MARKET THOUGHTS

FIRST QUARTER 2016 VOLUME 41

Quarterly EQUITY INDICATOR	Quarterly BOND INDICATOR	Quarterly HEDGE FUND INDICATOR	Quarterly PENSION LIABILITY INDICATOR
Down 0.9%	Up 3.0%	Down 2.2%	Up 9.2%

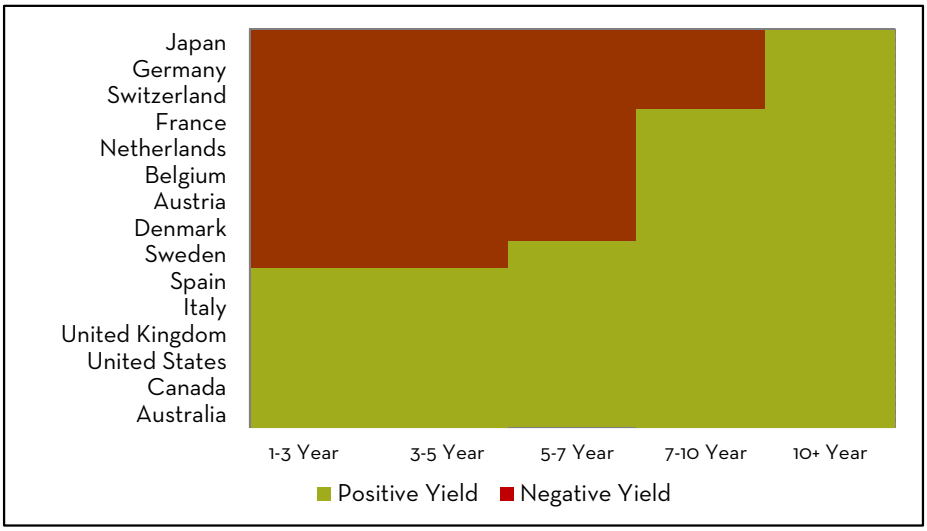
NEPC is an independent, full-service investment consulting firm, providing asset allocation, traditional and alternative asset manager search, performance evaluation and investment policy services to institutional investment programs. We offer our market letters to provide insight into recent market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

WHY WE REBALANCE: INFLECTION POINTS OF FEAR AND OPTIMISM

Introduction

Markets took a nosedive at the beginning of the year as concerns around slowing growth the world over spooked investors, pushing them to seek refuge in sovereign debt (Exhibit 1) while shunning riskier securities such as stocks and credit. Long-term Treasury bonds rallied more than 10% over fears of a US recession. Meanwhile, global equities lost 10% for the year and high-yield credit spreads pushed well past 800 basis points.

Exhibit 1: Global Government Bond Yields by Maturity Bucket



Source: Barclays

At NEPC, we have a preferred course of action for investors during just such times of heightened volatility: we encourage them to rebalance back towards long-term policy targets. This is because over time a consistent process of reducing exposure to assets that have outperformed expectations relative to a strategic asset allocation, and increasing exposure to assets that have underperformed are beneficial to a portfolio. When appropriate, we remind investors of this benefit, like we did following the resurgence of volatility in August or in our annual asset allocation letter in January.

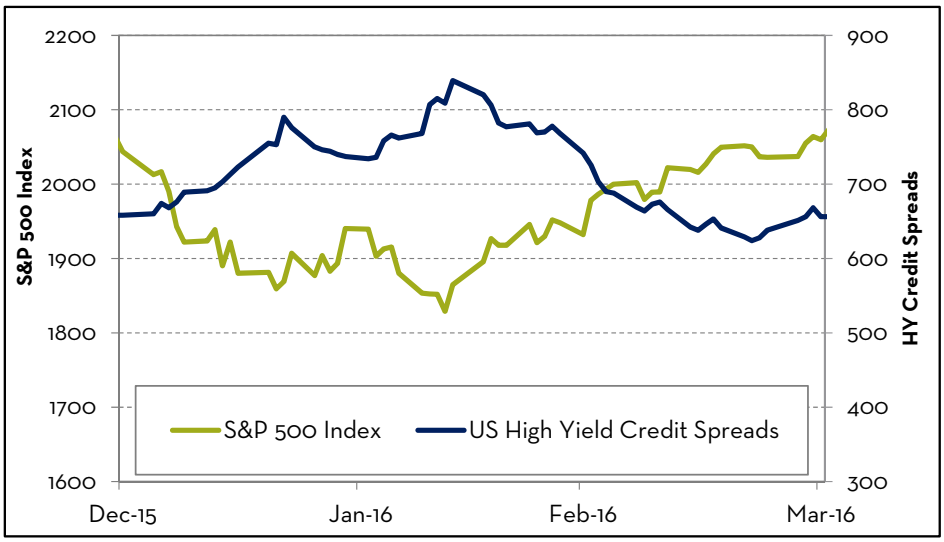
That said, any rebalancing approach that asks investors to increase exposure to assets that have sold off in a volatile environment requires discipline and a rules-based implementation strategy to offset our natural biases. In January, keeping this in mind and adhering to the fundamentals informing our annual outlook, we urged investors to rebalance. We felt the US economy was on firm ground supported by the spending power of its consumers. To this end, we viewed the decline in domestic stocks and high-yield bonds a compelling entry point. Similarly, we were confident the accommodative monetary policies in Japan and Europe would support non-US developed market equities. Within emerging markets, we thought the prolonged bouts of currency depreciation represented the necessary adjustments to support future asset gains, thus offering an attractive buying opportunity.

In a testament to the disciplined and rules-based rebalancing approach we advocated, March yielded clear benefits: US equities and high-yield bonds rebounded sharply (Exhibit 2), while emerging market stocks and local debt staged an even

more dramatic reversal, ending the quarter up around 6% and 11%, respectively.

While the rally has continued into April, many of the themes in our annual outlook remain pertinent. Foremost is our belief that investors must attempt to capture quickly-evolving opportunities when they arise. Should volatility re-emerge, we encourage investors to be prepared to rebalance back into risk assets as US duration exposures serve as a ready liquid funding source. Among risk assets, domestic equities and high-yield bonds currently offer lower expected returns but pockets of opportunity can still be found as the US economy expands. Looking at a longer-term horizon, we recommend an overweight for non-US developed market stocks with unprecedented central bank support in Europe and Japan providing a positive backdrop. Furthermore, we believe non-US developed small-cap equities offer the purest opportunity to benefit from local country earnings' growth. For emerging market equities, we recommend greater use of consumer-focused and small-cap strategies to capture increases in consumer wealth. We believe future return expectations in emerging markets adequately compensate investors relative to long-term risks; however, with volatility likely continuing in these regions, we encourage clients to re-affirm their target allocations and rebalance appropriately at attractive entry points.

Exhibit 2: S&P 500 Index and High Yield Credit Spreads



Source: Bloomberg

Global Equities

Concerns around global growth and the precipitous decline in oil prices roiled stocks initially in the first quarter but reassuring economic data triggered a dramatic reversal in March. The Standard & Poor's 500 Index posted its best return in March since 2009, putting it back in the black for the year. The S&P 500 ended the quarter with gains of 1.3%, while the Russell 2000 Index was down 1.5%. Returns were generally driven by the beaten down areas of the market, including smaller, lower-quality and commodity-related equities; however, high-quality stocks still lead for the year. Defensive bond-proxy sectors, for instance, telecom and utilities, were the best performers; value outperformed growth.

Equity Index Returns as of 3/31/2016				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	-0.9%	-5.3%	4.7%	4.3%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	1.3%	1.8%	11.8%	11.6%
Dow Jones Industrial Average	1.5%	-0.5%	6.7%	7.5%
NASDAQ Composite	-2.7%	-0.6%	14.2%	11.9%
Russell 1000 Growth	0.7%	2.5%	13.6%	12.4%
Russell 1000 Value	1.6%	-1.5%	9.4%	10.2%
Russell 2000	-1.5%	-9.8%	6.8%	7.2%
Russell 2000 Growth	-4.7%	-11.8%	7.9%	7.7%
Russell 2000 Value	1.7%	-7.7%	5.7%	6.7%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	-3.0%	-8.3%	2.2%	2.3%
MSCI Emerging Markets	5.7%	-12.0%	-4.5%	-4.1%
MSCI Europe	-2.5%	-8.4%	2.7%	2.1%
MSCI UK	-2.3%	-8.8%	0.2%	2.2%
MSCI Japan	-6.5%	-7.1%	3.8%	4.0%
MSCI Far East	-5.3%	-7.2%	3.3%	3.8%

Across the pond, developed markets also sold off earlier in the year and then rebounded following further rate cuts by the European Central Bank, and comments from the Federal Reserve on a slowing pace for raising rates that fueled a weaker dollar. Non-US markets lost 3%, according to the MSCI EAFE Index. European banks were hit the hardest during the quarter leading to losses of 9.6% for the financial sector. Energy, a laggard in 2015, was the best performing sector with returns of 4.7%. Japan experienced the worst results, selling off 6.5% in the first quarter.

Similarly, emerging markets started the year with a sharp selloff, subsequently reversing course. As a result, emerging markets returned 13% in March - their best month since 2011. For the quarter, emerging markets gained 5.7%, besting other eq-

uity markets. Strongest performers included Brazil with gains of 27.4%.

Global Fixed Income

Global fixed-income markets staged a dramatic comeback in the second half of the quarter. Global yields were pushed lower with the ECB and Bank of Japan cutting rates deeper into negative territory. Further stimulus from the ECB, a dovish Fed statement and improvements in macroeconomic data bolstered performance.

Global investment-grade spreads tightened during the period led by the industrials sector, while global high-yield debt sharply rebounded; at home, high-yield issues gained 3.2%. Given the rebound in commodities, commodity-related sectors led performance. Returns were positive across emerging markets with local sovereign debt markets leading the way as rates fell and currencies appreciated.

Fixed Income Index Returns as of 3/31/2016				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
Citi WGBI	7.1%	5.9%	0.5%	1.2%
JPM EMBI Plus	5.9%	5.9%	2.8%	6.1%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	3.0%	2.0%	2.5%	3.8%
BC US Agg. Treasury	3.2%	2.4%	2.1%	3.6%
BC US Credit	3.9%	0.9%	2.9%	5.0%
BC Mortgage Backed	2.0%	2.4%	2.7%	3.2%
BC Interm. Gov't/Credit	2.4%	2.1%	1.8%	3.0%
BC 1-10 Yr TIPS	3.6%	1.8%	-0.7%	1.9%
BC High Yield	3.4%	-3.7%	1.8%	4.9%
S&P LSTA Lev. Loan	1.5%	-1.3%	1.9%	3.2%
3 Month T-Bills	0.0%	0.1%	0.1%	0.1%
10-Year Bond Yields	**Mar-16**	**Dec-15**	**Mar-15**	**Mar-14**
US	1.8%	2.3%	1.9%	2.7%
Germany	0.2%	0.6%	0.2%	1.6%
UK	1.4%	2.0%	1.6%	2.7%
Japan	0.0%	0.3%	0.4%	0.6%

Currency Markets

The US dollar halted its march upward in the first quarter as Fed Chairwoman Janet Yellen suggested rate increases may be slower than originally anticipated, citing concerns around global growth and the impact of a strong US dollar. An index measuring the US dollar versus a basket of currencies declined approximately 4% in the three months ending March 31. Commodity currencies rallied in February amid optimism around a potential cut in oil production amongst OPEC members, which could bolster energy prices. As a result, emerging market currencies returned 5.5% in the first quarter, according to the JP Morgan Emerging Local Markets Index Plus. Meanwhile, the British pound declined as markets continue to wrestle with England's potential exit from the European Union with a referendum set for June.

Commodity Markets

The rally in March helped commodities snap their losing streak as they posted their first positive quarter since the second quarter of 2015. The Bloomberg Commodity Index returned 0.4% for the three months ended March 31, bolstered by a weaker dollar and accommodative central bank policies. Precious metals led the way with gold—a safe haven asset—the most dominant performer, rising 16%. Industrial metals rallied on news that China was beginning to prioritize growth, while oil bounced back after OPEC and Russia said they were open to discussing a production freeze at January levels and on reports of declining production of US shale. Agricultural commodities were boosted by the weaker US dollar, unusual weather patterns in the Midwest and a drought in Asia driven by El Nino.

Pension Liability

Pension liabilities are estimated to have increased a staggering 9.21% in the first quarter. Driven by the drop in Treasury yields across the curve, the Citigroup Pension Liability Index fell 42 basis points to 3.92% on March 31 from 4.34% on December 31.

Following a quarter of modest equity returns, most typical pension plans saw their funded status fall this quarter on an economic basis. However, IRS corporate funding liabilities, calculated under MAP-21 modified segment rates, are unlikely to see much change due to the 25-year smoothed rates. In addition, clients with liability-driven investment (LDI) strategies in place may experience a more modest decrease in plan funded status as long-duration fixed-income and other interest rate hedging assets outperformed during the quarter under declining interest rates.

Hedge Fund Industry Performance Overview as of 3/31/2016				
Composite	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Hedge Fund Composite	-2.2%	-5.2%	2.3%	2.6%
Relative Value	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Convertible Arbitrage	-0.4%	0.0%	0.6%	1.8%
DJCS Fixed Income Arbitrage	-1.2%	-0.5%	1.8%	4.1%
DJCS Equity Market Neutral	-0.4%	3.9%	2.8%	2.2%
DJCS Multi-Strategy	-0.6%	0.2%	5.7%	5.8%
Event Driven	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Event Driven	-4.5%	-11.9%	0.1%	0.5%
DJCS Event Driven - Distressed	-1.9%	-7.4%	1.7%	2.9%
DJCS Event Driven - Risk Arbitrage	2.1%	1.9%	1.9%	1.5%
DJCS Event Driven - Multi-Strategy	-5.6%	-13.7%	-0.6%	-0.7%
Equity Hedge	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Long-Short Equity	-3.8%	-2.2%	5.6%	3.9%
DJCS Emerging Markets	-1.2%	-2.8%	1.4%	2.0%
DJCS Dedicated Short Bias	-0.9%	6.0%	-7.7%	-8.8%
Tactical	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Global Macro	-2.2%	-6.2%	1.0%	3.1%
DJCS Managed Futures	4.3%	-3.7%	4.8%	2.3%
Traditional Markets	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	3.0%	2.0%	2.5%	3.8%
S&P 500	1.3%	1.8%	11.8%	11.6%

Hedge Funds

Hedge funds, in line with other risk assets, struggled during the first quarter. Hedge funds lost 2.2%, according to the Credit Suisse Hedge Fund Index, and were down 0.8%, according to the HFRI Fund Weighted Composite. As a whole, they took a hit in January and February, although to a lesser extent than other asset classes; conversely, hedge funds didn't meaningfully capture the quick rebound in March.

On a sub-strategy basis, event-driven strategies were the leading detractor during the quarter – the Credit Suisse Event Driven Index was down 4.5%, while the HFRI Event-Driven (Total) Index lost 1%. It has been a challenging environment for event-driven managers and crowded trades have exacerbated weak performance as issues at other firms can create technical pressure on widely-held positions. Equity managers struggled with the choppy equity market during the quarter, losing 1.7%, according to the HFRI Equity Hedge (Total) Index. As managers cut risk through the first half of the quarter, they did not fully participate in the rally through the second half. Managers focusing on the biotechnology and healthcare sectors particularly struggled given the recent pressure on the space.

On the positive side, global macro strategies continue to perform well, led by systematic strategies. The HFRI Macro (Total) Index was up 1.2%, while the HFRI Macro-Systematic Diversified Index gained 2.2%.

Private Markets

The turbulent start to the year fueled caution among buyout managers, leading to a falloff in new deals and exits from the prior quarter and a year ago. That said, valuations held steady and fundraising remained strong for venture/ growth equity. The dislocation within the energy sector and European non-performing loans present the most attractive distressed opportunities; however, the low-default environment and the availability of ample capital create a challenging environment. Direct lending and mezzanine debt still offer attractive income relative to liquid markets; however, the recent pullback in public credit markets has narrowed the gap. Secondary deal activity remains strong, with opportunism—not distress—driving most seller motivations.

In real assets, we are positive on energy, negative on timber, and neutral on agriculture, infrastructure, and metals and mining. NEPC continues to evaluate energy-related investment opportunities and our highest conviction remains in private equity and credit as these strategies appear best equipped to invest and manage assets as stress continues to build. We are evaluating the midstream (MLP) space, which has experienced a huge selloff, but risks remain. To this end, we believe that asset selection is critical.

In real estate, we remain neutral on US private core real estate and REITS. While valuations in primary markets are well above peak levels, fundamentals are strong and pricing remains attractive on a relative basis to Treasuries. We are neutral on real estate debt as competition among traditional lenders keeps yields low. We are positive on value-add and opportunistic real estate and still believe Europe is appealing. For domestic non-core real estate, we favor cash flow-driven, niche-focused managers who are attentive to duration risk at the current stage of the expansion cycle and have a demonstrated ability to stay disciplined.

Final Thoughts

At NEPC, even as our investment outlook continues to evolve, we are constant in our belief that a diversified risk-balanced portfolio is the best starting place for long-term investors to opportunistically exploit future periods of volatility and navigate the intersection of multiple global themes.

We hope to expand on these themes and more at NEPC's 21st Annual Investment Conference on May 10 and 11 in Boston. The agenda covers various topics, ranging from the use of environmental, social and governance (ESG) factors in the investment process, to the most recent developments in defined contribution plans, and opportunities in energy given the ongoing dislocation. In addition, we are excited to bring you a roster of accomplished external speakers. We hope you can join us and we look forward to seeing you in Boston.

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