NEPC, LLC

To: NEPC Clients

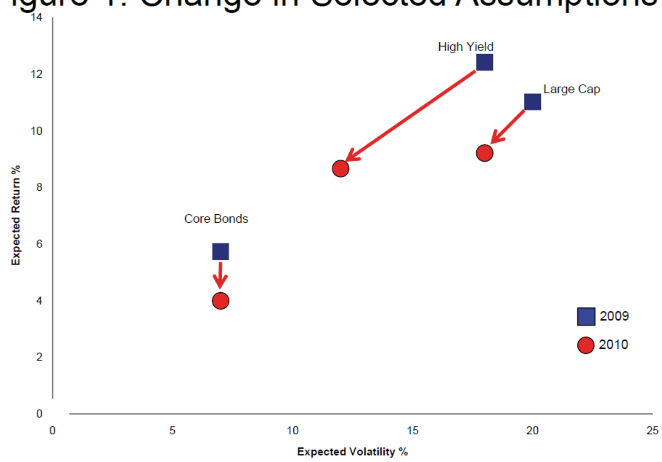
From: NEPC Asset Allocation Committee

Date: February 2010

Subject: Demand More of the New Decade

Introduction

Figure 1: Change in Selected Assumptions



Following the extreme market dislocations in late 2008, our letter *Finding the Balance* advised caution, but also identified outsized opportunities, notably in credit opportunities. In fact, the recovery in credit and all risky assets since March 2009 has been faster than we expected and a welcome respite for all investors. In recognition of these recent gains and the current economic environment, NEPC's forward-looking asset class assumptions call for lower returns with few outsized opportunities, but continue to recognize the long-term benefit of enduring investment principles.

Portfolio Management in a Low Return Environment

We expect a low return environment over the next 5-7 years, as demonstrated by the selected NEPC assumptions in Figure 1. We increased future expectations for 2009 after the significant losses of 2008, and expect lower returns going forward on the heels of the outsized returns earned in 2009. In addition, we expect low economic growth as debt levels are reduced, limiting returns for risky assets. Finally, the Fed has signaled that current very low short-term interest rates are expected to stay low for much longer than in the typical cycle, which suggests extended low returns for bonds.

We caution clients about "chasing returns" in this environment – taking greater investment risk may lead to only marginally higher returns, but with amplified volatility. Instead, we ask you to retain focus on risk management. Examine where risk is being taken in the portfolio using risk budgeting to moderate volatility. Look at unlikely, but harmful environments using scenario analysis to understand what could happen under certain economic regimes. Economic conditions could lead to a double-dip recession with more deleveraging, but also the possibility of high inflation. The possibilities of these "tail risks" present a challenge for asset allocation; they are in direct opposition to each other and require competing investments to offset their potential impact.

While we believe that the chance of tail risk is higher than usual, good overall risk budgeting accomplishes tail risk management by avoiding uncompensated risk and diversifying broadly. When specific events remain a concern, they can be addressed with targeted hedging. The many tail risk products that developed in the last year tend to be generic and not specific to a given portfolio situation. There is also a risk that products designed to avoid the dislocation in 2008 are "fighting the last war" and would not help if the next bubble bursts in a different way. Having said this, some tail risk products can be attractive in client portfolios if they provide a unique diversification benefit or an attractive opportunity for alpha.

Economic Outlook

The world economy is in unchartered territory. The recovery doesn't feel like one, harboring factors that make a robust economic rebound very unlikely. Job cuts continue, improving company financials but impairing prospects of sustained growth. Small business, which historically leads new hiring out of recessions, is still reeling. Short-term interest rates are extremely low and expected to stay there, yet banks are lending less to new enterprises. Instead, real estate and other levered businesses "pretend and extend," hoping for better future conditions. The government debt burden on a national and global basis has not been reduced, putting the economy on the same hoping-against-hope footing. In a sense, the economic recovery has been based on directly curtailing problems instead of starting new endeavors needed to stimulate the economy as a whole.

There are even discussions over the shape of the recovery – a "V" or strong rebound (which we don't expect), a "W" or double-dip recession, or more concerning shapes like "L" or "\". All of these latter shapes would damage the growth-biased, equity-centric portfolios that we have warned about for many years. If we can draw anything constructive from the investment decade of the 2000s, it is that risk is not always rewarded, and one-bet portfolios are dicey at best. The S&P 500 finished the 2000s with an annualized loss of (0.9%), representing the worst decade in US history. While many hope that a good decade will automatically follow a poor one, we learned from the market experience in Japan over the last twenty years that lost decades can be repeated. We believe that equities have an important place in diversified investment programs, but should continue to be sized with an acknowledgement of their risk contribution to the overall portfolio.

The second key risk to the economy is the specter of inflation, with the potential for inflation at its highest levels in nearly thirty years. While short-term price increases remain contained, the unprecedented actions of the Federal Reserve and other government programs will have consequences. This is especially true if the economy is weak and unemployment is high when prices rise. The Fed will need to decide which part of its dual mandate – economic growth or moderate inflation – to pursue. There is even some talk of pursuing an inflationary policy as a way to reduce the debt burden. This may be more palatable than higher taxes or less government spending. However, inflation is insidious to investor returns, destroying value for bonds, and increasing equity returns only after a painful adjustment period.

This concern over the potential for inflation raises the profile of real assets as an inflation hedge. We continue to advise building a strategic exposure to diversified real assets. However, we are concerned that the risk of higher inflation is already priced into some markets. Also, some real assets, such as commodities, are linked to both inflation and economic growth, and could decline with further reductions in industrial output. Importantly, those corporate pension plans that have moved to a funded status objective, but not fully implemented Liability-Driven Investment, would benefit from inflation's effects of decreasing liabilities more than assets, and therefore should generally not add real assets as an inflation hedge. We recognize that for some clients, inflation hedging is best addressed with commingled manager products that provide diversified exposure within one vehicle. For clients that are building multiple strategies of real assets, there may be greater opportunities in more illiquid strategies.

<u>Bubble Bursting</u>

We are experiencing the aftereffects of the credit bubble bursting, initially punctured by the collapse of subprime loans. The fundamental drivers of the subprime bubble and the economy as a whole in 2007 were extreme amounts of leverage and debt. The response to the 2008 panic has been to substitute private debt for new public debt (Treasuries and holdings at the Fed). This increase in government debt may be growing the next bubble in the US dollar. Many investors expect the dollar to decline over the next 30-years based on a longer-term move away from the dollar as the world reserve currency, the level of debt impairing the "balance sheet" of the US relative to emerging countries, and the lower economic growth rates relative to emerging countries. These latter two factors are shared with other developed currencies, notably the euro, pound and yen.

While it is in "everyone's best interest" for this dollar decline to occur slowly over time, we haven't seen gradual declines play out in practice (e.g., tech bubble, subprime, etc.). Instead, while we do expect a long-term dollar decline trend, we also expect fierce rallies and big drops along the way. For example, a dollar rally could be caused from carry trades unwinding – investors that have borrowed in US dollars due to very low short-term rates will need to cover their positions. Large dollar drops could also come as foreign central banks decide to diversify. To protect against this long term trend, we recommend an overweight to emerging market investments.

Defined Contribution Plans

The headwinds noted in this letter challenge defined contribution plans as well. The combination of lower return expectations and the potential for higher inflation and taxes reduces the probability of participants being able to meet their retirement goals. In this type of environment, we believe plan sponsors should help drive the best retirement outcomes for participants. While the solutions may sound familiar, they take on added significance in this environment. We continue to believe that streamlining your fund line-up, offering the most appropriate target date funds or income solutions, minimizing fees, and directing participants to target date funds via re-enrollment will help mitigate these challenges.

We believe that the most successful plan sponsors will be those that drive better outcomes for their employees and acknowledge their responsibility as fiduciaries of these programs, instead of simply offering fund choices and leaving participants to make their own decisions. Another critical area of focus is managing the "decumulation" stage of a participant's savings career and thinking about introducing post retirement choices into their defined contribution plans. We at NEPC are encouraged that work ahead will help ensure that defined contribution programs, as a primary retirement benefit, offer participants the ability to accumulate wealth and secure their retirement. In addition to these long-term strategic solutions, clients can also consider offering the Roth 401(k) feature and a real asset investment fund in the program, such as TIPS, to give participants tactical tools to combat the risks of higher inflation.

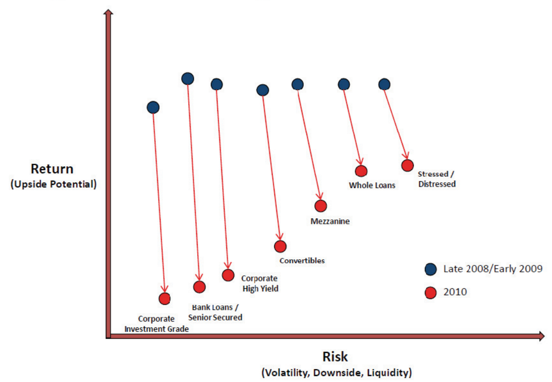
The Role of Fixed Income

From an investor standpoint, fixed income has been anything but boring over the last several years. The credit crisis created huge dislocations that resulted in unprecedented losses in 2008, but also led to considerable opportunity across a wide spectrum of investments as outlined in our paper: *When Opportunity Knocks*. The strong recovery in liquid credit markets came more quickly than expected, and provides a chance to review fixed income broadly and credit strategies specifically.

Because our clients implemented credit opportunities in many different ways – from liquid strategies such as bank loans to government-sponsored illiquid levered vehicles like PPIP – the response to the recovery in credit will differ by client. We discuss this issue in our fourth quarter *Market Thoughts* and the recent client webinar (both available at www.nepc.com). To summarize, we believe that while the opportunity for credit was outsized across all sectors one year ago, the forward-looking prospects for credit are in active management across sectors and illiquid credit investments. This change is shown in stylized form on Figure 2. We suggest harvesting gains from liquid single sector credit strategies, and redeploying into multi-sector liquid funds, illiquid strategies, or back into the total plan's long-term asset allocation.

More broadly, fixed income markets are fundamentally different than they were over the 25 years ending in 2007. Over that quarter century, the US experienced a secular decline in interest rates that provided a tail-wind to all fixed income returns. In addition, mortgage-backed bonds benefited from rising real estate prices and credit bonds did well as the high yield market developed with greater liquidity and corporate leverage. Now, interest rates are low, mortgage-backed bonds are more explicitly government-backed with little yield difference from Treasuries, and credit spreads are within a normal range, reflecting both improving company fundamentals and some concern over the long-term risk of Treasuries.

Figure 2: A Change in Relative Attractiveness



Historically, fixed income has been used in most institutional portfolios to provide liquidity and moderate the volatile returns of riskier assets. While these objectives remain, an increasing number of programs have altered the role of fixed income to meet specific program-related goals. For example, many corporate pension plans have moved to Liability-Driven Investments and endowments have focused on real returns or fixed income arbitrage. Given these trends and the changing nature of the broad fixed income market as represented by the BarCap Aggregate Index, it may be appropriate to reassess the objectives of fixed income investments. This review could result in no changes but could also lead to a focus on using fixed income to better meet program objectives and/or economic risks like deflation and inflation. Whatever the outcome of any review, we expect that the future role and implementation of fixed income investing will differ markedly from the experiences of the past.

<u>Illiquid Investment Opportunity</u>

As mentioned, we believe that part of the opportunity in credit has moved to illiquid structures. More broadly, we believe that the forward-looking prospect for illiquid investments (the "illiquidity premium") is quite high. This belief is grounded in the recognition that, while the demand for long-term capital continues and can be expected to increase in a recovery, the traditional suppliers of illiquid investment capital have exited the market or scaled back their commitments. Specifically, banks and large endowments continue to reduce commitments, private investors are cautious, and many corporate pension funds want to remain liquid to facilitate the option of freezing or eliminating the pension plan. In this environment, NEPC clients that want to continue a program of private investments, or those who would like to start, should benefit from discounted investments available on the secondary market. These investments may have more favorable terms than new funds, and hopefully higher returns. Importantly, while capital lock-ups are often seen as harmful because they decrease flexibility, in this environment they protect investors in illiquid investments from the potentially harmful impact of “fast money” flowing out.

Summary

While 2009 was a favorable year for asset returns, it did not offset the losses of 2008 and early 2009. In fact, the 2000s will be remembered by US investors as the decade in which risk was not rewarded. Despite this headwind, diversified portfolios grounded on risk management weathered the storm. Building on this foundation, seeking opportunities, and finding superior investment managers will allow NEPC and our clients to face the coming decade and the potential pitfalls. We look forward to working with you to help meet your investment goals and demand more of the coming decade.