MARKET THOUGHTS

FIRST QUARTER 2014 VOLUME 33

Quarterly EQUITY INDICATOR	Quarterly BOND INDICATOR	Quarterly HEDGE FUND INDICATOR	Quarterly PENSION LIABILITY INDICATOR
Up 0.8%	Up 1.8%	Up 0.9%	Up 8.8%

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.

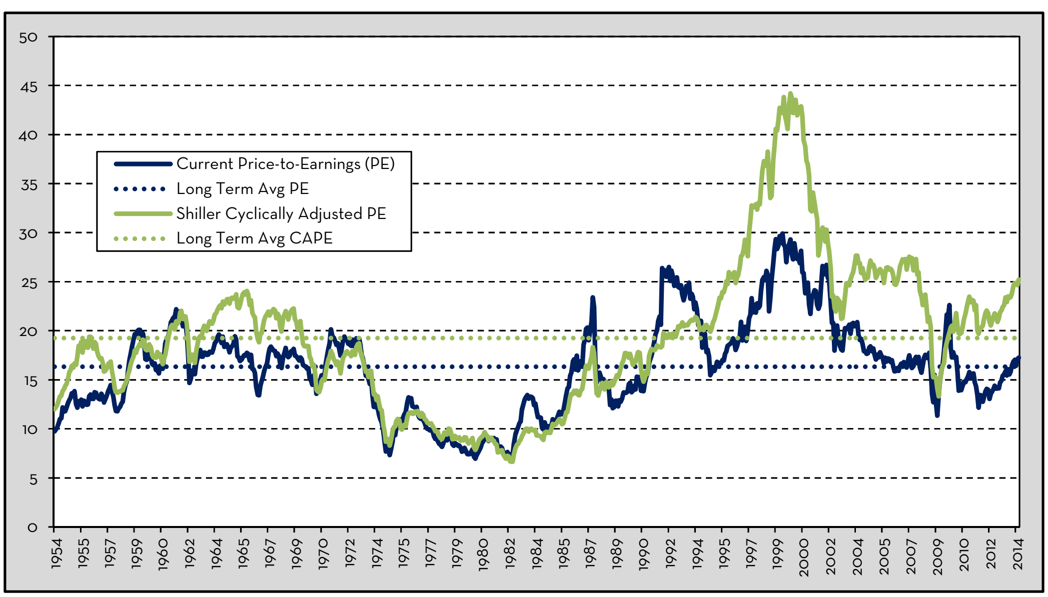
IS IT THE BEGINNING OF THE END OR THE END OF THE BEGINNING? THE NEXT CHAPTER FOR GROWTH ASSETS...

Nearly all asset classes gained in the first quarter as markets mostly shrugged off geopolitical tensions and concerns around slowing growth in emerging regions. Growth assets in developed markets were no exception, while emerging market stocks and bonds rallied in March.

The calm across investment markets provides an opportunity for investors to look back on the changes in the economic environment since the financial crisis, and then look ahead to the likely investment themes coming out of these changes. To this end, the role played by the Federal Reserve since the financial crisis is shifting, as it gradually pulls back on its quantitative easing with a $30 billion reduction (so far) in monthly bond purchases. If all goes according to plan, the Fed will phase out its quantitative easing with $55 billion in further monthly reductions through 2014. In another testament to the distance markets are putting between themselves and the financial crisis, high yield bond spreads are trading at levels last seen in 2005-2006. Across the pond, the Eurozone debt crisis has passed as bonds issued by peripheral European governments offer little yield premium compared to US Treasury debt.

The recovery of markets, without doubt, is a boon for investors. To be sure, these hefty gains have come at a cost. Returns posted by growth assets of developed markets have effectively borrowed from future expected gains, likely lowering the potential for future returns. Higher asset prices are raising the bar on future expectations for growth, leaving developed markets stretched to match the stellar returns of prior years. With the exception of emerging markets, valuations of global equities are above historical averages; US equities are leading the way with price-to-earnings ratios above long-term averages on both a current and cyclically adjusted basis (see Exhibit 1). To make these higher asset prices tenable, the optimism around improving profitability and growth expectations must continue, in addition to the steady flow of investors into growth assets.

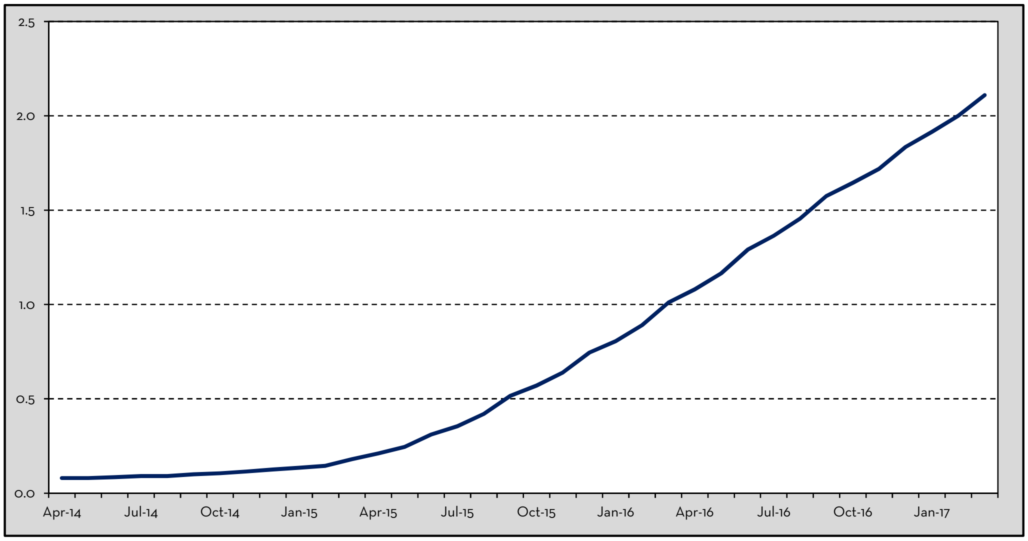
Exhibit 1: S&P 500 Valuations



Source: Bloomberg, Shiller data, long-term averages since 1954

That said, only time will tell whether we have reached the end of the beginning or the beginning of the end. The macro environment remains supportive for growth assets in developed markets as investors balance growth expectations and current valuations. The Fed has expressed a continued willingness to adjust policy and be creative if conditions evolve differently than anticipated. Expected short-term interest rates suggest a smooth transition to changes in Fed policy; the forward curve implies rate increases will occur over the next two years with few hiccups along the way (see Exhibit 2). Still, given previous challenges the Fed has faced in exiting quantitative easing programs, this seems somewhat optimistic. Economic growth is modestly positive and inflation is low (uncomfortably so in some markets). Consumer confidence is rising globally and unemployment rates are inching lower. Default rates and market volatility are hovering around historic lows. Markets continue to show resilience, even when faced with the Russian annexation of Crimea and slowing growth in emerging markets.

Exhibit 2: US Fed Funds Futures Curve



Source: Bloomberg

Regardless of how market conditions evolve, we continue to believe investors will be well positioned to weather whatever comes next if they are armed with a diversified and risk-balanced portfolio, while focusing on opportunities to earn alpha, or excess returns, in certain areas.

Global Equities

US stocks posted modest gains in the three months ended March 31, 2014, but there was a shift in dynamics, especially in the final week of the quarter. Following a strong 2013, stocks started the year with a drop in January amid concerns regarding the Fed tapering. They rebounded in February, hitting new record highs, on the heels of the Fed stating it would maintain current short-term interest rates near zero well beyond unemployment dropping below 6.5%, especially if inflation remains below 2%. Equities oscillated again in March, falling after the Fed touched on the possibility of raising interest rates. In anticipation of rising interest rates, investors sold their positions in small caps, fast-growing stocks and non-earners, while moving into stocks of more moderately-valued, stable companies exhibiting cyclical growth. The S&P 500 Index rose 1.8% while the Russell 2000 gained a modest 1.1%. Value outperformed growth across the market cap spectrum; large caps trumped small caps in the financials, healthcare, materials and technology sectors, while small caps stayed ahead in consumer discretionary, consumer staples, energy, producer durables and utilities.

Equity Index Returns as of 3/31/2014

Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	0.8%	16.7%	8.5%	21.6%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	1.8%	21.9%	14.7%	21.2%
Dow Jones Industrial Average	-0.7%	12.9%	11.2%	23.3%
NASDAQ Composite	0.5%	28.5%	17.0%	34.9%
Russell 1000 Growth	1.1%	23.2%	14.6%	21.7%
Russell 1000 Value	3.0%	21.6%	14.8%	21.8%
Russell 2000	1.1%	24.9%	13.2%	24.3%
Russell 2000 Growth	0.5%	27.2%	13.6%	25.2%
Russell 2000 Value	1.8%	22.6%	12.7%	23.3%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	0.7%	17.6%	7.2%	16.0%
MSCI Emerging Markets	-0.4%	-1.4%	-2.9%	14.5%
MSCI Europe	2.1%	24.5%	9.1%	24.7%
MSCI UK	-0.8%	16.8%	9.8%	26.9%
MSCI Japan	-5.6%	7.5%	5.7%	12.7%
MSCI Far East	-5.1%	6.4%	5.5%	14.5%

Source: Bloomberg

International equities lagged US markets, returning 0.7%, as measured by the MSCI EAFE Index. Returns within Asia were negative, with Japan declining 5.6% amid skepticism surrounding the potential for future structural and political reform. Europe led non-US equities as France and peripheral countries recorded robust gains. Italy and Ireland were two of the best markets for the quarter, with stocks returning roughly 14% so far this year. In developed and emerging markets, small cap significantly outperformed large cap. Despite rallying in March, emerging markets ended the quarter down 0.4% after absorbing volatility throughout the quarter. Russia was the worst performing market with a -14.4% return, while Indonesia gained a hefty 21.3%. Within emerging markets, consumer discretionary, healthcare and technology sectors beat energy and materials.

Fixed Income Index Returns as of 3/31/2014				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
Citi WGBI	2.7%	1.4%	1.9%	3.8%
JPM EMBI Plus	3.5%	-1.9%	7.1%	13.6%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	1.8%	-0.1%	3.7%	4.8%
BC US Agg. Treasury	1.3%	-1.3%	3.5%	2.8%
BC US Credit	2.9%	1.0%	6.1%	10.6%
BC Mortgage Backed	1.6%	0.2%	2.8%	3.8%
BC Interm. Gov't/Credit	1.0%	-0.1%	3.1%	4.2%
BC 1-10 Yr TIPS	1.0%	-4.9%	2.2%	4.0%
BC High Yield	3.0%	7.5%	9.0%	18.2%
S&P LSTA Lev. Loan	1.2%	4.4%	5.3%	16.1%
3 Month T-Bills	0.0%	0.1%	0.1%	0.1%
10-Year Bond Yields	**Mar-14**	**Dec-13**	**Mar-13**	**Mar-12**
US	2.7%	3.0%	1.8%	2.2%
Germany	1.6%	1.9%	1.3%	1.8%
UK	2.7%	3.0%	1.8%	2.2%
Japan	0.6%	0.7%	0.6%	1.0%

Source: Bloomberg

Global Fixed Income

Bond markets rallied in the first quarter, seemingly moving beyond the challenges faced by a majority of fixed income sectors in 2013. Early in the quarter, investors snapped up safer, higher-quality assets amid concerns around an economic slowdown in China and the unseasonably harsh winter in the US. This flight to quality was further reinforced following the crisis in Ukraine and Russia taking control of Crimea. A small portion of the gains in Treasuries was lost in March when markets interpreted Janet Yellen's first statements to Congress as Fed chairwoman as a signal that the Fed may increase the federal funds rate earlier than expected.

The 10-year US Treasury yield decreased 31 basis points to 2.72% during the first quarter. Intermediate-term Treasury Inflation-Protected Securities, or TIPS, gained 1.0% during the quarter, recouping some of the losses of 2013. Credit spreads tightened and yields fell during the quarter, fueling robust gains in credit markets. Investment grade credit spreads narrowed to 103 basis points, the lowest they have been since before the financial crisis. The US Credit Index gained 2.9% and the Long Duration Credit Index returned 6.3% in the first quarter. Agency mortgage-backed securities gained 1.6% in the first quarter. High yield bonds returned 3.0% during the quarter, outperforming leveraged loans. The yield spread, or yield advantage, of high yield bonds over Treasuries fell to 3.58% from 3.82% at the end of 2013. This spread tightening was fueled by steady demand for the asset class amid low default rates and healthy fundamentals in corporate credit. The Credit Suisse Leveraged Loan Index gained 1.3% during the first quarter. Lower-rated securities outperformed higher-quality issues during the quarter in line with last year's trend. Demand for floating-rate assets continues to be robust; bank loans have now experienced over 90 consecutive weeks of inflows from mutual funds and issuance of collateralized loan obligations remains strong.

Emerging markets debt continued to underperform through January amid concerns surrounding China's growth and its shadow banking system, but rebounded strongly in February and March. Local currency debt, as measured by the JP Morgan GBI-EM Index, gained 1.9%. Hard currency debt, boosted by declining Treasury yields, outperformed local currency debt during the quarter, posting returns of 3.5%.

Currency Markets

Currency woes of emerging markets drove foreign exchange movements in the first quarter. During this period, emerging market currencies were broadly weaker relative to the US dollar. The widening gap between the volatility exhibited by forex in developed economies relative to emerging markets continued. Russia's involvement in Ukraine pushed the Russian ruble to a five-year low against the US dollar, making it the worst performer among emerging economies. There were some pockets of strength in emerging markets fueled by indications the Fed will continue its accommodative monetary policy in the near-term, which led to the US dollar weakening against higher interest (carry) currencies such as the Brazilian real and

Mexican peso.
The New Zealand dollar was the largest mover in major currencies as the country's central bank raised interest rates and signaled further policy-tightening. The Australian dollar also strengthened against the US dollar. In addition, the euro, British pound and the Japanese yen strengthened moderately against the US dollar. The worst performing currency among the developed economies was the Canadian dollar, which weakened against the US dollar amid indications from the Bank of Canada that inflation was below expectations.

Commodity Markets

Commodities started the year with a bang—the DJ-UBS Index returned 7.2% in the first quarter. While geopolitical tensions and harsh weather challenged many asset classes, these trends were generally positive for commodities. The agriculture and livestock segments of the market drove commodities higher, while energy and precious metals still struggled. Fears of a grain shortage following Russia's invasion of Ukraine powered returns of 8.4% in the grain sector. Heating oil rallied early in the quarter on the heels of unseasonably cold weather, but subsequently retreated in March as temperatures returned to more normal levels, resulting in losses of 1.8% for energy. Precious metals declined 4.0% as copper prices fell amid slowing growth in China.

Pension Liability

Pension discount rates fell to levels last seen in May 2013 on the back of a year of rising interest rates and falling liability values. The Citigroup Pension Liability Index fell to 4.54% as of March 31, from 4.95% at the end of last year. The underlying Treasury curve dropped 40 basis points on the long end during the quarter, while corporate spreads remained relatively stable. The impact on liabilities was an estimated 8.80% increase for the first three months of the year.

It is likely that most pension plans saw their funded status fall in the first quarter with the increase in liabilities and the flat-to-modest returns from equities. However, clients with Liability Driven Investing, or LDI, strategies in place may witness a more moderate decrease or even increase in funded status, as long-duration fixed income and other interest-rate hedging assets outperformed under declining rates.

In February, the Society of Actuaries released a draft of their updated mortality tables, which are expected to be implemented in corporate plans over the next few years. These new assumptions will most likely increase plan liabilities by 2% to 12%, on average, depending on plan demographics and currently used mortality assumptions. Those clients with LDI glide paths in place may want to consider using an estimate of liabilities under the new mortality assumptions when reaching trigger points.

Clients who are considering implementing an initial LDI strategy should work closely with their NEPC investment consultant to discuss strategies and formulate a timeline for implementation. NEPC continues to believe that LDI may be a useful hedging tool, especially after the rise in funded status in most plans in 2013.

Hedge Fund Industry Performance Overview as of 3/31/2014

Composite	Quarter	1 Year	3 Yrs	5 Yrs
DJCS Hedge Fund Composite	0.9%	7.0%	4.4%	8.7%
Relative Value	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Convertible Arbitrage	2.5%	5.8%	4.3%	12.4%
DJCS Fixed Income Arbitrage	2.1%	3.7%	6.4%	11.3%
DJCS Equity Market Neutral	-0.3%	8.2%	3.5%	4.2%
DJCS Multi-Strategy	2.0%	10.0%	7.2%	11.0%
Event Driven	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Event Driven	2.9%	13.4%	5.1%	10.2%
DJCS Event Driven - Distressed	3.1%	13.9%	7.6%	11.5%
DJCS Event Driven - Risk Arbitrage	0.7%	5.3%	2.3%	4.3%
DJCS Event Driven - Multi-Strategy	2.8%	13.2%	3.6%	9.5%
Equity Hedge	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Long-Short Equity	1.6%	13.8%	5.5%	9.3%
DJCS Emerging Markets	-2.0%	2.0%	2.6%	9.7%
DJCS Dedicated Short Bias	-4.2%	-21.3%	-14.2%	-19.3%
Tactical	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Global Macro	-0.6%	1.5%	4.7%	7.3%
DJCS Managed Futures	-4.3%	-10.0%	-4.3%	-1.3%
Traditional Markets	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	1.8%	-0.1%	3.7%	4.8%
S&P 500	1.8%	21.9%	14.7%	21.2%

Source: Bloomberg

Hedge Funds

Hedge funds turned in a positive performance in the first quarter, with the Credit Suisse Hedge Fund Composite returning 0.9% compared to 1.8% for the S&P 500. Most hedge fund strategies were in the black for the quarter, with some exceptions, including the Credit Suisse Managed Futures Index, which lost 4.3%, and the Credit Suisse Emerging Markets Index with returns of -2.0%.

The broad Credit Suisse Long-Short Equity Index returned 1.6% for the quarter, with strong returns in January and February from healthcare and technology, followed by a sharp selloff in March. Event-driven and distressed managers benefited from special situation equities and continued appreciation in Lehman bankruptcy claims. Global macro managers struggled as successful themes in the fourth quarter reversed course in January, causing select managers to decrease exposure and re-examine positioning.

At the beginning of each year NEPC's Hedge Fund research team re-evaluates our asset class themes. In recent years we have over-weighted exposure to directional/hybrid credit structures and longer-biased equity. This year, we reduced directional credit exposure, and are favoring more hedged exposure to equities. We believe there may be greater opportunity in stock markets for individual security selection on both the long- and short-side in the future.

Private Markets

Private equity fundraising got off to a strong start in the first quarter with new commitments—at around $75.6 billion—keeping pace with the $313.5 billion of commitments made in 2013. In line with previous years, North American private equity funds comprised nearly 70% of total new commitments. Asian fundraising, totaling $10.8 billion in the first quarter, got a shot in the arm as three firms—Boyu, Affinity and CVC—raised over $1.0 billion each. Europe saw $12.0 billion of new commitments, with approximately 60% going to buyout and growth equity funds.

Globally, buyout and growth equity commitments totaled $33.3 billion, representing 44% of all funds raised so far this year, while energy, natural resources and infrastructure accounted for 19%. Venture capital fundraising surged to $13.2 billion powered by five firms—TCV, Founders Fund, Accel, Andreessen Horowitz and Lightspeed—raising over $5 billion. Mezzanine funds, at $3.2 billion, accounted for only 4% of all new capital raised as they faced competition from senior and unitranche lenders for deal flow. Secondary funds raised only $3.1 billion in the first quarter, but we expect this number to increase to over $20 billion as the year progresses with several large funds launching new fundraises. Secondary deal flow remains elevated and we continue to be vigilant of the effect of capital inflows and compression of discounts on fund's underwriting targets.

Going into 2014, we are advising clients to balance their commitments between those likely benefiting from long-term economic recovery and those capitalizing on near-term volatility in public equity and debt markets. We are still guarded on the large buyout sector as an active high-yield market, elevated transaction prices, and the return of "covenant-lite" term sheets leave scant room for operational missteps, providing little protection in the event of a prolonged recession. We favor managers who have demonstrated price discipline and strong value orientation, and who possess the operational capabilities to enhance portfolio company performance. Turnaround specialists can provide attractive options in light of the recession and its impact on businesses. Investors also need to show a readiness to make quick decisions as many top-tier fund managers are meeting their capital fundraise targets within a few months of marketing as interest in private equity grows.

In real estate, NEPC remains neutral on core strategies in the US, and positive on non-core strategies, for instance, value-add and opportunistic. For US core real estate, fundamentals continue to improve with decreasing vacancy rates, higher rents, limited new construction (outside of the apartment sector), and still attractive—though narrowing—income spreads relative to Treasury rates. The main concern for US core real estate centers around the market's expectation for higher future Treasury rates and their impact on cap rates (and capital values), specifically, if any rise in cap rates will be offset by net income growth. For clients who are underweight their core allocation, we recommend continuing to build to the target, albeit at a slower pace. We are neutral on REITs based on our views above. REITs are trading at slight discounts to net asset values but close to record high multiples of funds from operations. For non-core real estate, select attractive opportunities remain in the US for skilled firms—generally niche-focused—with a proven ability to identify undervalued assets, buy right and create value, and managers who have demonstrated discipline in investment decisions. In Europe, non-core properties are still undervalued and capital structure distress remains, creating, what we believe, are more appealing opportunities than in the US. In general, NEPC views Europe as optimal for a marginal dollar of real estate investment. That said, this particular opportunity is expected to be short-lived with capital flowing back into the market. We still believe real estate debt strategies are tempting, particularly in Europe's distressed lending environment, although currency risk is a potential consideration. This opportunity, too, is expected to be short-lived as debt markets recover.

NEPC remains positive on energy, especially in North America, which continues to evolve as the "shale revolution" matures. The land grab that characterized the sector for most of the past five-to-seven years is now largely over. To this end, large, outsized returns with short-holding periods are unlikely going forward; however, we believe there are value opportunities in the new market dynamic. Ultimately, operational expertise and industry experience are vital characteristics for managers investing in the upstream and midstream segments of the energy value chain. NEPC is neutral on agriculture, infrastructure, and metals and mining; that said, we believe there are pockets of opportunity within each segment. We believe in long-term demand drivers for agriculture, especially for row crops such as corn and soy. Infrastructure is an opportunity that can be utilized without a widely apparent “buy” signal. We believe core/core plus and some brownfield investments should be in highly defensive assets with conservative debt levels, so as to enjoy the benefits provided to true infrastructure assets, and prevent timing risk from more risky, opportunistic investments. Metals and mining offer the prospect to invest in assets that will continue to help feed urbanization trends, especially in Asia. We maintain our bearish outlook on North American timber due to a supply overhang largely at the mercy of a robust housing recovery. Still, there have been pockets of opportunity in this market, for instance, the Pacific Northwest which has benefitted from sustained demand in the Asian markets. However, these deals have been largely fully priced. Foreign timber opportunities have the potential to generate higher total returns. That said, the asset class risk-return profile shifts when assets are purchased outside of North America (and Australia/New Zealand).

Final Thoughts

The first quarter, though choppy in parts, ended with nearly all asset classes on positive ground. Growth assets in developed markets continued their upward trajectory, while emerging market stocks and bonds rallied in March. Markets mostly shrugged off the geopolitical tensions arising from Russia taking control of Crimea, and the sustained economic slowdown in emerging economies. That said, these events serve as a cautionary tale, providing an opportunity to revisit NEPC’s core beliefs and outlook. Unexpected events have a way of disrupting market expectations for growth and forward guidance for returns. To this end, we suggest investors remain disciplined, and rebalance developed market equities back to targets. A diversified and risk-balanced portfolio is a worthy starting point to weather uncertainties, especially in markets where expectations have, perhaps, advanced beyond the current economic reality.