CHARTING A COURSE THROUGH THE STORM

Erik Knutzen, CFA
Chief Investment Officer

The Market Environment

This is a turbulent time in the capital markets. We've just completed the second worst June in the history of the S&P 500 (-8.4%) trailing only June 1930 (-16.3%). The U.S. stock market completed the worst first half of the year since 1970. For the twelve months ending June 30, the S&P has declined 13.1%. Many sponsors with fiscal years ending June 30th face negative total returns for the period. And the news hasn't gotten better at the start of the 3rd quarter: further stock market declines have now pushed the US stock market officially into "bear territory" as major benchmarks have fallen more than 20% from their October peaks.

Index Returns as of 6/30/2008 (Preliminary):

		Last Month	Last Qtr	YTD	Last Year	Last 3 Years	Last 5 Years
Domestic Stocks:	S&P 500	-8.4%	-2.7%	-11.9%	-13.1%	4.4%	7.6%
	S&P Mid Cap 400	-7.0%	5.4%	-3.9%	-7.3%	7.5%	12.6%
	Russell 2000	-7.7%	0.6%	-9.4%	-16.2%	3.8%	10.3%
Domestic Bonds:	Lehman Aggregate	-0.1%	-1.0%	1.1%	7.1%	4.1%	3.9%
	High Yield Bonds	-2.8%	1.8%	-1.3%	-2.3%	4.6%	6.9%
	90-Day T-Bills	0.2%	0.3%	1.2%	3.6%	4.3%	3.2%
Non-US Stocks:	MSCI EAFE	-8.2%	-1.9%	-10.6%	-10.2%	13.3%	17.2%
	MSCI Emerg Mkts	-10.0%	-0.8%	-11.7%	4.8%	27.4%	30.1%
Global Bonds:	Citi World Gov't	0.5%	-4.2%	5.0%	17.0%	6.2%	6.4%

The wrenching dislocation in markets that began a year ago with sub-prime debt has spread broadly across markets, causing blow-ups among financial companies, massive de-leveraging and drying up of global liquidity, and declining U.S. home prices. Many asset classes and investment strategies that behave independently in normal times have become more correlated, causing underperformance among a wide variety of strategies and losses even among supposedly conservative portfolios such as high-quality bonds and market-neutral hedge funds.

At the same time, rapid growth in developing market countries, led by China and India has created a surge in demand for energy, metals, and food products amid continued supply constraints in global natural resources. The resulting supply/demand imbalance has caused dramatic price increases in commodities (DJ AIG Commodities Index +27.2% YTD and +41.56% over the last 12 months) and translated into inflationary pressures in the U.S. and other developed economies. In the U.S. the impact of rising commodities prices has been exacerbated by the decline in value of the dollar relative to our trading partners.

THE EBB AND FLOW OF GOOD AND BAD NEWS ALMOST GUARANTEES THAT HEIGHTENED MARKET VOLATILITY WILL CONTINUE.

Monetary and fiscal authorities have sought to apply remedies including innovative liquidity techniques from the Fed as well as rebate checks to individual consumers from the government, but rising prices and deficits are limiting the opportunity for future stimulus.

There are some reasons for cautious optimism. For example, there is as much as $3 trillion in money market accounts as well as robust balances in private equity and sovereign wealth funds sitting on the sidelines of the capital markets, the global economy is still showing signs of modest growth (even the U.S has not technically entered a recession yet), and the recent declines in asset prices have improved valuations in some markets. Nevertheless, the ebb and flow of good and bad news almost guarantees that heightened volatility in the markets will continue for some time.

MARKET VOLATILITY HAS CREATED OPPORTUNITIES IN THE BROAD CREDIT MARKETS.

Where Do We Go From Here?

We start by focusing with our clients on their long-term investment time-horizon – their greatest asset, especially in challenging times – and their resultant ability to withstand short-term volatility. A long-term investment time horizon can be an advantage in markets being driven by the behavior of short-term players, allowing investors to show leadership and seek out undervalued asset classes.

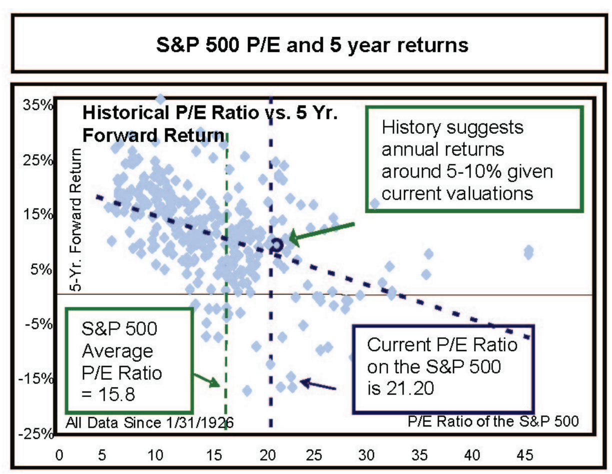
The recent sharp losses in the equity-market, however, should serve as a reminder of the dangers of one asset class dominating the risk profile of an entire investment program. If total equity exposure is greater than 50% of a program's asset allocation, then stock market volatility likely represents as much as 90% of the total portfolio risk. For some time we have recommended the reduction of equity exposure toward the level of "risk parity" such that equity risk is approximately equal with the other major market exposures in a fund's overall asset allocation.

We recommend that clients continue diversification into alternative assets and risk-mitigation strategies such as Liability-Driven Investment (LDI) for corporate pension plans. Over time, our clients who have committed significant assets (10+%) to Alternative Assets programs, including Hedge Funds, Private Equity, Real Estate, Real Assets and Global Asset Allocation strategies have experienced significantly better results, both on an absolute and risk-adjusted basis. We also expect that these clients will have weathered the most recent market experience more effectively than investment programs with more traditional allocations. We recommend that our clients continue on this path.

But volatility can also create opportunity. At this juncture, we recommend that clients consider:

1. Credit strategies as highlighted in our client letter sent in May entitled "When Opportunity Knocks";
2. Looking to the managers in their program who have the flexibility to take advantage of inter-market volatility to generate excess returns such as Global Asset Allocation managers and Global Macro managers; and,
3. Loosening the constraints on existing mangers and/or allocating to managers with broad absolute return-seeking mandates to take advantage of opportunities that present themselves and get out of the "style-box" mode of thinking.

From a valuation perspective, although US stocks may appear to be "on sale" with prices down dramatically over the last year, valuations have not yet moved to extremes. Wall Street analysts have been reducing 12-month forecast earnings as severely as stock prices have been declining, and there are continued concerns about the Financial and Consumer sectors and the effect of additional asset write-downs and reduced consumer spending on earnings in these large components of the economy.



Source: Standard & Poors

At best, the US equity market can be characterized as very modestly under-valued, but not at the kind of significant levels of mis-valuation that would cause us to suggest clients make an opportunistic allocation.

In contrast, the severe dislocations in the credit markets continue to represent significant opportunities. Bank loans, areas of distressed debt and structured credit, and segments of mezzanine financing present compelling risk/return characteristics. We have been working with clients to build exposure to these areas of the markets and we view the spectrum of Credit Opportunities to be more attractive at this juncture than a greater long-only bet on US stocks.

WHILE THE LAST 12 MONTHS HAVE BEEN PAINFUL, INVESTORS SHOULD FOCUS ON THEIR LONG-TERM HORIZON.

Finally, we believe that the environment for active management strategies will be better going forward. The nine months from July 2007 to March of 2008 represented the "perfect storm" for many active managers, particularly those pursuing quantitative strategies, as valuation relationships were turned on their heads by a flight to quality, rising correlations across markets, and the forced sale of liquid positions by hedge funds meeting margin calls. These trends appear to have normalized somewhat in the last three months as early results indicate hedge fund and other absolute return-oriented strategies have held their ground even as markets tumbled. In an environment of increased volatility, the opportunities for active strategies to add value should increase, even as downward pressure on markets continues.

Conclusion

The market results of the last twelve months have been painful for many investors, and significant uncertainty around future market direction remains. We would like to take this opportunity, though, to work with our clients to:

1. Continue moving toward "risk parity" through reductions in overall portfolio equity commitment;
2. Increase the diversification of their overall programs through allocations to alternative investments and risk-mitigation strategies;
3. Consider an allocation to credit strategies as part of an Opportunistic component of their Strategic Asset Allocation policy
4. Continue to seek excess returns from active strategies including portable alpha and global asset allocation strategies, and loosening the restraints on managers, where appropriate, to allow them to take advantage of opportunities for excess return wherever they may occur; and,
5. Maintain their focus on their long-term investment objectives without focusing over-much on short-term volatility.

Please call us if you would like to speak further about any of the issues highlighted above. We look forward to discussing these developments at our next meeting with you.

ONE MAIN STREET, CAMBRIDGE, MA 02142 | TEL: 617.374.1300 | FAX: 617.374.1313 | www.nepc.com
CAMBRIDGE | ATLANTA | CHARLOTTE | DETROIT | LAS VEGAS | SAN FRANCISCO