NEPC, LLC

To: NEPC Clients

From: NEPC Asset Allocation Committee

Date: January 31, 2008

Subject: Stay the (Better) Course

For those who have read our client communications over the last several years, it is clear that NEPC champions investment approaches that are outside of the mainstream. A noticeable example of this contrarian spirit has been our belief that typical equity exposures represent too much risk in investment programs. When the stock market sustains an extended period of outperformance, this focus on risk can seem unduly conservative, possibly leading to below-average returns. Fortunately, our other major themes have performed well during the five year market run. In particular, our focus on manager value-added through portable alpha, global asset allocation, and alternative investments, as well as target-date retirement funds for defined contribution plans, has benefited client portfolios and should continue to do so.

Strong markets give traditional 60+% equity allocations a strong tailwind. Our recommendations aim to stabilize returns, participating in up markets, and preserving capital better when conditions change. Like tacking a sailboat against the wind, sound investment techniques such as diversification, risk-budgeting and rebalancing allow investors to capture gains and minimize losses in volatile markets. In past years, we have stressed the importance of leadership and encouraged our clients to "dare to be great." This year we reaffirm those messages as the markets have returned to the higher volatility levels we have been expecting.

A common theme for investors in times of economic stress is "Stay the Course." Most often this is applied to remaining in stocks after a sell-off. But the course we have outlined does not rely upon high allocations to equities to right itself. So our message for 2008 is to "Stay the (Better) Course."

2007 Review

Calendar year 2007 was the most difficult for domestic equities since 2002. In fact, all the major troubles occurred during the second half of the year. Stock market peaks at mid-year were only slightly exceeded in the October rally. A June 30, 2007 snapshot presented a very rosy picture, and some NEPC themes – lower equity, diversification, liability hedging – may have seemed out of step.

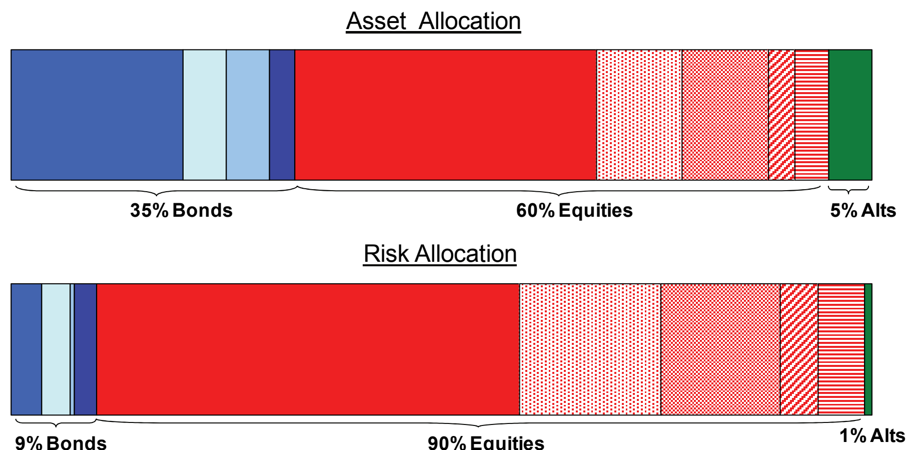
Then came the subprime meltdown, credit contagion, and a broad-based re-pricing of risk for all assets. The broader stock market held up through most of the year, with the S&P 500 index having a positive but below expectation return of 5.5% for 2007. Unfortunately, mid-January 2008 losses of almost 10% in equities have more than erased this small gain.

2008 Outlook

The headline economic issue for 2008 is the increasing likelihood of a US recession and some market commentators believe we are already there. The Federal Reserve has taken unprecedented actions this month to restore liquidity. In seeking a delayed or "soft landing" recession, these actions increase pressures for higher inflation and the continued decline of the US dollar. In addition to recession concerns, investors must recognize that the increase in volatility resulting from the subprime contagion will influence opportunities and returns for years to come. The hopeful news about these concerns is that we have worked to position clients for this uncertain future.

The Better Course

We believe that the same themes brought to clients over the last few years remain appropriate for the current uncertainty. We encourage those clients who have not yet reduced equity exposure at the policy level to reconsider their outlook from a risk perspective. Our risk budgeting model demonstrates that even a well-diversified fund with 60% equity exposure has **90%** of its risk tied to the broad stock market.



For those clients that have already reduced equity exposure, the market in 2008 could present an opportunity to return policy risk to target or to increase the active risk budget for strategies that should benefit from volatility.

Last year, we outlined some trends that we believe are emerging as characteristics of superior investment programs. We recognize that all of these factors are different than past practice and may take several years to adopt. The passage of time since last year's letter gives an opportunity to judge whether your program has made progress towards the factors of tomorrow.

Yesterday	Tomorrow
Peer/universe rankings	Performance versus target
Efficient frontier asset modeling	Risk budgeting, capital efficiency, and surplus modeling
Style/capitalization boxes	Relaxed constraints and multi-asset portfolios
Manager risk & return	Manager alpha and information ratio
5-year track record	Record of innovative alpha
Long-only mandates	Derivatives, leverage & shorting
Asset-based fees	Performance-oriented fees

In planning for the investments of tomorrow, NEPC has worked with investment managers to develop or improve global asset allocation, portable alpha and liability-driven investment strategies. Managers know that we have a track record of innovation with our clients, and we especially want to thank you for giving newer strategies an opportunity.

NEPC News

Our annual client conference will be held **May 14-15**, once again at the Westin Boston Waterfront. Our keynote speaker will be John Powers, the President & CEO of Stanford Management Company. We hope you will join us. We'll expand on the topics in this letter, and you'll have an opportunity to interact with NEPC consultants and researchers, as well as other clients and outside speakers. Watch your mailbox; invitations will be sent in February.

We thank you for the trust you have placed in us, and hope to continue to keep you on the right course into the future.