NEPC, LLC

To: NEPC Clients

From: NEPC Asset Allocation Committee

Date: February 2009

Subject: Finding the Balance

All investors struggle with finding the right balance. At the most basic level, investors attempt to balance risk and reward. Many investors need to balance current spending needs with the desire to grow assets over the long term. Others may need to balance the attractiveness of a potential strategy with the uncertainty and discomfort of branching out to something different. There are a number of balancing acts that our clients are asked to perform as they carry out their fiduciary duty. Unfortunately, the balancing act is much harder now than it has ever been. Our goal is to help you strike the right balance for your program in these trying times.

The year 2008 was one that investors would like to forget. The S&P 500 declined almost 40%, the financial markets experienced unprecedented upheaval across virtually all risk assets, and the economic outlook is as negative as any time since the Great Depression. While there is hope that the new administration in the US might assist in a recovery, the mortgage crisis, the banking panic, and the heavy level of total US debt will likely take years to resolve, even with the best of leadership. These events are inherently destabilizing and make our collective job that much more difficult. Despite the difficulty, we must continue to determine the right course of action based on each unique set of circumstances.

The near-term pain and the dour forecast have created a conflict for many investors. We are forced to deal with the reality of the recent losses at the same time we are tasked with building a portfolio to succeed over the long-term. Nowhere is this conflict clearer than in the outlook for inflation. There is a small but credible risk of a continuing deflationary spiral such as Japan has experienced since 1989. Longer term, however, inflation is more likely, as policy-makers have taken many unprecedented actions that will be complicated to unwind. The way this issue unfolds will have a significant impact on portfolios going forward and will also have spillover economic effects, particularly as it relates to the relative strength of the dollar. Clients should examine whether their portfolio is allocated to protect against deflation (sovereign bonds) and high inflation (TIPS and real assets).

The trade-offs required today are more acute because of the current financial turmoil. The list below provides a sample of the issues that clients face as they strive to improve portfolios.

Issue	Challenge
Desire to rebalance	Illiquidity in many assets
Attractive opportunities	Concern about short-term losses
Safety provided by Treasuries	Potential third bubble (after tech and real estate)
Ancillary revenue from securities lending	Collateral investment losses
Higher forward-looking returns	Much higher volatility environment
Active management opportunity	Near-term underperformance

Looking Ahead

We expect 2009 to be a year when tough questions will be asked, premises will be reexamined, and new ideas will be explored. Out of this process, we expect each client program to be improved, reflecting the pain of the recent past, but also the promise of the emerging future. Some part of this optimism is borne of a contrarian spirit that recognizes that it's always darkest before the dawn, or more specifically, that once markets bottom out, forward-looking returns will be much higher than at any time in nearly 30 years. We expect the risk premia available to patient capital to be remarkable, corresponding to the dreadful losses we have experienced.

We expect a return to "normal" markets over time. We define normalcy as a functioning credit market, long-term relationships between risk and return, and prices being driven by fundamentals. Normal will not mean a return to the level of liquidity and leverage seen in early 2007. In fact, we believe that recent markets will influence investor behavior for years to come. Just like people that lived through the Great Depression had their perspectives colored by their experiences, we expect individuals living through current markets to think much differently about saving and investing.

As you revisit the overall objectives for your investment program, we encourage you to keep in mind the following:

- The long-term time horizon of an institutional investment program is a competitive advantage, and not one that should be given up easily.
- For most long-term investors, investing in a diversified portfolio of risky assets is a better option than not taking any risk at all, and much better than taking concentrated risks.
- The investments made at the most difficult times are often the ones that bear the most fruit.

- For defined contribution clients, adopting automation features including auto-enrollment into target date funds, auto-escalation and auto-rebalance takes on added importance as participant behavior did not change dramatically in 2008.

Clients face challenges arising from what has happened. Our challenge together is to incorporate the changed landscape with a clear focus on what the future may hold. While we continue to stress many of the same themes from recent years (reduce equity, diversify risk, and consider alternative strategies) we feel that there will be some compelling opportunities that will warrant your attention, particularly in the credit markets.

Many investment managers believe that in their own specialty area, they face the best opportunities of their careers. Our mission is to take advantage of these possibilities, but to size risk positions appropriately. The approach to sizing opportunity and risk should extend beyond the measures of expected return and standard deviation. For example, our risk budgeting analysis has given different complementary insights in managing risk. Newer tools like scenario modeling and liquidity analysis can further differentiate potential risks in uncertain times.

Despite our guarded optimism, we recognize that there is a great deal of uncertainty as to the timing and nature of a recovery in economic activity or the investment markets. Therefore, we want to stress that you should consider allocating some of your assets to:

- strategies that perform well in multiple environments, such as “risk parity”;
- strategies that can move quickly as conditions change, like hedge funds and global asset allocation; and,
- strategies that are structured to take advantage of unique opportunities, including private markets and credit opportunities.

We recognize that the market results of the last year have been painful for investors. However, we encourage investors to focus on their long-term investment time horizon and not overreact to short-term volatility. Each investor’s response to the current environment—the risks and the opportunities—will be unique, driven by current portfolio positioning, liquidity constraints, return targets, and risk tolerance.

We look forward to working with you this year to help you find the right balance for your investment program. We hope to accomplish this through the investment tools we have developed, the collective insights of our professionals and our unwavering commitment to the highest levels of client service. We sincerely appreciate the opportunity you have given us to work as your consultant and will continue to work on your behalf to enhance your investments.