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FAIR VALUE IN FINANCIAL REPORTING

Fair Value[1] is a term often referred to, but frequently misunderstood, while the use of fair value in financial reporting is much debated by banking, accounting and risk management professionals, regulators and accounting standard setters. Many financial instruments are valued and reported using fair value and financial firms normally use some form of ***valuation modeling*** in estimating fair value. Firms also have robust internal control processes for ensuring that models reasonably reflect underlying market conditions and are used appropriately, and they disclose how they calculate fair value in financial reports.

Fair value is the established and required standard in the U.S. for valuing many financial instruments. However, the use of fair value connotes different meanings reflecting a variety of points of view. Although there is generally agreement that the use of fair value is a critical component of financial reporting, the industry was not able to agree to a uniform view in a report on financial reporting released by the Group of Thirty[2] in December 2003. The subject of fair value financial reporting is central to several current hot topics including the resistance to fair value accounting for financial instruments that threatens to stall European Union ("EU") efforts to adopt ***International Financial Reporting Standards*** ("***IFRS***") and the recent U.S. Securities and Exchange Commission proposal to require fair value reporting for mutual funds.

Use of Fair Value

Fair value is a required measure for many financial instruments. Determining whether a financial instrument should be recorded at fair value in a company's financial statements depends in part on what type of institution owns the instrument and the intended use of that instrument. For example, in the case of a broker-dealer, a high percentage of its assets are typically traded and must therefore be accounted for at fair value. Other institutions record financial instruments at fair value depending on what their intent is for holding the instrument or the nature of the business activity. This is the heart of the "banking book" versus "trading book" difference where a bank might value a loan at historical cost and accrue its value to maturity, while a broker-dealer which trades its loans would value it at its best estimate of fair value.

In addition to using fair value measures to comply with public reporting requirements, companies measure their financial instruments at fair value for a number of internal processes including: making investing and trading decisions; measuring and managing risk; determining capital allocations to various lines of business; and calculating compensation. Because fair value is the way that many firms look at their holdings internally, they want to use the same methods to evaluate their holdings for public reporting.

Determining Fair Value

The process of valuing an instrument to its fair value depends on how difficult it is to determine a price for that instrument. Since fair value is the price at which a willing buyer and seller agree to trade, finding the right price is crucial to valuation. In the simplest case, a firm can find the price of an instrument on a ***quotation system***, which reflects the last price reported to the sec-

[1] Terms in ***bold italics*** are defined in the glossary at the end of this report.

[2] The Group of Thirty, founded in 1978, is a private, nonprofit, international body composed of senior representatives of the private and public sectors and academia. The G30 focuses on international economic and financial issues (www.group30.org).

ondary market. This generally works in actively traded markets because listed prices are normally available for such securities. Multiplying the reported price (P) times the quantity (Q) of securities held, or "PxQ", yields the simplest type of fair value. The apparent simplicity of accepting PxQ for actively traded instruments, can be just that – apparent. There are conditions under which adjustments are warranted, such as high concentrations. One might own shares that trade visibly every day, but if the position represents several days' trading volume, would it really be correct to price the entire position at the current price? For example, a trading desk might purchase a large block of an actively traded equity at a 5% discount to the then current trading price. If the firm is required to use PxQ for all liquid securities, then it must value the position at its visible closing price even though the firm believes, and indeed demonstrated by its purchase, that such a large block trades at a 5% discount to the market. Such an accounting practice generates an unrealized gain that is not justified by the basic concept of fair value, i.e. the value one would realize in a current transaction between willing parties.

Such an approach becomes even more untenable when applied to securities for which there are no observable prices. Historical price basis is just as unsatisfactory in its own way in that it doesn't take into account substantive evidence of changes in the market since the transaction date. Firms use valuation models that take into account a variety of relevant data, such as current economic forecasts, general market conditions, the price of similar financial instruments, estimates of volatility, and correlations to estimate fair value.

For example, U.S. corporate bonds, which may not have reported prices, generally trade in a well-defined spread (number of basis points) above the yield of U.S. Treasury securities of a similar maturity. Contemporaneous transaction prices in such instruments may be helpful in estimating the fair value of similar securities. In most cases, some verifiable market data exists to bolster the objective determination of fair value through modeling. Firms must rely primarily on judgment for very complex instruments where market parameters and prices are not observable.

In another situation, a derivatives trader may purchase a derivative product at a discount to the value derived from the firm's valuation model. The firm would be required by current rules to value the derivative at the transaction, or historical, price on day 1. Even though the firm believes that its expertise and model values the derivative properly, it may not change the price for valuation purposes, except when verified by subsequent market transactions or derived from other substantive evidence. Again, this outcome is not consistent with the idea of fair value, as the firm believes it values the derivative properly and would be able to sell it at the modeled valuation price.

Benefits of Fair Value

Fair value provides important information about financial assets and liabilities as compared to values based only on the historical cost (original price paid or received). Since fair value reflects current market conditions, it provides comparability of the value of financial instruments purchased (or sold) at different times. In addition, financial disclosures that use fair value provide investors with insight into prevailing market values, further helping ensure the usefulness of financial reports.

Critics of fair value point out that fair value will inject volatility into earnings, which, they contend, will scare investors. Conversely, proponents of fair value argue that showing the volatil-

ity that exists, rather than masking it with smoothed numbers, is the way to regain investor confidence. Historical prices, it is argued, are only accurate and relevant on the day they are recorded and reserves, which are used to acknowledge changes in historical prices, are not transparent and are subject to manipulation. A fair value price is a clearer way of reporting than the combination of a price and a reserve. Transparency is a key benefit of fair value reporting.

Ensuring Accuracy and Disclosure

Although judgment is involved in the fair value process, most firms have robust internal control processes for ensuring that valuations are reasonable and consistent. Management review and oversight are key to monitoring accuracy. Valuation models should be subject to independent review as part of the internal control process to ensure that they reflect underlying market conditions. In addition, estimates generated by models are compared to actual trades to determine the reasonableness of the estimates. Firms also employ other means of independent verification, such as comparing estimates to the value of the instrument at termination.

Regardless of whether financial instruments are reported in a firm's balance sheet, the financial statement footnotes contain information on the fair value of all the firm's financial instruments. These footnotes provide details on how such values are determined, e.g., quoted prices, comparison to similar instruments, other valuation models, etc. In addition, firms must highlight their most critical accounting policies, including fair value policies, in the Management's Discussion and Analysis (MD&A) section of their financial statements.

International Financial Reporting Standards

The use of fair value in the valuation of financial instruments is also at the heart of the EU's current dilemma concerning the adoption of IFRS. The SEC currently requires EU companies with U.S. securities listings to produce an additional set of accounts under ***U.S. Generally Accepted Accounting Principles*** ("***GAAP***"). The EU has been working on adopting IFRS, which would satisfy SEC requirements and relieve EU companies from producing two sets of books. The ***International Accounting Standards Board*** ("***IASB***") and ***Financial Accounting Standards Board*** ("***FASB***") have been working together to harmonize standards, but have hit a roadblock over ***IAS 32*** and ***IAS 39***, which would require fair value accounting for financial instruments, such as derivatives. France in particular, which complains that IAS 39 would introduce unwanted volatility into financial statements, is loudly denouncing these standards. Their objection has been so strong that it threatens the EU's adoption of the standards and has injected a more heated tone into the process. Public hearings are scheduled throughout the EU to determine how to proceed.

Fair Value in Fund Pricing

Fair value is also among the issues surrounding attempts to limit or otherwise thwart rapid trading in mutual fund shares. The SEC has long allowed and even encouraged mutual funds to use fair value in determining their daily net asset value ("NAV"). Rapid trading is an attractive practice if and when the NAV of the fund does not accurately reflect the actual value of the portfolio of the fund. This occurs mainly in funds with significant stale prices, usually of overseas shares that trade in markets that close long before the U.S. markets close. Such stale prices distort the NAV on days where markets move significantly after the foreign close. Funds are currently encouraged (and soon will be required) by the SEC to develop and use fair value ad-

justments when calculating their NAVs. If a fund's NAV no longer contains stale pricing, then there should be no incentive for rapid trading of mutual fund shares.

Enhanced Public Confidence in Financial Reporting – The G30 Report

With the range of opinions in mind, the failure of the Group of Thirty's ("G30") accounting policies and practices Working Group[3] to reach a consensus on fair value was certainly disappointing. One area of agreement was that many of the most public corporate scandals were caused not so much by a failure in accounting standards as a breakdown in corporate governance and controls. Accordingly, the G30 Working Group did publish a report on Enhancing Public Confidence in Financial Reporting ("G30 Report")[4] that provides agreement on principles that provide proposed industry best practices. The standards outlined in the G30 Report could provide a positive first step towards more robust fair value policies and practices (see Box 1 for G30 Recommended Best Practices and Box 2 for G30 Principles for More Effective Public Disclosure).

Box 1

Group of Thirty "Enhancing Public Confidence in Financial Reporting"
Summary of Recommended Best Practices Regarding
Governance, Controls, Price Verification and Internal and External Audit

Governance

1. A clear and delineated governance structure should exist including provision for appropriate segregation of duties as well as documented procedures for escalation of issues and exceptions to the board of directors or the audit committee.

2. A senior management grouping should have responsibility for the management and oversight of control and calculation policies and procedures. This group should report the results of its work directly to the board of directors or the audit committee.

3. Initial responsibility for the determination of fair value should reside with the risk taking business. Ultimate responsibility for determining the fair values incorporated into financial statements must be outside the risk taking function.

4. Senior management should ensure that there are adequate resources, with the appropriate experience, training and reward to ensure that control, risk management, and independent price verification functions are performed to the highest standards.

Control

5. Risk limits (for both market and credit) should be established, approved and monitored within a framework and overall risk appetite approved by the board of directors or the audit committee.

[3] The Working Group was formed in December 2002 to examine accounting-related issues arising from a number of corporate scandals and reporting restatements and to look into the ongoing debate regarding the application of fair value accounting as the future accounting standard. A survey of 13 of the largest banking and securities firms in the U.S. and Europe underpins the development of the "Best Practices" detailed in Box 1.

[4] "Enhanced Public Confidence in Financial Reporting," Group of Thirty, Washington, DC 2003 ("G30 Report").

6. For financial assets and liabilities measured at fair value, organizations should disclose information in their financial statements that is consistent with the way they measure and monitor risk. Any significant differences between day-to-day measurement and management of risk and GAAP should be well documented and approved by senior management and appropriate board-level committees. The same practice should be sought for other financial assets and liabilities to the extent that risk oversight and management reporting is not based on GAAP principles. This recommendation is not intended to limit the use of risk management information based on non-GAAP principles (e.g. value-at-risk).

7. There should be a procedure for the approval of new transaction types and markets ("New Product Approval") and related controls and risk management approaches. This is a critical element of the control framework.

8. An appropriately qualified and experienced independent price verification ("IPV") unit should be responsible for the fair values used in the financial statements.

9. There should be a group dedicated to model verification, independent of risk taking activities, employing highly experienced and qualified quantitative professionals.

10. Valuation models or changes to a valuation model must be reviewed and approved by the Model Verification Group ("MVG"). Details of model approvals and changes thereto should be recorded in an inventory.

11. There should be procedures for the timely review of highly structured/complex trades independent of the persons responsible for their design and execution.

12. For institutions using hedge accounting, the documentation, valuation and control requirements should be managed by financial control.

Price Verification Procedures

13. Institutions should undertake a rigorous process, at least monthly, to verify fair values. The results should be reported to senior management. Where fair value is a critical component of reported results, senior management should report the price verification results to the board of directors or the audit committee.

14. An independent group should be responsible for approving and monitoring valuation adjustments for consistency and appropriateness. The group's findings and any changes to the method of determining such adjustments should be reported to senior management and, where fair value is a critical component of reported results, to the board of directors or the audit committee.

15. In addition to the rigorous IPV process there should be a process for the review and explanation of daily profit and loss (and for non-traded financial assets/liabilities the relevant periodic profit and loss), which should be reported to senior management on a daily basis.

Audit

16. Internal audit departments should review at least annually the independent price verification procedures and control processes.

17. External audit should devote considerable resources to reviewing the control environment, including the price verification processes, and performing valuations of transactions, especially in those institutions where fair value is a critical component of reported results.

The G30 Report stresses that it is only a starting point and much work needs to be done to reach industry-wide agreement on Fair Value as a critical component of accounting policies. It recommends that all major banks and securities firms should review their practices in light of the recommended Best Practices and report to their boards on the results of such a review, and further should apply them as soon as practicable. The G30 Report also recommends that the recommended Principles for Public Disclosure should form the basis of future development of disclosure procedures and policies. The report states that ultimately consensus must be reached on the issue of Fair Value, concerning both the definition and measure issues and the scope of application. Recommending continued and focused dialogue among all interested parties, the report concludes that "the dialogue should be pursued as a matter of urgency."[5]

Box 2

Group of Thirty "Enhancing Public Confidence in Financial Reporting"
Summary of Recommended Principles for
More Effective Public Disclosure in Financial Statements

1. Public disclosure should reflect information that is consistent with management's approach to risk management.
2. Public disclosure should focus on how risk within a firm changes over time.
3. Public disclosure should be responsive to changes in internal practices.
4. Public disclosure should be properly balanced between quantitative and qualitative information.
5. Public disclosure should include a plain language description of the business model, management's objectives and strategy, the risk and risk mitigation traits of the business and the ebbs and flows of the business dynamics over time.
6. Public disclosures – both quantitative and qualitative – should be consistent with and cross referenced to relevant accounting policies and, for example, to those policies which are considered "critical accounting policies," as discussed, for example, in relevant SEC guidance.
7. Public disclosure should include a written statement of each institution's governance policies broadly consistent with the best practices outlined in Part I of the Best Practices for Governance (above).
8. Public disclosure requirements need continuing reevaluation to ensure that they remain relevant and beneficial to users.

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[5] G30 Report, p. 4.

Glossary

Fair Value may be defined as an estimate of the price an entity would realize if it were to sell an asset, or the price it would pay to relieve a liability in a current transaction between willing parties, other than in a liquidation.

Financial Accounting Standards Board ("**FASB**"), since 1973, has been the designated private sector organization for establishing the standards of financial accounting and reporting that govern the preparation of financial reports in the U.S. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

U.S. Generally Accepted Accounting Principles ("**GAAP**"), established by the FASB, are the standard to which U.S. corporate public financial reporting must conform.

International Accounting Standards Board ("**IASB**"), formerly known as the International Accounting Standards Committee (1973–2001), is an independent, privately funded accounting standard setter based in London, UK. Board Members come from nine countries and are committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the Board cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

International Financial Reporting Standards ("IFRS") are statements issued by the IASB which govern financial reporting in many countries world-wide and are due to be adopted by members of the EU in 2005 and converge with U.S. standards as soon as practicable. IFRS were designated International Accounting Standards ("IAS") between 1973 and 2001 and were adopted in total by the IASB in 2001.

IAS 32 (Financial Instruments: Disclosure and Presentation) & **IAS 39** (Financial Instruments: Recognition and Measurement) have attracted disagreement, particularly in regard to fair value accounting of derivative products, in the process of the EU's adoption of IFRS for listed companies. Although the deadline for adoption is approaching, the agreement has yet to be reached, and failure to adopt is a possibility.

Quotation systems can include quotes contained in newspapers, received from brokers, electronic trading systems, or subscription services that provide price data for specific instruments.

Valuation modeling is the use of statistical techniques that take into account various factors so as to provide an estimate of the value of a financial instrument.

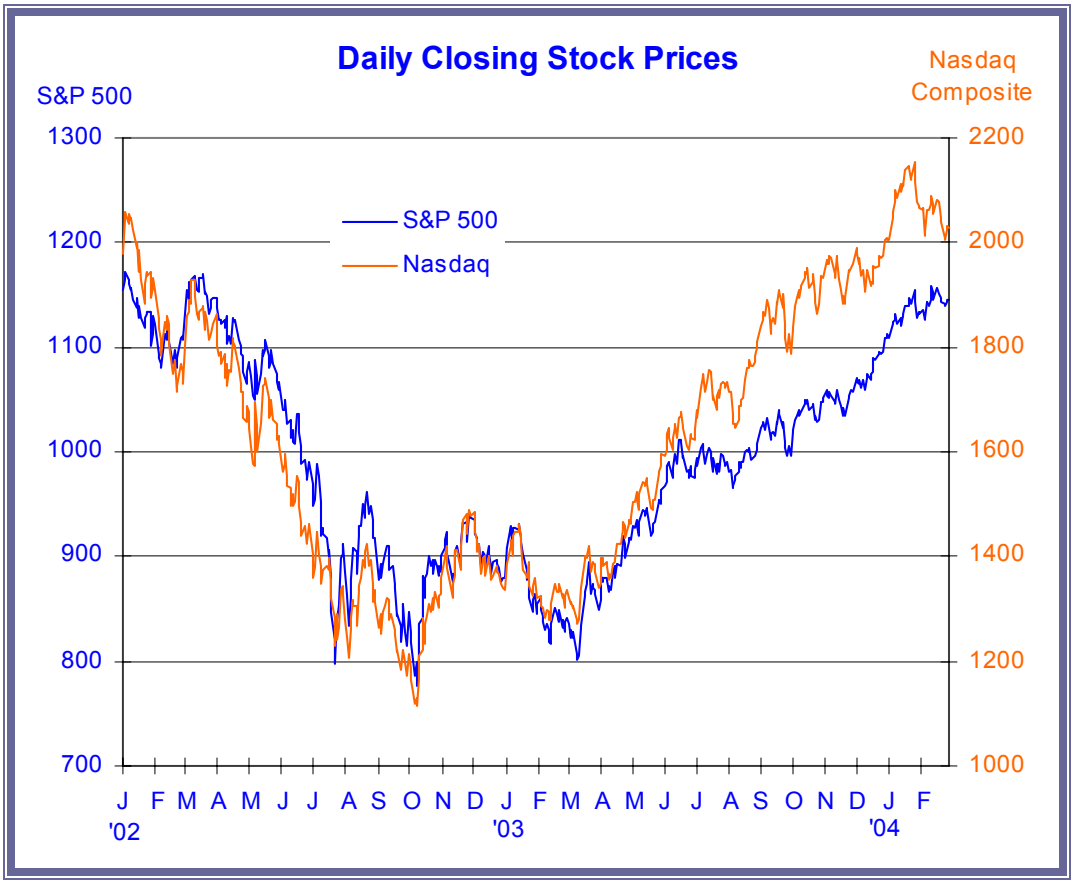
U.S. EQUITY MARKET OUTLOOK

Summary

The strong, broad-based rally in U.S. equity markets, which has extended, without interruption, for the past eleven months, showed signs of faltering in February. Strengthening investor sentiment, increased risk appetites and momentum, sustained by favorable lagging economic and financial indicators, should continue to lift equity prices during the first half of 2004. However, slowing growth of corporate earnings and the economy as a whole, along with prospects for interest rate increases, will leave equity markets vulnerable to a correction in the fall. Fortunately, the correction, when it does come, is unlikely to be lengthy or severe. The factors underlying this outlook as well as a brief look at some recent research supportive of these views are examined below.

Recent Performance

After three years of declines, U.S. equity prices registered major, broad-based gains in 2003. The Dow Jones Industrial Average (DJIA) finished last year up 25%, closing at a 21-month high. The S&P 500 Index (S&P) increased 26% to reach a 20-month high, while the NASDAQ Composite Index (NASDAQ) rose a stunning 50% to a 23-month high. Even with this sharp rebound, the DJIA, the S&P and the NASDAQ indexes remained 12%, 28% and 61%, respectively, below their all-time highs set at the peak of the "bubble" in early 2000. Performance in January 2004 continued this upward trend, exceeding all but the most optimistic forecasts.



This recovery from the lows set in October 2002, got off to a rocky start as uncertainties over the invasion of Iraq, higher oil prices and weak economic growth held back the market rally. However, these concerns were dispelled by late March 2003 and U.S. equity prices began an ascent, which although not unprecedented, has been remarkably steady. Since end-March 2003, the market has been climbing without significant interruption, that is to say, without a "routine decline", which is defined as a fall of 5% or more from any new peak.[1] History shows that this occurs on average about three times a year. The last one occurred in 2003, between mid-February and mid-March, when the market, as measured by the DJIA, fell 6.4%. At eleven months, this is already the 10th-longest run without a "routine decline" for the S&P since 1932.[2] Just such a decline has occurred on the more volatile, NASDAQ, which began to falter in January and recorded, six consecutive weekly declines through the week ending February 27, and closed February 5.8% off the previous near-term peak.

Correction-Free Stock Market Zones

Through Wednesday, February 25, 2004, the Standard & Poor's 500-stock index has risen for 331 days without a decline of at least 5 percent from any new peak, the 10th longest such period.

	Beginning of Growth Period	% change for the period	Number of calendar days	End of Period	Subsequent Decline	Number of calendar days
1	12/18/57	54.2%	593	08/03/59	-9.2%	50
2	11/22/63	29.7%	538	05/13/65	-9.6%	46
3	12/08/94	52.3%	533	05/24/96	-7.6%	61
4	10/09/92	19.7%	481	02/02/94	-8.9%	61
5	09/14/53	61.8%	476	01/03/55	-5.9%	14
6	10/25/60	38.9%	413	12/12/61	-23.6%	167
7	10/23/62	39.2%	370	10/28/63	-6.5%	25
8	06/13/49	43.2%	364	06/12/50	-14.0%	35
9	04/28/42	57.4%	343	04/06/43	-5.3%	3
10	03/31/03	34.8%	331	02/25/04	NA	NA

Source: Birinyi Associates, SIA and *The New York Times* 2/1/2004 (Sunday), Business Section, page 1 Portfolios, Etc.: "This Winning Streak Is Moving Up the Charts"

Most market analysts anticipate continued, albeit substantially more modest, gains in stock prices. This outlook appears to be justified given that most of the factors that have driven the current rally remain in place. Economic activity which increased 4.3% in real terms in 4Q'03 compared to the same period a year earlier, remains robust. Forecasts for 2004 real GDP growth range between 4.5% and 5.0%, and growth is expected to be more balanced, as the long awaited revival in business investment complements continued strength in consumer spending. Corporate earnings growth which reached 28.3% in 4Q '03, while slowing, is still expected to top 14% in 1Q '04. Interest rates remain near 45-year lows, and the stimulative impact of last year's tax cuts continues, with a $35-$40 billion increase in tax refunds expected this year.

[1] See Box on market terms from SIA "Understanding Market Risks" following this article.

[2] According to Birinyi Associates. See "This Winning Streak Is Moving Up the Charts", Jonathan Fuerbringer, *New York Times*, Portfolios, Etc, February 1, 2004.

Weighing Near-Term Prospects: Market Valuation and Dispelling Illusions

Are these expectations of a continuation of the current rally reasonable or more likely to disappoint investors? There is no definitive answer, and forecasting stock price changes can be a humbling experience. While many believe that stock price changes are not predictable, research in recent years supports a quite different conclusion. Specifically, that valuation ratios (such as dividend-price ratios or price-earnings ratios) do appear to be useful in forecasting stock price changes, contrary to what would be suggested by the conventional random-walk theory of the stock market embodied in simple efficient-markets models.[3]

The standard approach to valuing equities relies on two basic elements – earnings growth and discounting – that reflect why investors hold equities. Investors hold stocks because they expect to receive future income in the form of stock price appreciation (capital gains) and dividend payments. Income depends on the firm's ability to grow earnings: the higher its earnings growth, the greater its potential to pay dividends and the greater its potential stock price appreciation.

However, these future income flows are uncertain and need to be discounted both over time (since investors would prefer to receive income sooner rather than later) and to reflect the degree of uncertainty or risk of these future cash flows. Historically, a diversified portfolio of equities produces returns that are more variable (and hence riskier) than the returns on "safe" or "riskless" assets such as U.S. Treasury bonds. A "rational" investor expects a return on his equity holdings greater than the return provided by "safe" assets to compensate him for this risk. This extra return is often called the equity premium or ***equity risk premium***. The sum of this premium and the appropriate risk-free rate is seen as the appropriate discount rate to be applied to stock returns.

Currently, the most commonly used valuation ratio, the price-earnings ratio, is well above its long-run historical average value of about 15.[4] Most analysts give at least some weight to the mean-reversion theory that states that when stock prices are high relative to these normal indicators of fundamental value, such as earnings, as they are now, then prices will eventually fall in the future to bring ratios back to more normal levels, or in other words, revert to their mean. While this idea currently gives us a pessimistic long-run outlook for stock prices, history tells us that it may take years for stock prices to adjust. In the interim, stock prices and price-earnings ratios could easily move still higher and stay there for some time.

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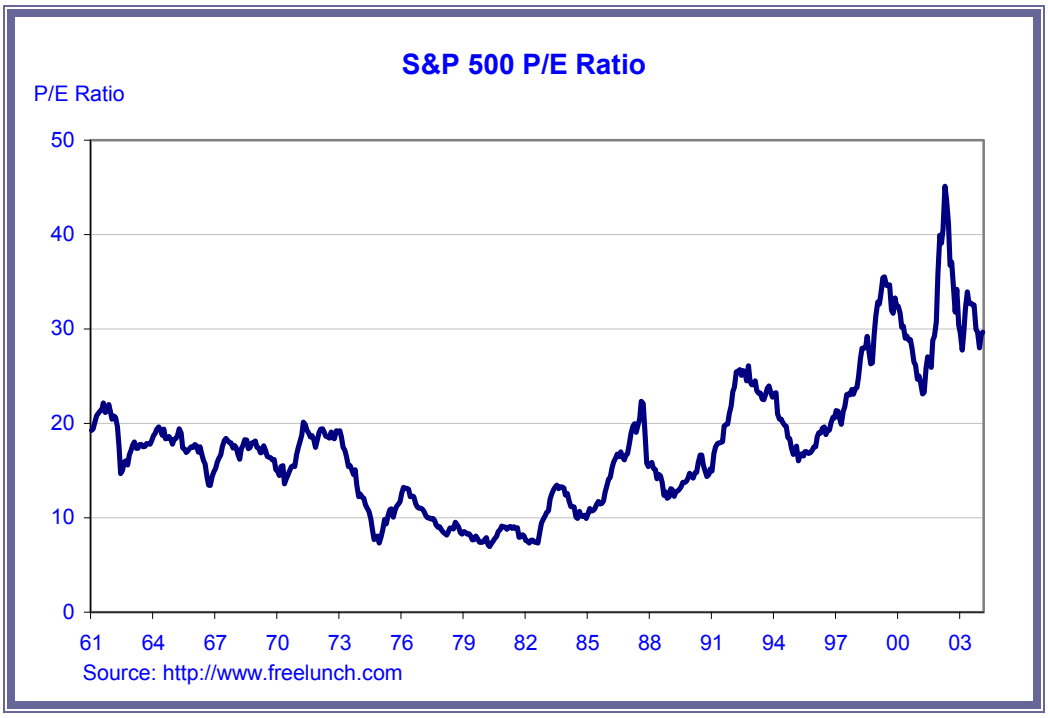
[3] See John Y. Campbell and Robert J. Shiller, "Valuation Ratios and the Long-Run Stock Market Outlook: An Update", Cowles Foundation For Research in Economics Discussion Paper No. 1295, Yale University, New Haven, Conn., March 2001. For example, on p.3, "The random-walk theory is a special case of the efficient markets theory of stock prices. In general, the efficient-markets theory allows the equilibrium rate of return required by investors to vary over time. The random-walk theory assumes that this required rate of return is constant, and says that stock returns, not prices should be unforecastable."

[4] This "overvaluation" is also true of the dividend-price ratio as well as the level of Tobin's Q. Dividend-price ratios normally move in a range from 3% to 7%, with a mean of 4.65% during the period from 1872 to 2003. Values of Tobin's Q, which is the ratio of the stock market's capitalization (in terms of current prices) to the replacement costs of corporate asset also presents a similar picture, e.g. that of currently being well above its long-run average level.



Several explanations have been offered for why investors today would be willing to pay more for each dollar of corporate earnings than they have in the past. These include: "(1) higher expected future earnings growth, (2) lower perceptions of risks of holding stocks, and (3) irrational exuberance".[5] The first of these explanations may go a long way towards explaining current price levels. Near-term optimism may represent an extrapolation of the high returns gained in the past year. Over short time horizons, these expectations may be rational, since stock price increases tend to persist, and investment strategies designed to exploit this fact, such as so-called momentum investment strategies, can prove lucrative.[6] However, if strength in fundamentals, such as earnings growth, fades across the course of this year as it is expected to do, this strategy would not be profitable any longer and markets, deprived of the support of these investors, would become increasingly vulnerable to a "correction", a decline of 10% or more from recent peaks.

The second explanation, that perception of the risk in holding stocks has declined, also seems to be supported by recent observations, although there is little agreement among either academics or market participants as to the ***sustainable*** size of the equity risk premium or the reason for its decline in recent years. While there is no agreement on exactly what this premium is or ought to be, there is a general consensus that: a sustainable premium for U.S. equities is between 2% and 4%; and that it has been declining in recent years.[7] Commonly used measures that are consistent with current equity prices produce estimates of the equity risk premium between 1% and 2%. One commonly used measure of the equity risk premium, the difference between the volatility[8] of stocks and that of bonds, which is shown below, supports those conclusions.

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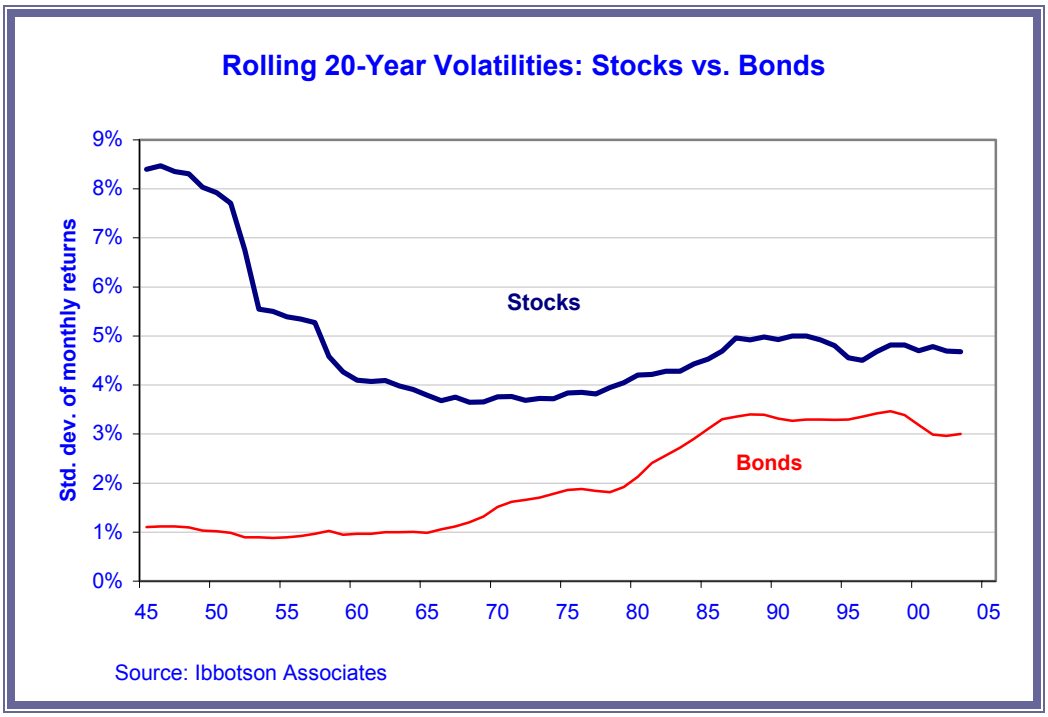
[5] Kevin J. Lansing, "Searching for Value in the U.S. Stock Market", FSBSR Economic Letter, Number 2002-16, May 24, 2002.

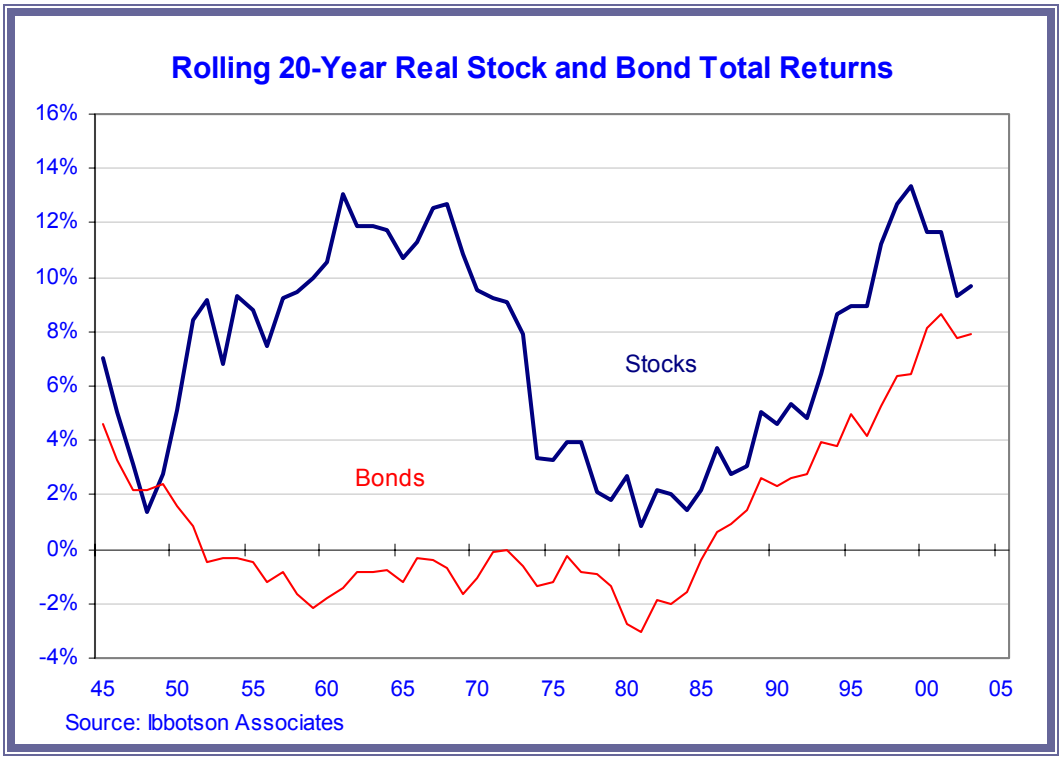
[6] Over extended horizons, momentum investing will be profitable only if supported by fundamentals. A theoretical justification for momentum-investment strategies is provided by Harrison Hong and Jeremy C. Stein, "A Unified Theory of Underreaction, Momentum Trading, and Overreaction in Asset Markets," *Journal of Finance*, Vol. 54, No. 6, December 1999, pp. 2143-84.

[7] Ravi Jagannathan, Ellen R. McGrattan, and Anna Scherbina, "The Declining U.S. Equity Premium", Quarterly Review, Federal Reserve Bank of Minneapolis, Fall 2000, pp. 3-19.

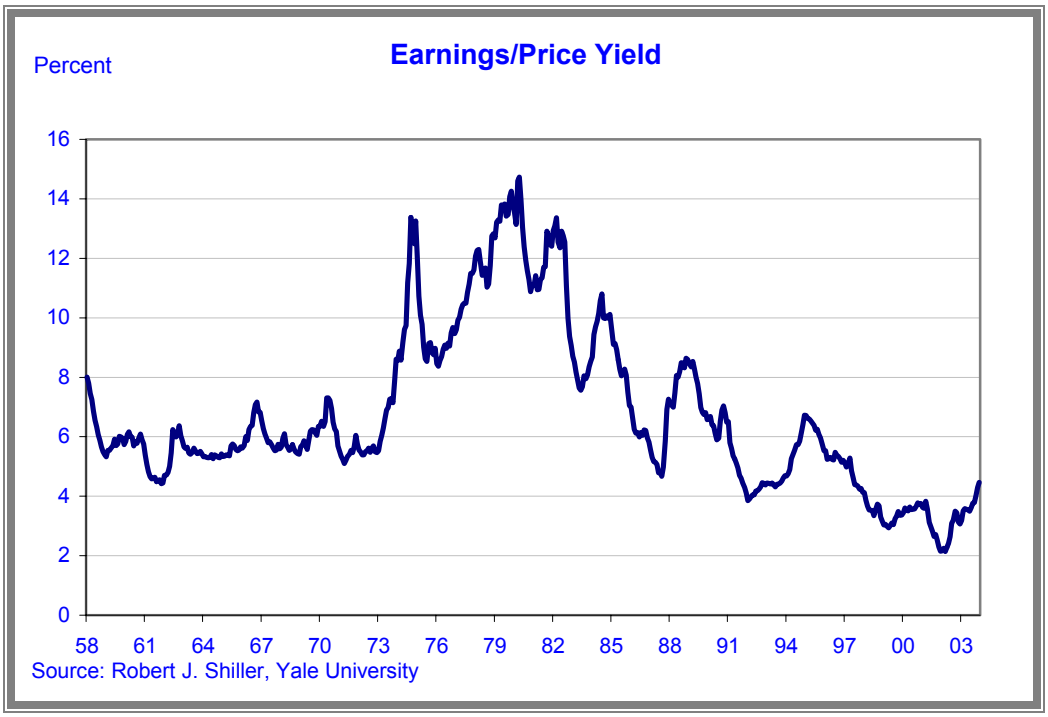
[8] Defined here as the standard deviation of monthly returns.



Another measure of the expected premium, the difference between the expected real long-term rate of return on equities and the expected real yield on bonds, also supports those conclusions. This too suggests that the equity risk premium has been declining, is below its long run historical mean, and is likely to rise in the near term.



Another explanation of why investors would pay more to hold stocks than they have in the past gained additional support recently. In 1979, Modigliani and Cohn[9] hypothesized "that stock market investors (but not bond market investors) are subject to inflation illusion. Stock market investors fail to understand the effect of inflation on nominal dividend growth rates and extrapolate historical nominal growth rates even in periods of changing inflation."[10] They argued that "high inflation leads to stock market underpricing and low (or negative) inflation leads to overpricing. The main competing hypotheses are that low stock prices coinciding with high inflation are rationally justified because high inflation coincides with low expected dividend growth or a high subjective risk premium".[11]

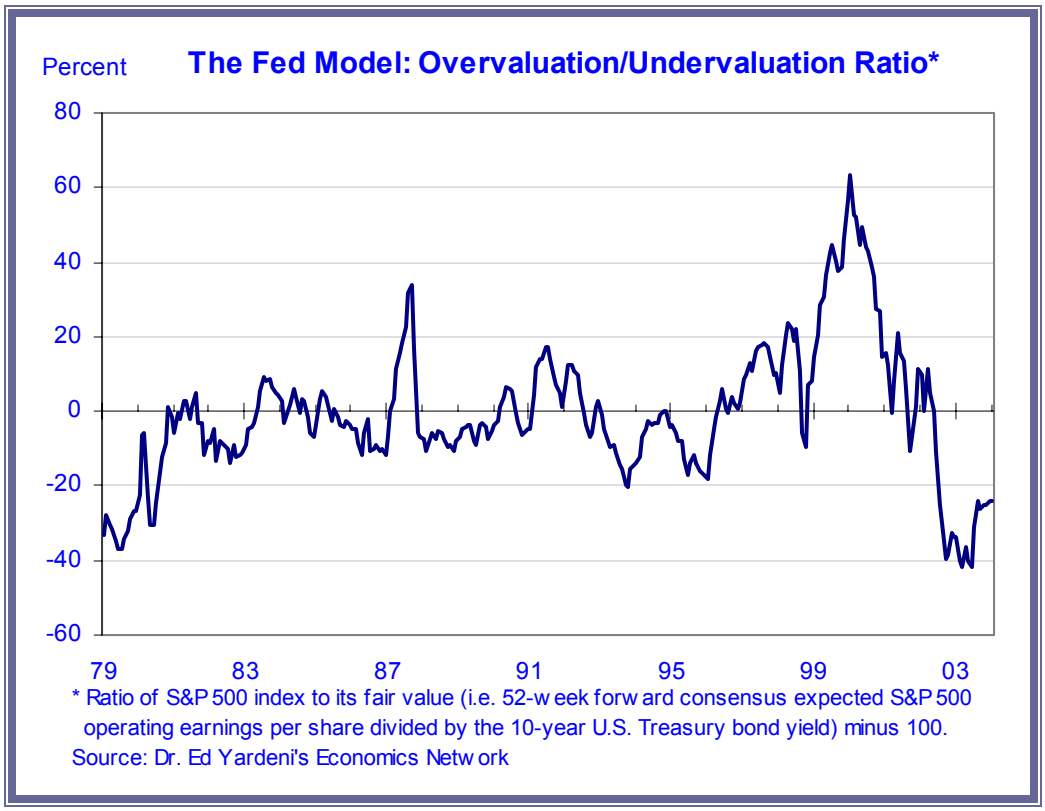


The "persistent use" of the leading practitioner's model of equity valuation, the so-called "Fed Model", contributes to the persistence of this inflationary illusion. The Fed Model "relates the yield on stocks (as measured by the ratio of dividends or earnings to stock prices) to the nominal yield on Treasury bonds. The idea is that stocks and bonds compete for space in investors' portfolios.

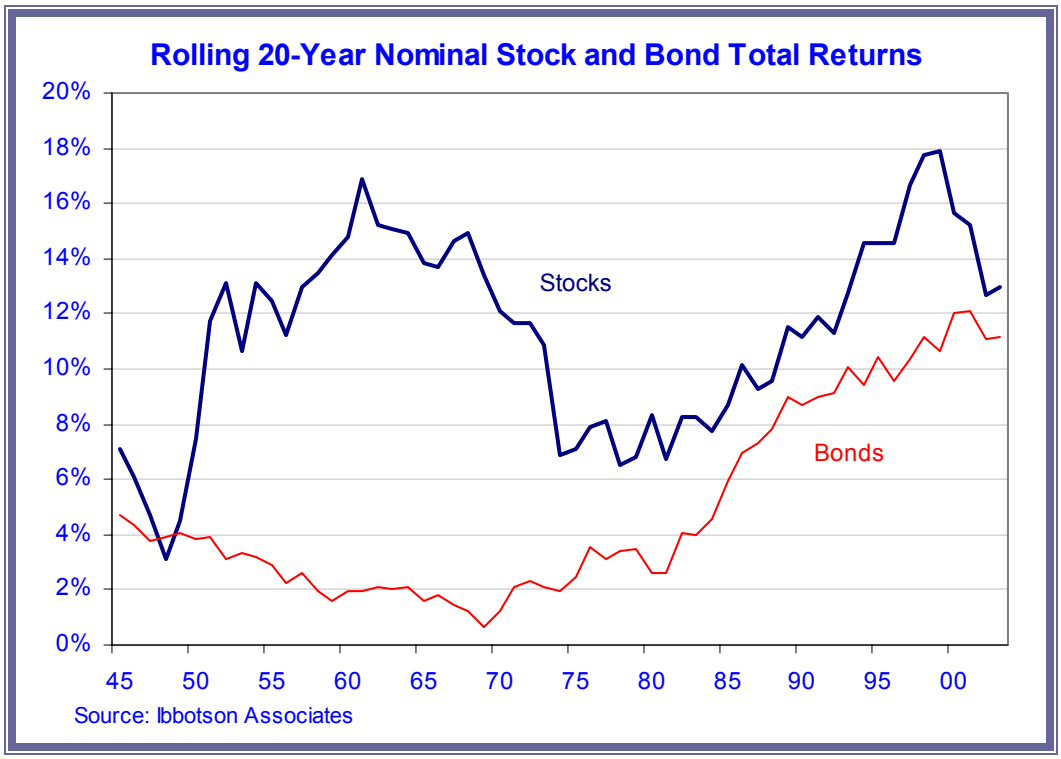
[9] Franco Modigliani and Richard Cohn, "Inflation, Rational Valuation and the Market", *Financial Analysts Journal*, 1979.

[10] John Y. Campbell and Tuomo Vuolteenaho, Inflation Illusion and Stock Prices, NBER Working Paper 10263, NBER, Cambridge, MA, January 2004.

[11] Op. cit. 10, p.7.



If the yield on bonds rises, then the yield on stocks must also rise to maintain the competitiveness of stocks. The model holds that the bond yield plus a risk premium defines a "normal" yield on stocks and that the actual stock yield tends to revert to this normal yield. If the measured stock yield exceeds the normal yield defined by the Fed Model, as it does now, then stocks are believed to be (by users of the Fed Model) attractively priced or "undervalued"; if the measured yield falls below the normal yield, as it is expected to do towards end year, then stocks could be seen as overpriced.



Recognizing that empirically the Fed Model is successful as a behavioral description of stock prices, but that there "is a serious difficulty with this model as a rational explanation of stock prices", two Harvard finance professors, John Y. Campbell and Tuomo Vuolteenaho, in a paper released this January, persuasively tested these competing points of view. Specifically, they "empirically decompose the S&P 500's dividend yield into (1) a rational forecast of long-run real dividend growth, (2) the subjectively expected risk premium, and (3) residual mispricing attributed to the market's forecast of dividend growth deviating from the rational forecast".

Using a value-at-risk (VAR) system to construct empirical estimates of these three components, they found that: high inflation is positively correlated with rationally expected long run real dividend growth; inflation is almost uncorrelated with the subjective risk premium; and inflation is highly correlated with the mispricing term. The last observation supports the view of Modigliani and Cohn that equity investors form subjective growth forecasts by extrapolating past nominal growth rates without adjusting for changes in inflation. In fact they found that "the level of inflation explains almost 80% of the times-series variation in stock-market mispricing".[12] The presence of this inflationary illusion suggests that investors are currently overvaluing the market.

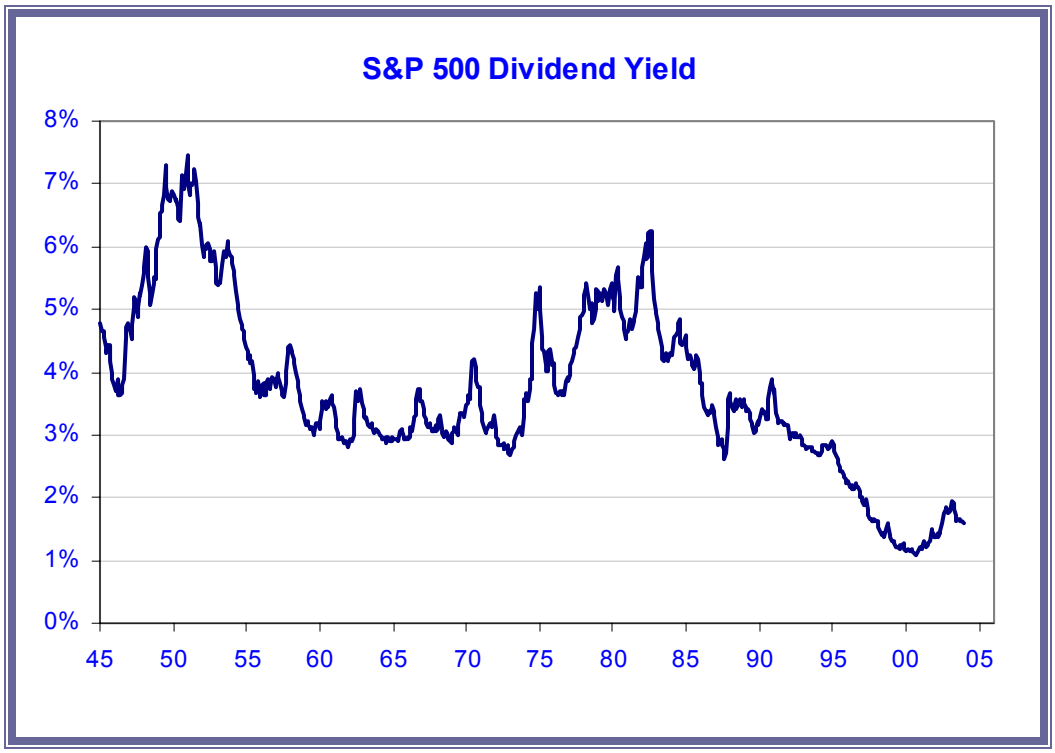
The authors correctly advise that "in interpreting this result, it is important to keep in mind that inflation, the stock market dividend yield, and its estimated components are all highly persistent processes" and that "it might be useful to use survey data to measure subjective inflation expectations".[13] To take a closer look at these views, while heeding the authors' recommendations, graphical presentations of the relevant variables are presented below. Real and nominal stock and bond returns and yields were examined with and without the use of rolling, moving averages over a period as long as 20 years, to account for the persistence of expectations. Expected values for inflation were drawn from survey information[14] while "consensus" forecasts for earnings growth supplied by Thomson First Call were used for projected values. Expected values for bond yields were those implied by Treasury futures markets.

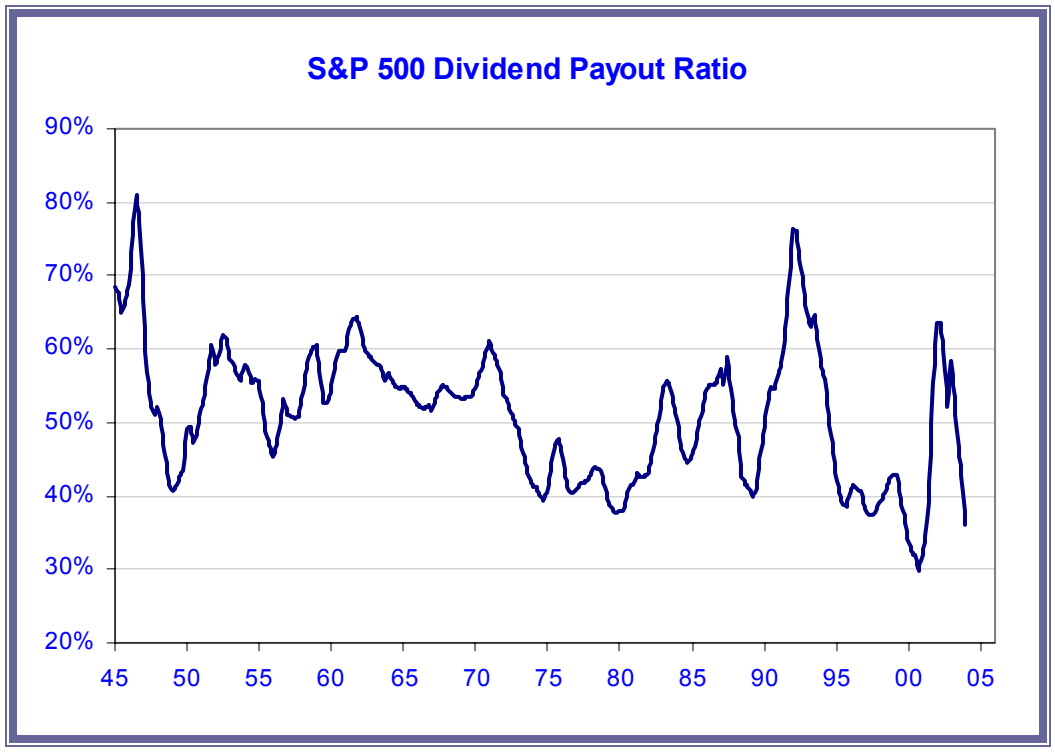
Our expectations are that real stock yields will decline gradually over the near term in line with expected declines in real earnings growth and that these declines will more than offset an even more gradual rise in dividend yields and a rebound in dividend payout ratios in response to recent, more favorable tax treatment.

[12] Op. cit. 10.

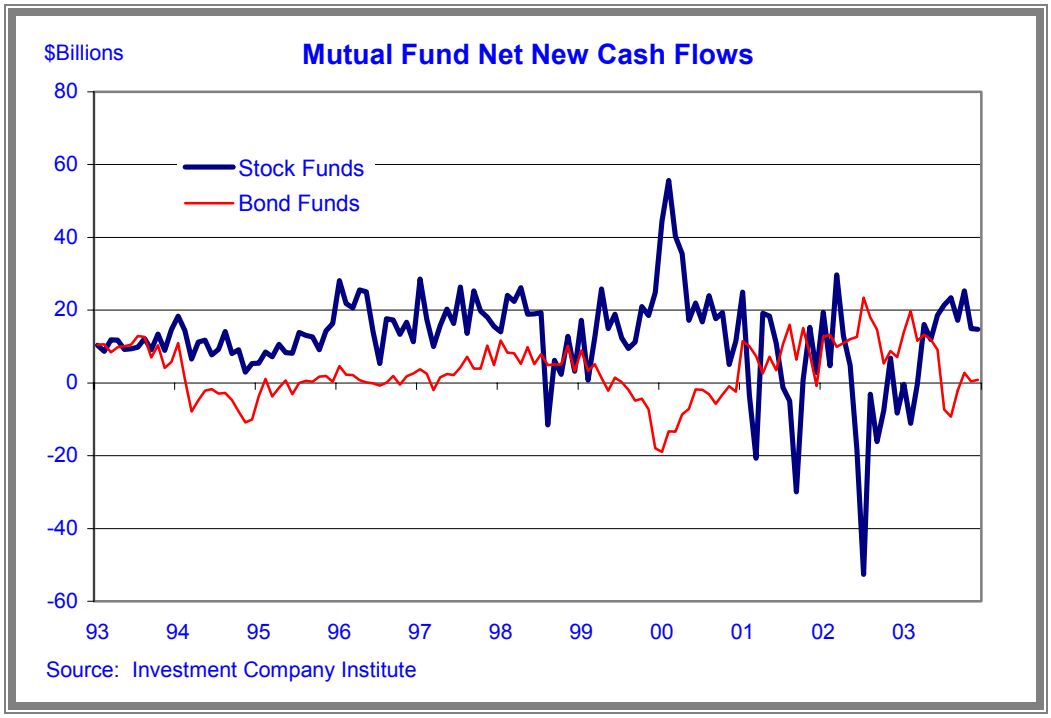
[13] Op. cit. 10, p. 8.

[14] Federal Reserve Bank of Cleveland, Monthly Economic Report, February 2004.





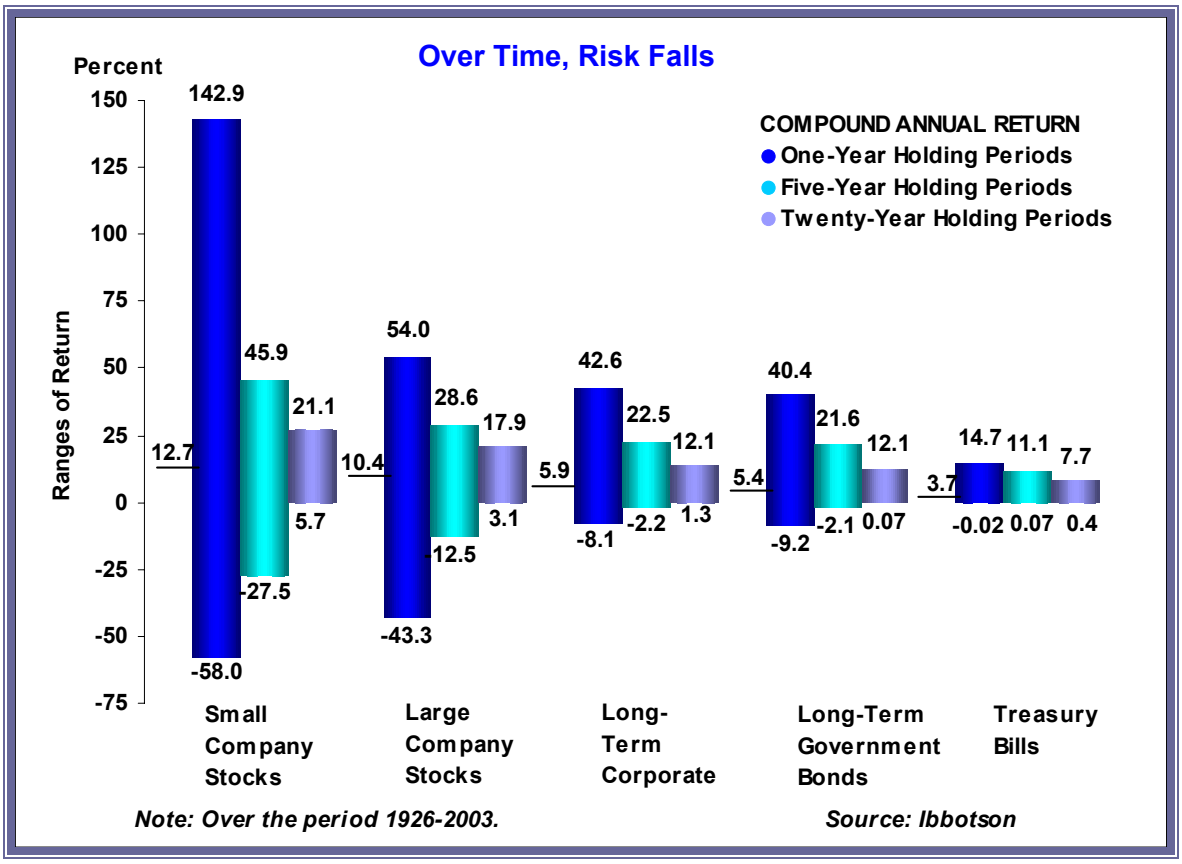
However, in the short run at least, stocks are expected to remain attractive to investors relative to bonds given near-term expectations for interest rates and inflation. These perceptions, which have been reflected in strong net inflows into stock funds, and strong net outflows from money market mutual funds and to a lesser extent, bond funds, should continue. Both portfolio choices however are expected to diminish relative to yet another alternative investment choice – real estate.



If expectations for interest rates and inflation for this year are confirmed and continue to rise into next year, stock prices could come under pressure as both stock and bond yields would be expected to revert towards their respective means. The probability of this correction will hinge on the actual evolution of inflation and activity in the broader economy which will drive the Fed's actions. Currently, it appears that a correction is not imminent, nor expected to be extended or severe, when it does come.

Campbell and Vuolteenaho's work has some other important implications for investors. Their work supports the view that stocks, as real assets, provide a hedge against inflation. While there is much documentation that inflation shocks have a negative effect on realized stock returns, this can be explained as a result of mispricing driven by the inflation illusion, an effect which appears to diminish over time. Earlier research found that stocks are better inflation hedges over five-year periods than over one-year periods. We find this to be even more true over longer periods, such as twenty years. Their conclusions also imply that a successful stabilization of inflation, which it appears the Fed has been able to achieve, "will reduce the volatility of mispricing and thereby contribute to the efficiency of the stock market".[15]

[15] Op.cit 10, p. 9.



However, as was pointed out earlier, periods of overvaluation and undervaluation in securities prices can persist for extended periods of time. While it is believed that the market has become more efficient, how long the current rally actually does persist and whether the performance of the last eleven months heralds the start of another "bull market", remains to be seen.

Historical Stock Returns

	Nominal	Real	#Yrs	
1946-2003	11.6%	7.2%	58	
1946-1965	13.8%	10.7%	20	bull market
1966-1981	5.9%	-1.0%	16	bear market
1982-1999	18.5%	14.7%	18	bull market
2000-2002	-14.6%	-16.6%	3	bear market
2003	28.7%	26.4%		

Frank A. Fernandez
Senior Vice President, Chief Economist and Director, Research

MARKET DECLINES: SOME COMMON TERMS

Reporters and stock market commentators use different terms to describe drops in the stock market. Here's a rundown of the words most commonly used.

- **Routine Decline**—Typically, a fall of 5 percent in the Dow. History shows it happens about three times each year. One occurred in 2003 from mid-February through mid-March, when the market fell 6.4 percent.

- **Correction**—A 10-percent drop is the threshold. The market usually "corrects" once a year, but there's only been one near-correction — a 9.8-percent fall from mid-March through mid- April 1997 — over the last nine years.

- **Severe Correction**—15 percent or more. During the last 53 years, there have been 16 severe corrections. Eight of these turned into bear markets; most recently in early 2000.

- **Bear Market**—A fall of 20 percent or more. A two-year 45-percent decline in 1973-74 was the worst in 50 years. Recently, the Dow fell 38-percent from January 2000 through October 2002.

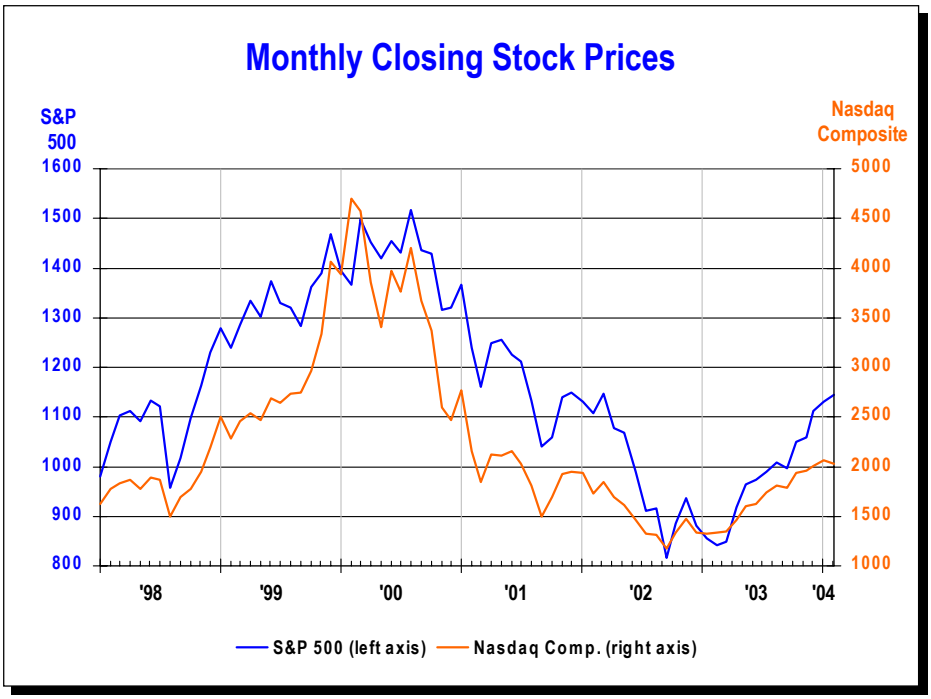
- **Crash**—A drop of 20 percent or more that is concentrated within a few days. In 1929, the market fell 23 percent over two days; in 1987, the decline was 22.6 percent in one day.

From SIA's "Understanding Market Risks"

MONTHLY STATISTICAL REVIEW

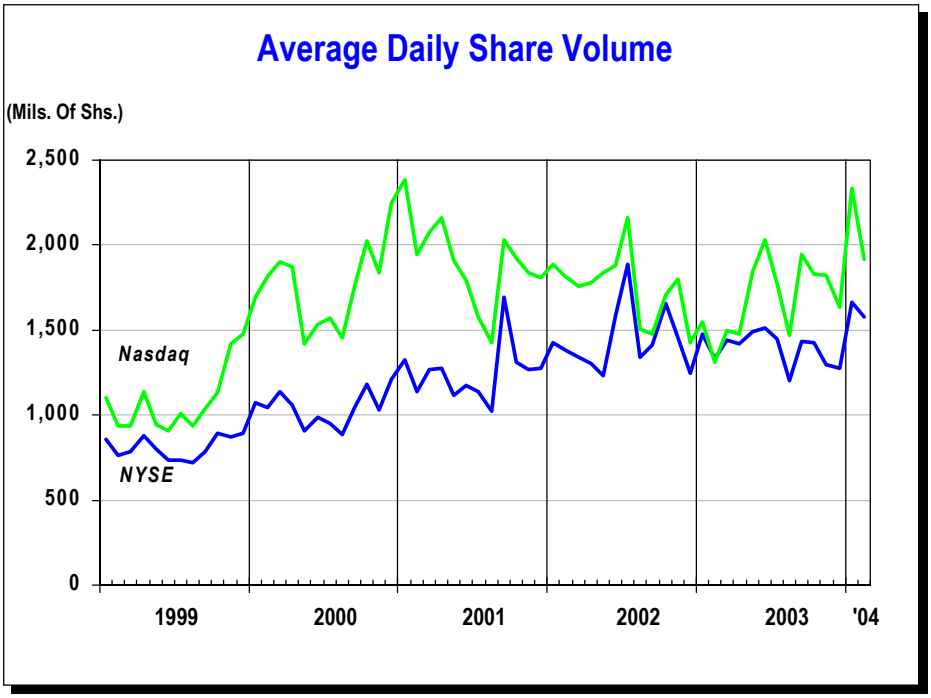
U.S. Equity Market Activity

Stock Prices – The 11-month stock market rally stalled in February as investors turned cautious amid mixed economic signals and growing concern that the market is overvalued. Large cap stocks generally moved sideways for several weeks yet managed to post moderate gains for the month overall, while the small caps and tech stocks lost ground. The DJIA closed out February with a 0.9% increase, and the S&P 500 added 1.2%. Meanwhile, the tech-laden Nasdaq Composite Index fell 1.8%, its first monthly decline since last September. Nevertheless, all major market barometers are still showing gains for 2004. Since year-end 2003, the DJIA and S&P 500 are up 1.2% and 3.0%, respectively, and the Nasdaq Composite is up 1.3%.

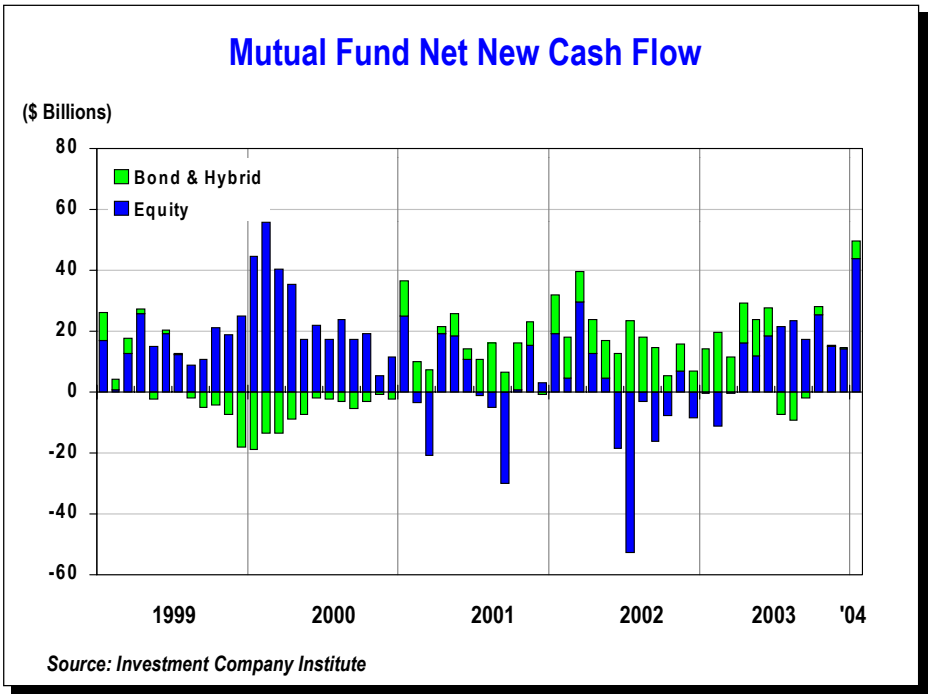


Share Volume – Trading activity on the major U.S. equity markets subsided in February from January's robust pace yet remained strong. After rebounding 30% in January from weak December levels, NYSE volume fell 5.4% to 1.57 billion shares daily in February. On Nasdaq, average daily share volume stumbled 18.0% to 1.91 billion daily in February following a 42% surge to 2.33 billion shares daily in January.

Despite the slowdown in trading during February, volume on both Nasdaq and the NYSE year-to-date remain well above last year's levels. At 2.13 billion shares daily, year-to-date through February, volume on Nasdaq is 26.0% higher than 2003's average of about 1.69 billion daily, while NYSE average daily volume of 1.62 billion shares stands 15.7% above last year's average of 1.40 billion shares traded daily.

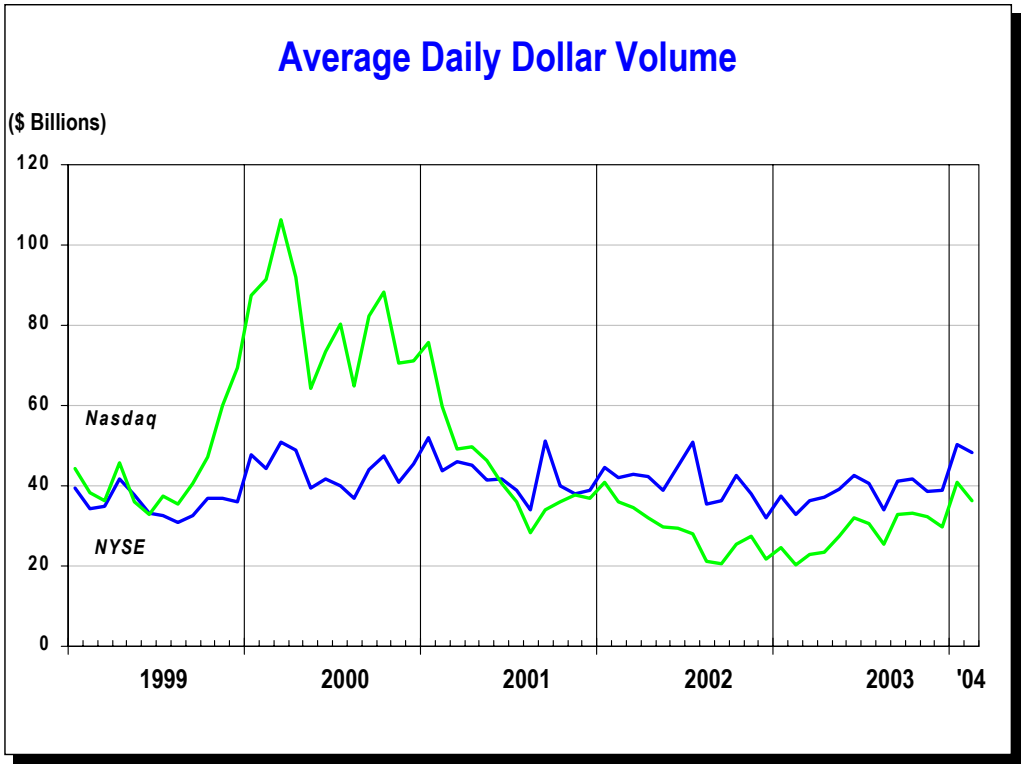


Mutual Fund Flows – Investors poured $43.8 billion into stock mutual funds in January, more than triple the $14.2 billion inflow posted in December. According to the Investment Company Institute, the January inflow to stock funds was the third largest monthly inflow on record, trailing only the $55.6 billion inflow in February 2000 and the $44.5 billion increase in January 2000. Stock fund flows continued to be positive in February. AMG Data Services estimates that stock funds had net inflows of $25 billion to $30 billion in February.

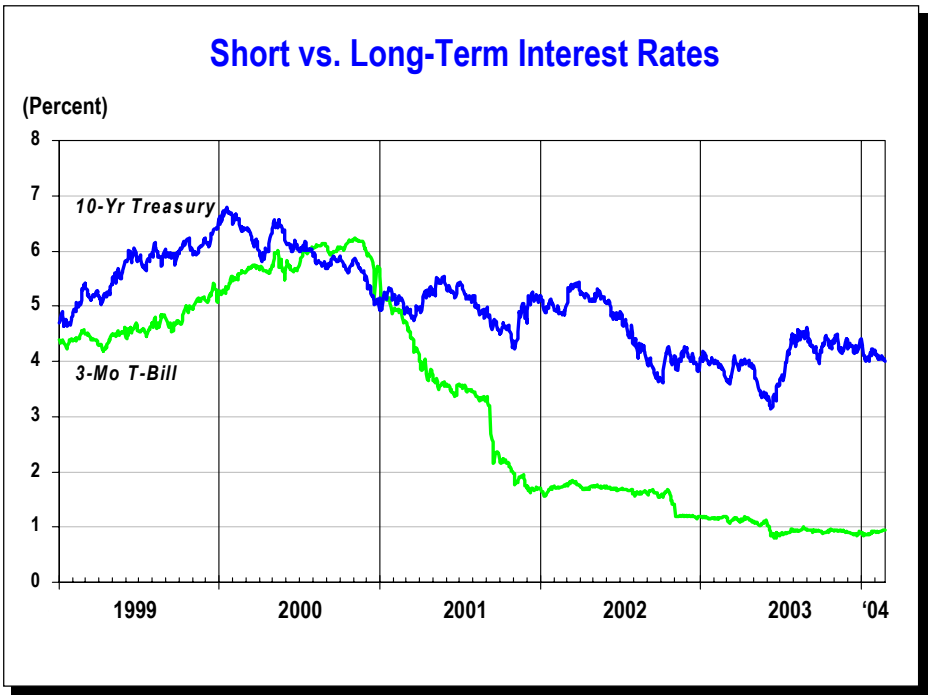


Dollar Volume – The value of trading in NYSE and Nasdaq stocks fell in February, reflecting the slowdown in trading activity. NYSE dollar volume slipped 3.8% in February from January's level to $48.4 billion daily. That brought the year-to-date average to $49.4 billion daily, a 28.3% increase over full year 2003's average daily pace of $38.5 billion.

Average daily dollar volume on Nasdaq declined 11.5% in February to $36.2 billion from $40.9 billion in January. Year-to-date, Nasdaq daily average dollar volume of $38.6 billion stands 37.9% above 2003's $28.0 billion daily average.

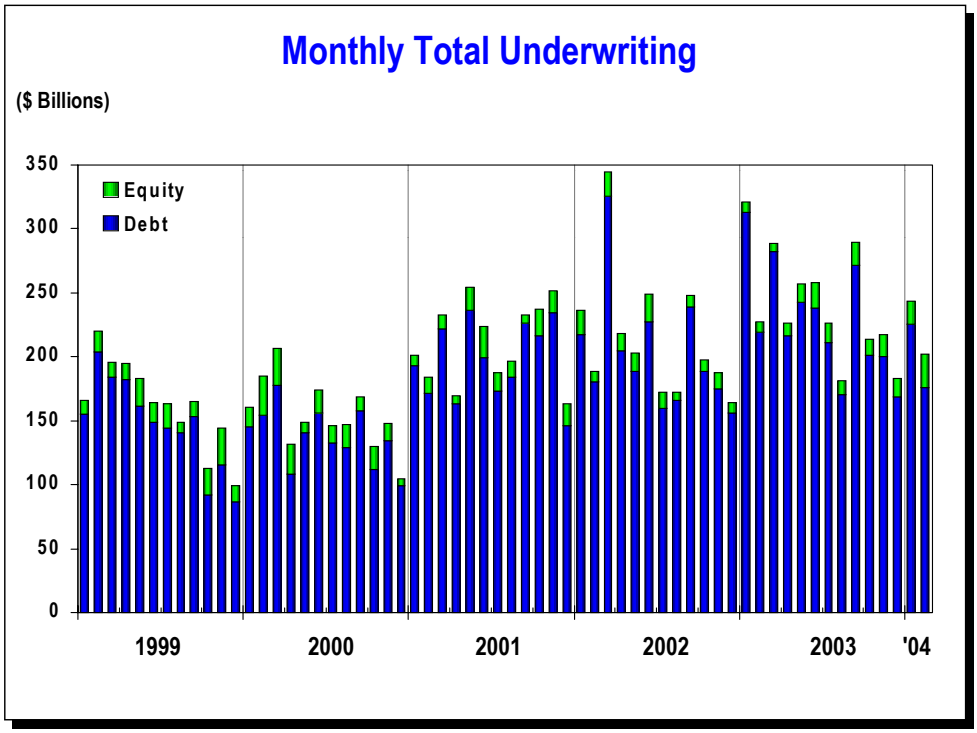


Interest Rates – Long-term Treasury yields generally trended downward in February. The yield on the benchmark 10-year Treasury fell to 3.99% by the end of February from 4.16% one month earlier, and is now near its lowest level in seven months. Meanwhile, the three-month T-bill yield closed February at 0.94%, up 4 basis points for the month. As a result, the yield spread between the 10-year Treasury and the three-month T-bill flattened to 305 basis points in February from 326 basis points in January.

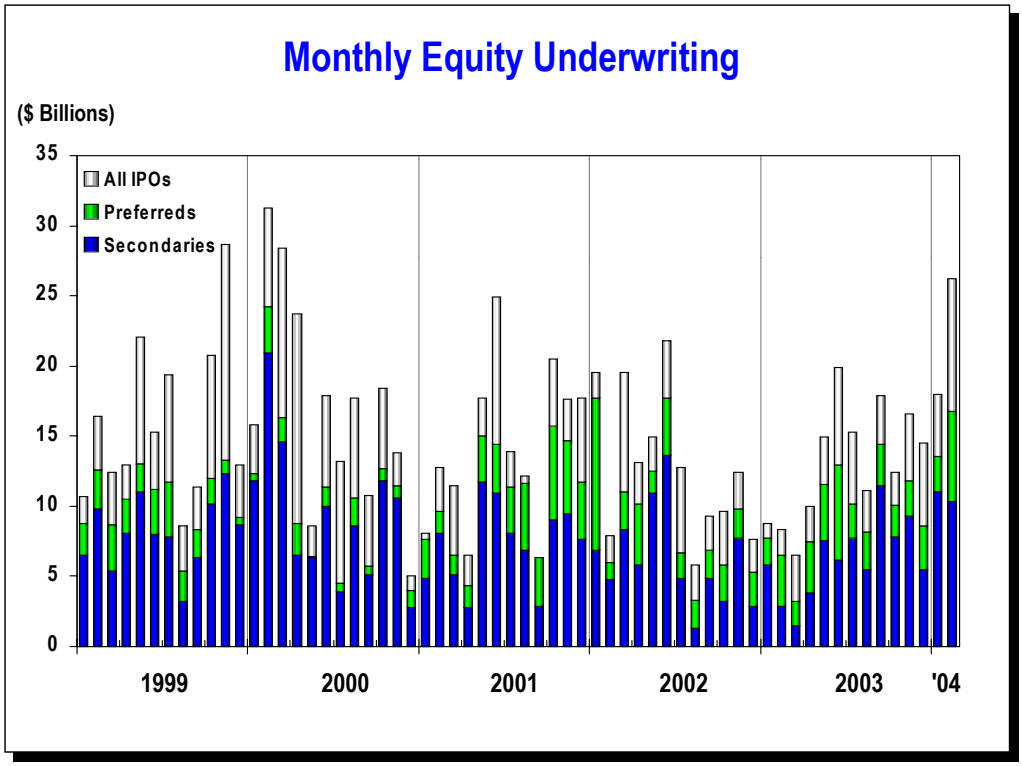


U.S. Underwriting Activity

Total Underwriting Activity -- Although equity underwriting activity increased in February, the overall total was dragged down by a cutback in corporate bond issuance. Total underwriting activity slid 17.1% to $201.9 billion in February from $243.5 billion in January. The year-to-date total of $445.4 billion is 18.8% below the $548.6 billion issued in the same period a year ago.

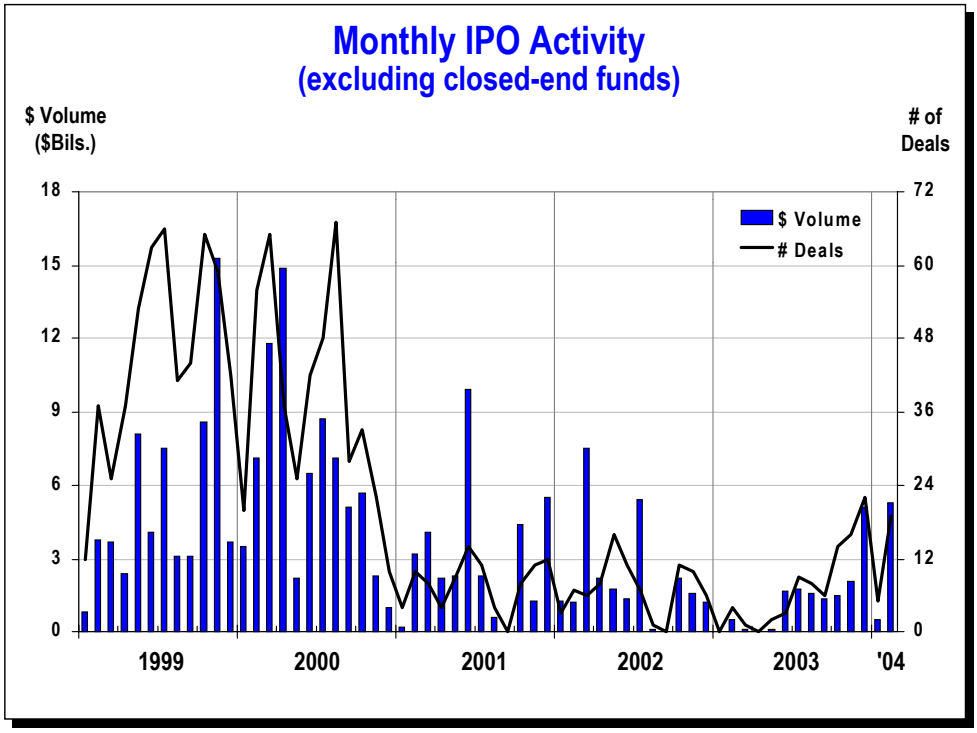


Equity Underwriting – Dollar proceeds from common and preferred stock offerings totaled $26.2 billion in February, a 45.6% increase over January's level and the largest amount raised in any month since March 2000. Year-to-date through February, equity underwriting totaled $44.2 billion, a 2-½ fold increase over the $17.1 billion underwritten in last year's comparable period.

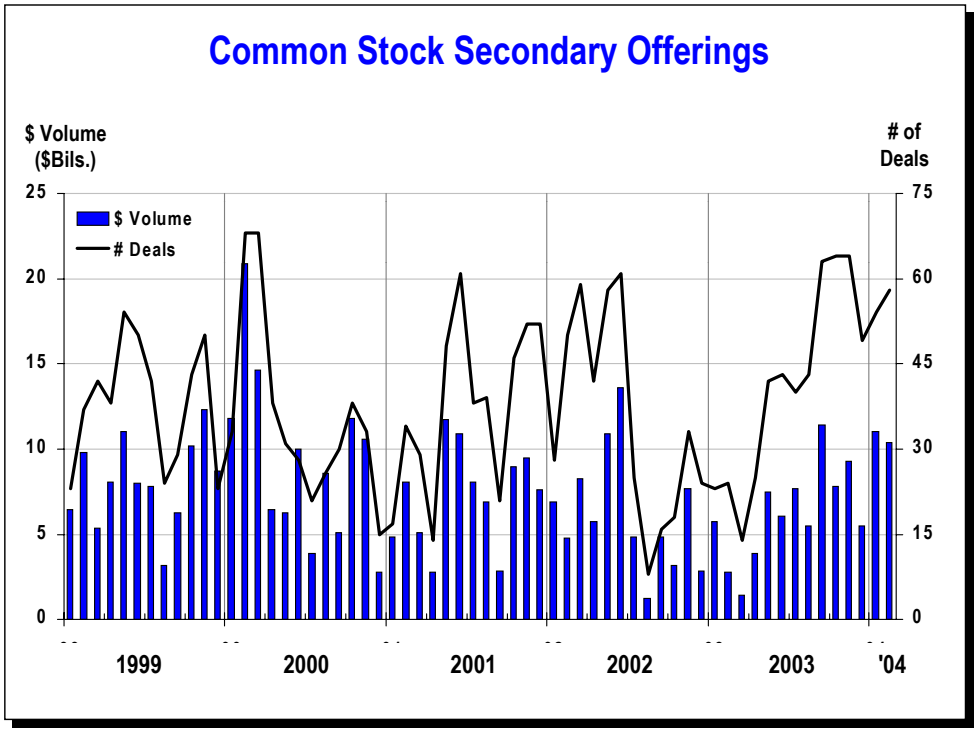


The ***IPO market*** staged a strong recovery in February. Over $5.3 billion was raised via 19 deals, compared with $514 million on 5 deals in January. February's dollar volume represented the highest monthly total since July 2002. In addition, the first billion-dollar IPO of the year hit the market on February 4, when Assurant Inc., the insurance unit of Belgian financial services company Fortis, raised $1.8 billion. The sale was the biggest U.S. IPO since July 2002, when the spin-off of CIT Group inc. from Tyco International Ltd. raised $4.6 billion.

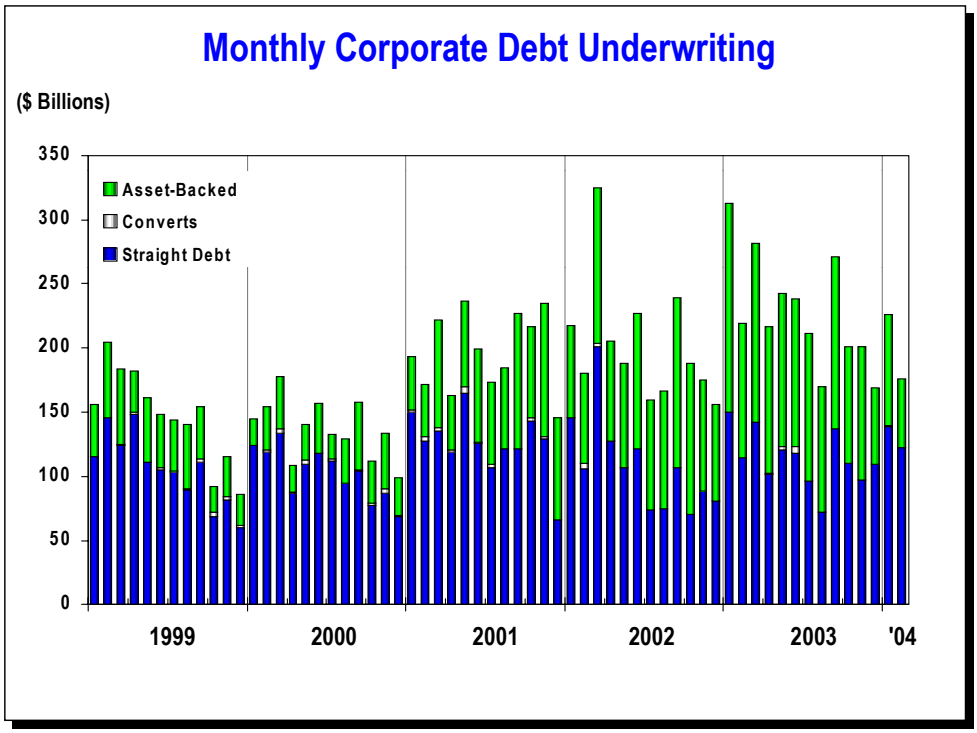
During the first two months of 2004, dollar proceeds from IPOs totaled over $5.8 billion, a substantial improvement from the mere $510 million raised in the comparable period last year. IPO activity is expected to strengthen in the coming months, as the backlog rose to $10.6 billion at the end of February, compared to $9.8 billion a month ago and $4.0 billion a year ago.



In February, ***secondary common stock issuance*** slipped 5.5% from January's elevated level to $10.4 billion. That brought the year-to-date total to $21.4 billion, a whopping 148.0% increase over the $8.6 billion issued in last year's comparable period.



Corporate Bond Underwriting – On the debt side, total corporate debt underwriting activity decreased 22.1% in February to $175.7 billion from a revised $225.5 billion in January. Through the first two months of 2004, corporate bond issuance totaled $401.2 billion, a 24.5% decline from $531.5 billion a year ago. A sharp fall-off in asset-backed bond issuance has accounted for most of the weakness in the primary corporate bond market this year. Year-to-date through February, asset-backed bond issuance of $138.6 billion is down 48.0% when compared with $266.5 billion in the same period last year.



Grace Toto
Vice President and Director, Statistics

U.S. CORPORATE UNDERWRITING ACTIVITY

(In $ Billions)

	Straight Corporate Debt	Con-vertible Debt	Asset-Backed Debt	**TOTAL DEBT**	Common Stock	Preferred Stock	**TOTAL EQUITY**	All IPOs	"True" IPOs	Secondaries	**TOTAL UNDER-WRITINGS**
1985	76.4	7.5	20.8	104.7	24.7	8.6	33.3	8.5	8.4	16.2	138.0
1986	149.8	10.1	67.8	227.7	43.2	13.9	57.1	22.3	18.1	20.9	284.8
1987	117.8	9.9	91.7	219.4	41.5	11.4	52.9	24.0	14.3	17.5	272.3
1988	120.3	3.1	113.8	237.2	29.7	7.6	37.3	23.6	5.7	6.1	274.5
1989	134.1	5.5	135.3	274.9	22.9	7.7	30.6	13.7	6.1	9.2	305.5
1990	107.7	4.7	176.1	288.4	19.2	4.7	23.9	10.1	4.5	9.0	312.3
1991	203.6	7.8	300.0	511.5	56.0	19.9	75.9	25.1	16.4	30.9	587.4
1992	319.8	7.1	427.0	753.8	72.5	29.3	101.8	39.6	24.1	32.9	855.7
1993	448.4	9.3	474.8	932.5	102.4	28.4	130.8	57.4	41.3	45.0	1,063.4
1994	381.2	4.8	253.5	639.5	61.4	15.5	76.9	33.7	28.3	27.7	716.4
1995	466.0	6.9	152.4	625.3	82.0	15.1	97.1	30.2	30.0	51.8	722.4
1996	564.8	9.3	252.9	827.0	115.5	36.5	151.9	50.0	49.9	65.5	979.0
1997	769.8	8.5	385.6	1,163.9	120.2	33.3	153.4	44.2	43.2	75.9	1,317.3
1998	1,142.5	6.3	566.8	1,715.6	115.0	37.8	152.7	43.7	36.6	71.2	1,868.3
1999	1,264.8	16.1	487.1	1,768.0	164.3	27.5	191.7	66.8	64.3	97.5	1,959.8
2000	1,236.2	17.0	393.4	1,646.6	189.1	15.4	204.5	76.1	75.8	112.9	1,851.0
2001	1,511.2	21.6	832.5	2,365.4	128.4	41.3	169.7	40.8	36.0	87.6	2,535.1
2002	1,303.2	8.6	1,115.4	2,427.2	116.4	37.6	154.0	41.2	25.8	75.2	2,581.1
2003	1,370.7	10.6	1,352.3	2,733.6	118.5	37.8	156.3	43.7	15.9	74.8	2,889.9
2003											
Jan	150.3	0.0	162.5	312.7	6.8	1.9	8.8	1.0	0.0	5.8	321.5
Feb	114.7	0.0	104.1	218.8	4.7	3.6	8.3	1.9	0.5	2.8	227.1
Mar	141.9	0.1	140.2	282.3	4.8	1.8	6.5	3.3	0.1	1.5	288.8
Apr	101.5	1.3	113.6	216.5	6.4	3.6	10.0	2.5	0.0	3.9	226.5
May	120.7	3.0	118.7	242.4	10.9	4.1	15.0	3.4	0.1	7.5	257.4
June	118.0	5.1	114.7	237.9	13.1	6.8	19.9	7.0	1.7	6.1	257.8
July	96.4	0.4	114.0	210.8	12.9	2.4	15.3	5.2	1.8	7.7	226.1
Aug	72.7	0.0	97.5	170.3	8.4	2.7	11.1	3.0	1.6	5.5	181.4
Sept	137.4	0.0	133.9	271.3	14.9	3.0	17.9	3.5	1.4	11.4	289.2
Oct	110.5	0.1	90.6	201.2	10.2	2.3	12.4	2.3	1.5	7.8	213.6
Nov	97.4	0.0	103.1	200.6	14.0	2.5	16.6	4.8	2.1	9.3	217.1
Dec	109.1	0.6	59.3	169.0	11.3	3.2	14.5	5.9	6.7	5.5	183.5
2004											
Jan	138.5	1.4	85.7	225.5	15.5	2.5	18.0	4.4	0.5	11.0	243.5
Feb	122.5	0.3	52.9	175.7	19.9	6.4	26.2	9.5	5.3	10.4	201.9
Mar											
Apr											
May											
June											
July											
Aug											
Sept											
Oct											
Nov											
Dec											
YTD '03	265.0	0.0	266.5	531.5	11.5	5.6	17.1	2.9	0.5	8.6	548.6
YTD '04	260.9	1.7	138.6	401.2	35.3	8.8	44.2	13.9	5.8	21.4	445.4
% Change	-1.5%	--	-48.0%	-24.5%	206.6%	58.7%	158.4%	381.6%	1044.2%	148.0%	-18.8%

Note: IPOs and secondaries are subsets of common stock. “True” IPOs exclude closed-end funds.
Source: Thomson Financial

MUNICIPAL BOND UNDERWRITINGS
(In $ Billions)

INTEREST RATES
(Averages)

	Compet. Rev. Bonds	Nego. Rev. Bonds	**TOTAL REVENUE BONDS**	Compet. G.O.s	Nego. G.O.s	**TOTAL G.O.s**	**TOTAL MUNICIPAL BONDS**	3-Mo. T Bills	10-Year Treasuries	SPREAD
1985	10.2	150.8	161.0	17.6	22.8	40.4	201.4	7.47	10.62	3.15
1986	10.0	92.6	102.6	23.1	22.6	45.7	148.3	5.97	7.68	1.71
1987	7.1	64.4	71.5	16.3	14.2	30.5	102.0	5.78	8.39	2.61
1988	7.6	78.1	85.7	19.2	12.7	31.9	117.6	6.67	8.85	2.18
1989	9.2	75.8	85.0	20.7	17.2	37.9	122.9	8.11	8.49	0.38
1990	7.6	78.4	86.0	22.7	17.5	40.2	126.2	7.50	8.55	1.05
1991	11.0	102.1	113.1	29.8	28.1	57.9	171.0	5.38	7.86	2.48
1992	12.5	139.0	151.6	32.5	49.0	81.5	233.1	3.43	7.01	3.58
1993	20.0	175.6	195.6	35.6	56.7	92.4	287.9	3.00	5.87	2.87
1994	15.0	89.2	104.2	34.5	23.2	57.7	161.9	4.25	7.09	2.84
1995	13.5	81.7	95.2	27.6	32.2	59.8	155.0	5.49	6.57	1.08
1996	15.6	100.1	115.7	31.3	33.2	64.5	180.2	5.01	6.44	1.43
1997	12.3	130.2	142.6	35.5	36.5	72.0	214.6	5.06	6.35	1.29
1998	21.4	165.6	187.0	43.7	49.0	92.8	279.8	4.78	5.26	0.48
1999	14.3	134.9	149.2	38.5	31.3	69.8	219.0	4.64	5.65	1.01
2000	13.6	116.2	129.7	35.0	29.3	64.3	194.0	5.82	6.03	0.21
2001	17.6	164.2	181.8	45.5	56.3	101.8	283.5	3.39	5.02	1.63
2002	19.5	210.5	230.0	52.3	73.1	125.4	355.4	1.60	4.61	3.01
2003	21.1	215.8	236.9	54.7	87.7	142.4	379.3	1.01	4.02	3.00
2003										
Jan	1.4	16.8	18.2	4.4	4.3	8.8	27.0	1.17	4.05	2.88
Feb	1.8	15.6	17.4	5.1	7.6	12.8	30.2	1.17	3.90	2.73
Mar	2.0	16.4	18.4	4.2	5.5	9.7	28.1	1.13	3.81	2.68
Apr	1.6	18.4	20.1	4.6	10.2	14.8	34.9	1.13	3.96	2.83
May	3.0	20.3	23.3	5.5	7.1	12.6	35.8	1.07	3.57	2.50
June	2.1	22.6	24.7	6.6	17.1	23.7	48.4	0.92	3.33	2.41
July	2.2	18.5	20.6	6.5	6.1	12.6	33.3	0.90	3.98	3.08
Aug	1.1	17.6	18.7	3.9	3.4	7.2	25.9	0.95	4.45	3.50
Sept	1.4	17.6	18.9	3.6	3.2	6.8	25.7	0.94	4.27	3.33
Oct	1.6	16.7	18.4	3.8	12.2	16.0	34.3	0.92	4.29	3.37
Nov	1.3	16.2	17.5	4.1	4.2	8.3	25.8	0.93	4.30	3.37
Dec	1.7	19.1	20.7	2.3	6.8	9.1	29.8	0.90	4.27	3.37
2004										
Jan	0.7	10.7	11.5	3.5	5.5	9.0	20.5	0.88	4.15	3.27
Feb	1.1	9.7	10.8	5.6	7.9	13.5	24.3	0.93	4.08	3.15
Mar										
Apr										
May										
June										
July										
Aug										
Sept										
Oct										
Nov										
Dec										
YTD '03	3.2	32.4	35.6	9.6	12.0	21.5	57.2	1.17	3.98	2.81
YTD '04	1.8	20.4	22.2	9.2	13.3	22.5	44.7	0.91	4.12	3.21
% Change	-44.9%	-37.0%	-37.7%	-4.3%	11.6%	4.6%	-21.8%	-22.6%	3.5%	14.4%

Sources: Thomson Financial; Federal Reserve

	STOCK MARKET PERFORMANCE INDICES (End of Period)				STOCK MARKET VOLUME (Daily Avg., Mils. of Shs.)			VALUE TRADED (Daily Avg., $ Bils.)	
	Dow Jones Industrial Average	S&P 500	NYSE Composite	Nasdaq Composite	NYSE	AMEX	Nasdaq	NYSE	Nasdaq
1985	1,546.67	211.28	1,285.66	324.93	109.2	8.3	82.1	3.9	0.9
1986	1,895.95	242.17	1,465.31	348.83	141.0	11.8	113.6	5.4	1.5
1987	1,938.83	247.08	1,461.61	330.47	188.9	13.9	149.8	7.4	2.0
1988	2,168.57	277.72	1,652.25	381.38	161.5	9.9	122.8	5.4	1.4
1989	2,753.20	353.40	2,062.30	454.82	165.5	12.4	133.1	6.1	1.7
1990	2,633.66	330.22	1,908.45	373.84	156.8	13.2	131.9	5.2	1.8
1991	3,168.83	417.09	2,426.04	586.34	178.9	13.3	163.3	6.0	2.7
1992	3,301.11	435.71	2,539.92	676.95	202.3	14.2	190.8	6.9	3.5
1993	3,754.09	466.45	2,739.44	776.80	264.5	18.1	263.0	9.0	5.3
1994	3,834.44	459.27	2,653.37	751.96	291.4	17.9	295.1	9.7	5.8
1995	5,117.12	615.93	3,484.15	1,052.13	346.1	20.1	401.4	12.2	9.5
1996	6,448.27	740.74	4,148.07	1,291.03	412.0	22.1	543.7	16.0	13.0
1997	7,908.25	970.43	5,405.19	1,570.35	526.9	24.4	647.8	22.8	17.7
1998	9,181.43	1,229.23	6,299.93	2,192.69	673.6	28.9	801.7	29.0	22.9
1999	11,497.12	1,469.25	6,876.10	4,069.31	808.9	32.7	1,081.8	35.5	43.7
2000	10,786.85	1,320.28	6,945.57	2,470.52	1,041.6	52.9	1,757.0	43.9	80.9
2001	10,021.50	1,148.08	6,236.39	1,950.40	1,240.0	65.8	1,900.1	42.3	44.1
2002	8,341.63	879.82	5,000.00	1,335.51	1,441.0	63.7	1,752.8	40.9	28.8
2003	10,453.92	1,111.92	6,440.30	2,003.37	1,398.4	67.1	1,685.5	38.5	28.0
2003									
Jan	8,053.81	855.70	4,868.68	1,320.91	1,474.7	62.9	1,547.6	37.5	24.7
Feb	7,891.08	841.15	4,716.07	1,337.52	1,336.4	53.6	1,311.4	32.8	20.4
Mar	7,992.13	848.18	4,730.21	1,341.17	1,439.3	64.7	1,499.9	36.3	23.0
Apr	8,480.09	916.92	5,131.56	1,464.31	1,422.7	54.7	1,478.2	37.1	23.5
May	8,850.26	963.59	5,435.37	1,595.91	1,488.6	69.6	1,847.9	39.2	27.4
June	8,985.44	974.50	5505.17	1,622.80	1,516.3	79.5	2,032.2	42.7	32.0
July	9,233.80	990.31	5,558.99	1,735.02	1,451.1	67.4	1,771.7	40.7	30.5
Aug	9,415.82	1,008.01	5,660.16	1,810.45	1,200.3	57.7	1,470.8	34.1	25.3
Sept	9,275.06	995.97	5,644.03	1,786.94	1,436.7	83.9	1,943.2	41.1	33.0
Oct	9,801.12	1,050.71	5,959.01	1,932.21	1,430.0	68.6	1,827.1	41.7	33.1
Nov	9,782.46	1,058.20	6,073.02	1,960.26	1,293.3	71.7	1,821.0	38.5	32.4
Dec	10,453.92	1,111.92	6,440.30	2,003.37	1,275.7	70.4	1,637.0	38.9	29.7
2004									
Jan	10,488.07	1,131.13	6,551.63	2,066.15	1,663.1	79.8	2,331.7	50.3	40.9
Feb	10,583.92	1,144.94	6,692.37	2,029.82	1,574.5	75.5	1,914.8	48.4	36.2
Mar									
Apr									
May									
June									
July									
Aug									
Sept									
Oct									
Nov									
Dec									
YTD '03	7,891.08	841.15	4,716.07	1,337.52	1,409.0	58.4	1,435.4	35.3	22.7
YTD '04	10,583.92	1,144.94	6,692.37	2,029.82	1,619.9	77.7	2,128.6	49.4	38.6
% Change	34.1%	36.1%	41.9%	51.8%	15.0%	33.0%	48.3%	40.1%	70.2%

MUTUAL FUND ASSETS

($ Billions)

	Equity	Hybrid	Bond	Money Market	**TOTAL ASSETS**
1985	116.9	12.0	122.6	243.8	495.4
1986	161.4	18.8	243.3	292.2	715.7
1987	180.5	24.2	248.4	316.1	769.2
1988	194.7	21.1	255.7	338.0	809.4
1989	248.8	31.8	271.9	428.1	980.7
1990	239.5	36.1	291.3	498.3	1,065.2
1991	404.7	52.2	393.8	542.5	1,393.2
1992	514.1	78.0	504.2	546.2	1,642.5
1993	740.7	144.5	619.5	565.3	2,070.0
1994	852.8	164.5	527.1	611.0	2,155.4
1995	1,249.1	210.5	598.9	753.0	2,811.5
1996	1,726.1	252.9	645.4	901.8	3,526.3
1997	2,368.0	317.1	724.2	1,058.9	4,468.2
1998	2,978.2	364.7	830.6	1,351.7	5,525.2
1999	4,041.9	383.2	808.1	1,613.1	6,846.3
2000	3,962.0	346.3	811.1	1,845.2	6,964.7
2001	3,418.2	346.3	925.1	2,285.3	6,975.0
2002	2,667.0	327.4	1,124.9	2,272.0	6,391.3
2003	3,684.8	436.7	1,240.9	2,051.7	7,414.1
2003					
Jan	2,597.7	324.7	1,138.2	2,273.6	6,334.2
Feb	2,537.8	322.9	1,171.1	2,236.2	6,268.0
Mar	2,551.3	325.3	1,183.3	2,204.7	6,264.6
Apr	2,770.3	346.8	1,210.5	2,157.7	6,485.3
May	2,958.5	365.8	1,238.7	2,140.6	6,703.6
June	3,031.1	373.6	1,248.4	2,164.4	6,817.5
July	3,126.0	376.4	1,212.1	2,152.5	6,867.0
Aug	3,238.5	382.3	1,209.4	2,141.0	6,971.2
Sept	3,228.5	388.2	1,231.3	2,100.0	6,948.0
Oct	3,440.4	405.9	1,226.6	2,080.1	7,153.0
Nov	3,513.3	416.4	1,232.7	2,071.7	7,234.1
Dec	3,684.8	436.7	1,240.9	2,051.7	7,414.1
2004					
Jan	3,804.7	447.7	1,250.7	2,033.4	7,536.5
Feb					
Mar					
Apr					
May					
June					
July					
Aug					
Sept					
Oct					
Nov					
Dec					
YTD '03	2,597.7	324.7	1,138.2	2,273.6	6,334.2
YTD '04	3,804.7	447.7	1,250.7	2,033.4	7,536.5
% Change	46.5%	37.9%	9.9%	-10.6%	19.0%

MUTUAL FUND NET NEW CASH FLOW*

($ Billions)

	Equity	Hybrid	Bond	Money Market	**TOTAL**	Total Long-Term Funds
1985	8.5	1.9	63.2	-5.4	68.2	73.6
1986	21.7	5.6	102.6	33.9	163.8	129.9
1987	19.0	4.0	6.8	10.2	40.0	29.8
1988	-16.1	-2.5	-4.5	0.1	-23.0	-23.1
1989	5.8	4.2	-1.2	64.1	72.8	8.8
1990	12.8	2.2	6.2	23.2	44.4	21.2
1991	39.4	8.0	58.9	5.5	111.8	106.3
1992	78.9	21.8	71.0	-16.3	155.4	171.7
1993	129.4	39.4	73.3	-14.1	228.0	242.1
1994	118.9	20.9	-64.6	8.8	84.1	75.2
1995	127.6	5.3	-10.5	89.4	211.8	122.4
1996	216.9	12.3	2.8	89.4	321.3	232.0
1997	227.1	16.5	28.4	102.1	374.1	272.0
1998	157.0	10.2	74.6	235.3	477.1	241.8
1999	187.7	-12.4	-5.5	193.6	363.4	169.8
2000	309.4	-30.7	-49.8	159.6	388.6	228.9
2001	31.9	9.5	87.7	375.6	504.8	129.2
2002	-27.7	8.3	140.7	-46.6	74.7	121.3
2003	151.4	33.3	31.3	-258.5	-42.5	216.1
2003						
Jan	-0.4	1.1	13.0	-1.2	12.5	13.7
Feb	-11.1	0.1	19.7	-39.6	-30.9	8.7
Mar	-0.3	0.9	10.6	-32.3	-21.0	11.3
Apr	16.1	2.7	10.5	-53.8	-24.4	29.4
May	11.9	3.1	8.9	-17.8	6.1	23.9
June	18.6	4.0	5.1	22.1	49.9	27.7
July	21.4	3.5	-10.8	-12.9	1.2	14.1
Aug	23.4	3.3	-12.6	-20.3	-6.1	14.2
Sept	17.3	3.7	-5.9	-50.5	-35.3	15.1
Oct	25.3	4.1	-1.3	-22.1	6.0	28.1
Nov	14.9	3.0	-2.6	-7.6	7.8	15.3
Dec	14.2	3.6	-3.3	-22.6	-8.1	14.6
2004						
Jan	43.8	5.5	0.5	-19.8	30.0	49.8
Feb						
Mar						
Apr						
May						
June						
July						
Aug						
Sept						
Oct						
Nov						
Dec						
YTD '03	-0.3	1.1	12.9	-1.1	12.6	13.7
YTD '04	43.8	5.5	0.5	-19.8	30.0	49.8
% Change	NM	405.2%	-96.2%	NM	137.9%	262.9%

* New sales (excluding reinvested dividends) minus redemptions, combined with net exchanges
Source: Investment Company Institute

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