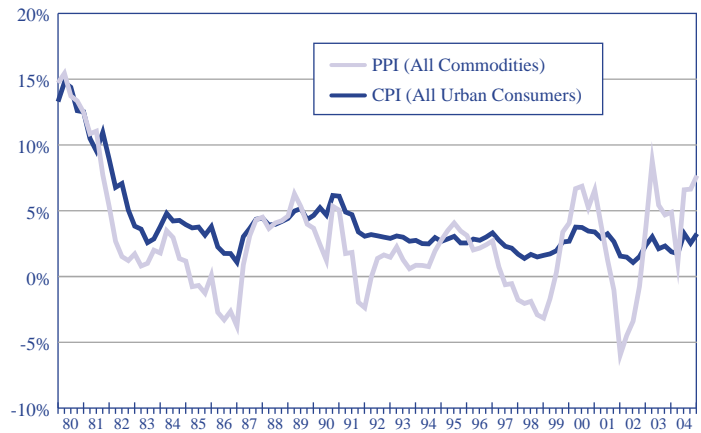
## Good But Not Great

2004 was a good year for the economy and the capital markets. GDP rose 3.1% in the fourth quarter, resulting in a gain of 4.4% for the year, the best performance since 1999. While continually characterized as “disappointing,” the job market finally delivered new jobs in sizable numbers. Payrolls rose 2.2 million during 2004, on a base of about 130 million at the start of the year. While 2.2 million sounds like a lot of new jobs, especially after the experience of the past few years, it is still about half a million jobs short of expectations. Oil prices shot up to \$50 a barrel and inflation fears were fanned, yet the economy and the price levels overall shrugged it off. The year-over-year change in the CPIU fell back below 3% after visiting 3.25% in June, and the rise in October and November to 3.5% was largely due to the decline in prices experienced a year earlier. A sharp decline in energy prices sent the CPIU down in December, and overall increase in inflation for the year was 3.3%. The dollar fell further in 2004, but not by as much as headlines would have you believe; the big move downward in the dollar’s value occurred in 2003. Internationally, sluggish growth continued to dog Europe, and the recovery in Japan began to falter during 2004 after it appeared the Japanese economy was finally getting on track. China is still growing at remarkable rates, but many observers are calling for a controlled “soft landing” over the next year or two. The currency peg to the dollar is coming under increasing pressure, and the biggest risk for China is now a “hard” rather than a soft landing, should a significant revaluation of the yuan become unavoidable.

Looking forward, leadership in the expansion is expected to pass (reluctantly) from consumers to businesses. Consumers would like to keep spending, but the tax cuts are finished, housing markets have likely peaked, interest rates are rising, and consumer spending is running out of gas. Businesses have been reluctant to hire and invest, but are being prodded to move by record profits, low inventories, growing markets and increased utilization of capacity. Exports are rebounding in response to the dollar’s depreciation, although they are tempered by slow growth in Europe and Japan. The Federal government’s stimulus is ending, both from spending and from tax cuts, and the budget deficit will place increasing pressure on taxes to rise, despite campaign promises to the contrary. With upwards of 85% of Federal spending “locked in” through entitlements and defense, there is little room to fix the budget gap through spending alone. In sum, the economy is coming off a strong year but faces some headwind, and the outlook for 2005 is best characterized as “good but not great.”

Business spending on equipment is finally surging. The Report on Business, published by the Institute for Supply Management (ISM), suggests that December marked the nineteenth consecutive month in which the manufacturing sector of the U.S. economy grew. The “new orders” and “backlog of orders” components of the ISM data show particular strength, and confirm growing demand from capital spend-

Inflation – Year Over Year



ing. The ISM tracks purchasing activity in both the manufacturing and non-manufacturing sectors of the economy, and its data are often reliable leading indicators of economic activity. The ISM’s Non-Manufacturing Business Activity Index also indicates continued growth in the U.S. economy. Consistent with the “good but not great” theme of the current outlook, the level of activity, as depicted by the indexes for both manufacturing and non-manufacturing, has slowed since the first half of 2004.

Consumer spending growth will now be determined by employment and income gains, rather than positive responses to Fed policy and administration tax cuts. 2004 marked the first year since 1997 that consumer spending rose less rapidly than GDP, and this pattern is likely to become the new norm. Housing activity will also no longer grow faster than the economy (and demographic forces) will allow. The greatest concerns for the economy stem from the dollar, investment flows and fiscal policy, all of which are closely linked. Foreign capital continues to flow into the United States, fueled in part by “official inflows,” code words for exchange rate intervention by our trading partners’ central banks. Official inflows rose from 21.5% of net inflows in 2003 to almost 30% of net inflows in 2004, an increase of \$100 billion. Overseas investors have been willing to finance our twin trade and budget deficits, but our increasing reliance on intervention by other countries’ central banks suggests the dollar drifting lower. With European and Japanese economies remaining soft, there is little chance for the trade deficit to narrow without the dollar falling further. This decline in the dollar could weaken the resolve of foreign investors to support our free-spending ways, and a loss of appetite for dollar-denominated assets could send the dollar into a tumble and cause a major correction in the bond market (i.e., a spike in U.S. interest rates). The impact of the decline in the dollar on prices and interest rates has been surprisingly muted thus far; foreign exporters have absorbed the dollar decline in their margins, and investors have been willing to absorb actual losses in local currency terms to remain invested in dollar-denominated assets.

### U.S. ECONOMY

#### Recent Quarterly Indicators

	1Q03	2Q03	3Q03	4Q03	1Q04	2Q04	3Q04	4Q04
<b>Economic Indicators (seasonally adjusted)</b>								
CPI—All Urban Consumers (year over year)	3.0%	2.1%	2.3%	1.9%	1.7%	3.3%	2.5%	3.3%
PPI—All Commodities (year over year)	8.8%	5.4%	4.7%	4.9%	1.1%	6.6%	6.6%	7.7%
Employment Cost—Total Compensation Growth	5.5%	3.4%	4.2%	3.1%	4.3%	4.0%	3.5%	3.9%
Non-Farm Business—Productivity Growth	3.7%	6.7%	9.0%	3.1%	3.7%	3.9%	1.8%	2.8%
GDP Growth	1.9%	4.1%	7.4%	4.2%	4.5%	3.3%	4.0%	3.6%
Manufacturing Capacity Utilization (level%)	73.5	73.0	73.7	74.7	75.6	76.5	77.0	77.6
Consumer Sentiment Index (1966=1.000)	0.800	0.893	0.893	0.920	0.980	0.933	0.956	0.939

## A Solid Ending Makes the Year

In the fourth quarter, world markets turned around, posting solid gains across the globe. Whether it was the result of a post-election rally, declining oil prices, measured rate hikes by the Fed, or some combination of the three, equity markets rallied both at home and abroad. Median fund sponsor returns were well into positive territory during the quarter, as the double-digit returns coming out of the international markets only added to a strong equity market at home.

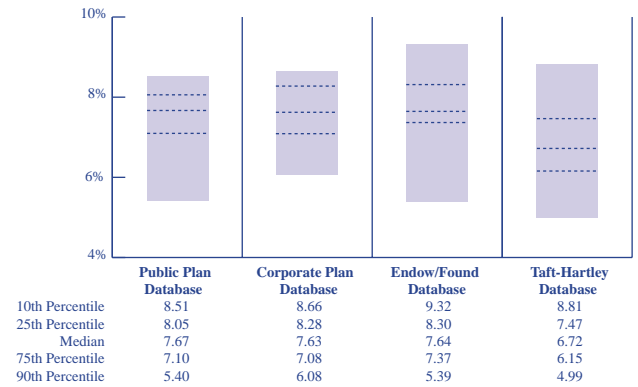
Using the median manager returns from the latest quarter and ending asset allocations from the prior quarter, Callan estimates the recent total returns of the institutional investor community.

The adjacent graph illustrates the range of returns for public, corporate, and Taft-Hartley pension plans, as well as endowments/foundations, showing strength across the board. The table below compares the returns of the four institutional fund sponsors to several benchmarks over longer periods. Choices in asset allocation explain much of the difference in performance.

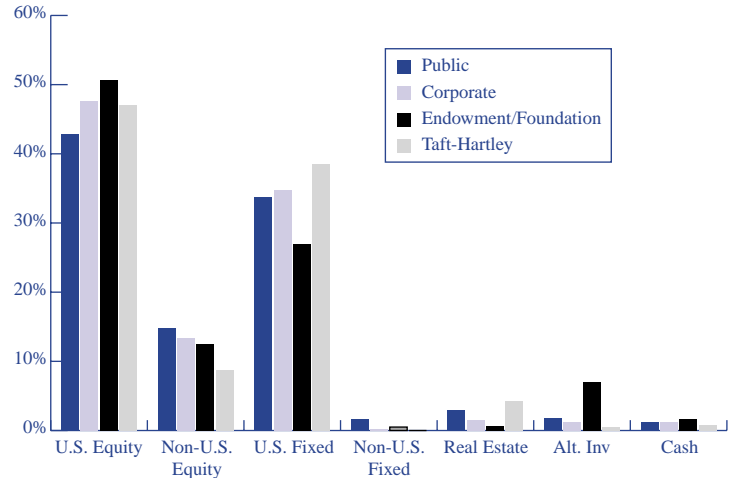
With international markets leading the charge in the fourth quarter, fund sponsors with greater allocations abroad typically performed better. With an average international allocation of 16%, the median public plan fared the best, up 7.67% for the quarter. With slightly lower international allocations, corporate and endowment/foundation plans were not far behind, advancing 7.63% and 7.64% in the median case, respectively. The median Taft-Hartley plan (+6.72%) lagged its peers due in large part to a more domestically oriented asset allocation.

Callan's balanced manager groups generally maintain well-diversified portfolios and attempt to add value by underweighting or overweighting asset classes, as well as through stock selection. In the recent quarter, domestic balanced managers beat their static 60% equity and 40% fixed income benchmark, while global balanced managers lagged their benchmark.

### Callan Style Group Returns – Fourth Quarter 2004



### Average Asset Allocation as of September 30, 2004



### DIVERSIFIED ACCOUNT DATABASE

#### Style Median and Index Returns\* for Periods ended December 31, 2004

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
<b>Plan Sponsor</b>						
Public Database	7.67	11.02	7.30	4.15	9.95	9.40
Corporate Database	7.63	10.67	6.88	3.48	10.89	10.12
Endowment/Foundation Database	7.64	11.38	7.03	4.03	10.91	9.92
Taft-Hartley Database	6.72	9.65	6.63	4.46	10.16	9.35
<b>Diversified Manager</b>						
Asset Allocator Style	8.30	10.89	4.86	2.51	10.93	10.67
Domestic Balanced Database	6.32	9.65	5.40	3.72	10.87	10.49
Global Balanced Database	8.92	11.98	9.16	4.58	11.41	11.31
60% S&P 500 + 40% LB Aggregate	5.92	8.35	5.18	2.15	10.80	9.99
60% MSCI World + 40% Citi World Govt	10.57	13.01	10.65	2.46	8.39	7.68

\* Returns less than one year are not annualized.

The *Capital Market Review* is published quarterly for members of the institutional investment community, both domestic and international. The *Capital Market Review* focuses primarily on the latest quarterly performance of market indices and Callan style groups for each of the major asset classes used by institutional investors. *Capital Market Review* contributors are as follows:

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