



# MARKET THOUGHTS

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QUARTERLY EQUITY INDICATOR	QUARTERLY BOND INDICATOR	QUARTERLY HEDGE FUND INDICATOR	QUARTERLY DIRECTION OF LIABILITIES	<i>New England Pension Consultants (NEPC) is an independent, full service investment consulting firm, providing traditional and alternative asset manager search, asset allocation, 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.</i>
 Up 2.5%	 Up 1.2%	 Up 3.3%	 Down 1.5%	

On February 27<sup>th</sup>, the Chinese stock market sold off 9%, unraveling stock markets around the world. The Dow Jones Industrial Average tumbled 416 points or 3.3%, the UK market sold off 148 points or 2.3%, and the German market fell 3.0%. The Japanese market sustained the smallest loss among the developed markets, falling only 0.5%.

Both the day and the ensuing week were reminiscent of the “Asian Contagion” ten years ago. Then, in the summer of 1997, a steep fall in the Thai Bhat was followed by a similar depreciation in the currencies of Indonesia, Malaysia, and the Philippines. Malaysia and the Philippines saw their markets decline by more than 40% over just a few months. Thailand, whose problems began earlier than the others, experienced an 18% drop in share prices, for a total loss of about 60% over twelve months. The root of the financial crisis was a prior influx of liquidity to the Asian markets, leading to unsustainable economic policies. Early hints and warning signals of the impending crisis went largely unheeded. What is the similarity between the events of this quarter and those of a decade ago? Then, as today, there was an overabundance of global liquidity and a tipping point that caused investors to re-think their appetite for risk. This time around, the Chinese market’s dramatic one day decline was that tipping point, and even though by quarter-end most of the world’s stock markets recovered their February losses, some, like the U.S., did not. As of March 31<sup>st</sup>, the Dow Jones Industrial Average, S&P 500, and Nasdaq remained below their pre-sell off levels. Concerns about waning global liquidity, trouble brewing in the U.S. housing and sub-prime mortgage markets, and weakness in some key readings on the U.S. economy dampened sentiment.

## Global Equity Markets

The global equity markets rose about 1.0% in January, sold-off 0.5% in February, and rebounded 1.8% in March. The quarterly gains by region and segment of the market can be seen in the accompanying table. The UK, European, Japanese, and Far East markets gained about 3% to 4% for the quarter. The weakening dollar continues to play a role in boosting foreign returns for U.S. investors. The dollar weakened against the British Pound (-0.2%), Euro (-0.9%) and Yen (-0.9%).

The U.S. market was one of the weakest in the world, with the Dow Jones Industrial Average down 0.3% for the quarter and the S&P 500 Index up a mere 0.6%. When China sold-off on February 27<sup>th</sup>, *everything* sold off: oil & gas, technology, financials, materials and other shares, commodity futures, and gold. As one of Barron’s columnist remarked, the ferocity of the beating was plain to see within the U.S.: 99 of the stocks in the NASDAQ 100 fell, along with 498 from the S&P 500.

Equity Index Returns (3/31/07)	Quarter	1 Year	3 Yrs	5 Yrs
<b>Global Equity</b>				
MSCI World	2.5%	15.4%	14.6%	10.4%
<b>US Equity</b>				
S&P 500	0.6%	11.8%	10.1%	6.3%
Dow Jones Industrial Average	-0.3%	13.8%	8.5%	5.8%
NASDAQ Composite	0.3%	3.5%	6.7%	5.6%
Russell 1000 Growth	1.2%	7.1%	7.0%	3.5%
Russell 1000 Value	1.2%	16.8%	14.4%	10.3%
Russell 2000	2.0%	5.9%	12.0%	11.0%
Russell 2000 Growth	2.5%	1.6%	9.4%	7.9%
Russell 2000 Value	1.5%	10.4%	14.5%	13.6%
<b>International Equity</b>				
MSCI EAFE Net	4.1%	20.2%	19.8%	15.8%
MSCI Emerging Markets Free Net	2.3%	20.7%	27.5%	24.5%
MSCI Europe	3.9%	25.4%	22.1%	15.8%
MSCI UK	3.0%	24.3%	19.3%	14.2%
MSCI Japan	3.5%	3.0%	11.6%	14.0%
MSCI Far East	3.6%	5.4%	12.6%	14.2%

Source: Independent Consultants Cooperative (ICC).  
 Note: Periods longer than one year are annualized; data is in \$ terms.

The Dow lost 3.3% in a day and another 1% by the end of the week. For reasons mentioned in the preface of this letter, the U.S. market did not recover all of February's losses in March and was a drag on global equity performance for the quarter.

Separately, the CBOE Volatility Index (VIX), a barometer of market volatility and investor sentiment, rose 64% on February 27<sup>th</sup>. The VIX is known as a "fear gauge", when it rises, fear is rising, and when it declines to lower levels, fear is falling. The VIX spent a couple of weeks at substantially elevated levels before closing the quarter at about 14.6, which, as signals go, was still noticeably higher than at any point earlier in the year, but low by historical standards where a value of 20 to 25 might be considered normal.

## **Global Fixed Income**

Global fixed income, as represented by the Citigroup World Government Bond Index, returned 1.2% for the quarter, benefiting modestly from a flight to quality from the stock market's turmoil. Domestic fixed income returned 1.5%, but returns were indistinct across the credit and quality spectrum: T-bills returned 1.3%, government paper 1.5%, U.S. credit 1.5%, and mortgage backed securities 1.6%. High yield returned 2.6%, which is contrary to expectations in a downturn, but consistent with the view that risk-taking hasn't subsided. Spreads over Treasuries widened for high quality paper, but narrowed for B and Triple-C rated bonds.

Bonds rally in times of economic uncertainty, and if we start to see interest rate cuts and the long-end of the curve responds, bonds could perform well against stocks this year. While that's a possibility, it's perhaps not the most likely one. The Federal Reserve Open Market Committee left the key federal funds rate unchanged at 5.25% in the March meetings. The markets initially reacted positively to the implication that the Fed might be open to lowering rates, but reversed themselves one week later when Fed Chairman Ben Bernanke suggested to Congress that the risk of inflation still makes the Fed more likely to raise rates than lower them. In other markets, tightening continued. The Bank of England raised the Bank Rate one-quarter of a percent in January, to 5.25%. The Bank of Japan raised its benchmark interest rate to 0.50% in February, and the European Central Bank did the same in March, to 3.75%. It was the seventh increase since the ECB began to tighten credit in December 2005.

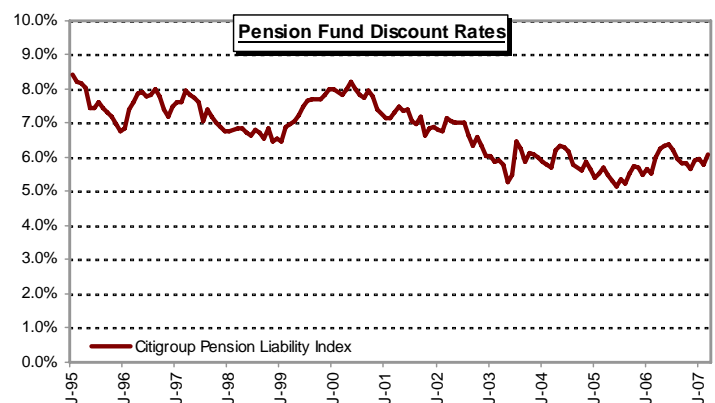
Finally, we'll share that the Treasury yield curve regained a slightly positive slope. The benchmark 10-year yield moved up to 4.65% at quarter end, six basis points higher than the two-year Treasury at 4.59%.

## **Citigroup Pension Liability Index**

This quarter NEPC introduces coverage of the Citigroup Pension Liability Index to our quarterly Market Thoughts. The Citigroup Pension Liability Index provides a single discount rate equivalent to discounting a set of hypothetical pension plan cash flows at the Citigroup Pension Discount Curve rate applicable to each cash flow. The Liability Index can be used to provide a simple estimate of how your pension obligations have changed over a given period. As the Index increases, the value of liabilities decreases and (unfortunately) vice versa. Recognizing the volatility of liabilities will be increasingly important for most pension plans.

Fixed Income Index Returns (3/31/07)	Quarter	1 Year	3 Yrs	5 Yrs
<b>Global Fixed Income</b>				
Citigroup World Gov. Bond	1.2%	7.8%	2.7%	9.0%
<b>Domestic Fixed Income</b>				
LB Aggregate	1.5%	6.6%	3.3%	5.4%
LB Government	1.5%	5.9%	2.7%	5.1%
LB U.S. Credit	1.5%	7.1%	3.2%	6.3%
LB Mortgage Backed	1.6%	6.9%	4.1%	5.0%
LB Govt/Credit	1.5%	6.4%	2.9%	5.6%
LB TIPS	2.5%	5.3%	3.0%	7.4%
LB High Yield	2.6%	11.6%	8.6%	10.4%
91 Day Treasury Bills	1.3%	5.2%	3.7%	2.7%
<b>10-Year Bond Yields</b>	<b>End 2005</b>	<b>End 2006</b>	<b>3/31/07</b>	
U.S.	4.5%	4.6%	4.7%	
Europe	3.3%	3.9%	4.2%	
U.K.	4.1%	4.7%	4.7%	
Japan	1.5%	1.7%	1.6%	

Source: Independent Consultants Cooperative (ICC).  
Note: Periods longer than one year are annualized; data is in \$ terms.



As of March 31, 2007, the Citigroup Pension Liability Index reported a discount rate of 6.09%, based on a duration of 15.59 years, up from 5.90% at the end of 2006. This was the first time since July 2006 that the discount rate at month end crossed the psychologically important 6% barrier. In January, the Index rose to 5.97%, then dropped almost one-quarter of a percent in February to 5.79%, before ending at 6.09% in March. These numbers equate to a 1.5% decrease in liability value over the quarter. Plan sponsors targeting 6% as an entry point for liability driven investing (LDI) should take notice. The spectrum of LDI strategies range from structuring portfolios to totally immunize liabilities against interest rate moves to extending portfolio duration to partially reduce the interest rate sensitivity of a plan's surplus. If you were waiting for your liabilities to tick down a few percentage points before moving forward, it might be time to act.

### **Alternatives: Hedge Funds**

This quarter, NEPC introduces coverage of the major hedge fund indices to our quarterly Market Thoughts. NEPC has been advising on hedge funds for over ten years and our clients have over \$9 billion invested in the area. We believe hedge funds will continue to play an important role in our clients' portfolios, because properly implemented, hedge funds provide the ability to reduce risk and diversify portfolio returns.

Hedge funds employ various investment strategies, which generally fall into four major categories: relative value (capitalizing on pricing inefficiencies among individual securities), event-driven (investing on anticipated outcomes of company-specific situations such as a merger), equity hedge (taking both long and short positions in securities), and tactical (seeking to benefit from macro-economic opportunities in the global equity, fixed-income, currency, and commodities markets).

Hedge funds performed respectably during the first quarter, outperforming the traditional markets. The CS Tremont Composite gained in all three months and returned 3.3% for the quarter. Seven of the twelve sub-strategies reported returns at or above 3% and only one reported a negative number. Managed Futures were down 4.7%, experiencing 4.4% of that loss in the month of February. Every other sub-strategy was up in February and the increase in volatility (see earlier comments about the VIX) benefited most of the event driven strategies, giving them the leading returns of the group.

### **Final Thoughts**

NEPC capitalizes on our expertise in both traditional and alternative investments by developing programs targeted to client liability requirements, spending needs and/or other goals and objectives. Many of the issues we see in the Capital Markets suggest increasing risks ahead and call for broad diversification and the efficient implementation of return-enhancing and risk-reducing strategies. To enjoy above-average returns over the long-term, our clients must not automatically accept the world in its current state. They must be willing to lead and embrace change, and stay focused on the longer-term.

Hedge Fund Index Returns (3/31/07)	Quarter	1 Year	3 Yrs	5 Yrs
<b>Composite</b>				
CS Tremont Hedge Fund Composite	3.3%	11.6%	10.3%	10.4%
<b>Relative Value</b>				
CS Tremont Convertible Arbitrage	3.1%	11.7%	4.7%	7.0%
CS Tremont Fixed Income Arbitrage	2.3%	8.9%	5.6%	5.9%
CS Tremont Equity Market Neutral	2.8%	10.3%	8.3%	8.0%
<b>Event Driven</b>				
CS Tremont Event Driven Composite	5.0%	15.9%	13.5%	12.3%
CS Tremont Event Driven - Distressed	4.3%	15.3%	14.4%	13.6%
CS Tremont Event Driven - Risk Arbitrage	2.7%	7.6%	5.7%	4.9%
CS Tremont Event Driven - Multi-Strategy	5.6%	16.9%	13.3%	11.8%
<b>Equity Hedge</b>				
CS Tremont Long-Short Equity	3.8%	11.1%	11.8%	11.0%
CS Tremont Emerging Markets	3.2%	14.2%	15.8%	15.6%
CS Tremont Dedicated Short Bias	1.6%	0.8%	2.2%	-3.7%
<b>Tactical</b>				
CS Tremont Multi-Strategy	3.8%	12.6%	10.3%	10.9%
CS Tremont Global Macro	3.0%	10.6%	10.2%	12.7%
CS Tremont Managed Futures	-4.7%	-1.1%	0.6%	9.0%
<b>Traditional Markets</b>				
S&P 500	0.6%	11.8%	10.1%	6.3%
LB Aggregate	1.5%	6.6%	3.3%	5.4%

Data Source: PerTrac

Note: Periods longer than one year are annualized; data is in \$ terms.