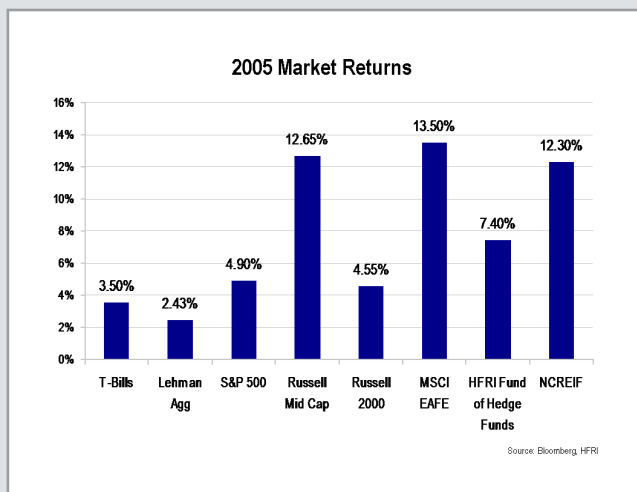




## YEAR IN REVIEW

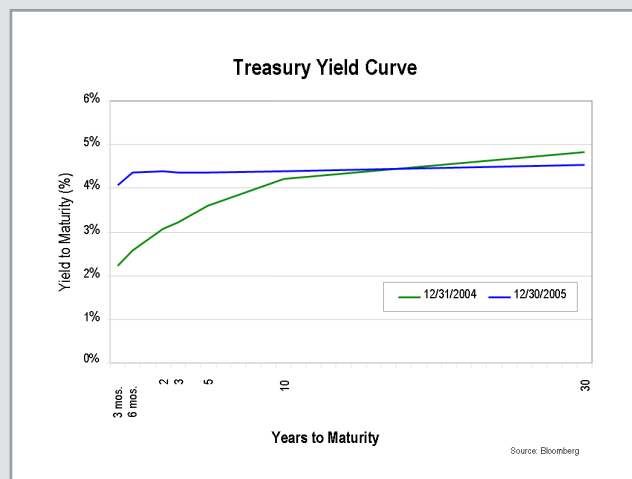
Following up on “The Perfect Storm” 2004 edition of the MCG journal, the theme for 2005 can be called “Survivor.” Despite the hurricanes, rising oil prices, cooling housing market, credit downgrades of GM and Ford, rate hikes by the Federal Reserve and continued geopolitical uncertainty, overall market returns for 2005 were positive but mediocre. Please refer to the graph below for market return details.



### U.S. Economy

2005 proved to be a period of weak returns for major U.S. financial market indices. Given the events of the past year, markets held their ground and did not suffer great losses, however the returns were still well below average. This reflects the normal maturation phase of a bull market for stocks and rising interest rates. Over the last 12 months, the U.S. economy has grown an estimated 3.7%, higher than analysts expected and .7% above its long term growth rate. Inflation concerns were elevated due to rising energy costs, but did not manifest into any serious threat. The Federal Reserve kept inflation in check with eight rate increases, leaving the overnight lending rate at 4.25%.

As evidenced by the chart below, the treasury yield curve flattened over the last year. In fact, at year end, the curve briefly inverted – long-term rates fell below short-term rate. Reasons for the shape of the yield curve include: excess global liquidity, low long-run inflation expectations, the Federal Reserve’s tendency to overshoot during the tightening process, and the risk of a recession next year.



The unemployment rate dropped from 5.4% to 5.0% as job growth expanded. To round out the picture, there was strong growth in corporate profits, personal income, and capital gains realizations. On the downside, inflated prices in the housing market loomed, rising oil prices reached a high of \$70 per barrel, pension plans were threatened, the U.S. dollar dropped in value versus other currencies, and U.S. automakers faced distressed times. All of these issues remain a threat to U.S. economic stability.

### Equity Markets

The lackluster return in the stock market came as a slight surprise. Aside from the negative events that occurred, the economy was strong, and both economic



and corporate profit growth outpaced forecasts. Despite this, returns were weak and mainly came in the second half of the year. The Dow Jones Industrial Average returned +1.71% (the price appreciation component was -.61%), while the S&P 500 and NASDAQ returned +4.9% and +1.4% respectively. All indices were off significantly from their historical averages, some speculated that the market is still working off the excesses of previous bull markets and that this is a normal phase following a bull market run. 2005 reminds us that the years of double digit returns are the exception, not the norm.

A review of the S&P 500, one U.S. large cap equity index, illustrates the varied performance in the market. The Energy sector was the main driver of returns, due to the increase in oil prices seen over the last year. Ending 2004 at \$42 per barrel, oil reached a high of \$70 per barrel in August 2005, closing the year at \$61 per barrel, for a 41% gain over 2005. As you can see in the graph below, the top three performers of the S&P Sectors were Energy (+31.4%), Utilities (+16.8%), and Financials (+6.5%). Two sectors experienced significant reversals. Telecommunications reversed from one of the top performing sectors in 2004 to one of the worst at -5.3%. The worst performing sector was consumer discretionary at -6.4%.

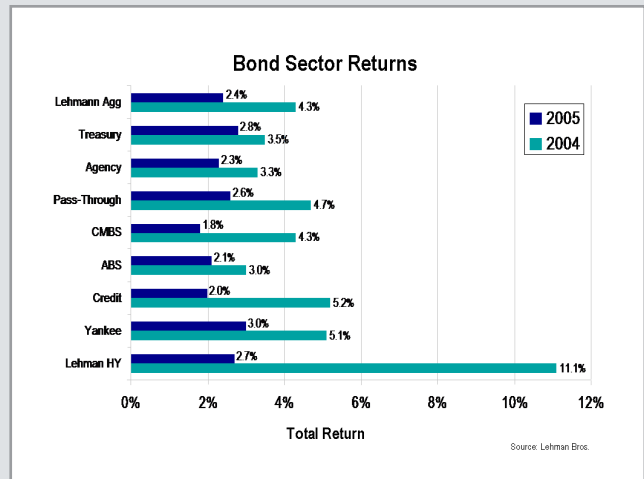
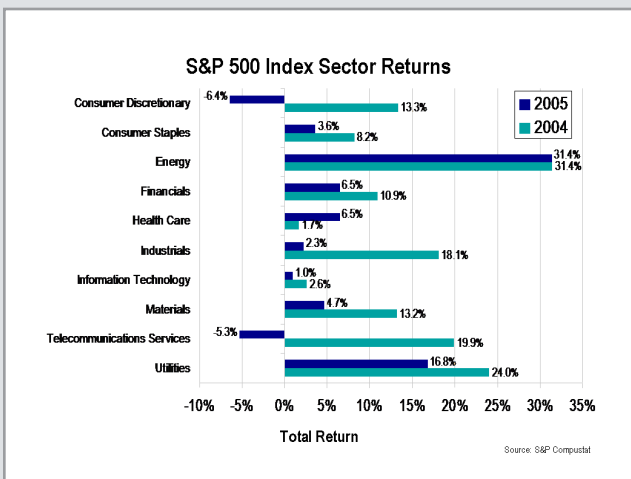
For the sixth year in a row, Mid Cap Equity performed better than Large Cap. As measured by

the Russell MidCap Index, returns were +12.65% for 2005. Although all 12 sectors in the Russell Midcap increased in 2005, once again energy stocks were the primary driver, with a +61% return.

Similarly, International Equity ended the year at +13.5%, as measured by the MSCI-EAFE Index. Investors in search of additional return and diversification were rewarded on a global basis. Lower interest rates world-wide generated a wave of borrowing and investment. European and Japanese companies generated larger profits and their share prices rose. Emerging markets in Asia benefited from strong economic growth. Latin America gained from rising commodity prices. And finally, European companies became more profitable as a result of technological efficiencies and cost cutting.

### Fixed Income Markets

A calm market and stable prices resulted in below average returns for most of the bond market. Despite a 2% increase in short term interest rates and GM and Ford being downgraded to “junk” status, overall bond prices remained high and yields low. The reason for the buoyancy in the market was mainly the demand for U.S. Treasuries by pension plans and foreign investors. Furthermore, the demand for debt, fueled by investors in search of higher yields, kept prices up and returns low. Results for the Lehman Brothers U.S. Aggregate Index sectors are shown below.





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## Alternatives

In 2005, some of the strongest returns were in Alternative Investments. Many of our clients added alternatives to their asset mixes over the past few years in order to capitalize on the low correlation, low risk and/or higher return potential that they provide. Clients who added these investments tended to survive the year in better shape compared to their peers. These vehicles delivered positive absolute returns and diversification in a period when traditional equity and fixed income market returns were weak.

Multi-strategy Fund of Hedge Funds, which are diversified portfolios of hedge funds, finished the year on a positive note with an average return of +7.4% as measured by the HFRI Fund of Funds Composite Index (HFRI). The return is consistent with our expectations of the risk free rate plus roughly 4%. Many fund of hedge funds ("FOHFs") with exposure to a strategy called Convertible Arbitrage experienced losses in the first half of the year, but overall FOHF performance rebounded in the latter half of 2005. The top performing hedge fund strategies driving returns for the year were long-short equity +10.7%, distressed securities +9.0%, and corporate events 7.6%.

Due to the quarter lag in reporting, Private Equity returns are not available as yet but this year was extremely active. Buyout sponsors reached record level deal volume, fundraising and distributions, while venture capital activity continued its recovery. Buyout and Mezzanine funds raised approximately \$86.2 billion while venture capital fundraising was an estimated \$25.2 billion. It was also the year of mega-club deals, large buyout firms joining together to buyout companies. This trend is expected to continue and expand to other strategies. Continued fundraising will create opportunities for our clients to partake in funds offering diversification and higher expected returns.

In 2005, Real Estate also provided strong returns and diversification to portfolios. Although final figures won't be available until mid February, the NCREIF NPI, an index for Private Real Estate Equity, is estimated to produce a total return of +18% for 2005. Typically, the index is driven by its income component, which averages 7-8% annually. However, most of the return this past year is attributed to substantial property market value appreciation.

## Marco Consulting Group News

*Welcome to our new clients:*

Laborers' District Council Pension/Disability Trust No. 2  
SEIU Local 32BJ, CT District Pension Fund  
MI BAC Apprenticeship & Training Fund  
Chicago Area Laborers-Employers Cooperation/Education  
IBEW Health & Welfare of Southwest Washington  
Arizona Sheet Metal Workers  
Upstate NY Carpenters Pension, Annuity and Health Funds  
Western Line Constructors Chapter, Inc. NECA  
California-Nevada Jt. Apprenticeship Training Trust  
Roofers Local No. 134 Retirement Plan  
IBEW Local 43 Health & Welfare Fund  
APWU 401(k) Guild Plan  
UFCW Local 881  
Oregon Sheet Metal Workers Master Retirement Plan  
International Union of Boilermakers Officers  
and Employees Pension Plan