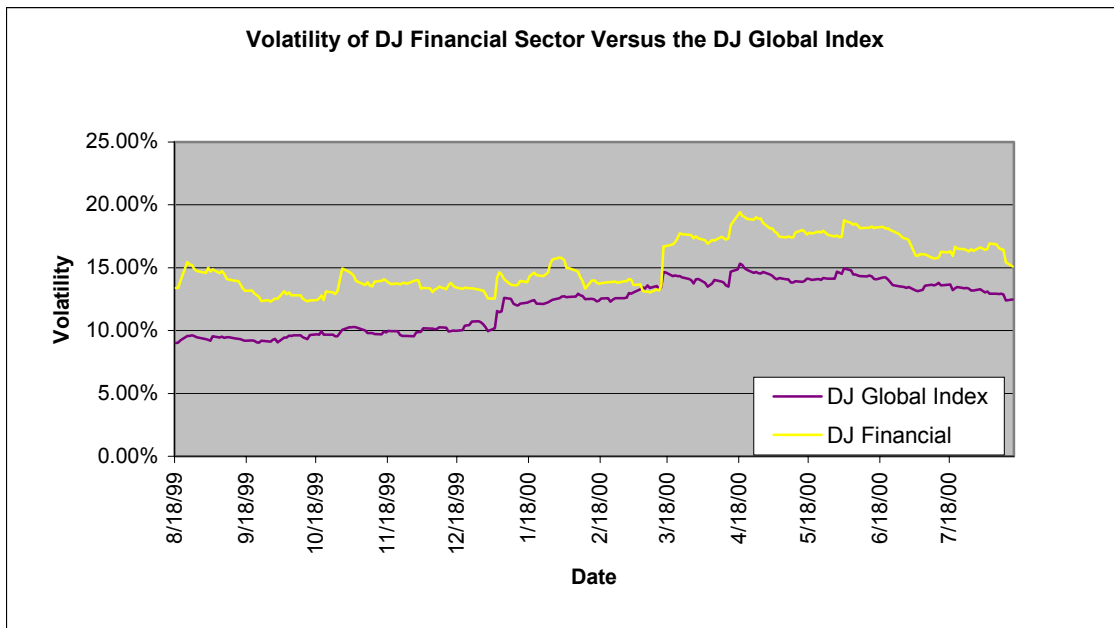
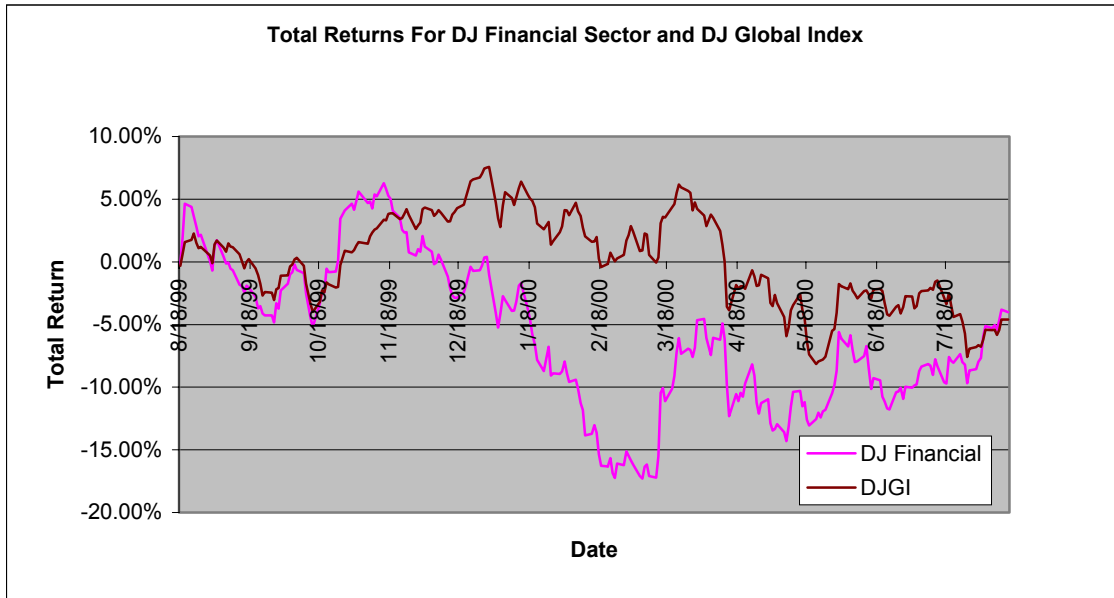
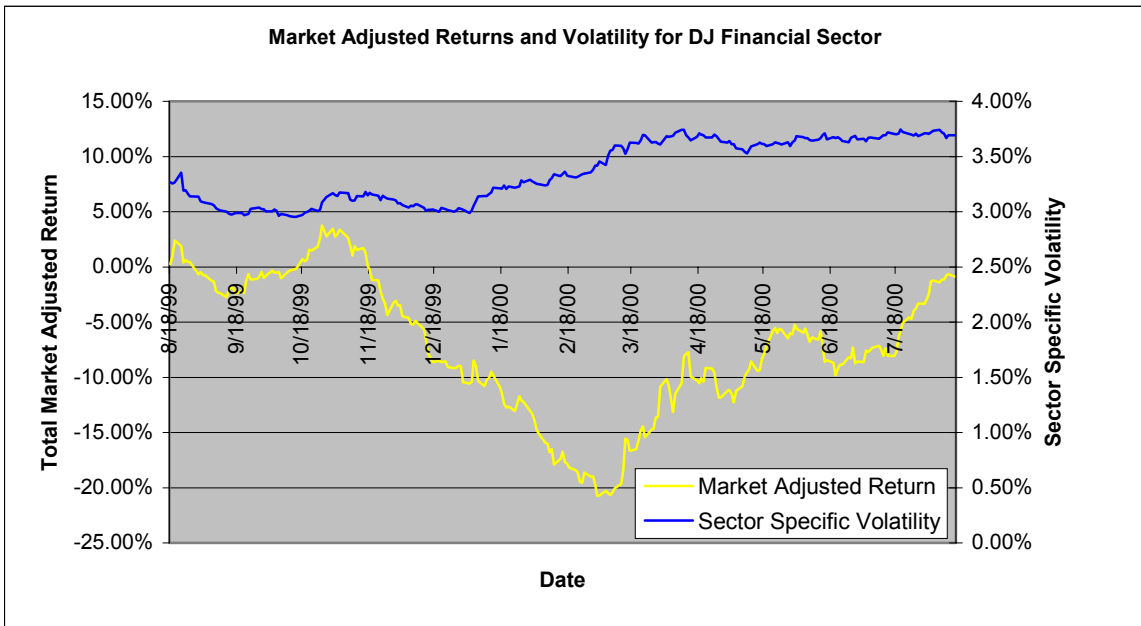


Using the Sector Analysis: An Example

Sector returns are affected by factors such as future prospects for profitability within a sector, but they are also influenced by the market as a whole. These charts are designed to help you form a clearer picture of sector trends. As an illustration, consider the recent history of cumulative returns and estimated volatility for the Dow Jones Financial and Global Indexes:

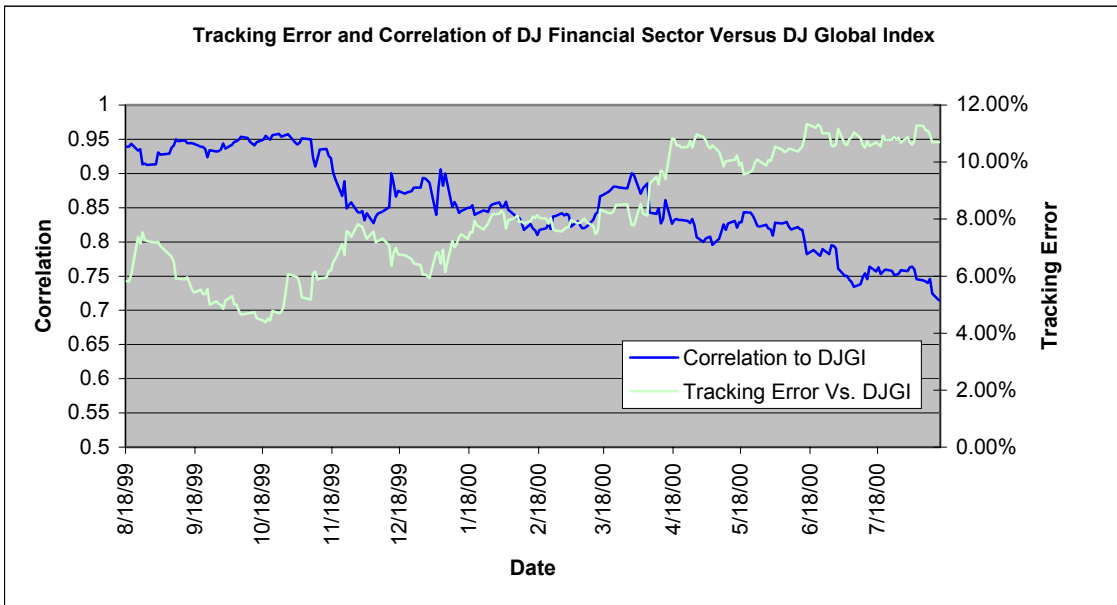


The financial sector substantially under-performed the Index from mid-November 1999 through March 2000, while volatility remained reasonably stable until March 2000. At that time, volatility “ticked up,” reflecting then-current events. To help focus in on the determinants of Financial Sector performance, the volatility movements specific to the Financial Sector are broken out and plotted in the following graph, together with the difference between the Sector return and the Index return:



It can be seen that the downward movement in the Financial Sector starting in November was largely sector-specific, reflecting concerns about profitability in a rising interest rate environment, possibly accompanied by increasing default risk. The concern about financial sector profitability persisted, and the volatility of the Financial Sector more than doubled by April 2000.

The increase in volatility that is specific to the Financial Sector manifests itself as an increase in tracking error --- almost a doubling --- for the Financial Sector relative to the Global Index, and of course for the tracking error of portfolios tilted toward Financials. The increase in Financial Sector-specific volatility and the increase in tracking error volatility also result in a decrease in predicted short-term correlation between the Financial Sector and the Index, as confirmed in the following graph:



The immediate-term correlation between the Financial Sector and the Global Index decreased, but if you were rotating out of Financials in April 2000, you would like to know whether that decreased correlation with the Index was concentrated in a few other sectors. The chart below summarized the then-predicted relationship between Financials and other Sectors at any point in time. If you are worried about the Financial Sector prospects, which the market seems to interpret as having little to do with the Index as a whole, you should avoid rotating into Basic Materials and Consumer Cyclical.

