Market Thoughts

Fourth Quarter 2009 — Volume 18 · Issue 4

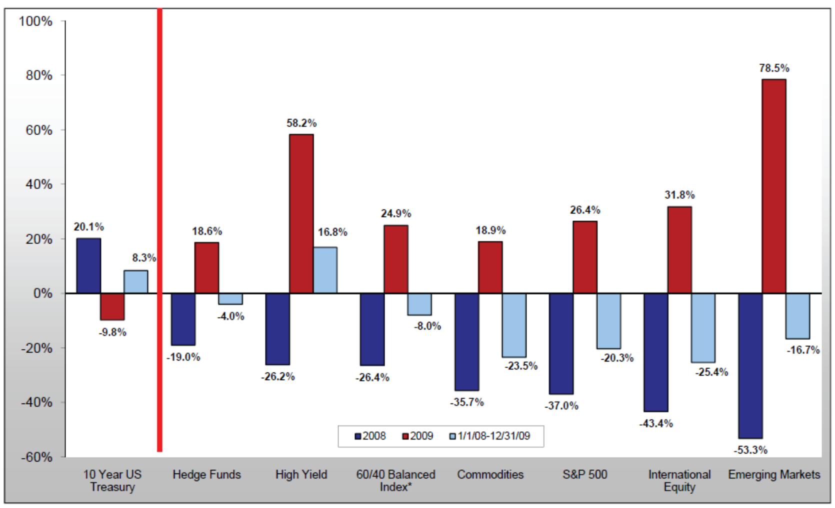
Quarterly Equity Indicator	Quarterly Bond Indicator	Quarterly Hedge Fund Indicator	Quarterly Pension Liability Indicator
Up 6%	Up 0.2%	Up 3%	Down 5%

NEPC is an independent, full service investment consulting firm, providing asset allocation, traditional and alternative asset manager search, 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.

Tighten Your Belts

Thank goodness for the rally of 2009! The overall market and economic mood feels better; we seem to have stepped back from the abyss. Yet all is not necessarily back to "normal", new or otherwise. We observe that significant global economic imbalances remain. Forward looking growth in the developed world looks tepid at best, government interest rates are low, and equity markets appear fairly valued. As a result, our five-to-seven year market forecasts are lower than they were one year ago. Faced with the prospect of lower expected returns combined with investment programs that are struggling to meet spending and funding status requirements, investors must assess difficult choices. Should investors increase risk, primarily through greater equity exposure in search of higher returns? Or should they maintain their strategic allocations, marshaling resources for when opportunities appear more attractive? Consistent with oft-made New Year's resolutions to slim down, we counsel investors to *tighten their belts*, balance risk amidst uncertainty and position their portfolios to take advantage of future opportunities. These challenges and our recommendations are discussed in greater detail in our forthcoming annual asset allocation client letter and our recent client webinar (available at www.nepc.com).

Exhibit 1 - Market Results 2008 & 2009

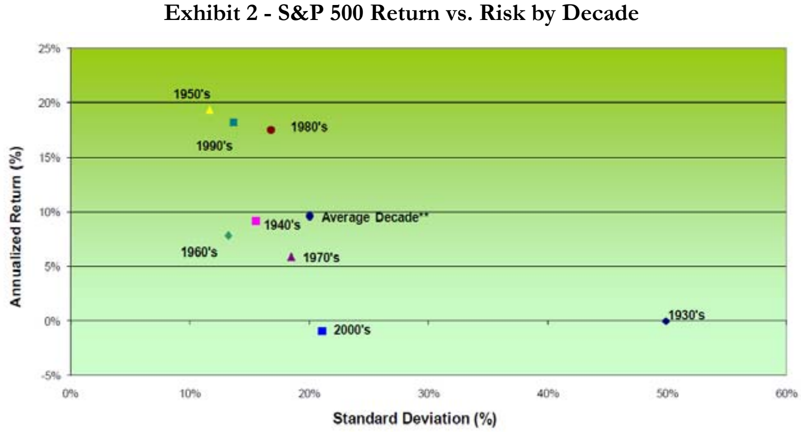


* 35% S&P 500, 10% Russell 2000, 12% EAFE, 3% MSCI Emerging Mkts Equity, 25% BarCap Agg, 5% BarCap HY, 5% CitiGroup WGBII, 5% Wilshire REIT

Source: Bloomberg

We acknowledge that the rebound of risky investments in 2009 has proven to be remarkably robust and broad-based. Nevertheless, the recent upbeat returns still leave markets well short of their late-2007 highs (Exhibit 1), and merely moderate the pain stemming from the worst decade on record for the S&P 500—even worse than the 1930s (Exhibit 2). In the near-term, the current momentum in equity markets can persist for several quarters as companies post favorable earnings relative to depressed prior year results and government spending stimulates growth. Further positives for markets include the onset of economic growth in most countries—albeit modest in the developed world—

Exhibit 2 - S&P 500 Return vs. Risk by Decade



Source: Standard and Poor's

and the moderation of key "fear indicators" such as the VIX (S&P 500 volatility index) and the difference in yield between LIBOR and short Treasuries (the so-called "TED spread"), both of which have returned to pre-crisis levels.

Longer-term, we believe that massive U.S. government debt issuance will put pressure on the dollar, particularly relative to the currencies of more rapidly growing and financially healthier emerging economies. As a result, we recommend broad global diversification including exposure to emerging markets currencies, debt, and equity. We bear in mind the potential for event risk, such as a sovereign default (Portugal and Greece are examples of countries on the brink), creating short-term volatility in global markets.

We remain concerned that the expansion of the Federal Reserve balance sheet and sizeable U.S. government budget deficits may spark inflation in the medium-term. We do not, however, expect inflation to be a significant problem in 2010 due to high unemployment and excess productive capacity. We suggest clients continue to build real asset exposure to increase diversification and help hedge against the possibility of a high inflation environment.

The Evolving Credit Opportunity

*In April of 2008, NEPC published **"When Opportunity Knocks"** in response to the emerging 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. At that time we indicated that the time horizon for the credit opportunity would be two-to-three years. Less than two years later, the liquid components of the credit markets have already experienced a remarkable recovery, as shown by returns in the table below. Those investors who allocated to investment grade credit, bank loans and/or high yield, have experienced a significant return premium over stocks during this period. While there may be some modest excess return yet available in liquid credit sectors at this juncture, we believe the majority of the opportunity has been realized. <u>As a result, we recommend that investors sell or significantly reduce their exposure to bank loans and investment grade credit, and trim their exposure to high yield and other liquid credit portfolios.</u> Opportunities remain in longer-term credit strategies that can take advantage of what we view as a meaningful upcoming distressed cycle. For those investors that can invest in longer lock-up vehicles we recommend gains from the liquid credit markets be re-allocated to credit-oriented hedge funds, as well as mezzanine, direct lending, and distressed strategies.*

Index	***2008***	***2009***	***7/1/08-12/31/09***
Barclays Inv. Grade Credit	*-3.1%*	*16.0%*	*13.0%*
Barclays High Yield	*-26.2%*	*58.2%*	*18.4%*
S&P LSTA Lev Loan	*-30.5%*	*44.9%*	*8.7%*
S&P 500	*-37.0%*	*26.4%*	*-9.6%*
MSCI EAFE	*-43.4%*	*31.8%*	*-16.2%*

Global Equity Markets

The fourth quarter of 2009 brought continued positive results to equity markets. The S&P 500 finished up 26.4% for the year, an amazing result after the year began with a continuation of the sharp dive set in motion by the Lehman bankruptcy. Since March 9, however, investors once again flocked to risky assets and equity markets were obvious beneficiaries. Just as with the steep decline, the strong rally in the markets was sentiment-driven, as the lowest quality stocks–i.e., those with high debt and low profits–soared. This junk rally ended in September, when investors appeared to refocus on fundamentals. The fourth quarter concluded with positive single-digit returns. Large caps beat small caps; growth beat value. Technology and materials were the best performing sectors, while telecom and utilities lagged.

Equity Index Returns (12/31/09)

Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	4.1%	30.0%	-5.6%	2.0%
US Equity				
S&P 500	6.0%	26.4%	-5.6%	0.4%
Dow Jones Industrial Average	8.1%	43.9%	-2.1%	0.9%
NASDAQ Composite	6.9%	22.7%	-3.1%	1.9%
Russell 1000 Growth	7.9%	37.2%	-1.9%	1.6%
Russell 1000 Value	4.2%	19.7%	-9.0%	-0.3%
Russell 2000	3.9%	27.2%	-6.1%	0.5%
Russell 2000 Growth	4.1%	34.5%	-4.0%	0.9%
Russell 2000 Value	3.6%	20.6%	-8.2%	0.0%
International Equity				
MSCI EAFE	2.2%	31.8%	-6.0%	3.5%
MSCI Emerging Markets Free	8.5%	78.5%	5.1%	15.5%
MSCI Europe	3.2%	35.8%	-6.1%	3.9%
MSCI UK	7.0%	43.3%	-7.1%	2.4%
MSCI Japan	-2.8%	6.3%	-10.4%	-3.7%
MSCI Far East	-1.7%	10.4%	-10.3%	-1.0%

Global equity markets followed a similar path throughout the year. International developed markets finished up 2.2% in the fourth quarter rounding out a 31.8% calendar year return. Performance within the financials, technology, and materials sectors led the way for the year. Japanese equity markets continued to lag, posting a negative 2.8% return during the quarter and a 6.3% return for the year, significantly trailing global indices.

Developing economies continued to experience strong growth and returns during the quarter and year. Country selection proved to be critical to investment success in this area as Brazil and most Asian economies outperformed during 2009. Since emerging market stocks hit their low point in October 2008, they have more than doubled. Improving fundamentals, a declining dollar, and strong asset flows have fueled the rise, resulting in a

78.5% return for the investment category in 2009. While we may see profit-taking and rebalancing in the near-term, the investment case for emerging markets remains attractive for the foreseeable future. Visible short-term growth rates, a resilient banking sector, an unlevered consumer, strong current account balances, and an overall lower perception of risk will benefit these economies and could lead to a re-rating of the asset class as a whole. As a result, we remain bullish on emerging markets relative to other equity categories.

Global Fixed Income

The rally in credit-related fixed income markets continued in the fourth quarter while interest rates rose in the belly and long end of the yield curve, eroding returns in Treasuries and other government-backed debt. Impressive in both its magnitude and breadth, the rally in corporate and other credit sectors was particularly notable in light of the near default of Dubai World and weakness, including ratings downgrades, of major sovereigns such as Ireland, Iceland, Spain and Greece. Headline indicators in the US were generally positive, with improved conditions in industrial production and the extension of the first-time homebuyers tax credit helping to support the housing market. The Federal Open Market Committee reiterated its commitment to keep administered interest rates at exceptionally low levels, leading to a yield curve that is currently very steep: the difference between the 10-year and 2-year yield was 271 basis points on December 31, 2009. The market appears to anticipate higher inflation over the long-term and Fed tightening in the near-term, although the eventual withdrawal of stimulus will be the first form of tightening.

Fixed Income Index Returns (12/31/09)				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
Citi World Gov. Bond	-1.9%	2.6%	8.1%	4.5%
JPM EMBI Global Diversified	1.6%	29.8%	6.6%	8.0%
Domestic Fixed Income				
BC Aggregate	0.2%	5.9%	6.0%	5.0%
BC Government	-1.0%	-2.2%	6.1%	4.9%
BC US Credit	1.0%	16.0%	5.7%	4.7%
BC Mortgage Backed	0.6%	5.8%	7.1%	5.8%
BC Govt/Credit	-0.2%	4.5%	5.8%	4.7%
BC TIPS	1.8%	11.4%	6.7%	4.6%
BC High Yield	6.2%	58.2%	6.0%	6.5%
CSFB Leveraged Loan	3.7%	44.9%	1.7%	3.6%
91 Day Treasury Bills	0.0%	0.2%	2.4%	3.0%
10-Year Bond Yields	**Dec-09**	**Jun-09**	**Mar-09**	**Dec-08**
US	3.3%	3.5%	2.8%	2.2%
Europe	3.2%	3.4%	3.0%	3.0%
UK	3.6%	3.7%	3.2%	3.0%
Japan	1.3%	1.4%	1.2%	1.2%

The Barclays Capital Aggregate Index returned 0.2% in the quarter, led by investment grade credit and mortgage-backed securities, driven by the Federal Reserve's MBS purchasing program (set to expire in March 2010). The expiration of Fed programs coupled with a forecasted record Treasury issuance in 2010 has led to some concerns about the future direction of the bond market, despite the good results in 2009.

Returns continued to be dramatic in below investment grade bonds, where the lowest rated sectors performed best. CCC rated bonds returned 90.7% in 2009, while BBs returned 46.1%. Bank loans, as measured by the CSFB Leveraged Loan Index, returned 44.9% in 2009. As discussed in "The Evolving Credit Opportunity" sidebar, above, we are counseling clients to review their Opportunistic allocations to the credit markets.

Currency Markets

The US dollar posted mixed results against other major currencies in the fourth quarter, gaining ground against the Japanese Yen (+4%) and the Euro (+2%), but continuing to decline versus UK Sterling (-1%). Commodity-oriented currencies like the Canadian dollar and the Australian dollar gained further against the U.S. dollar during the quarter, extending calendar-year gains of 14% and 24%, respectively. While the USD may show signs of some relative strength against the currencies of developed nations, its performance relative to emerging market currencies is expected to continue a long-term decline as weaker fundamentals and relative prospects for economic growth combine with uncertainty surrounding China's peg to the US dollar.

Commodity Markets

Commodities continued to soar in the fourth quarter, gaining 9.0%, and bringing the 2009 return to 18.9%. Resurgent Chinese demand, spurred in large part by stimulus programs geared toward domestic consumption, met with tight global inventories to boost many commodity prices. Energy rose 3.4% on the back of some signs of an economic rebound, with crude oil gaining 6.7%. Precious metals rose 6.1% as gold crossed $1,200/oz before settling at $1,096/oz to end the year up 25%. Investors have been bidding up precious metals amidst concern about a weaker US dollar and other developed currencies. In agriculture (+11.2%), commodities such as corn (+16.1%) rose on weaker than expected production and poor weather. Industrial metals rallied and base metals rose 16.9% in aggregate on continued demand from emerging markets. Strong demand from China, Brazil and other developing countries, coupled with a restocking cycle in the developed world, could continue to drive commodity prices higher.

Pension Liability Experience

A significant increase in long Treasury rates of 58 basis points brought some relief to plan sponsors. Though pension liabilities did decrease during the fourth quarter, the decline in pension liabilities was moderated by tightening corporate spreads (compressed 38 basis points according to the Barclays Capital Long Credit Index). As a result, the Citigroup Pension Liability Index increased 42 basis points from 5.54% as of September 30, 2009 to 5.96% as of December 31, 2009. This increase in assumed pension discount rates is estimated to have lowered pension liabilities by 5.3% for the quarter; however, liabilities are still estimated to have increased 4.6% since the beginning of 2009. The Citigroup Index can serve as an approximation of accounting liability results. Conversely, the different methodology of the PPA Funding Target Liability, when using the full yield curve, leads to increases of approximately 12% for the average pension plan in 2009.

New regulations and pension relief issued by the IRS during the year may have the effect of more corporate plans deciding to use smoothing techniques in their funding valuations for 2009. A white paper, entitled "*Pension Protection Act Regulatory Updates and Their Effects on Liability Driven Investment Strategies*" describes these regulations in detail and is available at www.nepc.com. Smoothing techniques will likely show a higher funded status for plans with a January 1, 2009 valuation date compared to mark-to-market measurements, but may make benchmarking a Liability Driven Investment (LDI) policy more difficult, though not impossible. We continue to recommend consideration of LDI strategies for corporate pension clients to protect against declining interest rates, to reduce surplus volatility, and to help maintain funded status.

Those clients who would like to manage assets relative to liabilities, but have not yet implemented LDI may want to dollar cost average into an LDI allocation over a period of months or quarters, or develop a program to extend duration through LDI after yields reach certain target levels. As always, an LDI strategy implementation and the amount of hedging maintained in your portfolio should be reviewed with your consultant.

Hedge Funds

Hedge funds reported a 3.1% return for the fourth quarter and are up 18.6% for the year, according to the CS Tremont Hedge Fund Composite. That same index was down 19.0% in 2008, meaning many hedge funds have not yet recouped losses suffered in 2008. For the quarter, most strategies reported positive returns with the exception of Dedicated Short Bias (-2.7%) and Equity Market Neutral (-1.1%). Looking at the last decade, hedge funds have produced an annualized return of 6.6% while the S&P 500 returned -1.0%.

Hedge Fund Index Returns (12/31/09)

Composite	Quarter	1 Year	3 Yrs	5 Yrs
CS Tremont Hedge Fund Composite	3.1%	18.6%	2.6%	5.8%
Relative Value				
CS Tremont Convertible Arbitrage	5.3%	47.3%	2.0%	3.4%
CS Tremont Fixed Income Arbitrage	4.5%	27.4%	-2.0%	0.6%
CS Tremont Equity Market Neutral	-1.1%	4.1%	-12.1%	-4.4%
Event Driven				
CS Tremont Event Driven	4.9%	20.4%	3.9%	7.2%
CS Tremont Event Driven - Distressed	5.4%	21.0%	1.4%	6.1%
CS Tremont Event Driven - Risk Arbitrage	1.6%	12.0%	5.6%	5.6%
CS Tremont Event Driven - Multi-Strategy	4.7%	19.9%	5.5%	7.9%
Equity Hedge				
CS Tremont Long-Short Equity	2.4%	19.5%	2.9%	6.5%
CS Tremont Emerging Markets	4.3%	30.0%	2.9%	9.0%
CS Tremont Dedicated Short Bias	-2.7%	-25.0%	-3.0%	0.0%
Tactical				
CS Tremont Multi-Strategy	3.3%	24.6%	1.6%	5.2%
CS Tremont Global Macro	2.3%	11.6%	7.7%	9.1%
CS Tremont Managed Futures	-2.5%	-6.6%	5.4%	4.8%

In the fourth quarter, hedge funds benefited from a strong equity market. Performance was also driven by the evolution of market sentiment from technical/liquidity considerations to more of an emphasis on fundamental valuations and increased dispersion across securities. In this environment, stock pickers like equity long-short managers should excel.

While the quarter saw intra-month reversals in broad asset classes, the predominant profitable themes were long equities, long commodities and short USD positions against developed market currencies. The Dubai World debt issue did not have a meaningful impact on hedge funds overall, other than to cause less liquid debt securities to slump temporarily on fear that the sovereign credit problems might spread.

Investor redemptions seemed to have abated with very modest positive inflows into hedge funds reported in the fourth quarter. The steep global yield curves, coupled with the potential for continued dispersion among securities, provide ample opportunity for hedge funds to maintain their positive streak. Going forward the landscape looks favorable as hedge funds return to their core competencies of strong fundamental research, identifying idiosyncratic mis-pricings, and evaluating single security risk (both long and short).

Private Markets

Private equity and private real estate managers continue to face market uncertainty and limited sources of capital. Institutional investors have curtailed new capital commitments—during 2009 private equity funds raised $85.5 billion (compared to $246 billion in 2008) and real estate funds raised $5.4 billion (versus $15.5 billion a year earlier). Managers continue to focus on rationalizing operations to improve cash flow in an environment where top-line revenue growth is limited or non-existent. Real estate managers face increasing vacancies, declining net operating income, and rising cap rates with falling valuations.

Investment managers' ability to work with lenders varies by debt structure. Many private equity and real estate managers have been able to extend loans with some traditional lenders. However, it is different for those involved with a structured financing. The CMBS servicers have limited ability to work out troubled properties. This problem will likely increase as the tsunami of CMBS issued during 2003-2006 ($542 billion) matures. With the lack of new issuances, equity holders and the owners of the lower tier debt tranches are at risk.

Going forward, we expect the opportunity in credit to extend multiple years. In this environment, we expect mezzanine, venture lending, intellectual property and secondary interests and secondary directs–strategies that have a shorter time horizon to liquidity than traditional buyout or venture vehicles–will continue to see strong risk-adjusted returns.

Final Thoughts

Looking into the new decade, we hope for continued economic recovery and strong capital markets. While the catalyst for strong economic growth is not yet obvious, we know the night is often darkest before the dawn. As we put the first decade of the 2000s behind us and embark on the year 2010, we are gratified that the overall market and economic environment has become more constructive. Historic risk and return relationships appear to have re-emerged and modest economic growth has resumed. Nevertheless, after the market rebound of 2009, our expectations for asset class returns have declined sharply from one year ago.

In this environment, we recommend investors pursue a disciplined and diversified approach, focusing on balance and risk management while seeking to add value in those markets where opportunities appear most attractive. Scenario analysis remains important—evaluating how portfolios would perform in a variety of economic regimes, including deflationary and inflationary environments and even possible "stagflation". Significant components to this approach will include: 1) global diversification and allocation to more rapidly growing economies such as the emerging markets; and, 2) building exposure to real assets including TIPS, global inflation-linked bonds, liquid commodities, and direct investment in energy and other real assets.

We recommend that clients take advantage of those opportunities that do exist. We believe there will be a premium available to investors who can provide liquidity to key segments of the market where traditional providers of financing have exited. Finally, active management should be considered to seek excess return in a lower overall market-return environment. Active strategies rebounded in 2009 and we believe the environment will remain constructive into 2010, particularly for those managers pursuing relatively unconstrained strategies in less efficient areas of the global markets.

The last several years have been remarkable and challenging. We appreciate the trust our clients have put in us during this extraordinary period. We look forward to embarking on the new decade with a strong focus on helping our clients balance the risks and opportunities in the global markets to meet their investment objectives.