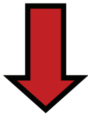
NEPC

MARKET THOUGHTS

SECOND QUARTER 2008 VOLUME 17 · ISSUE 2

QUARTERLY EQUITY INDICATOR	QUARTERLY BOND INDICATOR	QUARTERLY HEDGE FUND INDICATOR	QUARTERLY DIRECTION OF LIABILITIES
			
Down 2.7 %	Down 1.0%	Up 2.6%	Unchanged

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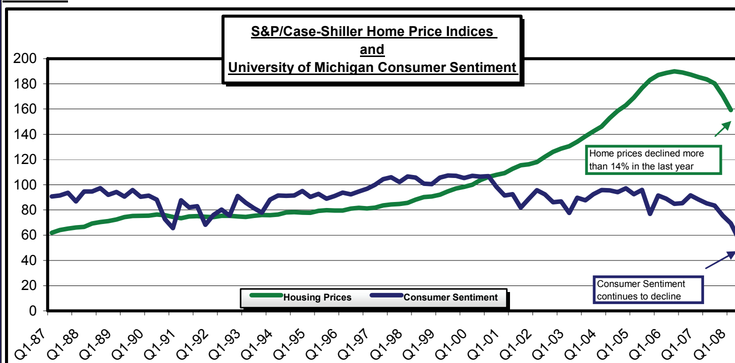
Between a Rock and a Hard Place Lies Volatility

The most recent quarter was a very turbulent time for the global capital markets. US equity markets approached official "bear" territory as housing and financial woes continued to plague corporate earnings and consumer confidence. Meanwhile, economic growth in emerging markets maintained a healthy pace, pressuring prices for many commodities and raising the specter of global inflation. Developed market monetary and fiscal authorities find themselves between a rock and a hard place with not much room to engineer a "soft landing," while trying to mitigate the effects of financial institution blow-ups and to address the damaging effects of rising inflation on corporations and consumers alike.

Exhibit 1

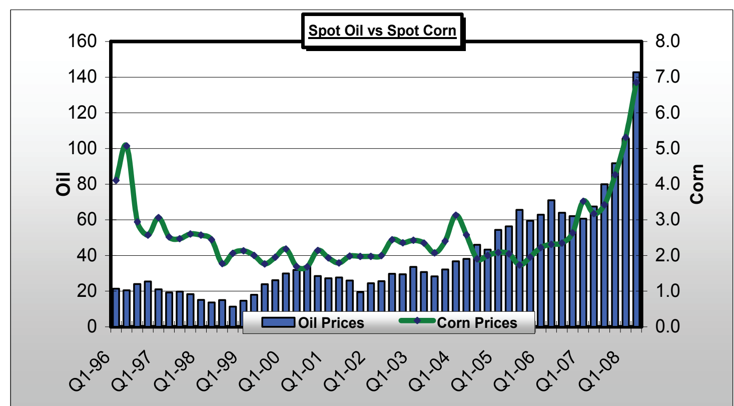


Source: Standard & Poors

The far-reaching impact of housing-related declines remains at the forefront of U.S. consumer confidence and investor sentiment (exhibit 1). The sub-prime mortgage fallout continues to plague financial institutions, now including the likes of the government-sponsored home mortgage giants. Deleveraging continues across the capital structure, with a wide variety of financing entities trying to minimize the levels of risky assets on their balance sheets. The cost of borrowing has risen as credit requirements have tightened, deal terms have become more stringent, and liquidity is low.

At the same time, global inflation is rising. The rapid pace of industrialization and urbanization in emerging markets continues to create a strong demand for commodities, while supplies of many global natural resources remain constrained (exhibit 2). Higher energy prices are limiting corporate profits all along the supply chain, in diverse industries and regions. The budgetary squeeze on the consumer that began with the housing crisis has been exacerbated by rapidly rising inflation as employment and wage gains have not kept pace with the rising costs of food and transportation.

Exhibit 2

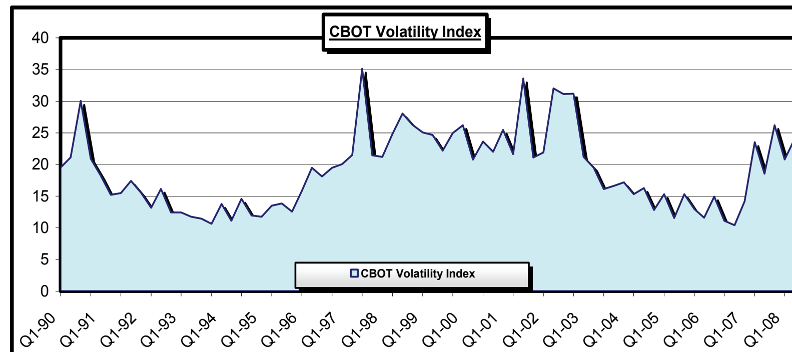


Source: Bloomberg

In this tumultuous market environment, volatility is mounting (exhibit 3) as investors remain anxious. Some positive factors for markets, however, include large amounts of cash on the sidelines (up to $3 trillion in money market balances as well as robust balances in sovereign wealth funds and private equity funds) and potentially improved valuations in some markets as prices fall. In jittery markets such as these, we remind investors to

focus on their ultimate investment time horizon, diversify by asset class to reduce risk, and better equalize the contribution to overall plan risk across a variety of asset classes with dissimilar return patterns. This includes alternative strategies that can enhance return potential and take advantage of increased market volatility. The current market dislocations may also create opportunities for patient capital, including investing across a spectrum of credit strategies as discussed in our April 2008 correspondence, "When Opportunity Knocks".

Exhibit 3



Source: Bloomberg

Global Equity Markets

Equity Index Returns (6/30/08)	Quarter	YTD	1 Year	3 Yrs	5 Yrs
Global Equity					
MSCI World	-1.7%	-10.6%	-10.7%	8.9%	12.0%
US Equity					
S&P 500	-2.7%	-11.9%	-13.1%	4.4%	7.6%
Dow Jones Industrial Average	-6.8%	-13.4%	-13.3%	5.8%	7.2%
NASDAQ Composite	0.6%	-13.5%	-11.9%	3.7%	7.2%
Russell 1000 Growth	1.3%	-9.1%	-6.0%	5.9%	7.3%
Russell 1000 Value	-5.3%	-13.6%	-18.8%	3.5%	8.9%
Russell 2000	0.6%	-9.4%	-16.2%	3.8%	10.3%
Russell 2000 Growth	4.5%	-8.9%	-10.8%	6.1%	10.4%
Russell 2000 Value	-3.6%	-9.8%	-21.6%	1.4%	10.0%
International Equity					
MSCI EAFE	-2.3%	-11.0%	-10.6%	12.8%	16.7%
MSCI Emerging Markets Free	-0.9%	-11.8%	4.6%	27.1%	29.8%
MSCI Europe	-4.2%	-12.4%	-11.3%	13.6%	17.2%
MSCI UK	-0.8%	-11.2%	-13.2%	10.2%	14.6%
MSCI Japan	2.5%	-5.5%	-12.0%	8.6%	13.0%
MSCI Far East	1.7%	-7.4%	-10.6%	9.6%	14.0%

Most global equity markets lost ground during the second quarter of 2008 as the investor optimism with which the quarter began was quickly dampened by lingering credit concerns and rising inflation. Financial worries continued to dominate US equities as the S&P 500 fell 2.7% and the DJIA lost 6.8%. MSCI World equities dropped 1.7%, with the EAFE index losing 2.3%. Japan experienced a reversal of fortune, gaining 2.5% compared to a 7.8% drop last quarter. Emerging markets equities fared better than most developed markets, dropping 0.9% in aggregate with Latin American equities gaining 11.0% while emerging Asian equities lost 9.1%. China (–3.5%) fell from the recent speculative rally as rising input costs and an improving currency squeezed corporate profit margins. On a sector basis, global financial companies, banks, insurance, and real estate stocks fell hardest. Global consumer-related stocks also suffered sharp losses. On the positive side, companies in the commodity-related energy and materials sectors performed best. The defensive-oriented utilities and health care sectors provided some downside protection.

US Equity Markets

Within US equities most major indices experienced declines for the quarter amid broadly pessimistic earnings announcements, rising inflation, and the threat of higher interest rates to contain price increases. Yet some relative signs of investor optimism and risk tolerance remain. Small cap companies in the Russell 2000 (+0.6%) outperformed large caps in the S&P 500 (-2.7%) and stocks in the Russell 1000 Growth index (+1.3%) managed to outpace those in the Russell 1000 Value benchmark (-5.3%). Within the S&P 500, only four of ten sectors gained ground. Financials (-18.3%) fell hardest on sharp earnings declines and continued credit concerns. Consumer discretionary stocks (-8.0%) declined on eroding revenues amid slower spending. Energy (+16.4%) led all sectors as crude continued to rally. The defensive utilities sector (+8.0%) provided investors some protection; materials stocks (+8.2%) benefited from rising commodity prices; and technology companies (+2.5%) gained on solid international revenue.

Commodity Markets

Commodities rallied during the second quarter of 2008, with the DJ AIG Commodity index gaining 16.1% to lead all sectors of the otherwise bearish public capital markets. Energy (+34.5%) and agriculture (+14.6%) were the leading commodity sectors for the quarter. Precious metals (+0.2%) traded sideways on mixed inventory signals while industrial metals (-4.2%) declined on concerns about slowing economic growth in the developed world limiting future demand. Powerful exogenous and internal market forces conspired to push several commodities to re-

cord price levels. Crude oil reached a series of all-time highs, trading at a new intraday peak of $144/bl on June 30th as markets reacted to continued geopolitical tension and several supply disruptions. In agriculture, devastating floods in the US Midwest helped encourage dramatic gains in corn, wheat, and soybean prices. Corn reached a record $7.55/bsl on June 27th amid weather-related supply concerns and continued strong ethanol demand. Investor desire for higher returning assets amid the recent declines in global equities, rise in market volatility, and an increased outlook for rising inflation also contributed to higher commodity prices.

Currency Markets

After briefly reaching an all-time low against the euro in April ($1.60) the USD recovered to finish the second quarter up modestly (+0.6%) against that currency. The dollar was buoyed by mounting concerns over slower growth and continued banking woes in Europe. This tailwind was offset by ECB signals that it may raise rates (from 4.0% to 4.25%) to help contain rising inflation. The USD gained 6.5% against the Japanese yen during the quarter and was down just 0.1% against the British pound. Meanwhile, the Chinese yuan gained 2% on the USD as the Chinese monetary authorities continued a slow devaluation from the dollar. The dollar lost value against commodity-related currencies in the dollar block—namely the Australian dollar (-4.9%) and the Canadian dollar (-1.1%).

Global Fixed Income Markets

Negative broader market conditions bled into fixed income markets during the second quarter, as investors grew leery of rising global inflation and weakening economic fundamentals. The Citigroup World Government Bond Index lost 4.2% in the quarter, but was still up 17.0% in the past twelve months driven by the declining dollar and falling global yields. Domestic fixed income dropped 1.0% for the quarter but gained 7.1% for the year ended June 30, 2008. In a reversal of last quarter, high yield bonds were the best performing domestic fixed income sector, posting a 1.8% gain. Spreads in investment grade and high yield corporate bonds tightened during the quarter as markets reacted positively to Fed liquidity provisions, and to the Fed's encouragement of JP Morgan's acquisition of Bear Stearns. US government bonds were the worst performing domestic bond sector as yields rose during the quarter.

Fixed Income Index Returns (6/30/08)	Quarter	YTD	1 Year	3 Yrs	5 Yrs
Global Fixed Income					
Citigroup World Gov. Bond	-4.2%	5.0%	17.0%	6.2%	6.4%
Domestic Fixed Income					
LB Aggregate	-1.0%	1.1%	7.1%	4.1%	3.9%
LB Government	-1.9%	2.1%	9.7%	4.6%	3.8%
LB U.S. Credit	-0.9%	-0.5%	3.8%	2.8%	3.3%
LB Mortgage Backed	-0.6%	1.8%	7.9%	4.8%	4.6%
LB Govt/Credit	-1.5%	1.0%	7.2%	3.8%	3.6%
LB TIPS	-0.3%	4.9%	15.1%	5.6%	6.0%
LB High Yield	1.8%	-1.3%	-2.3%	4.5%	6.9%
91 Day Treasury Bills	0.4%	1.0%	3.1%	4.2%	3.2%
10-Year Bond Yields	**6/30/2008**	**3/31/2008**	**12/31/2007**	**9/30/2007**	**9/30/2007**
U.S.	4.0%	3.5%	4.0%	4.6%	5.0%
Europe	4.7%	3.9%	4.3%	4.3%	4.6%
U.K.	5.2%	4.4%	4.6%	5.0%	5.5%
Japan	1.8%	1.4%	1.5%	1.7%	1.9%

Interest rates increased at a greater pace in Europe, the UK, and Japan, in comparison to the US. The broad-based increase in global yields is largely reflective of the prevailing sentiment that rapidly rising headline inflation will force policy makers to raise administered interest rates. Facing the balancing-act of controlling inflation and staving off economic stagnation, the Federal Open Market Committee slowed the pace of rate cuts during the second quarter, cutting only 25 basis points, leaving the policy rate at 2.0% by quarter end. In reaction, the US yield curve flattened slightly, with the spread between the 2-year note and the 10-year note contracting to 140 basis points, from a 180 basis point spread last quarter.

Liability Experience

According to the Citigroup Pension Liability Index, corporate liabilities remained relatively stable during the second quarter of 2008 after a seesaw of increasing in April and decreasing in May. We saw the beginning of tightening in historically wide credit spreads, as fears of inflation prevailed and US Treasury yields rose at the end of the quarter. The cumulative effect of these lower spreads and higher Treasury yields translated into a mere 11 basis point increase in the Citigroup Pension Liability Index, from 6.71% on March 31, 2008 to 6.82% on June 30, 2008.
Although liability values did not move significantly, equities continued to fall and interest rates remained low, creating fears of another "perfect storm" like the one in 2001-2002. Pension plans that are heavily weighted in equities

likely experienced a decline in funded status during the second quarter. For our corporate clients, we continue to recommend consideration of Liability-Driven Investment (LDI) strategies to reduce surplus volatility and maintain funded status. Yet, fears of inflation and the Fed's move to hold rates steady in June lead some to believe that rising interest rates are coming. Timing interest rates is a daunting challenge at best. We suggest that plans that have agreed to change to an asset/liability framework should adopt LDI strategies to protect the downside, even if it is considered unlikely. Dollar-cost averaging into an LDI strategy can be a way to reduce the timing impact of the move. Although it is true that tightening spreads and rising rates may decrease returns for some LDI strategies, these returns should be more than offset by the decline in liabilities in such an environment.

Alternatives: Hedge Funds

Second quarter results were markedly different from the first three months of 2008, with hedge fund indices generally closing the period in positive territory. The CS Tremont Hedge Fund Composite gained 2.6% during the quarter, with managed futures and long/short equity the best performing strategies. While both long-biased and relative value approaches did well during April and May, June was a more challenging environment for most hedge fund managers. April saw a general move up in equity markets globally as well as a tightening in credit spreads, thus managers with a long directional positioning tended to generate strong performance during the month. Arbitrage strategies in mergers, fixed income, and convertible bonds also performed well. May was a benign but interesting month in that a seemingly increasing level of dispersion in performance amongst securities, sectors, and countries allowed hedge funds to make money both long and short. Equity and credit markets extended their rally in the month, leading to generally good performance for directional managers, but losses for more pessimistic managers who held significant defensive short positions. Merger spreads tightened during the month and a few widely held distressed credits led to outsized gains for many funds focused on that space. In June general market concerns began weighing heavily on investor's minds. More directional approaches such as long-biased equity and emerging markets encountered difficulty during the month while those that were defensively positioned were able to benefit from the market downturn.

Hedge Fund Index Returns (06/30/08)	Quarter	YTD	1 Year	3 Yrs	5 Yrs
Composite					
CS Tremont Hedge Fund Composite	2.6%	0.5%	4.1%	11.0%	10.2%
Relative Value					
CS Tremont Convertible Arbitrage	2.3%	-5.6%	-5.6%	5.7%	3.3%
CS Tremont Fixed Income Arbitrage	2.9%	-4.1%	-4.0%	3.3%	3.5%
CS Tremont Equity Market Neutral	2.0%	3.8%	7.9%	9.7%	8.1%
Event Driven					
CS Tremont Event Driven	2.3%	-1.1%	1.0%	10.9%	11.8%
CS Tremont Event Driven - Distressed	1.2%	-1.4%	-2.1%	9.9%	11.8%
CS Tremont Event Driven - Risk Arbitrage	0.6%	3.4%	7.2%	7.5%	6.9%
CS Tremont Event Driven - Multi-Strategy	3.0%	-1.0%	2.9%	11.8%	11.9%
Equity Hedge					
CS Tremont Long-Short Equity	3.8%	-0.5%	3.1%	12.1%	11.6%
CS Tremont Emerging Markets	0.7%	-3.6%	6.1%	15.8%	16.0%
CS Tremont Dedicated Short Bias	1.9%	12.0%	21.3%	4.6%	0.0%
Tactical					
CS Tremont Multi-Strategy	1.9%	-2.1%	-0.5%	9.8%	8.9%
CS Tremont Global Macro	2.2%	9.2%	18.8%	15.6%	13.0%
CS Tremont Managed Futures	4.0%	14.9%	13.4%	9.9%	7.5%
Traditional Markets					
S&P 500	-2.7%	-11.9%	-13.1%	4.4%	7.6%
Lehman Aggregate Bond Index	-1.0%	1.1%	7.1%	4.1%	3.9%

Final Thoughts

The market results of the last twelve months have been painful for many investors, and significant uncertainty around future market direction remains. As we highlighted in our recent client letter, "Charting a Course Through the Storm," we are working 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; and, 4) Continue to seek excess returns from active strategies including portable alpha and global asset allocation strategies, and loosening constraints on managers, where appropriate, to allow them to take advantage of opportunities wherever they may occur.

To enjoy above-average returns over the long-term, our clients should not automatically accept the world in its current state. They must be willing to lead and embrace change, stay focused on the longer-term horizon, and be open to near-term opportunities. While the current turbulent market environment may persist, we will continue to offer our clients the perspective and guidance necessary to navigate the storm.