SECURITIES LENDING PROGRAM OUTLOOK

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Background

Many clients participate either directly in Securities Lending programs administered by their custodian bank or third party lender, or indirectly through investments in various commingled and mutual fund vehicles. In recent weeks the investments in the Cash Collateral pools used to secure assets on loan have experienced significant pricing pressures, and, in some cases, impairment. While we cannot predict the future impairment of additional issuers, NEPC believes the practice of Securities Lending has a long-term place within a functioning securities market and is a viable activity for institutional investors when viewed within the same risk and return framework which governs all investment decisions. NEPC has reached out to the major lenders and cash managers to assess the long term implications of this event and we continue to monitor our clients' ongoing securities lending exposures.

Securities Lending Overview

Securities Lending is a widely practiced market activity in which a client authorizes a lending agent (usually the custodian bank) to take the individual equities and bonds which reside in the client's separately managed accounts and lend them to the open market. Through the lending process, clients can earn incremental returns on their assets while still maintaining the benefits of actually holding the securities (i.e. income and dividends).

In return for the loan of securities, the lending agent accepts from the borrower collateral in excess of the market value of securities loaned (usually 102% for domestic securities and 105% for non-US securities), which typically comes in the form of cash. The Cash Collateral Pool assets are rebalanced daily so that assets in the pool always represent 102-105% of the securities on loan, where borrowers must contribute additional cash when the ratio falls below 102-105%. Borrowers are primarily Broker/Dealers, Market Makers and Prime Brokers/Hedge Funds. When the loaned security is returned by the borrower, the lending agent returns the cash collateral plus an

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amount for the temporary use of the borrower's funds called the rebate rate. In the interim, the cash collateral is invested in a Cash Collateral Pool which is typically managed like a Money Market fund with a $1.00 Net Asset Value (NAV). However, these pools are often unregistered, and as such, are not restricted by the same maturity and credit guidelines, or requirements to maintain the $1.00 NAV.

Many of these funds will invest in a combination of short term and medium term instruments such as Repurchase Agreements, Commercial Paper, Certificates of Deposit, Bank Notes, Asset Backed Securities and Corporate Debt. The investments are structured to allow for sufficient liquidity for participant and borrower activity in the securities lending program. The return targets vary by pool with some lenders offering a variety of choices from very conservative, high-quality, short-term pools to more aggressive approaches using slightly longer maturity structures and taking on additional credit risks. The quality of the pools is generally quite high, and credit risk is typically in the most senior part of capital structures. With rebate rates being paid to brokers at some spread to the Federal Funds Effective Rate, the cash collateral pools need to make a return in excess of that hurdle. The difference is called the spread and this represents earnings which can be split between client and lending agent.

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While this description represents a client-level program, many commingled and mutual fund sponsors will engage a lending agent to provide incremental income on the assets within their fund structures. In this case, the process is the same, but the client is the commingled/mutual fund itself. Investors who have this type of indirect exposure to securities lending may or may not be impacted by the current situation depending on the credit quality of the cash collateral pool.

Credit Market Dislocation

Over the last year there have been a number of events that have caused repeated tightening of credit in the short-term cash markets, beginning last fall with the troubles in the Structured Investment Vehicle (SIV) market. The turmoil in short term credit markets culminated in the last 5 weeks starting in earnest with the bankruptcy of Lehman Brothers on September 15th. The ensuing failures of AIG and Washington Mutual added to the general concerns in the market regarding counterparty solvency. Banks in general became more and more hesitant to lend to each other and also to other companies. In the US, the Treasury, Federal Reserve and Congress have all participated in a number of actions designed to promote some confidence in the market. The US-driven efforts, while important to the long-term viability of the financial system, have struggled to free up global credit markets in the very near term.

Credit Impact on Securities Lending

The impact of the freeze in short term markets has resulted in a lack of appetite to take on any credit risk. The demand for Treasury bills has been quite high, and at one point in September the 3-month bill actually offered a negative yield. The low demand for anything except Treasury securities has had a negative impact on pricing in longer term instruments maturing out 3 months to over 3 years. While many cash collateral pools have very short duration and low credit risk, there are certain higher credit risk pools that have experienced a decline in NAV driving the market price below $1.00. Institutions have handled this decrease in value in different ways depending on the situation.

While some agents opted to write the value of the assets up to $1.00 and impose client payables, others elected to trade the pools at $1.00 even though the market value was not $1.00. Each method is appropriate, with credit analysis being the key to the long term viability of the programs; should the liquidity event come to a close, the strong credits will appreciate back to par. In any event, transactions in the pools continue to happen on a $1.00 basis in order to continue the day to day operations of the lending programs.

Lending agents have been very careful to treat all their clients fairly during this market dislocation. All the firms contacted indicated their liquidity is sufficient to conduct business as usual. Each has been increasing the overall liquidity of their collateral pools since late 2007 as credit concerns became more apparent. Should a large redemption occur, each lender has articulated several alternative approaches for providing liquidity to clients in a smooth and equitable manner. At this point, there have been some high visibility news items indicating certain large players are leaving the securities lending business, but this is clearly the minority of the multi-trillion dollar securities lending market.

Future of Securities Lending

There are three key issues when evaluating the future of the securities lending industry. First, the supply and demand characteristics; second, the reinvestment opportunities; and third, the risk management process of the cash collateral pools.

Demand for securities lending could be impacted by a protracted decrease in risk appetite from hedge funds and proprietary trading desks. The de-leveraging which has occurred since mid-2007 has reduced some of the near term demand for short selling and borrowed securities. Also, the supposition that the hedge fund market may contract could also reduce demand. The counter arguments to these points are the potential long term changes to SEC regulations regarding "naked" short sales. Temporary rule changes have been enacted which promote the borrowing of securities and dissuade failed trades beyond 3 days. These measures, if made permanent, could help offset any drop in demand. On the supply side, the shrinking number of lenders in the marketplace should be beneficial as securities become scarcer to borrowers.

IN THE LONG TERM WE THINK THE MARKET WILL NORMALIZE FOR THE COLLATERAL REINVESTMENT OPTIONS.

The spread available to lenders is currently quite strong. Historically, the spread between Fed Effective and reinvestment rates runs around 15-18 basis points, but with Fed Effective rates around 2.5% and reinvestment rates around 3.0% to 3.5%, the spread was 50-60 basis points in mid-October. While some of this represents perceived/actual additional credit risk in the markets, there has been some near term increase in demand which has helped lenders on the rebate side.

In terms of the risk management process, cash collateral managers have had various degrees of success in avoiding the pitfalls of poor credit selection in 2008. Some have had exposure to a number of impaired securities from SIVs to Lehman, while others have steered clear of trouble to date. The spot-light is now on what was thought of as a low-risk investment. The credit selection process and capabilities of collateral pool managers are matters of due diligence that cannot be underestimated.

In the long term we think the market will normalize for the collateral reinvestment options and the supply/demand characteristics of securities lending will come into balance with marginally fewer players on both the borrower and lender side. As clients focus more on this historically underappreciated section of their portfolio, seasoned, independent, process-oriented credit evaluation will be the norm.

Conclusion

For clients who are comfortable with the risk implications, securities lending can offer a return which is commensurate with the risk level taken. There are lenders who will offer varying levels of credit risk with differing earnings levels. For other clients, the mere potential for any loss through a lending program may lead them to a decision to withdraw from the program. While each client will be different in their risk and return preferences going forward, during this period of low liquidity, it is prudent to be cautious and discuss with your consultant before making any decision.

While securities lending does offer a relatively low risk return enhancement, it does represent an investment decision. As such, Securities Lending should be evaluated in a risk and return framework. In the long run, NEPC believes that Securities Lending is a viable market activity that can provide incremental earnings to clients.

Glossary of Terms

Borrower

- Borrowers include Market Makers, Broker/Dealers, and Prime Brokers/Hedge Funds. Securities are borrowed for a variety of activities from covering failed trades to short selling

Cash Collateral Pools

- Investment pool managed with a primary goal of providing liquidity to securities lending operation. Fund guidelines can vary in terms of both credit quality and maturity. Typically managed similarly to Money Market funds, but are often unregistered and may have slightly longer maturity structures

Federal Funds Effective Rate

- Overnight effective rate for borrowing. Different from Fed Funds target rate in that it fluctuates nightly and is derived from actual loan activity at the rate at which depository institutions lend to each other overnight

Lending Agent

- Lending agent coordinates loans of securities, hires manager to invest cash collateral and takes on counterparty risk for proper retrieval of client securities. Often the same firm as custodian.

Rebate Rate

- Rate paid from Lender to Borrower for the use of the cash collateral that is provided at the inception of a loan. Rate is dependant upon type of security and supply/demand dynamics. Often this rate is a spread from the Fed Effective Rate.