THE LONG VIEW

NEPC'S 2011 ASSET ALLOCATION LETTER

NEPC Asset Allocation Committee

As we celebrate our 25th anniversary in 2011, NEPC has an opportunity to reflect on a remarkable quarter century and examine what we believe the next 25 years will bring. Just as the markets in the 1980s and 1990s stand in stark contrast to the 2000s, we believe prospects for the medium term and the long term are very different.

Today, we face a market cycle with the lowest expected returns in our firm's history. However, we face this future with hope and believe our three-pronged approach — a focus on the diversification we have always championed, an extension of investment into a few areas of opportunity, and a fresh examination of investments within asset classes — will best serve our clients in the coming year and for years to come.

The Next Few Years

Our core asset allocation assumptions have always focused on expectations over the medium term (five to seven years). This represents a reasonable planning period for asset allocation decisions, reflects pricing expectations on the most actively traded markets, and offers ample time for pursuing opportunistic investments.

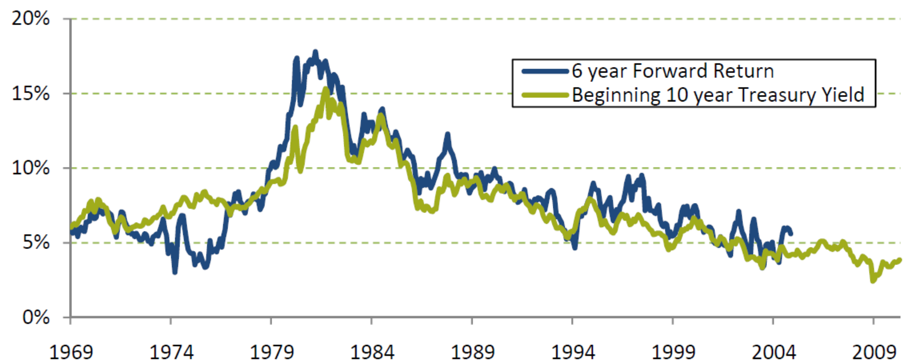
Our five- to seven-year assumptions are designed to be forward looking, based on current market pricing. A good example is bond returns, which are largely determined by starting yields (**Figure 1**). With yields down roughly 0.75% from last year, it is not surprising that our expected returns are generally about 75 basis points lower than at this time last year. Although forecasting stock market performance involves more factors, including expectations for economic growth, dividend yield, inflation, and valuations, our expected returns for equities are also down by a similar amount as bonds.

When combined with forecasts for every other asset class, our combined asset allocation assumptions result in current expected five- to seven-year returns for diversified investment programs that are generally 0.50-1.00% lower than we projected in 2010. These assumptions represent our best thinking, and reflect a strong market-wide belief that high debt and unemployment will, unfortunately, take many years to solve.

The Longer Term

While our forecast for the next five to seven years is materially lower than it was in 2010, our 30-year assumptions are only slightly lower than

Figure 1: Link Between Initial Yield and Actual Treasury Return



Source: St. Louis Fed, Ibbotson, Research Affiliates

25 Years 1986-2011

they were last year. These longer-term forecasts are developed using the same process as our medium-term projections and are intended to reflect the "normalized" return potential for asset classes. As such, our long term forecasts don't change significantly from year to year. For clients who need assumptions that reflect a longer term horizon, such as those used in actuarial calculations, our 2011 30-year assumptions support significantly higher returns than our standard assumptions.

The differences in the returns for the medium and long term provide information about the relative opportunity set in the market. Despite our subdued medium-term expectations, we believe that investment risk is more likely to be rewarded beyond the next several years. This is best demonstrated by a very steep yield curve (the difference between long yields and short yields), which indicates a market expectation that returns will be higher in the future. These higher returns could come from elevated inflation or supply/demand factors, such as unprecedented issuance of Treasury bonds driving up future yields.

Mission Possible

Every investment program can benefit from thoughtful examination on an ongoing basis. Our fundamental belief is that diversification is critical to long-term performance, especially in low-return and potentially volatile environments. While we continue to stress risk management and asset allocation discipline, we also think there are a few opportunities to consider.

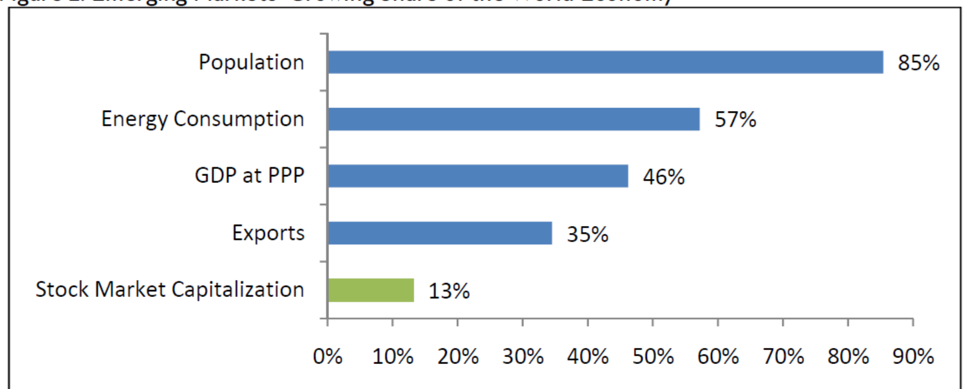
Emerging Markets: We still view emerging market investments as the most attractive area within traditional assets, although we recognize the potential for high volatility as well. Higher expected economic growth and an outlook for strengthening currencies are primary drivers of our positive outlook on emerging markets. We also believe that the "emerging consumer" will be a key theme for higher returns during this difficult time for developed economies. In addition, emerging markets are under-represented by stock market weight when compared to their global economic footprint (**Figure 2**). Potential approaches for expanding emerging investments include:

- An updated overweight of emerging markets relative to developed international markets
- A restructuring of international equity toward market segments and manager strategies that benefit from the emerging consumer
- A greater focus on emerging-market debt issued in local currencies

Illiquid Investments: We continue to believe that illiquid investments will provide a higher return premium over liquid markets, given continued demand for capital and constricted supply. In this area, multiple forms of distressed investing remain attractive, including direct lending, distressed real estate, mezzanine financing, and bank regulatory capital strategies. A critical component of any illiquid investment is to understand the liquidity needs within the entire investment program.

Active Management: In a period when market returns are expected to be low, the search for manager outperformance, or alpha, takes on added significance. We remain convinced that active management can add incremental value. While it is easy to find strategies that have outperformed in the past, we focus our manager research on finding strategies that we strongly believe will outperform in the future.

Figure 2: Emerging Markets' Growing Share of the World Economy



Source: MSCI and IMF

While many investment managers have performed well since the financial crisis, recent markets have been dominated by top-down, macro factors (such as "What is the Fed doing?" or "Will the tax cut extension pass?"). This has been called a "risk on/risk off" environment, with individual security returns having little distinction. Many managers adhere to a fundamental, bottom-up, and/or valuation discipline, a strategy which has not been rewarded in recent markets.

We have two somewhat opposing thoughts about investing in this macro environment. First, we believe a return to fundamentals is overdue. We anticipate that the market impact of daily news headlines will diminish, which should allow strategies with a quality bias to perform well. At the same time, we believe that macro-driven themes are here to stay, and investment portfolios should include strategies that benefit from these markets, including exposure to global asset allocation and global macro hedge funds, among others.

Portfolio Structuring

We believe that portfolio structuring and implementation should be another key area of focus in this challenging investment climate. We believe that investment programs can benefit from a deeper dive into the specific structures of individual asset classes, even if changes are not ultimately needed. Portfolio structuring can also highlight opportunities to seek higher alpha in less -efficient markets and to broaden manager opportunity sets through reduced constraints.

For many asset classes, only one manager strategy may be necessary, but for broad asset classes — domestic equity, international equity, fixed income, etc. – a thoughtful combination of market exposures and strategies is advisable. One example, outlined earlier, has to do with investing around a theme of the emerging consumer. Another involves including long/short equity strategies within the equity allocation, not only to tap into their higher return potential but also to benefit from their traditionally more defensive approach.

Defined Contribution

Our defined contribution clients — and, more specifically, their DC plan participants — face the same challenges of the current low expected return environment as they invest their retirement assets. We recommend greater exposure to international and emerging markets, but we realize that participants are unlikely to incorporate such investments on their own. In order to increase participant exposure to international markets, we must direct them to one of the following: target-date funds, which have 6%–20% international allocations across the glide path; or custom target-date funds in which sponsors can leverage the best thinking and investment philosophy of their defined benefit plans and institutional programs.

Saving for retirement and investing for retirement are different decisions. For years we have encouraged plan sponsors to pursue strategies 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. Today, tools such as automatic enrollment and automatic deferral increase are mainstream, and sponsors that have postponed decisions on these features should consider adopting them. Encouraging participants to save more and save early improves the odds of a successful outcome, in any investing environment.

Conclusion

In this difficult environment, NEPC is asking our clients to take the long view. Our commitment is to provide recommendations and expectations that reflect our best judgment, even when parts of the message may seem daunting. Together we can capitalize on an array of strategies — in asset allocation, portfolio structure, and manager selection — that can add significant value over the next few years and beyond.

We sincerely appreciate the trust you have placed in us, and we remain dedicated to helping you meet your goals over the next 25 years.