



NEPC, LLC

RICHARD M. CHARLTON
CHAIRMAN AND CEO

February 9, 2009

RE: Chairman's Annual Update

Dear Client,

Calendar year 2008 was a sobering experience for market participants, unlike any year since the beginning of my investment career in 1972. In an environment like this, with considerable uncertainty still in the cards, I want to assure you of the financial strength and viability of NEPC. We are supporting your investment programs with the strongest consultant and research complement in our 23-year history. Our staff has grown to 151 professionals, 41 of whom are very highly credentialed consultants to your programs, supported by 33 research specialists and 65 analysts preparing your performance analytics and special reports. They have never worked harder than in the months of September, October and November, when NEPC responded in every way possible to address the needs of your investment programs as markets fell and liquidity evaporated.

In response to the sharp selloff in the financial markets, we hosted client conference calls on October 3rd and January 23rd so that our President, CIO, our Director of Consulting Services, the Head of our Alternatives Assets Group and I could talk with you directly.

On another front, all are aware of the negative impact of the material market losses on the funded status of most pension plans throughout the country, and the need for fair and balanced short term funding relief in the difficult economic environment that we are facing. As we've apprised you, we are providing input to New Jersey Representative Robert Andrews, Chairman, Subcommittee on Health, Employment, Labor, and Pensions (HELP) on this important topic so that Congress and the Administration may fully appreciate the financial stresses in our clients' pension programs, and the need for federal action.

I update our views on the economy, our client recommendations, and the state of our business in the balance of this letter. I thank you for your continued partnership with NEPC, and for making us the industry's Consultant of Choice. We are at your side.

The Economy and Investment Markets: In NEPC's 2007 Annual Client Update, written exactly one year ago, I wrote, *"From Tulips to Tech, all bubbles correct, and the US housing market has proved to be no exception. Volatility and risk returned to the equity markets with a vengeance during the second-half of 2007, after an extended period of remarkable stability where easy money, lax lending practices and political expediency relegated risk to the sidelines and fueled unsustainable demand for residential real estate. The multi-year run-up in housing prices peaked during the year, triggering a far-reaching crisis in the sub-prime mortgage markets as speculators and poorly qualified buyers were no longer able to flip and/or refinance their mortgages. In the aftermath, lenders have materially tightened credit standards, housing prices are correcting significantly, and foreclosures have skyrocketed'...'* Financial Service firms including Merrill Lynch, Citigroup, Morgan Stanley, Bank of America, Bear Sterns and UBS have secured offshore financing to shore up their weakened balance sheets; the Fed has pumped money into the system and sharply lowered

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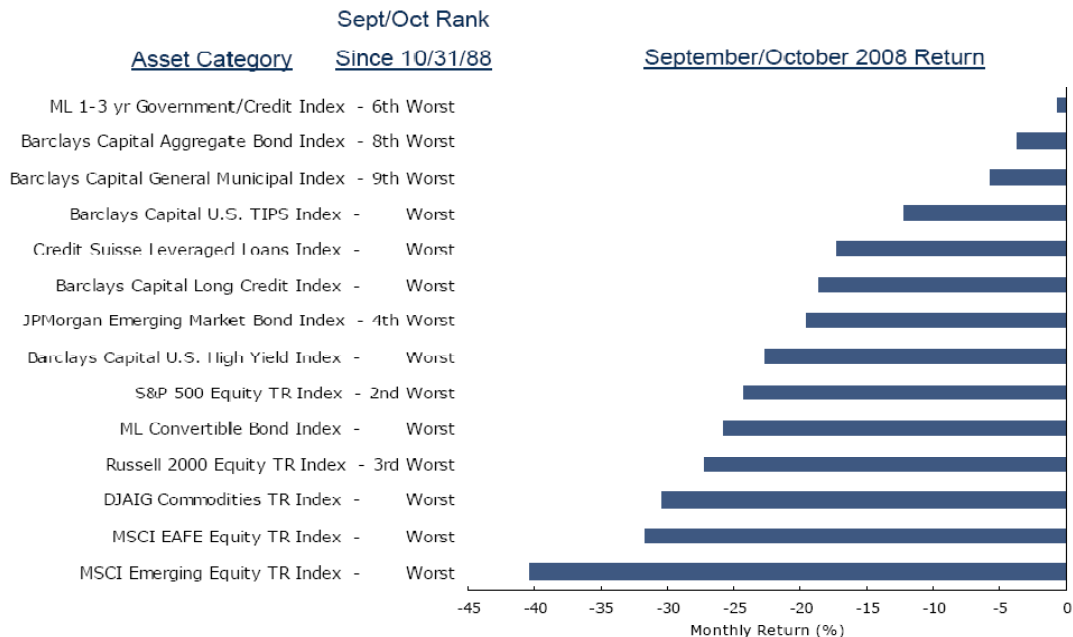


short-term rates’...’Many, however, view these stimulus efforts as too little and too late. Indeed, recession is increasingly likely if the contagion from the mortgage crisis extends through the economy’...’These powerful headwinds have the potential to curtail growth in the months ahead and have focused all eyes on consumer spending, which accounts for 70% of GDP. If consumer spending declines, these headwinds will bring the storm clouds to our markets and economy, and we will be in for a rough patch.”

Unfortunately, the storm clouds developed with a fury that few could have foreseen, as the ensuing “rough patch” was presaged by the virtual shut down of the global credit markets, triggered by the bursting real estate bubble and massive investment bank deleveraging, the collapse of the mortgage market and its repackaged CDO and CLO derivative investments. The crowning blow, in the opinion of many, was the bankruptcy of Lehman Brothers. As the credit markets ceased to function and job losses mounted, global economies began to deflate at a rapid pace. Here in the US, fourth quarter GDP declined at a -3.8% annual rate (understated, since production of unsold inventory artificially masked some of the decline), unemployment reached 10% in some states and could reasonably climb to that level nationwide, and consumers began to cut back their spending, either because they have already lost their jobs or fear that they may. All of which has led to more defaults and foreclosures and a continuation of the downward economic and market spirals as this letter is being written.

Calendar year 2008 will be known for many things as historians do their postmortems, perhaps most infamously as the year in which fundamentals were cast to the sidelines and diversification did not work. Virtually every risk-bearing asset class lost ground, some by historically wide amounts. Benchmark losses were exacerbated in many asset classes by active management, which recorded one of its poorest years ever, particularly in the fixed income, hedge fund and selected equity sectors. Sell offs peaked at almost unbelievable levels in the fourth quarter, as depicted in the exhibit below, courtesy of PIMCO. There was literally no place to hide.

All Assets Were Hurt in Global Deleveraging of September/October 2008





In the face of this extraordinary decline in consumer confidence and world-wide economic activity, the major global governments have begun an unprecedented program of coordinated fiscal stimulus, designed to resupply liquidity, revive investor confidence and stabilize the free enterprise economic system. Treasury and the Federal Reserve have provided credit backing to Fannie, Freddie and AIG among others, backstopped the commercial paper markets and successfully promoted the enactment of the \$700 billion TARP. Some 50% of the TARP assets have been distributed to date, most to troubled banks in an effort to provide liquidity and stimulate loans, but banks have actually tightened lending standards in the interim and reduced outstanding loan levels. Congress is preparing (and Obama is likely to sign) an additional \$800 billion stimulus package and the President likely will target the balance of the TARP program to buy or guarantee troubled assets directly.

The question posed in our letter of one-year ago remains, however; is this too little, too late? NEPC believes that 2009 domestic GDP will likely be negative before turning positive in 2010, that the return to "normal" markets will take several years, and that there remains a small, but credible risk of a deflationary spiral, not unlike Japan in the 1990's or the world in the 1930's. Moreover, should the economy respond to the very significant rescue programs, as is more likely, we believe that the relatively short deflationary period will be followed by several years of increasing inflation. Indeed, turning off the government funds spigot will be a major challenge for our society, yet our failure to do so carries the risk of creating yet a third bubble.

Client Recommendations: With the correction of the tech bubble several years ago, NEPC began to focus on ways to both stabilize and improve client returns through fundamental changes in our asset allocation recommendations. These efforts are focused on the reduction of the significant influence of equity risk within the investment programs that we advise, accomplished by reducing equity commitments and adding non-correlated return streams into each client's portfolio through the use of alternatives, risk parity, global asset allocation and other strategies. Those recommendations, together with our recommendations on asset/liability matching (LDI) remain timely, and have nicely improved client performance where implemented. Indeed, NEPC's clients have now collectively outperformed national averages for seven consecutive years and for 20 of the 23 years that we have been in existence, despite notable underperformance of the portable alpha and credit exposures within our client base. Notwithstanding that underperformance, we believe that the severe capital market price dislocations now present in the marketplace represent opportunity for both strategies going forward.

Additionally, we continue to recommend relaxing investment constraints; incorporating distressed credit and mezzanine strategies, which have historically high return potential at this time; adding scenario forecasting to model unlikely economic environments and enabling your portfolio to be tilted to better protect capital in adverse conditions; rebalancing toward targets while being mindful of potentially high transaction costs incurred by the very significant price reductions in many fixed income portfolios; dollar cost averaging; and allocating interest rate and/or inflation sensitive securities to better match liabilities or spending costs.

The sub-prime crisis will likely impact markets for years to come, and we believe that the industry will accelerate its move to the diversification and investment concepts which we are recommending. NEPC is pleased to remain at the forefront advocating these diversification principles to our clients.



Our Client Ratings: During 2007, you ranked NEPC number two among the 10-largest consulting firms in the country in the most respected independent national survey of overall consultant client satisfaction. Over the five-year cumulative period through 2007, we remain the top ranked firm among the 10-largest providers of investment advice, and we thank you for your support and confidence as we continue to improve our infrastructure, research and consultant resources.

NEPC's Growth: NEPC enjoyed double digit growth in client revenues during 2008 for the 23rd consecutive year, enabling us to continue our mission of adding quality personnel and resources to our service commitment. As we reported to you last year, all five of our offices and each of our consulting practice groups also grew at double digit rates. We continue to be selective in pursuing our new business opportunities and declined over 120 RFPs during the year, the highest in our history.

Alternative Assets: Our commitment to alternatives, LDI and the diversification concepts outlined above continue to set NEPC apart in the marketplace and materially benefit our clients. At year-end, we were working with almost \$44 billion in committed/placed alternatives across 184 separate relationships. Included in this total were \$11 billion in private equity, \$22 billion in hedge funds and funds of hedge funds, and \$11 billion in real assets and real estate.

Defined Contribution: Our Defined Contribution team continues to distinguish itself in the industry and ended 2008 with 16 professionals serving 107 DC clients with collective assets of \$68 billion. It published research papers during the year on topics including the Supreme Court's finding in the LaRue case, mapping regulations and the problems within stable value products. Ross Bremen, CFA, Partner and Robert Fishman, CFA, Partner also co-published with PIMCO in the PIMCO DC Dialogue titled, "Smooth Ride Ahead", which addressed the evolving investment structure of defined contribution plans.

When we start thinking about the policy implications of this financial crisis, our thoughts turn to plan participants and plan design. The significant losses experienced by participants have some calling 401(k) plans a failure and demanding a system change. We acknowledge the call for change, but do not believe it is necessary. The vast majority of participants did not stop contributing to their retirement plans, and did not change the way they are invested. This is good news as long as they are saving enough and investing on a diversified basis. It is bad news if they are not. The S&P 500 has lost almost 4% per year over this decade while Target Date Funds have earned positive returns. This is the time to be diversified and to be investing.

Personnel and Organizational Changes: NEPC's commitment to research was punctuated with the addition of Erik Knutzen, CFA, as our first Chief Investment Officer. A graduate of Williams College and the Harvard Business School, Erik brings over twenty-two years of investment consulting and financial industry experience to NEPC. He joined us from RiverSource Investments, LLC in April of 2008 after stints at Standish, Putnam and Slocum Associates.

At year-end, Erik and Craig Svendsen, CFA, were elected into our partnership. Craig worked at NEPC for several years before joining State Street Global Markets as their Vice President and Head of Transition Strategy and Analysis. He returned to NEPC in 2004 as a senior consultant working out of our Detroit office, where he supports a number of Public, Corporate and Taft-Hartley relationships. Craig earned his undergraduate degree from Bucknell University and his MS degree in Finance from Northeastern University.



We also added two additional research consultants: Claire Woolston, who joined us from the Williams College Endowment staff bringing seven years of investment experience to our firm, is focusing on real estate and real assets. She is joined by Frank Barbarino, CAIA, who brings considerable hedge fund experience and eleven years of experience with Riverview Advisors, Fix Asset Management and Morgan Stanley to our hedge fund research group. Internally, Kristin Reynolds, Bryan Schneider and John Shanklin were promoted to senior consultant positions; Jeff Markarian and Lynda Dennen were promoted to research consultants; and, Ashwini Apte, Kristen Colvin, Mike Sullivan and Mike Valchine were promoted to consultants.

Rounding out the recognition accorded our professional staff, Jaeson Dubrovay was named Hedge Fund Consultant of the Year and Allan Martin Consultant of the Year by Money Management Letter and John Minahan, PhD, CFA, was elected President of the Boston Security Analysts Society.

These professionals are among our best and brightest and we are very pleased to recognize their contributions to our research and support functions along with the key roles which they are playing in supporting your investment programs.

NEPC's Client Conference: Our annual client conference will be held **May 20-21**, once again at the Westin Boston Waterfront. Our keynote speakers will include Paul McCulley, Managing Director, Portfolio Manager of PIMCO and Wilbur Ross, perhaps the best-known turnaround financier in the United States. We'll expand on the topics in a later letter, and you'll have an opportunity to interact with NEPC consultants, researchers, and other clients and outside speakers. **Please save the date!**

In closing, I would be remiss if I did not thank you for your confidence in NEPC during these incredibly difficult times. The economic uncertainty and challenged market environment that we are facing make your choice of a consultant all the more important, and we are pleased to be partnering with you. I am incredibly proud of the talent and resources that we have assembled to meet your needs, and I fervently believe that no other firm in our industry is as committed, prepared and well qualified to meet the challenges of tomorrow with you as NEPC.

Thank you,

A handwritten signature in black ink, appearing to read 'Allison', is written below the text.