Market Thoughts

Second Quarter 2009 — Volume 18 · Issue 2

Quarterly Equity Indicator	Quarterly Bond Indicator	Quarterly Hedge Fund Indicator	Quarterly Pension Liability Indicator
Up 16%	Up 2%	Up 6%	Up 21%

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.

The Summer of Our Discontent

With the close of the second quarter and the full onset of summer, we find the stock market coming off a rip-roaring 35% rally from the bottom to regain positive territory for the year, the credit markets returning to signs of health, and consumer confidence rebounding. After months of unprecedented stimulus by the US and countries around the world, the risk of a deflationary spiral has been materially reduced. Perhaps the recent advance of most risky asset classes will be just the spark needed to ignite global demand, curb unemployment, and stimulate global growth.

Perhaps not. With the turning of the calendar to the warmer months, investors must face some grim realities. First, many must still grapple with trailing twelve month returns as deeply negative as any previous period of the last several decades along with everything that implies for retirement plan funded ratios, endowment spending, and associated liquidity challenges. Second, the markets now must face a continued headwind of negative economic news – unemployment threatening to rise above 10%, anemic economic growth, and real estate prices still seeking a bottom. And, third, the prospect of significantly increased regulation (and attendant potentially higher costs), already beginning to take shape as initial plans were laid out by the Obama Administration in June. All these factors lead to the current season of concern and challenge – a summer of discontent.

We recognize a struggle between the return of some measure of optimism and the challenging economic milieu. Following a season of reducing payroll, cutting inventory, and curtailing capital expenditures, corporations seized upon the improved market conditions, issuing record levels of new equity as well as accessing the debt markets. Notably, financial organizations took advantage of the optimism following the US Treasury's stress tests, bringing in significant new capital and repaying $68 billion in TARP funds. Yet profit growth will be challenged by double-digit unemployment, consumers weighed down by debt, the wearing off of the current stimulus programs, and further real estate price declines. According to many standard measures the stock market is fairly valued - although it is benefiting from favorable momentum and plentiful cash on the sidelines - and will face significant challenges in moving higher without meaningful improvements in the economic landscape. To illustrate this dichotomy, in Exhibit 1, we contrast the recent abating of a key "fear indicator", the VIX or US equity volatility index, amidst a continued climb in unemployment.

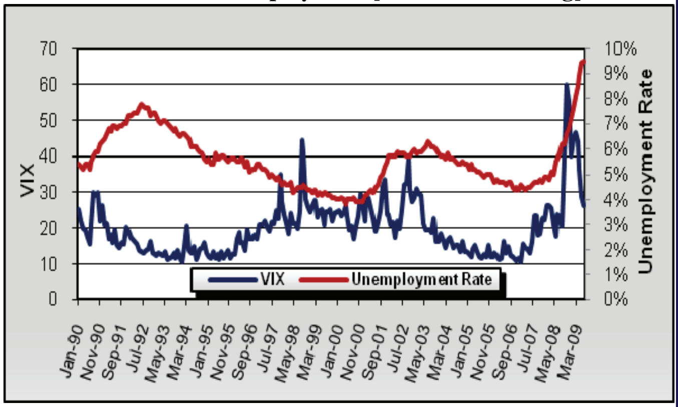
Credit Opportunities - One Year Later

*In April of 2008, NEPC published **"When Opportunity Knocks"** to address the situation in the credit markets. We recommended that clients create an Opportunistic component of their strategic asset allocation and build exposure to credit sectors to take advantage of significant dislocations in the marketplace. We recommended that clients fund the new credit exposures primarily from equity allocations to help balance the overall risks in the portfolio and we indicated that the time horizon for the credit opportunity would be two-to-three years. Just over a year later, we re-visit these recommendations. At the time, we did acknowledge that "the opportunity may improve after you invest." In fact, it did, with credit markets deteriorating further into the fourth quarter of last year. Nevertheless, credit markets, using investment grade bond, high yield, and bank loan indices as proxies for broad exposure to the credit opportunity set, have provided a significant return advantage over stocks for the periods ending June 30, 2009, as shown in the table below. We still see opportunity in credit markets, and comment further on this area in the balance of this Market Thoughts.*

Index	*Q2*	*YTD*	*1 yr*
Barclays Inv. Grade Bond	*8.8%*	*6.9%*	*4.1%*
Barclays High Yield	*23.1%*	*30.4%*	*-2.4%*
S&P LSTA Lev Loan	*20.4%*	*32.2%*	*-5.3%*
S&P 500	*15.9%*	*3.2%*	*-26.2%*
MSCI EAFE	*25.4%*	*8.0%*	*-31.4%*

Treasury bond prices should remain under pressure as increased issuance to deficit-finance the stimulatory programs will require higher yields to entice (primarily foreign) buyers. Increasing rates on long-term debt are contrasted by a continued desire to keep short term rates low to support the economy. With target rates already at zero, quantitative easing will likely continue, adding further fuel to fears of future inflation. This will also put pressure on the dollar. Overseas, European economies appear to be behind the US in terms of recovery while many emerging markets, benefiting from robust government balance sheets and rebounding commodities prices seem poised to maintain or resume economic growth. While near-term inflation does not appear to be a problem with significant slack in the economy, we remain concerned that the multi-trillion dollar expansion of the Federal Reserve balance sheet and massive government spending can translate into money-supply growth and higher-than-average inflation in the medium and long-term. Higher future inflation is beginning to be priced into the market with the rise in commodities prices in the second quarter and the increase in Treasury yields. We continue to focus on this as perhaps the most significant “tail risk” ahead of us, and believe that investors can address this future challenge with the addition of inflation hedging assets (including real assets) to their existing asset allocation.

Exhibit 1 - VIX vs. Unemployment [Source: Bloomberg]



Global Equity Markets

Optimism from government stimulus continued into the second quarter. This bounce seemingly gave greater weight to hope than to economic fundamentals as companies continued to report weak earnings. Instead, positive results from bank stress tests, and, at the very least, a slowing rate of decline in economic indicators boosted investor confidence and risk appetite. What was left for dead just months ago in US markets – namely financials, cyclicals, materials, and REITS – not only saw new life, but led the way, driving the S&P 500 to a 15.9% return for the quarter. Defensive sectors such as healthcare, consumer staples, and utilities took a backseat as investors appeared willing to assume risk again. Growth and value both posted strong results across the cap spectrum.

Equity Index Returns (6/30/09)				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	20.8%	-29.5%	-8.0%	0.0%
US Equity				
S&P 500	15.9%	-26.2%	-8.2%	-2.2%
Dow Jones Industrial Average	12.0%	-22.9%	-6.3%	-1.7%
NASDAQ Composite	20.0%	-20.0%	-5.5%	-2.2%
Russell 1000 Growth	16.3%	-24.5%	-5.4%	-1.8%
Russell 1000 Value	16.7%	-29.0%	-11.1%	-2.1%
Russell 2000	20.7%	-25.0%	-9.9%	-1.7%
Russell 2000 Growth	23.4%	-24.8%	-7.8%	-1.3%
Russell 2000 Value	18.0%	-25.2%	-12.1%	-2.3%
International Equity				
MSCI EAFE	25.4%	-31.4%	-8.0%	-2.3%
MSCI Emerging Markets Free	34.7%	-28.1%	3.0%	14.7%
MSCI Europe	25.3%	-34.5%	-8.4%	2.3%
MSCI UK	26.6%	-34.2%	-10.1%	0.5%
MSCI Japan	23.1%	-23.1%	-10.2%	-0.6%
MSCI Far East	25.0%	-22.6%	-8.6%	0.6%

Developed international markets posted their strongest quarter in over 20 years as global central banks joined the US in providing stimulus to increase market liquidity and slow economic deterioration. Emerging market economies led the way for equity markets and appeared as the best candidates to stay on the road to recovery, due to healthier balance sheets and the potential to benefit from any increase in demand for commodities. Within both developed and emerging markets, Asian stocks, as well as materials and financials more broadly, contributed strongly to returns. Developed markets returned 25.4% while emerging markets fared even better with a 34.7% return. The sustainability of this recovery came into question in June with the MSCI ACWI index finishing down 1.10% in that month as markets demanded more fundamental signs of improvement before continuing upward.

Global Fixed Income

The rebound in credit markets was the major story in fixed income during the second quarter. Patient investors were rewarded across the credit spectrum with robust returns in investment grade, leveraged loan, and high yield corporate bonds. In general, lower quality out-performed higher quality issues by a large margin, reversing previous trends. The Barclays Capital US Credit Index was up 8.8% during the quarter, while high yield bonds posted their best quarterly return, up 23.1%. The rally in some fixed income markets has been dramatic; however, fundamentals in some of these areas continue to worsen. Default rates in the speculative grade sector of the bond market ticked up to near 10% (Moody’s), with forecasts pointing toward continued credit downgrades and defaults.

Fixed Income Index Returns (6/30/09)				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
Citi World Gov. Bond	3.5%	4.0%	7.8%	6.1%
Domestic Fixed Income				
BC Aggregate	1.8%	6.1%	6.4%	5.0%
BC Government	-2.2%	6.6%	7.3%	5.4%
BC U.S. Credit	8.8%	4.1%	4.9%	4.1%
BC Mortgage Backed	0.5%	9.5%	7.9%	6.0%
BC Govt/Credit	1.9%	5.3%	6.2%	4.8%
BC TIPS	5.5%	-2.0%	5.7%	4.1%
BC High Yield	23.1%	-2.4%	2.1%	4.3%
91 Day Treasury Bills	0.1%	0.6%	3.0%	3.1%
10-Year Bond Yields	**Jun-09**	**Mar-09**	**Dec-08**	**Jun-08**
U.S.	3.5%	2.8%	2.4%	4.0%
Europe	3.8%	3.0%	3.6%	4.7%
U.K.	3.7%	3.2%	3.0%	5.2%
Japan	1.4%	1.2%	1.6%	1.5%

Other credit sectors of the market also posted strong results including CMBS and ABS, benefitting from spread tightening that has accompanied the government's TALF program. Residential and Commercial Mortgage markets ended the quarter hoping for a further boost as the US Treasury revealed specifics for the Public-Private Investment Program (PPIP). We hope to provide further analysis of the PPIP opportunity to clients over the coming months.

Hidden beneath the excitement from thawing credit markets is the headwind from rising Treasury rates. Interest rate sensitive sectors of the market underperformed, with Treasury bonds posting a negative 2.2% return during the second quarter, and Agency Mortgages up a modest 0.5%. Markets began pricing-in an eventual end to the Fed's quantitative easing regime and tightening on the short end of the curve, causing longer-term rates to rise as well as the Treasury yield curve to steepen. This speculation will be challenged by strong incentives for policy-makers to keep rates low, attempting to ensure recovery and minimizing risk of a setback. International bond markets were up 3.5% (as measured by the CITI WGBI), delivering positive results despite a rise in rates, due largely to a weakening dollar. Emerging Markets Debt, as measured by the JP Morgan EMBI Global Diversified Index returned 11.4%, recovering from sell-offs in previous quarters.

Currency Markets

The US dollar depreciated against most major currencies during the quarter; as risk appetite increased, investors continued to retreat from their hiding places in US dollars. Continued pressure on the US dollar may occur as investors consider the longer term ramifications of unprecedented stimulus on the world's reserve currency. Better than expected economic readings helped the British pound (+13.0%), while performance in the Euro (+5.3%) was mixed as the European Central Bank continued to cut rates. The currencies of commodity-exporting countries gained the most ground versus the USD during a sharp increase in commodity prices. While the Japanese yen faced challenging domestic fundamentals, it did improve (+2.3%) against the US dollar.

Commodity Markets

Commodity prices rallied in the second quarter (up 19% as measured by the energy-heavy Goldman Sachs Commodity Index) as hopes for global economic recovery, led by emerging markets, spread to the developed world as well. Investor risk appetite for commodities rose, buoyed in part by worries that global stimulus programs may ultimately lead to higher inflation. Oil rose 41% to almost $70/barrel, doubling off of a 2009 low of $34. Prices rose across the Energy complex as optimism seemed to outweigh concerns about excess inventories and waning demand. Industrial Metals like Copper (+23%) gained on strong demand from developing countries, particularly China. Gold held its ground, gaining +0.5% to reach $927.10/ounce. Prices throughout Precious Metals (+0.5%) and Agriculture/Livestock (-0.3%) remained flat on mixed signals. Commodities were flat in June after an impressive rally as the dollar strengthened, worries about economic recovery resumed, and uncertainty around increased commodities trading regulation emerged.

Pension Liability Experience

Liabilities increased in the second quarter of 2009, according to the Citigroup Pension Liability Index. As the broad markets rallied in April and May, investors moved out of Treasuries. Subsequently, long Treasury yields rose 80 basis points over the quarter. However, corporate spreads over Treasuries tightened significantly, more than offsetting the increase in Treasury yields. The result was a decline in overall discount rates linked to the corporate yield curve, with a decrease of 116 basis points in the Citigroup Pension Liability Index, from 7.36% as of March 31, 2009 to 6.20% as of June 30, 2009. As a result of the decrease in discount rates, liabilities rose, with Citigroup estimating an increase of 20.5% for the quarter, but still negative year-to-date at -2.0%.

A large part of interest rate fluctuations effecting liabilities that are marked-to-market 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 to help maintain funded status. However, there is no perfect vehicle for implementing this hedge. Long corporate bonds were attractive over the past six to eight months given the wide spread over Treasuries, but improving markets and demand from pension plan sponsors has tightened spreads significantly. The opportunity to benefit from further spread tightening in long investment grade corporates is limited. Those clients who are considering implementing LDI should consider averaging into an LDI allocation over a period of months or years. As always, the implementation and amount of hedging maintained in your portfolio should be reviewed with your consultant.

Hedge Funds

Hedge funds continued to show positive performance in the second quarter with a strong 6.3% return, according to the CS Tremont Hedge Fund Composite. Performance was led by Convertible Arbitrage, Emerging Markets Equity and Multi-Strategy funds. Dedicated Short Equity Bias and Managed Futures reported negative returns as a result of the strong US equity market rally. Year-to-date, hedge funds have returned 7.2%. And over the trailing year, while a –13.7% return is disappointing, it is well ahead of the –26.2% posted by the S&P 500.

Hedge Fund Index Returns (6/30/09)				
Composite	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
CS Tremont Hedge Fund Composite	6.3%	-13.7%	1.5%	5.0%
Relative Value				
CS Tremont Convertible Arbitrage	15.1%	-10.2%	-1.8%	0.2%
CS Tremont Fixed Income Arbitrage	8.3%	-17.0%	-5.3%	-1.5%
CS Tremont Equity Market Neutral	4.8%	-41.9%	-11.8%	-4.1%
Event Driven				
CS Tremont Event Driven	6.8%	-11.3%	2.3%	6.4%
CS Tremont Event Driven - Distressed	7.6%	-14.3%	-0.4%	5.2%
CS Tremont Event Driven - Risk Arbitrage	3.5%	-0.5%	5.3%	5.2%
CS Tremont Event Driven - Multi-Strategy	6.4%	-9.7%	4.1%	7.3%
Equity Hedge				
CS Tremont Long-Short Equity	7.9%	-12.8%	2.4%	6.1%
CS Tremont Emerging Markets	13.3%	-18.3%	2.1%	8.3%
CS Tremont Dedicated Short Bias	-11.8%	-8.5%	-0.7%	1.9%
Tactical				
CS Tremont Multi-Strategy	8.3%	-12.4%	0.3%	4.0%
CS Tremont Global Macro	0.8%	-9.7%	6.6%	8.3%
CS Tremont Managed Futures	-4.7%	-4.6%	7.1%	6.6%

Hedge Fund managers continue to maintain low net and gross exposures as they navigate the volatile markets. A significant portion of the quarterly return was driven by arbitraging intra-market relative values, rather than making absolute market direction bets. Many hedge funds used long trades in commodities and equities and short bond and USD positions to produce profits.

Hedge Funds appear to be less focused on business and operational issues (leverage and redemptions) and more focused on developing and implementing investment strategies to take advantage of market conditions. The improved stability in the industry has given investors a higher degree of comfort as evidenced by positive asset flows toward the end of the quarter.

Private Markets

Fundraising, debt, deal workouts and the lack of exits are continuing challenges for both private equity and real estate managers. Distressed, secondary and mezzanine investment strategies are intriguing due to the shorter time horizon for liquidity and relatively attractive opportunity sets. We expect distressed investment strategies to be a multi-year investment opportunity with 2011 – 2015 likely emerging as a challenging time period as $1.6 trillion of commercial real estate and corporate debt comes due.

Global mergers and acquisition activity is down for both transaction volume and disclosed deal value (off 28.9% and 37.7% through May, respectively, relative to one year ago). Only 12 private equity-backed companies have gone public over the last 18 months. This lack of liquidation opportunities is depressing distributions at a time when capital commitments must continue, fueling the denominator impact (increased private market allocation percentages due to the value of total plan assets falling faster than the value of total private market assets). Investors facing these conditions have increased the number of sellers of private market interests, leading to attractive opportunities in secondaries.

Recognizing that sale opportunities are limited and refinancings are difficult, real estate managers are retaining as much cash as possible in their funds to preserve their ability to negotiate with lenders and maintain operations. The limited distributions from real estate funds are also contributing to the liquidity challenge for private market investors.

The lack of cheap and available debt is creating opportunities for mezzanine lenders. The volume of opportunities is increasing. The terms and conditions are now being driven by the lenders. Traditional covenant structures have returned - covenant-lite loans are history - and competition from the investment and commercial banks is limited. We believe that there are good managers that have the experience to invest effectively during these conditions. As such, we believe that opportunities to achieve equity-like returns at debt-like levels of risk exist and we are advising private market investors to take advantage of the current opportunity and consider adding commitments to mezzanine, distressed, and secondary investment strategies.

Final Thoughts

In past letters, we have indicated that we believed that markets would normalize and the long-term relationship between risk and reward will be re-established. This process is clearly now well underway. We believe, however, that the post-crisis environment will be characterized by slower-than-trend economic growth, higher-than-historical inflation, a more rigorous regulatory regime, and higher levels of volatility. So how are investors to allocate assets in what PIMCO's Bill Gross refers to as "the new normal?" We continue to believe that building a diversified portfolio of risky assets is appropriate for most long-term investors. We recommend, as we have for years, that risk exposures be balanced between equity, fixed income, inflation-hedging assets, and alternatives. For many investors, this has meant a reduction in equity allocations. For those clients that have "right-sized" their target equity exposures, we recommend rebalancing toward targets.

We believe that there is still opportunity in the credit markets going forward; in fact, despite the advance in credit prices year-to-date, this area still represents the best combination of risk and return in the current environment. To take advantage of the opportunity from here, however, will require: 1) skilled management in the liquid credit sectors to realize further spread tightening while minimizing exposure to rising defaults; and/or 2) allocation to less-liquid vehicles that provide financing to deeply troubled segments of the credit markets, such as TALF/PPIP, mezzanine, distressed, and secondary strategies.

Finally, we recommend continued diversification into inflation-hedging assets to protect against future inflation. We are working with clients to build out an array of real assets investments ranging from TIPS to commodities and commodities-linked stocks to less-liquid strategies such as commodities-oriented hedge funds and direct investments in energy and other commodities producing assets.

The last twelve months have been painful for most investors and we expect the environment to remain challenging through the summer and into the fourth quarter. We look forward to helping our clients navigate these turbulent markets.