MARKET THOUGHTS

FIRST QUARTER 2009 VOLUME 18 · ISSUE 1

QUARTERLY EQUITY INDICATOR	QUARTERLY BOND INDICATOR	QUARTERLY HEDGE FUND INDICATOR	QUARTERLY PENSION LIABILITY INDICATOR
Down 12%	Up 0.1%	Up 1%	Down 19%

NEPC is an independent, full service investment consulting firm, providing traditional and alternative asset manager search, asset allocation, performance evaluation and investment policy services to institutional investment programs. We offer our market letters to provide insight into recent market conditions, and to assist your interpretation of investment results. We encourage your comments and feedback, as well as any inquiries you may have about our firm or our consulting services.

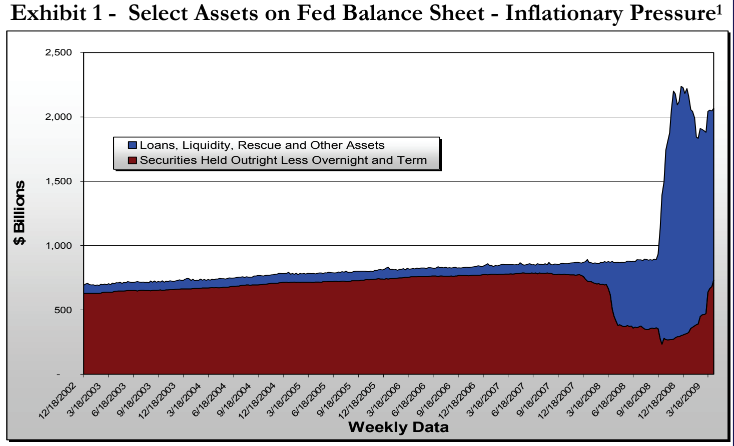
Green Shoots?

It's springtime and Federal Reserve Chairman Ben Bernanke sees "green shoots" not just in the flowerbeds of the Capital, but in the economy.

> *And I think as those green shoots begin to appear in different markets -- and as some confidence begins to come back -- that will begin the positive dynamic that brings our economy back.*

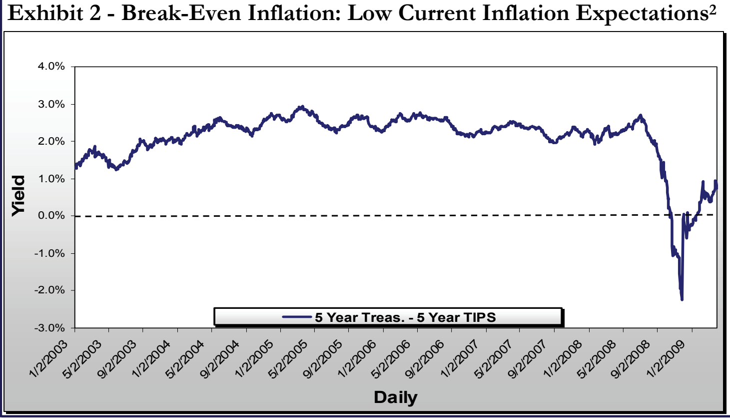
In mid-March, the stock market seemed inclined to agree with him, as it bounced off the nadir of a 58% peak-to-trough decline to rally over 20% and pare U.S. stock market losses to a total of 11% in the first quarter of 2009. So what are we to make of this surge in apparent equity investor optimism? Are the nascent buds popping from the ground truly the beginning of a new economic spring or nothing more than over-reaction to Washington's multi-trillion dollar stimulus programs?

Exhibit 1 - Select Assets on Fed Balance Sheet - Inflationary Pressure[1]



To assess this question we take a look at the potentially conflicting signals provided by stock and bond markets. Current stock market valuations (whether considering earnings yield compared to Treasury yields or relative P/E ratios), are at cyclical lows, although they have not sunk to the extreme lows of the early 1930s. Equity prices could imply that we are near the bottom of a recessionary trough (albeit a severe one) and potentially indicate a normalization of markets and economic activity within the next 6-9 months. Furthermore, there are record cash levels on the sidelines, with money market fund assets reaching almost 50% of the total capitalization of the S&P 500. According to these factors, the equity markets are attractive and should represent a nice *long-term* risk/return trade-off from these levels.

Exhibit 2 - Break-Even Inflation: Low Current Inflation Expectations[2]



On the other hand, pricing in the bond markets may be sending a different message. Ten-year Treasury bond yields dropped to 2.50% after the Federal Reserve announced their plans to buy Treasuries on March 18th. Though rates have since crept back into the range of 2.75-3.00%, these yields still indicate an expectation of fairly low economic growth over the near and intermediate-term. Historically, fiscal and monetary actions to increase the money supply have led to increased future inflation. Exhibit 1 shows the dramatic and unprecedented increases in the Federal Reserve's balance sheet as the Fed provides liquidity to the markets by taking on assets and establishing lending facilities. Despite these inflationary pressures , break-even inflation rates, as indicated by TIPS vs Treasury yields in Exhibit 2 suggest an extended period of disinflation or even deflation, much like Japan's lost decade of deflation and a stagnant economy. Credit spreads, despite improvements from November 2008 extremes, are still pricing in an impending credit default cycle more severe than anything experienced since the Great Depression.

Continued increases in unemployment and further declines in real estate values have been joined by a myriad of other pessimistic economic indicators. Even optimistic signals such as an increase in mortgage refinance activity must be viewed cautiously as homeowners are unable to pull cash out, limiting the stimulating effects that have accompanied previous waves. First quarter US economic growth is projected to be nearly as bad as that in the fourth quarter (-6.8%) if not worse, and global trade has slumped. Current forecasts for 2009 growth for the OECD countries are a dismal -4% and the IMF recently updated estimates for total credit losses to $4.1 trillion. Despite the gloomy outlook, we believe that the magnitude of the stimulus implemented by authorities to-date (particularly the actions of the Federal Reserve Bank and other developed central banks) have lessened the probability of the economy entering a deflation cycle, and correspondingly increased the probability of a future inflationary outcome.

A steady drumbeat of bad economic news in the coming months does not preclude rising stock prices. Bull markets usually start 6 months or so before a recession ends (always determined with fine 20/20 hindsight). At this juncture, however, the sustainability of the recent equity rally will remain tenuous until increased liquidity and optimism allow the credit markets to heal. We believe that there is likely more bad news ahead for the stock market to digest. While a recognition that there is truly a new economic springtime dawning would allow stocks to continue to rise and credit to recover robustly, a realization that bond investors have more accurately forecasted our near future may lead stock prices to re-visit lower levels.

Global Equity Markets

Recent gains overshadowed the pain of the first two months of the year - truly an extension of 2008, as the S&P 500 lost another 18% through February. Weak economic data, shrinking corporate profits, tough credit conditions, and uncertainty about the US banking system weighed on investor confidence. The green shoots in the US equity market were fertilized with an announcement of early profitability from Citigroup after injections of capital from the US government, as well as plans for quantitative easing, and the announcement of TALF and PPIP. The late quarter rally did not push domestic markets into positive territory but did provide positive momentum that has continued to produce gains into April and brought a dampening of volatility. Mid cap stocks as a group were the best relative performers. Growth outperformed value in all market cap segments. Financials and economically sensitive sectors such as Industrials, Energy, and Utilities dragged returns, while Technology posted positive results.

Equity Index Returns (3/31/09)				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	-11.9%	-42.6%	-13.8%	-3.5%
US Equity				
S&P 500	-11.0%	-38.1%	-13.1%	-4.8%
Dow Jones Industrial Average	-12.4%	-35.9%	-9.5%	-3.6%
NASDAQ Composite	-3.1%	-32.9%	-13.2%	-5.2%
Russell 1000 Growth	-4.1%	-34.3%	-11.3%	-4.4%
Russell 1000 Value	-16.8%	-42.4%	-15.4%	-4.9%
Russell 2000	-14.9%	-37.5%	-16.8%	-5.2%
Russell 2000 Growth	-9.7%	-36.4%	-16.2%	-5.4%
Russell 2000 Value	-19.6%	-38.9%	-17.5%	-5.3%
International Equity				
MSCI EAFE	-13.9%	-46.5%	-14.5%	-2.2%
MSCI Emerging Markets Free	0.9%	-47.1%	-8.2%	5.9%
MSCI Europe	-14.6%	-49.9%	-14.3%	-1.8%
MSCI UK	-10.7%	-48.4%	-15.5%	-3.8%
MSCI Japan	-16.6%	-36.0%	-17.5%	-5.4%
MSCI Far East	-15.2%	-37.0%	-16.4%	-4.6%

Global equity markets joined the US in both the sell-off to start the year and the mid-March rally, ending the quarter down 12%. As in the US, Financials and Utilities hurt markets the most. After finishing 2008 as the worst performing asset class, emerging market equities benefited the most from the recent rally, posting slightly positive performance in the first quarter. Results varied across markets and sectors. In particular, Brazilian commodity producers benefited from an uptick in commodity prices, while weak performance from telecoms and Eastern Europe muted results.

Global Fixed Income

The first quarter of 2009 saw uneven returns across fixed income sectors as the Treasury rally began to unwind and nascent signs of life emerged in Agency and lower quality markets. The Barclays Capital US Aggregate Index returned 0.1% in the first quarter, with Agency MBS the strongest sector, returning 2.2%, aided by the Fed's purchases of securities in the sector, improving liquidity and boosting returns. US Investment grade credit returned –1.8% and US Treasuries returned –1.3%, rounding out the weakest sectors of the bond market. The yield curve steepened modestly, with the spread between the two and ten year note widening from 149 basis points on December 31 to 190 basis points on March 31. The CITI World Government Bond Index returned –4.8% as yields rose globally and the dollar outperformed other developed currencies.

Fixed Income Index Returns (3/31/09)				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
Citi World Gov. Bond	-4.8%	-3.8%	7.6%	4.6%
Domestic Fixed Income				
BC Aggregate	0.1%	3.1%	5.8%	4.1%
BC Government	-1.0%	7.0%	8.1%	5.2%
BC U.S. Credit	-1.8%	-5.2%	1.8%	1.6%
BC Mortgage Backed	2.2%	8.1%	7.6%	5.6%
BC Govt/Credit	-1.3%	1.8%	5.5%	3.7%
BC TIPS	5.5%	-2.0%	5.7%	4.1%
BC High Yield	6.0%	-19.3%	-4.6%	-0.1%
91 Day Treasury Bills	0.1%	1.0%	3.4%	3.2%
10-Year Bond Yields	**Mar-09**	**Dec-08**	**Sep-08**	**Jun-08**
U.S.	2.8%	2.4%	4.1%	3.7%
Europe	3.0%	3.6%	4.3%	4.7%
U.K.	3.2%	3.0%	4.5%	5.1%
Japan	1.4%	1.2%	1.5%	1.6%

Many fixed income sectors remain in paralysis, cautiously interpreting the implications of TALF and PPIP and other creative attempts to restart the economy by freeing bank balance sheets, encouraging banks to begin lending once again. Asset-Backed Securities rallied on initial news of the government's efforts, returning 7.56% during the quarter. Non-Agency mortgages failed to react positively to these government initiatives, as some lingering concerns about loan modifications, cram-down legislation and loan forbearance remain unresolved.

High yield, the best performing fixed income sector during the quarter, posted a 6.0% gain. The weakening economic environment is reflected in fixed income markets, with price levels approaching all time lows; however, credit markets still present some compelling opportunities for investors, with investment grade credit, high yield bonds and leveraged loans offering attractive risk-return tradeoffs.

Currency Markets

During the quarter, the US dollar strengthened 5% against the euro, 9% against the yen, and 4% against a trade-weighted basket of 16 currencies. The dollar had rallied at the beginning of the year, with strong global demand buoyed by continued investor concerns over weak equity markets and an uncertain worldwide economic landscape. That rise was halted in mid March when the Federal Reserve announced that it would directly purchase US Treasury bonds. Global investors responded by selling US dollars, and the greenback experienced its worst ever one-day decline against the euro. Towards the end of the quarter, the dollar felt further pressure as investors began to unwind dollar holdings as the green shoots of recovery in equity and credit markets led some investors to begin considering the potential for a US Treasury bubble and return to more risky assets.

Globally, the US has been well ahead of other developed nations in its efforts to jumpstart an economic recovery. The UK, Europe, and Japan all face low short rates, leaving quantitative easing as the likely solution. More challenges are expected as the European Central Bank grapples with the problem of fixing different problems in different countries with only the tool of a single currency. While the run-up of US Treasury prices and the implications of unprecedented stimulus weigh heavy on expectations for future USD stability, it is likely that any devaluing of the US Dollar through inflation will be met by other developed currencies, though it is expected that the recent flight to quality will unwind over time, resulting in some relative loss of value for the dollar.

Commodity Markets

After falling more than 50% in the second half of last year, commodity markets continued to slide to start 2009 as the global economic contraction persisted. Commodities dropped 13% through early March, but benefitted, along with other asset classes, from the positive sentiment from global stimulus. Commodities ended the quarter down 6.4% in aggregate, but returns among sectors showed some strong gains as fundamentals improved. Crude oil rose 11% to reach $49.66 a barrel as substantial supply cuts began to support prices. Copper gained 32% on strong Chinese demand. Gold, a traditional safe haven during capital market volatility, gained 4.4% to reach $922.60 a troy ounce--at one point approaching its March 2008 record of $1,003.20. Meanwhile, Agricultural commodities fell on larger crops and weaker demand.

Investors may expect lower prices and heightened volatility to continue in commodities markets. Collapsing global demand can have severe effects on commodity markets, as pricing below production costs can force decisions, such as closing plants and mines, that are not easily reversed. Future rising demand for global natural resources may meet low commodity inventories, likely driving commodity prices higher as rising inflation flows directly to the cost of inputs, benefitting commodities. The paradox of the market's low inflation expectations despite the potential for rising inflation as global stimulus spending takes effect present inflation sensitive assets as potentially attractive long-term investments. Investors should consider adding to their inflation exposure, by taking advantage of potentially attractive current pricing in real assets.

Pension Liability Experience

After a sharp increase at the end of 2008, liabilities declined significantly during the first quarter of 2009, according to the Citigroup Pension Liability Index. As the government's plans for buying back Treasuries were unveiled, Treasury yields decreased dramatically but have consistently drifted upwards on the middle and long sections of the curve. High quality spreads widened out again, after tightening in December and January. The cumulative effect of the market movements was a jump of 149 basis points in the Citigroup Pension Liability Index, from 5.87% on December 31, 2008 to 7.36% on March 31, 2009. As a result of the increase in discount rates, liabilities dropped, with Citigroup estimating a return of -18.6% year-to-date. Plan sponsors must understand that results will differ dramatically depending on each liability measurement as smoothing techniques and the bond universe used to determine the discount rate or yield curve will vary.

Much of this fluctuation in the present value of liabilities can be hedged through Liability Driven Investment (LDI) solutions. We continue to recommend consideration of LDI strategies for corporate clients to reduce surplus volatility and help maintain funded status; however, implementation timing has become more difficult. Plan sponsors who implemented LDI strategies before the latter half of 2008 saw a large positive return in an environment where all risky assets declined. The amount of hedge maintained should be reviewed with your consultant. Those clients who are considering implementing LDI for the first time may find long corporate bonds attractive, given the continuing wide spread over Treasuries.

Hedge Funds

After reporting the worst annual returns in their history in 2008, hedge funds rebounded with a modest positive return in the first quarter of 2009, providing 0.9% of positive return according to the CS Tremont Hedge Fund Composite. Performance for the quarter was led by the Convertible Arbitrage, Multi-Strategy and Global Macro strategies; while Managed Futures gave back some of their positive performance from 2008.

In the first quarter, many strategies benefited from reducing gross and net exposures in anticipation of continued market volatility. Successful equity managers shortened their trading horizon and focused on more liquid markets, benefitting from the increased dispersion among stocks during the first two months of the year but participating less in the rally that ended the quarter. Credit managers also began to benefit from discrimination in markets, as a bifurcation began to emerge between the more liquid securities of high quality companies, and the less liquid, lower quality securities of leveraged companies that cannot access the capital markets, leaving them few alternatives to bankruptcy.

Hedge Fund Index Returns (3/31/09)

Composite	Quarter	1 Year	3 Yrs	5 Yrs
CS Tremont Hedge Fund Composite	0.9%	-16.7%	-0.3%	3.6%
Relative Value				
CS Tremont Convertible Arbitrage	7.7%	-20.2%	-5.7%	-2.9%
CS Tremont Fixed Income Arbitrage	3.3%	-21.2%	-6.7%	-2.6%
CS Tremont Equity Market Neutral	-3.5%	-43.4%	-12.3%	-4.9%
Event Driven				
CS Tremont Event Driven	-0.2%	-15.1%	0.9%	5.3%
CS Tremont Event Driven - Distressed	-1.1%	-19.3%	-2.0%	4.1%
CS Tremont Event Driven - Risk Arbitrage	2.7%	-3.3%	4.2%	4.5%
CS Tremont Event Driven - Multi-Strategy	0.4%	-12.6%	2.8%	6.2%
Equity Hedge				
CS Tremont Long-Short Equity	0.3%	-16.1%	-0.7%	4.3%
CS Tremont Emerging Markets	-0.1%	-27.4%	-2.5%	4.7%
CS Tremont Dedicated Short Bias	1.2%	5.8%	6.9%	5.3%
Tactical				
CS Tremont Multi-Strategy	3.7%	-17.6%	-1.9%	2.4%
CS Tremont Global Macro	2.6%	-8.5%	7.2%	8.3%
CS Tremont Managed Futures	-2.9%	4.1%	8.1%	5.4%

Hedge funds appear to have stabilized despite poor performance and unprecedented investor redemptions. The first quarter saw redemptions slow down markedly from the 2008 levels, but there is some overhang expected to last into the second quarter. The last quarter of 2008 saw weaker hedge fund managers close their businesses, marginal hedge fund investors head for the exits, and proprietary trading banks reduce their leverage – all events that we believe will benefit the industry in the long run.

Private Markets

The frozen credit market, followed by the downsizing of business operations and rising unemployment, are creating challenges for both private equity and real estate managers as they manage their respective top line revenues and bottom line profits. Both U.S. and European-based private equity managers, faced with the reality of multiple contraction and slowing EBITDA, wrote down the valuations of their portfolio companies during the fourth quarter of 2008. Although the mezzanine strategy posted a negative return for the quarter, it did manage to post positive results for the year.

LBO funds face significant challenges; *Buyouts* reported that during the first quarter, 13 LBO-backed companies defaulted on $14.7 billion of debt and 28 LBO-backed companies filed bankruptcy protection. This is in addition to the approximately $190 billion of speculative grade bonds that will mature in the United States between 2009 and 2011 as reported by *Moody's Investor Services*. Mezzanine, Distressed and Secondary managers continue to see tremendous opportunity as companies seek financing and investors continue to make capital calls while distributions are limited or non-existent.

Real Estate is faced with many of the same challenges as private equity managers: balance sheet issues and a deteriorating operating environment. The market is volatile for investors; landlords are concerned with filling the rent roll to meet budgets and meet lender requirements. U.S. Real Estate Fundamentals continue to deteriorate, with rents softening and vacancy rates increasing across all real estate sectors. As valuations shrink, loan-to-value ratios increase, potentially triggering default provisions. Without a viable work-out plan, investors may be faced with a decision of whether to inject additional capital into funds to prevent foreclosures and to preserve value. The ability to fill rental space and meet debt requirements will determine the sustainability of many existing real estate funds over the coming period.

Final Thoughts

The global economic system remains in crisis, with market volatility and overall uncertainty continuing at elevated levels. At this time, it is important for investors to re-visit important investing principles. First, a long-term investment time-horizon is a significant advantage. Second, for most long-term investors, building a diversified portfolio of risky assets is a better option than not taking any risk at all. Third, investments made at the most difficult times are often the ones that bear the most fruit.

We continue to believe that markets will normalize over time and the long-term relationship between risk and return will be re-established. While the timing of this return to normalcy remains unclear, we expect that it will happen at different times for different markets; for example, the credit markets likely need to recover before equity markets, and stocks usually act as a leading indicator for economic growth. While a small, but credible risk remains of a long-term deflationary spiral, we see high long-term inflation as an increasing risk, given the extraordinary stimulus currently underway.

Investors with patient capital can provide liquidity to profit from opportunities in credit, distressed securities, and perhaps even from the current government programs such as TALF and PPIP. We recommend clients rebalance toward asset allocation targets while considering such opportunistic strategies. We also recommend continued diversification into strategies that can help hedge against extreme economic environments such as high inflation. In the latter case, we also note that the cost of hedging inflation appears relatively inexpensive as the price of TIPS and many real assets remain near cyclical lows.

Finally, we note that in the first quarter, active management approaches such as diversified portfolios of hedge funds and hedge funds of funds, and global asset allocation strategies, in general, added value in a highly volatile market environment. Diversified hedge fund averages finished the quarter in positive territory during a period of double-digit declines for the US equity market. In fact, in the seven months ending March 31, 2009, hedge funds, on average, have provided the widest margin of out-performance relative to stocks in the history of the hedge fund averages, an advantage of 30% depending on the benchmarks observed. While this has been a challenging period for hedge fund investors in terms of negative absolute returns in 2008, liquidity challenges and headline issues, the investment category has been able to provide good relative results for investors in a difficult environment.

We expect that the balance of this year will remain challenging for investors. On May 20th and 21st in Boston, we are hosting our 2009 Client Conference (please register on our website at www.nepc.com) where we will continue to address the markets, as well as other important topical items. We look forward to working with our clients to help them work through these turbulent markets.

Footnotes: 1 - Source: Federal Reserve - H.4.1
2 - Source: US Treasury Department