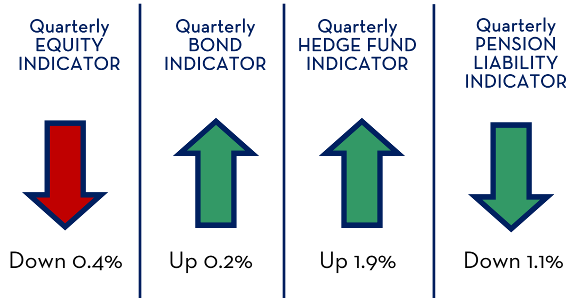
MARKET THOUGHTS

FOURTH QUARTER 2012 **VOLUME 28**

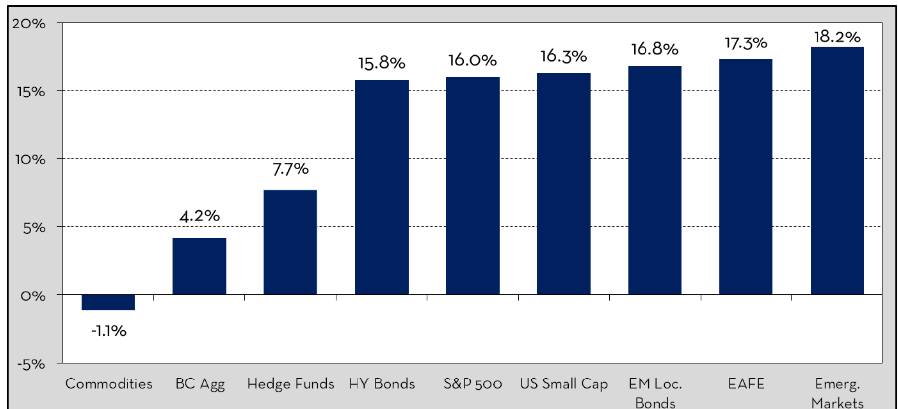


NEPC is an independent, full service investment consulting firm, providing asset allocation, traditional and alternative asset manager search, performance evaluation and investment policy services to institutional investment programs. We offer our market letters to provide insight into recent market 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.

Cliffhanger

As if following the plotline of a holiday movie blockbuster, US lawmakers kept investors on tenterhooks, bickering and posturing at the brink of the "fiscal cliff." But, just as savvy film-goers know the square-jawed movie hero will emerge victorious to fight another day, investors wagered a deal would be made. Indeed, stocks had already recovered from their brief sell off after the elections; equity market volatility remained muted through the dueling; and markets shot up as politicians thrashed out a compromise at the eleventh hour.

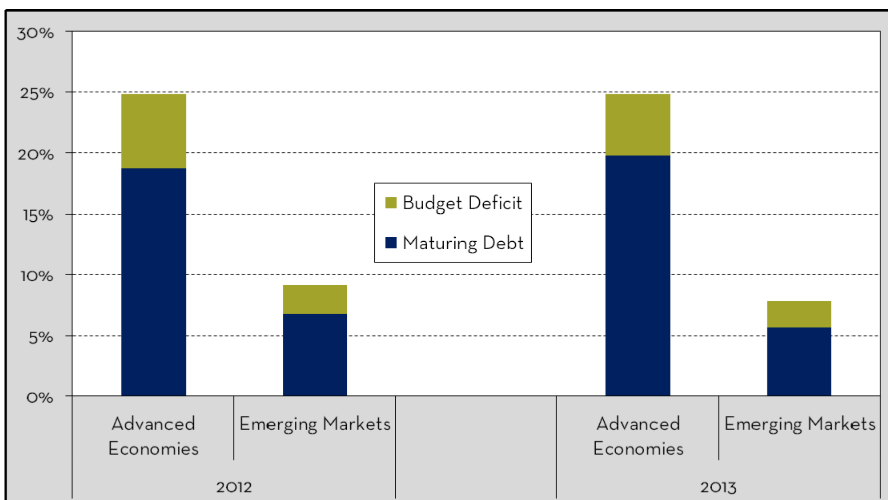
Exhibit 1: 2012 Market Returns



Source: Bloomberg

This theme played out through 2012, as stocks and risky bonds shrugged off potential macroeconomic perils, including the euro-zone debt crisis, uncertainties around the US presidential elections, slowing economic growth in China, and turmoil in the Middle East, to post hefty gains of 16% to 19% (Exhibit 1).

Exhibit 2: Average Gross Financing Needs (as % of GDP)



Source: IMF (2012 and 2013 are forecasts)

So how do we apply the teachings of the suspenseful close shaves last year to investment strategies in 2013? We are now entering a year of tricky plotlines with no obvious resolution: bond yields have hit rock bottom; economic growth is expected to be lackluster for the foreseeable future; developed markets are in the throes of a multi-year deleveraging; and developed country leaders are still struggling to reign in large budget deficits amidst high debt service levels (Exhibit 2). Central bankers around the world are keeping rates low, through quantitative easing, in efforts to spur growth in the face of fiscal tightening. This introduces the added danger of inflation, presenting a dilemma worthy of a big screen action hero: how do investors navigate between the real and present dangers

of allocating to low risk assets that cannot meet long-term financial objectives versus investing in higher-risk market segments that appear fairly valued, at best?

To be sure, sophisticated investors, armed with scale and a long time horizon, have the wherewithal to look past such short -term perils. We recommend that clients continue to build strategic exposures to emerging markets and inflation sensitive assets. The economic fundamentals likely to drive growth in emerging markets remain strong and should especially bolster consumer oriented stocks and debt issued in local currency. Although price increases have yet to manifest broadly, when inflation does arrive, it is likely to occur quickly. As a result, we believe that inflation hedging exposures should be built proactively rather than reactively.

On an opportunistic basis, non-US stocks in developed markets appear attractive from a valuation standpoint. That said, they will be vulnerable to headline risks fueled by the ongoing politically-fraught process of deleveraging. In the euro-zone, much will hinge on key elections in Italy and Germany, which promise to be too close to call. Investors may be able to garner attractive returns by locking up capital in less liquid but more rewarding credit strategies, including replacing traditional bank financing by providing direct lending to capital-starved borrowers.

We provide further details on our market observations and actions for 2013 in our annual asset allocation letter entitled, *More Questions than Answers*, available at www.nepc.com.

With one cliffhanger barely behind them, investors should keep their popcorn ready for the next nail biting fiscal climax: the inevitably contentious negotiations around the US debt ceiling. It's coming soon to a theater near you...

Global Equities

US equities posted mixed results for the fourth quarter amid uncertainties around the outcomes of the presidential election and the fiscal cliff. Macroeconomic concerns also took a bite out of returns. For the three months ended Dec. 31, the S&P 500 Index recorded a loss of 0.4%. Small cap stocks, as measured by the Russell 2000 Index, gained 1.9%. For the full year, however, US equity markets rose strongly with gains fueled by improving fundamentals in the financial services sector, a more robust housing market and lower unemployment. In terms of strategy, value trumped growth across all market capitalizations.

International equity markets, buoyed by positive news flow within the Euro zone, Japanese export-driven stocks and stronger economic data from China, beat domestic and emerging markets in the fourth quarter. To this end, the MSCI EAFE Index recorded gains of 6.6% during the period, with consumer discretionary and financial sectors leading the pack.

Emerging markets trailed developed markets in the fourth quarter. Posting gains of 5.6% during the period, developing countries initially started the quarter trading sideways. They subsequently rallied after the US elections, positive commentary out of Europe, and the change in leadership in China coupled with encouraging economic data. Asian markets led the group, bolstered by solid performance in China. Latin America finished last, with Brazil posting the strongest performance of 3.5%.

Equity Index Returns as of 12/31/2012				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	2.1%	13.2%	4.9%	-3.2%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	-0.4%	16.0%	10.9%	1.7%
Dow Jones Industrial Average	-2.5%	7.3%	8.6%	-0.2%
NASDAQ Composite	-3.1%	15.9%	11.0%	2.8%
Russell 1000 Growth	-1.3%	15.3%	11.4%	3.1%
Russell 1000 Value	1.5%	17.5%	10.9%	0.6%
Russell 2000	1.9%	16.3%	11.8%	3.6%
Russell 2000 Growth	0.4%	14.6%	12.4%	3.5%
Russell 2000 Value	3.2%	18.1%	11.0%	3.5%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	6.6%	17.3%	3.7%	-3.7%
MSCI Emerging Markets	5.6%	18.2%	5.0%	-0.9%
MSCI Europe	7.0%	19.1%	3.5%	-4.3%
MSCI UK	3.4%	10.8%	3.1%	-5.1%
MSCI Japan	5.8%	8.2%	2.1%	-4.3%
MSCI Far East	5.4%	9.1%	1.2%	-4.8%

Source: Bloomberg

Global Fixed Income

Risky fixed income assets continued their relentless march in the fourth quarter. Emerging markets debt and high yield bonds rose the most as yield hungry investors sought higher returns in the low interest rate environment.

Even as massive government stimulus poured into Treasuries, the yield curve shifted upwards in the quarter, retreating from all time lows in the summer. Despite the recent increase, Treasury yields were suppressed in 2012, defying the consensus that they could only go up. The yield on the 10-year Treasury ended the year at 1.8%, compared to 1.7% in the third quarter and 1.9% a year earlier.

The Barclays Aggregate Index returned 0.2% in the fourth quarter. Gains in credit and commercial mortgage backed securities (CMBS) aided results, which were partially offset

by the increase in rates. Banks and financials dominated investment grade credit. Agency MBS delivered positive returns over the year but were in the red in the fourth quarter, at -0.2%.

Assets continued to gush into the high yield sector even as yields eroded and spreads traded at historical averages. The Barclays High Yield Index gained 3.3% in the fourth quarter and 15.8% in 2012. The S&P LSTA Leveraged Loan Index, a bellwether of the US bank loan market, was up 1.4% in the three months ended Dec. 31 and 9.7% in 2012.

Emerging markets debt beat most fixed income asset classes last year. US dollar denominated emerging debt was up 3.2% in the fourth quarter and 18.0% in 2012, driven by the drop in US rates and robust demand. Local currency debt, as measured by the JP Morgan GBI-EM GD (unhedged), gained 4.1% in the fourth quarter and 16.8% in 2012 as local interest rates declined and local currencies appreciated versus the dollar

Fixed Income Index Returns as of 12/31/2012				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
Citi WGBI	-1.7%	1.6%	4.4%	5.3%
JPM EMBI Plus	3.2%	18.0%	14.7%	12.8%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate	0.2%	4.2%	6.1%	5.9%
BC US Agg. Treasury	-0.1%	3.0%	5.7%	5.4%
BC US Credit	1.1%	9.4%	8.7%	7.7%
BC Mortgage Backed	-0.2%	2.6%	4.7%	5.7%
BC Interm. Gov't/Credit	0.3%	3.9%	5.5%	5.7%
BC 1-10 Yr TIPS	0.5%	5.0%	6.3%	5.6%
BC High Yield	3.3%	15.8%	11.9%	10.3%
S&P LSTA Lev. Loan	1.4%	9.7%	7.1%	5.7%
3 Month T-Bills	-0.1%	0.0%	0.0%	-0.6%
10-Year Bond Yields	**Dec-12**	**Sep-12**	**Jun-12**	**Dec-11**
US	1.8%	1.6%	1.6%	1.9%
Germany	1.3%	1.4%	1.6%	1.8%
UK	1.8%	1.7%	1.7%	2.0%
Japan	0.8%	0.8%	0.8%	1.0%

Source: Bloomberg

Currency Markets

The Japanese yen (JPY) stood out in the fourth quarter, depreciating more than 10% versus the US dollar (USD). Contributing to the yen's selloff: the Bank of Japan (BoJ) alluded to the potential for further monetary easing in response to calls for a more aggressive monetary policy from the newly elected Japanese Prime Minister. In addition, the BoJ began expanding its asset purchase program in December, which affected the JPY.

Most other currencies rose compared to the USD, which weakened in the face of quantitative easing measures and increased risk taking in the fourth quarter. The euro appreciated significantly against the USD, ending the year higher on a relative basis. Asian and eastern European currencies also generally appreciated against the USD, particularly in October. Despite quantitative easing, gold has been range-bound for an extended period. Given concerns around the fiscal cliff and a weak USD, however, gold appreciated during the fourth quarter.

Other currencies of note: the Australian and Canadian dollars, both commodity currencies, saw a bounce during the quarter on the back of potential greater demand for commodities given China's rebounding economic performance. Broadly speaking, emerging market currencies, for instance, Brazil and Indonesia, lagged behind those of most developed markets.

Commodity Markets

Commodities suffered a steady bruising in the fourth quarter, wiping out most increases for the year. In particular, agricultural products, a strong performer during the third quarter, erased all weather-related gains. Within agriculture, price volatility in soybeans spiked dramatically as availability concerns eased after Brazil reported record supplies and the USDA posted a higher than forecasted yield for soybeans in 2012. Similarly, within the energy sector, natural gas retreated from its previous highs during the quarter. Gas storage levels remained robust, with increased production keeping pace with manageable demand, aided by a relatively warm winter and a seasonal rebound in nuclear energy production.

Pension Liability

Pension discount rates rose slightly in the fourth quarter, as increases in Treasury rates were partially offset by tightening credit spreads. The Citigroup Pension Liability Index climbed 11 basis points to 4.05%. Pension liabilities fell 1.1% for the quarter but were up 11.7% for the year, according to Citigroup estimates. Plans using Liability Driven Investing (LDI) strategies probably experienced losses from their long duration assets in the fourth quarter, but reported gains for the calendar year. In addition, a strong showing by equities in 2012 signaled little change in the average plan's funded status from the end of 2011.

NEPC continues to recommend corporate pension plan sponsors utilize LDI strategies to hedge interest rate exposure and reduce funded status volatility. This decision may be better evaluated within the context of a glide path strategy, given interest rates remain historically low, and the likelihood of MAP-21 funding relief legislation reducing contribution requirements over the next few years. Please feel free to contact your NEPC consultant to review LDI strategies and implementation options for your plan.

Hedge Funds

Hedge funds delivered solid returns in the fourth quarter with net exposure approaching calendar year highs in December. The Dow Jones Credit Suisse Hedge Fund Composite rose 1.9% during the quarter— even as the S&P 500 declined 0.4%— bringing year-to-date gains to 7.7%.

The fourth quarter brought the curtain down on a strong performance by select credit and event driven strategies. Fixed income funds returned 2.0%, buoyed by spread compression across asset classes and gains from Non-Agency residential MBS and other asset backed securities. Event driven assets posted returns of 3.2%, aided by the liquidation trades of Lehman Brothers and Capmark.

Long-short equity strategies gained 2.1% in the quarter, with emerging markets leading the way with returns of 3.9%. Managed futures strategies (-3.1%) struggled during the quarter, particularly in October (-4.6%), when periods of elevated short-term volatility dealt a blow to managers following medium- and longer-term trend strategies. Exposure to commodities, especially metals, hurt global macro (-0.7%) and managed futures strategies in October.

Hedge Fund Industry Performance Overview as of 12/31/2012)				
Composite	Quarter	1 Year	3 Yrs	5 Yrs
DJCS Hedge Fund Composite	1.9%	7.7%	5.2%	2.2%
Relative Value	Quarter	1 Year	3 Yrs	5 Yrs
DJCS Convertible Arbitrage	1.9%	7.8%	6.6%	4.0%
DJCS Fixed Income Arbitrage	2.0%	11.0%	9.4%	3.5%
DJCS Equity Market Neutral	0.8%	0.9%	1.5%	-8.3%
DJCS Multi-Strategy	2.7%	11.2%	7.4%	3.3%
Event Driven	Quarter	1 Year	3 Yrs	5 Yrs
DJCS Event Driven	3.2%	10.6%	4.2%	2.3%
DJCS Event Driven - Distressed	3.2%	11.8%	5.7%	2.6%
DJCS Event Driven - Risk Arbitrage	1.8%	2.8%	2.3%	3.0%
DJCS Event Driven - Multi-Strategy	3.2%	10.1%	3.5%	2.2%
Equity Hedge	Quarter	1 Year	3 Yrs	5 Yrs
DJCS Long-Short Equity	2.1%	8.2%	3.1%	1.0%
DJCS Emerging Markets	3.9%	10.3%	4.6%	0.7%
DJCS Dedicated Short Bias	-3.4%	-20.4%	-13.8%	-11.2%
Tactical	Quarter	1 Year	3 Yrs	5 Yrs
DJCS Global Macro	1.3%	4.6%	8.1%	6.1%
DJCS Managed Futures	-3.1%	-2.9%	1.4%	2.9%
Traditional Markets	Quarter	1 Year	3 Yrs	5 Yrs
Barclays Aggregate Bond	0.2%	4.2%	6.2%	6.0%
S&P 500	-0.4%	16.0%	10.9%	1.7%

Source: Bloomberg

Private Markets

The private equity industry continued its recovery in 2012. Investments in new private equity funds totaled $257 billion last year, a 6% jump from 2011. US and European fundraising gained modestly during the year, with $168 billion and $53 billion, respectively, committed to new funds. Private equity in Asia fell moderately as investors took stock of the region's near-term growth prospects. Perhaps signaling a degree of investor confidence in the economic recovery, buyout and growth equity funds raised $126 billion, comprising nearly half of all new commitments for 2012. Commitments to opportunistic strategies in the distressed and secondary categories ratcheted up two-fold and three-fold, respectively, as investors chased managers positioned to capitalize on financial or liquidity challenges. Global private equity returned 2.1% in the third quarter (the most recent period for which data are available), according to the Burgiss Group. All regions were in the black for that quarter with Europe at the top. In the ten years through the third quarter of 2012, global private equity earned 12.5%, annualized, with buyout funds returning 14.3% and venture capital funds gaining 5.4%. With the dust yet to settle on the near-term economic outlook, we believe a blend of growth- and value-oriented strategies is vital to balance the macroeconomic risk in a private equity program. We find secondary, mezzanine and direct lending strategies particularly attractive as they benefit from restructuring and regulation of the global banking industry.

In private core real estate, recent quarterly total returns have been above historical averages but are trending downward toward more normalized returns. NEPC has a neutral view for US core real estate. Heartening signs for core real estate: improving fundamentals in occupancy and rental rates, limited new construction, and attractive relative spreads versus Treasuries. A concern: lower absolute yields and significant capital inflows are driving up pricing for assets. NEPC remains neutral on US Real Estate Investment Trusts (REITs). REITs are trading at historically high multiples of their funds from operations (FFO), driven, in part, by investors hunting for yield. NEPC continues to spot opportunities in value-add and opportunistic real estate strategies, especially in Europe where the weakened lending power of the region's banks present an upper hand for investors seeking yield in non-core/secondary assets and capital structure distress. Debt related investment opportunities, also in Europe, appear to offer an attractive risk-return profile for investors.

Final Thoughts

A year ago we anticipated a possible blockbuster year as risky assets appeared relatively attractive, despite the macroeconomic dangers stalking the marketplace at the time. We recommended clients increase their exposure to these assets, where appropriate, particularly in credit and emerging markets. Fast forward to the end of 2012: the broad performance of stocks and credit issues during the year has been rewarding, so much so that the box office take may have been even more than expected.

As we enter the new year, we acknowledge the extent of gains in 2012 was likely greater than the relatively limited improvements in underlying economic conditions. Thus, markets may have borrowed from future returns as developed economies continue deleveraging and growth expectations remain subdued. Potential drivers of volatility loom large, including the impending political impasse in the US around the debt ceiling and spending cuts, the ongoing euro-zone debt crisis, slowing growth in the developing world, and turmoil in the Middle East. To combat these macroeconomic perils, we recommend investors reassess their asset allocation to ensure a balance of exposures across broad categories of risk. Investors should also be prepared to take advantage of market volatility to add to risky asset categories as valuations improve.

Non-US stocks appear attractive on a relative basis although they carry higher risks. Investing in emerging markets remains a compelling opportunity, particularly in smaller company and consumer oriented stocks. In addition, local currency debt of emerging economies features higher coupons, shorter duration and better credit quality than hard currency issues. Also investors with the ability to lock-up capital in illiquid investments have the potential to profit from replacing banks and other traditional funding sources for businesses. Finally, massive monetary stimulus by central banks the world over may fuel inflation. To this end, we continue to recommend building strategic exposure to inflation hedging investments for those programs with liabilities sensitive to rising prices.

Spoiler alert: 2013 is likely to keep investors at the edge of their seats with a rollercoaster of hair raising plotlines, starting with a potentially bruising battle in the next installment of the US fiscal franchise. At NEPC we remain committed to applying all our smarts and strength to combating the myriad dangers facing our clients so they may prevail and achieve their long-term investment objectives in this unnerving environment.