OLD PHRASES, NEW PHASES

NEPC's 2012 ASSET ALLOCATION LETTER

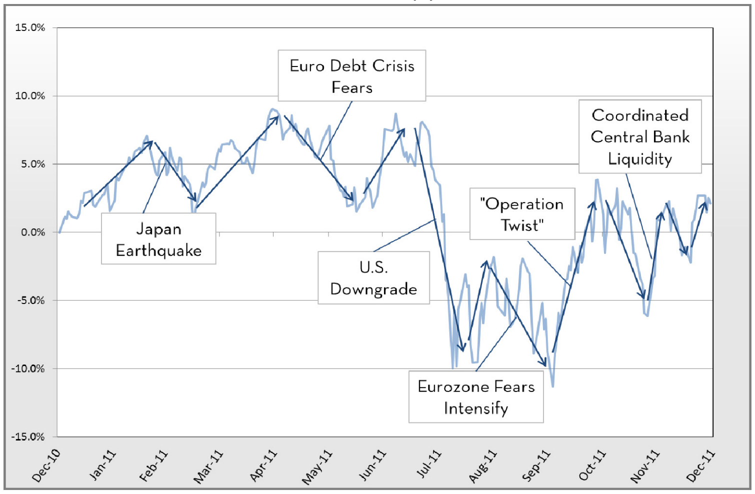
NEPC Asset Allocation Committee

A funny thing about New Year's resolutions, they can have a consistency from year to year: lose a few pounds, spend more time with family, get organized. Likewise, as we consider the investment environment entering 2012, there is a need to repeat, and even reinforce, many of the same resolutions as last year. Amidst this repetition, we do recognize a new theme for investors: most risky assets appear better positioned to reward investors for taking on prudent levels of risk.

We acknowledge that many global challenges persist. With so many long-term structural issues that must be resolved, we are perhaps at the "end of the beginning" of developed world deleveraging. Certainly the debt and banking issues in Europe remain unsolved. The ultimate fate of the Euro is following a Greek tragedy story line that seems unlikely to have a Hollywood ending. Here in the US, little progress has been made to address debt and deficit challenges, and the Federal Reserve has initiated *Operation Twist* by selling short-term and buying long-term Treasuries.

Just like the expression describing the Fed's latest operation – coined during a similar (unsuccessful) program of monetary stimulus in the 1960s during the Chubby Checker era – old phrases are popping up to describe our global predicament: *Kicking the Can* in order to push major issues into the future; *Macro-driven Markets and Risk on/Risk off* describing the daily and even hourly wild swings in security prices (Exhibit 1); The *Great Recession* giving us an uncomfortable allusion to a dismal decade of the 1930s.

Exhibit 1 - The S&P 500's 2011 Bumpy Ride to Nowhere



Source: Bloomberg

MOST RISKY ASSETS APPEAR BETTER POSITIONED TO REWARD INVESTORS FOR TAKING PRUDENT LEVELS OF RISK

We may even face a new phrase for a *Recession*, which was coined after *Depression* took on its ominous connotation, replacing the earlier *Panic*. Redefinitions are common in bad economic times, as policy makers realize one important driver of recovery is for individuals to have a positive outlook. *The Misery Index*, the sum of unemployment and inflation rates, was popularized by Jimmy Carter during the 1976 election. In this case the redefinitions have occurred in the underlying indices. If we use the 1970s formulas for inflation and unemployment (including those willing but not actively looking for work), the misery index today exceeds the 22% from 1980.

Reinforced Messages

Successful investing, however, is not just about identifying and naming the unique risks and challenges of the moment. Our annual asset allocation process allows NEPC to look ahead. We believe that there is a more positive outlook for risky assets, even in this uncertain and volatile market environment. In fact, it is clear that disciplined investing during uncertain times is a tremendous factor in long-term success. Many of the themes we are recommending should sound familiar, as they have been identified in past years, such as emerging markets, active strategies and distressed securities. While we prepare actions and assumptions each year, our focus is always on the next 5 - 7 years and what could reasonably be expected over a market cycle. Since few macro economic issues were resolved last year, 2012 presents another opportunity to consider or strengthen investments in these areas.

Emerging Markets: Despite recent poor performance, emerging markets remain a key recommendation of NEPC. The losses in EM equities during 2011 should be expected in this most volatile of equity markets. These losses also present buying opportunities for new investors as well as for the majority of US investors who remain underweight emerging markets. This underweight persists across emerging market equity and debt investing, providing an opportunity for those willing to lead. Part of our long-term case for developing markets is that we expect emerging market currencies to continue to appreciate relative to the dollar, boosting returns for unhedged local currency investments.

One caution we have towards emerging market investing is that this theme is held widely across many investors. While *groupthink* is always a concern, the fact that these same investors are in aggregate underweight emerging assets suggests that similar views have not yet led to similar implementations. In particular, while we expect emerging markets to outperform in general, we continue to focus on the theme of increasing consumption and demand for goods as these economies rapidly develop. Emerging markets small company or consumption-focused strategies provide direct access to this theme, while illiquid opportunities present a new area with potential for high returns.

Active Strategies: It was generally another rough year for active strategies, especially those based on fundamentals. Yet fundamentals do matter over the 5 - 7 year time period of our forecasts. While we believe markets will continue to be influenced by top-down decisions of governments and central banks, we expect there will be differentiation amongst companies and securities over time. This is a good time to confirm that fundamental strategies are committed to their investment philosophies and are poised for significant outperformance. This is also a good time to evaluate whether top down-oriented managers have outperformed as much as they should in this environment.

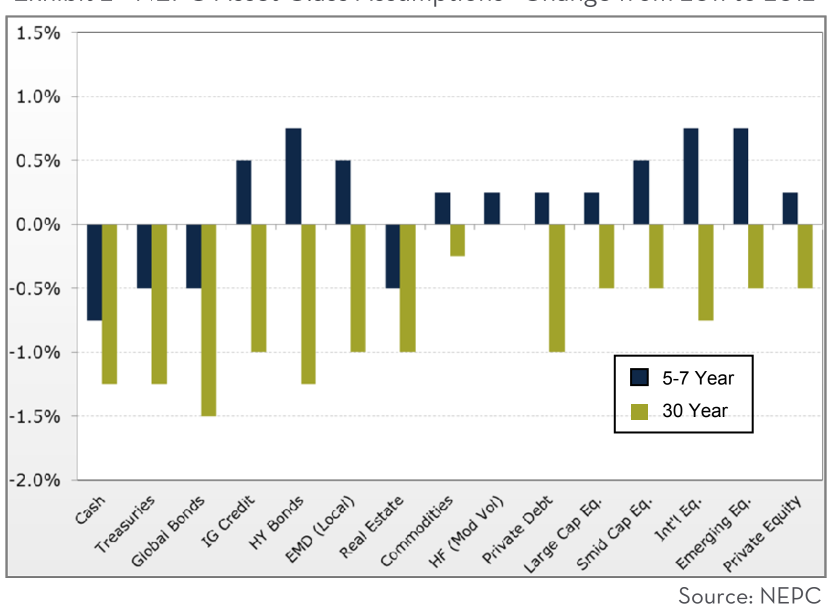
Distressed Securities: While many of these strategies have experienced good returns, we believe that deleveraging will continue to offer attractive lending opportunities across markets. Some segments, like seemingly abandoned areas of the structured and asset-backed securities markets, have already experienced distress and offer very attractive returns, even on an unlevered basis. Other markets, such as opportunities throughout Europe, offer attractive returns to patient investors. These strategies are most commonly available in structures with lock-ups and illiquidity; thus, investors must have long time horizons, and investment programs able to take on illiquid assets, to realize successful outcomes.

New Themes

Relative to the recent past (when NEPC has generally counseled reducing risk), we believe risk is more likely to be rewarded in the next 5 - 7 years. Similar to our outlooks in 2002 and 2009, we see stronger fundamentals underneath a weak economy. We do not expect an official recession in an election year with the Federal Reserve signaling a willingness to maintain an extended easy money environment. With the support of reasonable fundamentals, attractive valuations, and accommodating monetary policy, our 2012 5 - 7 year expectations for risky asset classes generally increased.

In conjunction with our 5 - 7 year forecasts, we also develop expectations over the long-term – a 30 year time horizon. While it is hard, if not impossible, to identify the investment themes that will drive markets over such an extended time frame, markets do provide us with a sense of return expectations and yields. With low yields extending out to the long-end of the yield curve, our expectations for returns have dropped meaningfully over the 30 year time horizon (Exhibit 2).

Exhibit 2 - NEPC Asset Class Assumptions—Change from 2011 to 2012



Source: NEPC

Like 2002 and 2009, we believe that the risk-adjusted opportunities are strongest in credit markets. If risky assets do well, credit spreads will decline leading to attractive returns. If instead we experience broad market sell-offs, we believe credit assets will hold their value much better than more equity-centric investments. Investors in credit bonds are generally more cautious than their equity counterparts during uncertain times, and the resolution of these different views has resulted in significantly higher risk-adjusted returns for credit instruments.

RISK-ADJUSTED OPPORTUNITIES ARE STRONGEST IN CREDIT MARKETS

We are confident in the 5 - 7 year return payoff of taking credit risk, however, we acknowledge that the short-term can be volatile. Looking at extremes, if credit spreads increase, leading to losses in the short term, it would present an additional chance to buy. Conversely, like 2009-2010, spread compression could occur swiftly, presenting an opportunity to harvest gains. The outlook for high risk-adjusted returns in credit provides another occasion to consider the purpose of fixed income, and the use of managers with relaxed constraints.

Yet as much as we recommend investors consider the best ways to pursue attractively priced risky assets and strategies, risk management remains important. It is likely that 2012 will see episodes of increased volatility, whether due to new chapters in the European debt saga, political impasse in Washington DC, slowing growth in China, or some other external shock. It is important that investors have exposure to strategies that will appreciate and provide a source of liquidity to be able to buy cheaper assets after market sell-offs. Despite extremely low yields, Treasuries and sovereign bonds can continue to play this critical role in diversified, risk balanced portfolios, hedging against deflation and/or further deleveraging.

Many institutional investors, especially those with liabilities or future commitments, face their worst economic environment when risky assets have losses and interest rates decline (the Perfect Storm that seems to come much more frequently than implied). It is difficult to maintain a substantial deflation hedge with such low expected returns. However, the increased use of risk parity and other strategies using leverage of low-return assets does offer the opportunity to have a meaningful hedge against deflation and deleveraging without sacrificing significant expected return.

Next Phase

There are many paths that markets can take in 2012. This is true whether or not long-term structural issues are solved, or even addressed at all. If anything, the outlook for 5-7 years and longer is a bit clearer. We believe certain long-term trends (such as emerging market growth) will continue, we expect there to be some progress on sovereign debt challenges, and are confident that fundamentals will become relevant again in coming years. The next phase is unlikely to generate double-digit returns, but it does offer the opportunity to take reasonable risks to achieve long-term objectives.

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