

## WORLD MARKET SURVEY

### US Stocks

The second quarter of 2004 was generally positive for US stocks, although return from certain market segments was below inflation. Among the major US stock indexes, the tech stock heavy NASDAQ composite led the way posting a 2.7% return. The large cap S&P 500 rose 1.3% higher, while the broad Wilshire 5000 gained 0.9%, and the small cap Russell 2000 managed to eke out a 0.20% gain.

### Foreign and Emerging Market Stocks

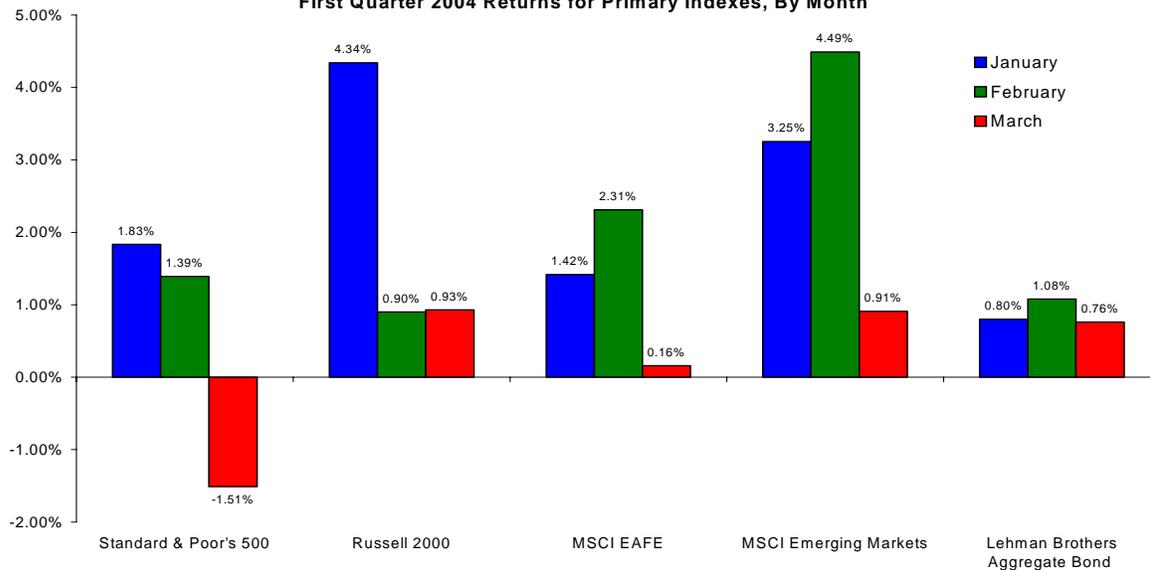
Foreign stocks followed a similar pattern, with European shares generally posting moderate gains, and Asian shares experiencing moderate losses. MSCI's Europe Stock index gained 2.4% in US dollar terms, while MSCI's Pacific index dropped 4.0%. Despite the fact that Pacific losses were larger than European gains, the greater market capitalization of European stocks helped MSCI's combined EAFE index to a 0.4% gain. Foreign small cap stocks followed the

same pattern as large caps, with MSCI's Europe Small Cap index up 1.6% and the Pacific Small Cap index off 0.5%. Investors in foreign stocks were hurt by a strengthening US dollar, as local markets generally performed better than dollar denominated returns indicate.

Emerging markets stocks were generally down, with MSCI's Emerging Markets Free index off 9.6%. Rising US interest rates harm heavily indebted emerging

*(Continued on page 8)*

First Quarter 2004 Returns for Primary Indexes, By Month



## REAL ESTATE IN A MULTI ASSET CLASS PORTFOLIO

Conventional wisdom holds that real estate investments should be part of an investor's portfolio. Purported benefits from real estate include:

- ◆ Diversification;
- ◆ Inflation hedging;
- ◆ Excellent long-term returns;
- ◆ Short-term stability (through use of 5 to 10 year triple-net-leases);
- ◆ Competitive cash flows.

Until recently, however, many individual investors' portfolios did not include real estate. Private real estate equity in-

vestments in apartments, offices, warehouses, hotels, etc. are expensive propositions that require complex financing arrangements, often including significant leverage. For many individual investors, leverage requirements increase risk beyond their tolerance level, or collateral and financing arrangements make private real estate impractical. Arguments against real estate investments include:

- ◆ Illiquidity (you cannot sell a fraction of a building);
- ◆ Poor marketability (high transaction costs);

- ◆ Lack of geographic or property type diversification;
- ◆ Sensitivity to local conditions (unemployment, tax policy, etc.).

Additionally, many investors remember the financial debacle that followed the Savings & Loan crisis, the collapse of commercial real estate prices as the Resolution Trust Company dumped property on the market, and the implosion of the tax-shelter (real estate limited partnership) industry as Congress changed the tax law. By the end of the 1980s,

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## REAL ESTATE IN A MULTI ASSET CLASS PORTFOLIO

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many believed that commercial real estate investments were best left to financial institutions such as insurance companies, and large pensions and endowments. These entities can afford to own and manage commercial real estate in several cities, or can purchase private mortgages secured by real estate assets.

Like many investments, real estate goes in and out of fashion. Today, following the spectacular run up in the price of single-family homes, and solid gains in the stocks of companies involved with real estate, real estate investing is very fashionable. Recently, stocks of real estate operating companies, home-building/home-improvement companies, other building-supply and raw materials firms, and real estate financing companies have performed well. For example, relative to the S&P 500, the cumulative outperformance of Freddie Mac stock between January 1991 and December 2003 was more than 1300%.

#### **REITs a Preferred Investment Vehicle**

The preferred investment vehicle for many individual investors is the Real Estate Investment Trust (REIT). A publicly traded REIT (i.e., a REIT which lists its shares on a stock exchange and, therefore, is both priced and traded like other stocks) is akin to a closed-end mutual fund. A REIT's assets consist primarily of real estate equity (ownership of properties) and/or real estate debt interests. Under current law, REITs pay no corporate income tax, provided that at least 75% of the REIT's net assets are invested in real estate, and that the REIT distributes at least 95% of its net income to shareholders. REITs are actively managed to increase shareholder value, just as a public corporation is actively managed to promote economic objectives including return on equity, return on assets, increased market share, and so forth. REITs buy and sell properties the same way that other corporations acquire and spin off divisions. Like other publicly traded companies, REITs use debt financing. From 2000 through 2003, most REITs had outstanding debt of approximately 30% to 40% of total assets.

An index for REITs—the National Association of Real Estate Investment Trusts, or NAREIT index—started in 1978. This is a capitalization-weighted index of all publicly listed REITs, constructed similarly to other capitalization-weighted stock indexes, such as the S&P 500. The NAREIT index provides the longest pricing history for the asset class of publicly traded real estate equity. Today, there are several indexes that track the performance of public REITs.

Although the first real estate equity fund, Stratton Monthly Dividend REIT was launched in 1972, the mutual fund industry generally didn't begin offering real estate funds until the late eighties/early nineties (the second real estate equity fund, Fidelity Real Estate, was offered in November 1986, and three more real estate funds were introduced in 1989). These funds invest, for the most part, in stocks of real estate related companies or in REIT shares. Among the early entrants offering indexed real estate mutual funds business were Dimensional (1991) and Vanguard (1996), each of which developed a mutual fund designed to track a specific REIT index (e.g. the Vanguard REIT index tracks the Morgan Stanley REIT index). More recent indexed real estate funds have been structured as Exchange Traded Funds (ETFs), such as iShares Dow Jones US Real Estate Index Fund (2000) and iShares Cohen & Steers Realty Majors and streetTracks Wilshire REIT Index (2001).

#### **A Review of the Academic Literature**

In this article, SCLC surveys several academic studies on real estate performance.<sup>1</sup> Our goal is to gather and to evaluate additional information regarding the prudence and suitability of real estate within a multi-asset class portfolio, to determine whether a portion of the portfolio's equity should be allocated to the real estate asset class. We focus on studies dealing with real estate equity (i.e., property ownership) rather than real estate debt.

#### **Does Real Estate Hedge Against Inflation?**

Is real estate an effective inflation hedge? The answer depends on how you define real estate, how you define inflation, and on what period you evaluate. As we noted, there are two types of equity real estate: (1) private equity, and (2) publicly-traded or 'securitized' real estate. For example, the former might be a hotel in Phoenix, the latter, a REIT stock. Here's where things start to get dicey. A REIT stock is priced in the continuously traded, liquid public market (i.e., a stock exchange), however, a building is valued by appraisal. This illustrates the apples-to-oranges valuation comparison problem. Appraisals may not:

- ♦ Represent actual transactions;
- ♦ Be based on current transactions involving comparable properties;
- ♦ Reflect an attainable level of use, rents or occupancy;
- ♦ Include trending factors, such as operating income, inflation, rents, etc.;

*(Continued on page 3)*

## REAL ESTATE IN A MULTI ASSET CLASS PORTFOLIO

- ◆ Account for likely future events in the local economy or political structure;
- ◆ Include liquidity discounts.

Although valuation of privately owned properties is not as exact as the price discovery process of the stock market, it is not entirely arbitrary. For example, the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index uses certain established formulae to measure the value of unleveraged properties held by large US Pension Plans. This time series of appraisals, although subject to lags, smoothing, and other statistical difficulties, is at least consistent.

#### Public vs. Private Real Estate Investment

Surprisingly, the distinction between public and private real estate equity is important with respect to real estate's inflation-hedging ability. Since REIT stocks are stocks of corporations that own portfolios of real estate assets, a working hypothesis might be that REITs and private real estate equity should respond similarly to inflation. One way to measure how well real estate hedges against inflation is to determine the correlation between the two return series. If returns from real estate rise at the same time that inflation is increasing, the two series exhibit positive correlation (values between 0.00 and 1.00).

Researcher Grayson Sanders notes a positive correlation (+0.41) between inflation and private real estate returns over the period 1978 through 1997, but he argues that the value of the correlation statistic between inflation and securitized real estate is 0.00 for the same period. Further, he notes that any correlation statistic is merely an average for the entire period: close review of sub-periods can reveal return patterns that differ significantly from the overall average. For example, although Sanders concludes "that private real estate provided a meaningful positive inflation hedge," this is not to be expected under all market conditions: "when space markets experience significant excess supply, as in the 1988-1992 period, the presence of unanticipated inflation will not necessarily result in a rise in real estate returns."

#### Expected vs. Unexpected Inflation

Some academic studies define inflation to encompass two different types: (1) expected inflation (an amount built into the current risk-free interest rate to compensate lenders for the time value of money), and (2) unexpected inflation (a realized inflation rate greater than that predicted by the slope of the yield curve).

#### Stocks/Bonds Don't Hedge Inflation Well

In general terms, the question of whether stocks and bonds are good inflation hedges has been resolved. The preponderance of evidence suggests that, all else equal, bonds do not like inflation. Likewise, most studies agree that stocks are poor short-term inflation hedges. However, since over the long-term, stocks tend to significantly outperform inflation, some commentators suggest that stocks provide an adequate long-term inflation hedge. The critical point for this latter assertion rests on the absence of cash flows. Taking money out of a portfolio that has been decimated by inflation gives the remaining net portfolio little or no chance of recovering its purchasing power over any reasonable planning horizon.

If stocks and bonds are poor inflation hedges, what about real estate? Liu, Hartzell & Hoesli provide an excellent survey of the academic literature on this question. While it is not clear whether REITs provide a hedge against expected inflation, there is strong, consistent evidence that REITs do not provide a hedge against unexpected inflation. In general, most studies suggest that "equity REITs are significantly negatively related to both expected and unexpected inflation." By contrast, many studies suggest that direct investment in real estate properties provides an effective hedge against anticipated inflation, although the evidence for direct real estate's ability to hedge against unexpected inflation is mixed. The authors conclude that, "REITs act in a perverse manner." Although the returns on their underlying real property assets are positively related to inflation, "REITs appear to behave like other common stocks with respect to their inability to hedge against inflation."

#### Real Estate as a Portfolio Diversifier

Does securitized real estate offer portfolio diversification benefits? Modern principles of financial economics are absolutely clear on one thing: a prudent portfolio is much more than a collection of "good stocks." Frequently used bottom-up stock picking methods (find stocks that offer above average appreciation potential and bundle them together in a portfolio) can result in sub-optimal and dangerously under diversified portfolios.

Some authors argue that real estate securities are a valuable addition to prudent and balanced portfolios because of their low correlation with other common stocks. By combining asset classes that respond differently to future economic conditions, the portfolio becomes more stable and, therefore, less likely to produce unacceptable downside returns.

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**Domestic Real Estate Can Diversify  
Stock/Bond Portfolio**

Susan Hudson-Wilson argues that real estate is a good portfolio diversifier. After developing a custom index reflective of the “four quadrants” of real estate investing (public and private debt/public and private equity), she observes that the correlation between stocks (S&P 500) and real estate is +0.547 during the period 1987 through 2000, while the correlation between bonds (Lehman Gov’t/Corp Bond Index) and real estate is +0.284. She notes, “when the return to an asset class is high enough, or the risk is low enough, and/or the correlation reflects a sufficiently different pattern of returns, the asset class earns a place in the portfolio for at least a portion of the return-risk spectrum. Real estate meets these tests, and is therefore a component of the well-diversified mixed-asset portfolio.”<sup>2</sup>

**International Real Estate Even More Effective**

Quan & Titman cover similar ground in their study (“Do Real Estate Prices and Stock Prices Move Together? An International Analysis”). They point out that many studies suggest that real estate investments are negatively correlated with the S&P 500 stock index—making such investments attractive portfolio diversifiers. The authors test this hypothesis by examining international data. Real estate values for their study were obtained from Jones Lang Wootton estimates of capital and rental values, based on market transactions (including rents paid) for prime commercial properties in select cities from 17 countries (US cities are Boston, Chicago, Houston, Los Angeles, New York, Philadelphia, San Francisco and Washington). The authors express their results in US dollar terms, but are careful to eliminate spurious correlations that may arise because foreign real estate and stock prices rise and fall together as a country’s currency strengthens or weakens relative to the US dollar. The authors begin their study with a brief discussion of efficient markets. One hypothesis they eliminate immediately is the “bubble economy” hypothesis. This hypothesis suggests that real estate is an extremely inefficient market and that real estate prices are “driven up and down by changing expectations (either rational or irrational) of future economic growth that is [sic] independent of current fundamentals, like current rents and GDP.” The authors reject this hypothesis: “we find that rental rates, which are the primary determinant of real estate values, are strongly correlated with GDP growth rates.” However, the authors also note that common stock prices generally reflect current economic fun-

damentals, and, therefore, negative correlation between real estate and stocks is surprising. They suspect that the appraisal method for determining real estate values serves to smooth underlying returns, thus inappropriately reducing covariance and correlation.

The study finds that between 1983 and 1996, there is positive correlation between changes in real estate values and stock returns. Cross sectional analysis, using data from various countries, demonstrates that real estate prices do not move independently from stock prices. With respect to the US, however, the correlation between real estate capital appreciation and stock price appreciation is effectively zero (+0.001), while the correlation between real estate net operating income and stock dividends is a weakly positive +0.13. Additionally, the evidence indicates that inflation is an important determinant of year-to-year real estate price changes: “although real estate appears to be a good long-term hedge against inflation, it does not appear to be a good hedge on a year-to-year basis.” Thus, the authors suggest that real estate has valuable short term diversification benefits. Further, over the long term, the linkage of stock prices and real estate prices through their relationships with fundamental economic variables (such as growth in GDP) make each asset class a good long-term inflation hedge.

**Recent Experience Shows  
Benefits of Diversification**

Several commentators note that recent history indicates significant changes in correlation between real estate and common stocks. This change was especially evident between 2000 and 2002, when REITs registered huge gains while S&P and NASDAQ stocks nosedived. Evan Millar argues that investments such as mutual funds specializing in real estate are especially appropriate for 401(k) plan menus because of the low correlation of REIT returns with the returns of stocks and bonds: “the correlations of monthly total returns of REIT stocks with the returns of large and small stocks have declined markedly over the past ten years.” Millar suggests “for the 401(k) plan fiduciary, the use of REITs and their low relative properties is a potentially powerful tool against claims of imprudence in picking investment options.”

**Does Active Management Add Value?**

Can real estate mutual fund managers “beat the market?” Many observers consider real estate to be a relatively inefficient market. In such a market, it may be possible for active

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managers to exploit perceived mispricings or other anomalies to achieve superior risk-adjusted returns. For investors selecting mutual funds, this is an important question. Skilled active managers, operating in an inefficient market, should be able to generate better returns than comparable REIT index.

O'Neal and Page measure real estate mutual fund returns over the period 1996 through 1998. During this period, "assets invested in real estate funds increased from \$240 million to \$9.58 billion." Thus, money was pouring into these investment vehicles at a compound annual rate of 58%. Early in the period, fund managers were investing relatively small sums, by the end of the period, managers faced decisions about how to invest a tsunami of cash.

The author's note that, during the three year period, there were twenty-eight discrete real estate funds offered. By chance, over this period, one would expect to find two funds that delivered abnormally positive returns (at a five percent confidence interval), and two funds that delivered abnormally negative returns (again, at a five percent confidence interval). Likewise, the authors point out that any testing for evidence of market-beating performance should recognize that fund managers can invest in securities other than REITs. These securities might include US common stocks that benefit from a real estate boom, such as Home Depot or Georgia Pacific, or foreign real estate firms. Therefore, they construct a four-factor regression model that includes the Wilshire REIT index, the Russell 2000 small stock index, the S&P 500 U.S. stock index and the MSCI World stock index. Their regression model measures risk-adjusted abnormal performance in terms of an alpha statistic (the value of the intercept of the regression equation). A positive alpha indicates that the fund manager has produced market-beating returns, a negative alpha indicates the reverse.

#### Number of Winners, Losers Same as Predicted by Probability Distribution

Not surprisingly, for the period under consideration, 26 of the 28 funds exhibit a statistically positive relationship to the REIT index (only Fidelity Real Estate High Income and Alpine Institutional Real Estate fail to provide exposure to the risks and rewards of REITs). Fourteen funds exhibit positive alpha and fourteen funds exhibit negative alpha. As predicted, during this short sample period, two funds generated positive alpha at the 5% significance level (Delaware Pooled Real Estate and Delaware REIT) and two generated negative alpha (Stratton Monthly Dividend REIT and Templeton Global Real Estate). The authors conclude:

"Real estate fund managers may appear to achieve abnormal returns against a REIT index by systematically loading on other types of securities. Real estate mutual fund managers on average do not display the ability to beat a properly specified set of market indices. The number of managers that generated positive abnormal returns in this sample period is consistent with that expected simply by chance."<sup>3</sup>

#### Apparent Large Outperformance Attributable to Allocation Differences

A similar study by Gallo, Lockwood and Rutherford, examines the performance of real estate mutual funds over the period 1991 through 1997. This period presents an idiosyncratic sample because there were only two funds investing primarily in US real estate in 1990. By 1997, the authors find sixty-nine real estate funds (four of which were international funds). The study determines whether real estate funds are able to beat the market through the manager's security selection or market timing skills. The authors begin: "our findings indicate that, on average, real estate funds outperformed the Wilshire Real Estate Securities index (the WRE) over the 1991-1997 period on a risk-adjusted basis by an average of 530 basis points [5.3%] annually." The Wilshire REIT index is a subset of the WRE, the latter indexes all publicly traded real estate securities (including operating real estate companies), while the former includes only REITs.

The authors note that the WRE excludes both health-care REITs and small-cap REITs (REITs with a market capitalization below \$100 million). Over the period reviewed, health-care and small-cap REITs each significantly outperformed the index (by 8% and 11% per year, respectively). Although, in practice, mutual funds tended not to invest in small-cap REITs, a full 11% of their assets were invested in health care REITs. Adjusting for the health care REIT exposure reduces the yearly outperformance from 5.3% to 4.3%—still a significant number. Additional statistical tests indicate, however, that the positive 4.3% differential was solely attributable to asset allocation decisions. In this period, fund managers overweighted the allocation to the apartment sector relative to its weighting in the WRE (37% v. 22%). Apartment sector investments outperformed the WRE by approximately 8% per year. After adjusting for asset allocation decisions, returns to security selection and market timing are zero.

The authors next review real estate funds using a multi-index/multi-property regression analysis. This approach calculates the percentage of fund returns that can be explained by the

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*Likewise, we see no compelling reason to avoid using a potentially helpful portfolio building block.*

fund's exposure to various property types. The residual values (i.e., the values that cannot be explained solely by asset allocation decisions) can be positive—i.e., the manager added value by good stock picking or shrewd market timing, or negative—i.e., the manager had a good allocation but subtracted value by stock-picking or market timing activities. This more sophisticated analytical tool reveals that only four of the sixty-nine funds exhibit positive alpha, and that only one fund (Longleaf Partners Realty) produced a statistically significant positive alpha value.

### What is Optimal Allocation to Real Estate?

#### 1. Some, for Conservative Investors Only

What is the optimal portfolio allocation to real estate? Experts present conflicting opinions in their response to this question. Susan Hudson-Wilson suggests that "real estate is a risk-reducer at low to moderate risk and return levels, and so has no role in highly risk-tolerant portfolios." She pegs the optimal allocation for very risk averse investors at 27%, but this weight drops to zero quickly as one moves up the efficient frontier<sup>4</sup> seeking higher returns. She concludes that real estate is primarily suitable only for investors interested in capital preservation.

#### 2. Some, for Aggressive Investors Only

Ziobrowski, Caines & Ziobrowski arrive at exactly the opposite conclusion: "conservative managers seeking low risk and willing to tolerate lower returns should hold little or no real estate. Managers seeking higher returns who are more tolerant of risk should hold some real estate, but not very much, ranging between 4% and 18% of the total portfolio maximum."

#### 3. Lots of Real Estate for Everyone

Grayson Sanders calculates the efficient frontier and suggests that "the optimal portfolio on the efficient frontier turns out to be 40% bonds, 30% stocks, and 30% public real estate. This is probably not a feasible solution in the marketplace because of the mismatch with the size of the investable universe.... From a practical perspective we can take comfort from this analysis that a 10 to 15 percent allocation to either public or private real estate or a combination thereof can be readily justified."

The diversity of learned opinion is a wonderful example of how statistical conclusions are hypersensitive to the sampling period and to the way the variables of interest are defined. SCLC sees no reason to subscribe to the "religion of real estate" that advances the proposition that real estate is always an ideal investment. Likewise, we see no compelling reason to avoid using a potentially helpful portfolio building block. How-

ever, the role of real estate within the portfolio should be clearly understood (i.e., it is not a guaranteed safety net against the ravages of unexpected inflation, nor is it an asset class that produces regular, consistent returns). We believe that allocation weightings are not so much a matter of precise optimization calculations, but rather a matter of investor preference and common sense. If an investor holds no real estate assets (excluding their personal residence) outside the portfolio, a modest allocation to real estate is prudent. However, if an investor owns a large amount of private real estate, a heavy real estate allocation within the portfolio may create redundancies and unnecessary concentration risks.

<sup>1</sup> Studies reviewed include: "Why Real Estate?" Susan Hudson-Wilson, Journal of Portfolio Management (Fall, 2001), pp. 20-31;

"Do Real Estate Prices and Stock Prices Move Together? An International Analysis," Quan & Titman, Real Estate Economics (Vol. 27), pp. 183-207;

"An Updated Look at Asset Allocation: Private and Public Real Estate in A Multi-Asset Class Portfolio," Grayson Sanders, Real Estate Finance Journal (Winter, 1998), pp. 5-13;

"Real Estate Stocks, Correlation, and the ERISA Prudence Rule," Evan Miller, Journal of Pension Planning & Compliance (October, 2002), pp. 1-14;

"Mixed-Asset Portfolio Composition with Long-Term Holding Periods and Uncertainty," A. J. Ziobrowski, R. Caines & B. J. Ziobrowski, Journal of Real Estate Portfolio Management (Vol. 5, 1999), pp. 139-144.

"International Evidence on Real Estate Securities as an Inflation Hedge," Liu, Hartzell & Hoesli, Real Estate Economics (Vol. 25, 1997), pp. 193-221;

"Real Estate Mutual Funds: Abnormal Performance and Fund Characteristics," O'Neal & Page, Journal of Real Estate Portfolio Mgmt (Vol. 6), pp. 239 - 247;

"Asset Allocation and Performance of Real Estate Mutual Funds," Gallo, Lockwood & Rutherford, Real Estate Economics (Vol. 28, 2000), pp. 165 - 184.

<sup>2</sup> When the four 'quadrants' are combined into a capitalization-weighted index of real estate debt and equity securities, the index suffered no nominal dollar losses in any year from 1982 through 2000. Note however, that for most of this period, the index is weighted primarily to private debt and equity.

<sup>3</sup> The authors note that on average, newer funds generate better returns than older funds. They hypothesize that this result is caused by the fund industry's practice of incubating funds, and publicly offering only successful funds. The SEC allows funds to advertise track record from the incubation period. Failed funds are never offered for public sale.

<sup>4</sup> The "Efficient Frontier" is a line on a risk-reward graph that tracks the performance of various optimal portfolios (portfolios with the highest expected return possible for the given amount of risk).

SURVEY OF INDICES & FUND AVERAGES  
PERIOD AND ANNUALIZED COMPOUND RETURNS

	First Quarter 2004	1 Year Ending 3/31/04	5 Years Ending 3/31/04	10 Years Ending 3/31/04
<b>Inflation Index &amp; Risk Free Rate</b>				
Consumer Price Index	1.03%	1.09%	1.86%	2.38%
U.S. 3-Month Treasury Bills	0.24	0.99	1.77	4.27
<b>U.S. Stock Market (Large Companies)</b>				
Standard & Poor's 500 Stock Index	1.69	35.10	0.63	11.68
Barra Large Cap Growth Stock Index	0.02	26.74	0.50	11.61
Barra Large Cap Value Stock Index	3.35	44.14	0.60	11.28
Average Large Cap Blend Fund ‡	1.80	33.80	<b>-0.13</b>	9.83
<b>U.S. Stock Market (Small Companies)</b>				
Russell 2000 Stock Index	6.09	63.56	10.84	10.42
Dimensional US Microcap Stock Fund	6.46	78.20	21.84	15.38
Russell 2000 Growth Stock Index	5.58	63.16	5.40	6.45
Russell 2000 Value Stock Index	6.60	63.98	15.90	13.58
Average Small Cap Blend Fund ‡	5.86	59.35	12.86	11.62
<b>Fixed Income (Bond) Markets</b>				
Lehman Government Bond Index	2.94	4.27	7.12	7.36
Average Intermediate Gov't Bond Fund	2.26	3.62	5.92	6.34
Lehman Municipal Bond Index	1.73	5.86	6.47	6.81
Avg. California Inter/Short Muni Bond Fund ‡	0.93	3.77	4.75	5.43
CSFB High Yield Bond Index	2.67	22.86	10.93	7.69
Average High Yield Bond Fund ‡	1.74	19.50	6.90	5.29
Salomon Bros. Non-Dollar World Gov't Bonds	1.57	16.05	14.21	6.69
Average World Bond Fund ‡	1.78	11.87	10.18	6.74
<b>International Stocks</b>				
MSCI EAFE Foreign Stock Index	4.34	57.54	3.43	4.55
Average Foreign Large Blend Stock Fund ‡	4.12	52.16	1.66	5.08
MSCI Europe Stock Index	0.89	53.96	2.66	8.97
MSCI Pacific Stock Index	12.73	65.52	5.14	<b>-0.78</b>
MSCI Emerging Markets Free Index	8.87	77.05	15.47	<b>-0.15</b>
Average Emerging Markets Fund ‡	8.74	79.79	18.32	2.57

‡ Source: Morningstar Principia 3/31/04

## INVESTMENT QUARTERLY

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SCHULTZ COLLINS  
LAWSON CHAMBERS

INVESTMENT COUNSEL

455 MARKET STREET, SUITE 1450  
SAN FRANCISCO, CA 94105

877.291.2205 Fax 415.291.3015

1912 SUNDERLAND PLACE NW  
WASHINGTON, D.C. 20036

202.429.0200 Fax 202.331.3803

22 WEST PENNSYLVANIA AVENUE  
SUITE 606 TOWSON, MD 21204

410.583.5800 Fax 410.339.7833

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SURVEY*(Continued from page 1)*

market economies. Individual countries exhibited a broad range of returns for the quarter, ranging from a 13% gain in the Phillipines, to losses of more than 20% in Russia (where the government is suing oil giant Yukos for tax evasion). Fixed Income and REITS

As interest rates trended upward, bond prices moved sharply down. The benchmark 10-year Treasury note lost 4.9% for the quarter, its worst quarter since the first quarter of 1994, and the third worst quarter since 1982. Yield on the 10-year T-note rose from 3.85% to 4.59% over the quarter. Major bond indexes posted losses for the quarter, with the Lehman Aggregate Bond index off 2.3%, the Lehman Mortgage-Backed index down 1.6% and the Lehman Municipal Bond index off 3.1%. Among higher risk fixed income, junk bonds, lost just 0.9% for the quarter, while emerging markets debt dropped 5.9%.

Rebounding from a 15% loss in April, the NAREIT Index of real estate stocks gained 7.1% in May and a 3.0% in June, to end the quarter off 6.6%. Year to date, the NAREIT Index is up 5.2%.

**Changes to Indexes**

Each July 1, Russell announces changes to the firm's family of 21 unmanaged US stock indexes. Russell indexes include the Russell 1000, a performance measure for US large cap stocks, the Russell 2000, an index for US small cap stocks, and the Russell 3000, a gauge for the overall US stock market. Russell reports that more than \$1.4 trillion is benchmarked to their indexes and more than \$364 billion is invested in index funds that use them as a model.

Market capitalization for stocks in the Russell 3000 ranges from \$317.8 billion for the largest stock (General Electric) to \$175.8 million for the smallest stock. Reflecting market gains over the past twelve months, total market capitalization for the Russell 3000 will be \$13.3 trillion, up 32% from last year.

**Increasing Dividends**

Perhaps in response to tax law changes, improving economic conditions, or shifting investor preferences, Standard & Poor's reports that there were 104 dividend increases in June, an 8.3% rise from the 96 increases reported in June 2003, but a 5.5% decline from the average 110 increases posted in June over the last decade. Standard & Poor's tracks dividends for approximately 7,000 publicly owned companies. For the first half of 2004, there were 895 dividend increases, a 13.6% rise from 2003 and a 19.8% increase from the same period in 2002.

**Individual Country Returns  
Second Quarter 2004**

	U.S. Dollar	Local Currency
<b>North America</b>		
United States	1.10%	1.10%
Canada	<b>-2.65</b>	<b>-0.69</b>
<b>Latin America</b>		
Brazil	<b>-10.02</b>	<b>-4.40</b>
Chile	<b>-3.05</b>	--
Mexico	<b>-5.31</b>	<b>-2.23</b>
Venezuela	9.59	<b>-8.19</b>
<b>Africa</b>		
South Africa	<b>-2.48</b>	<b>-3.87</b>
<b>Europe</b>		
Austria	5.74	6.80
Belgium	2.40	3.43
Denmark	3.89	4.77
Finland	<b>-18.37</b>	<b>-17.55</b>
France	1.62	2.64
Germany	2.21	3.24
Ireland	5.40	6.46
Great Britain	0.24	1.58
Italy	3.34	4.38
Netherlands	1.61	2.63
Norway	2.05	3.02
Portugal	<b>-2.85</b>	<b>-1.88</b>
Spain	<b>-0.09</b>	0.91
Sweden	2.96	2.84
Switzerland	1.62	0.46
<b>Asia</b>		
Australia	<b>-5.71</b>	3.34
Hong Kong	<b>-6.87</b>	<b>-6.76</b>
Indonesia	<b>-6.58</b>	2.58
Japan	<b>-3.06</b>	1.67
New Zealand	<b>-2.02</b>	2.72
Philippines	13.66	13.62
Singapore	<b>-3.58</b>	<b>-0.92</b>
South Korea	<b>-13.73</b>	<b>-13.05</b>
Taiwan	<b>-12.64</b>	<b>-10.81</b>
Thailand	<b>-3.28</b>	0.65

Source: Dow Jones Global Indexes