NEPC, LLC

To: NEPC Clients

From: NEPC Research

Date: August 8, 2011

Subject: US Government Downgrade – Where Do We Go From Here?

Late Friday, Standard & Poor's downgraded the US sovereign credit rating from AAA to AA+, with a negative outlook going forward. While this action was widely anticipated, the deepening European debt crisis and evidence of slowing growth in the US and abroad has led to precipitous sell-offs in global stock markets that have continued into this week. Today, Standard & Poor's also downgraded Fannie Mae, Freddie Mac, and other US government-backed debt issuers. As investors digest news of the downgrades, as well as the continuing challenges facing peripheral European countries, it is clear markets will remain volatile for some time.

At NEPC we are watching the situation carefully and acknowledge that these are uncertain and challenging times. While the US downgrade is certainly an important event, we believe that it has been priced into the bond markets. In fact US Treasury bonds have rallied strongly (yields on the 10 year Treasuries fell from 2.75% last week to below 2.40% today), reflecting worsening views of economic fundamentals and the continued status of Treasuries as "safe havens" relative to more heavily indebted European nations, rather than credit concerns about the US government. Also, and importantly, Moody's and Fitch re-affirmed their highest rating for the US, and Standard & Poor's maintained their highest rating on US short-term debt.

We have consistently advocated a disciplined approach to investing, particularly in times of market stress such as the current environment. As we watch this situation unfold, therefore, we do not believe that long-term investment programs should deviate from policy in the short-term. Some steps to consider in the coming months include:

- **Review investment guidelines.** If the downgrade impacts your investment portfolio's compliance with your investment policy statement, we recommend that you allow any affected managers 120 days to bring their portfolios into compliance. Over that time period, we will work with you and your managers to evaluate the guidelines, as well as any proposed changes in mutual fund or commingled trust guidelines, in light of current conditions and make adjustments accordingly.

- **Consider the risks in your portfolio.** Can you withstand short-term volatility? Do you have sufficient liquidity? If your program is broadly diversified following a risk-balanced approach to asset allocation, including a "right-sized" equity allocation, then you may be well-positioned potentially to use declines in risky assets to rebalance to targets, effectively buying on the dips.

- **Be prepared to take advantage of opportunities.** The current market volatility may present good entry points for gaining exposure to attractive components of the global markets, or for investing in strategies that seek to take advantage of the current market environment.

We recognize that these are uncertain times and the markets are changing quickly. As always, we will do our best to keep you informed and to help craft your next steps as we navigate these challenging markets. If you have any questions, please let us know.