



"Advancing Your Investments"
NEW ENGLAND PENSION CONSULTANTS

To: NEPC Clients
From: NEPC Consulting Staff
Date: January 13, 2004
Subject: From Exclamation Points to Question Marks!?!?!?

Calendar 2003 was a year of exclamation points for the markets and for NEPC's clients. Global markets posted double-digit returns in 2003, tempering the grueling losses of the three-year correction that followed the runaway markets of the late 1990's.

NEPC's clients achieved considerable success in 2003, as our advice early in the year to rebalance back to target equity allocations in anticipation of the rebound was both timely and accurate. Additionally, we correctly observed that the diversifying asset classes (international equities, emerging markets, domestic small cap, high yield, etc.) appeared unusually attractive. These diversifying asset classes led the market recovery, soundly outperforming their traditional domestic equity and core bond counterparts. Most of our clients followed our allocation advice and added incremental value to their investment programs.

Each January, NEPC conducts an Investment Offsite where we review several months of work by our asset allocation specialists. These reviews focus on the history and likely future trends of the global capital markets and are conducted to formalize our estimates of prospective return, risk and correlation values for the major markets over the coming five-to-seven year time periods. We then consider the potential impact of our forecasts on client investment programs. While it is gratifying to see our clients achieve significant gains from our recommendations, the exclamation points of 2003 have given way to question marks for 2004 and beyond. In short, the easy money has been made.

Generally speaking, clients can structure their programs to deliver their required returns by utilizing several "levers" of the investment opportunity set: the traditional "60/40" balanced fund approach; asset class diversification; manager value added; alternative investments and/or hedge programs; and, rebalancing.

As we have noted over the last few years, we do not believe that client programs can achieve their return goals with a traditional balanced fund commitment to domestic large cap stocks and treasury bonds. That was the strategy for the



great bull market of the 1980s and 1990s. Simplicity, buy-and-hold, and inaction delivered the necessary returns for nearly two decades. However, that strategy came to a crashing end on March 10, 2000.

Over the past few years, we have strongly encouraged our clients to maximize the benefits and opportunities of the other four “levers” available to investors. Our strongest recommendations over the last two years have been to capture the relative opportunities that existed in the diversifying asset classes, such as small cap stocks, international developed and emerging stocks, high yield bonds and global fixed income. We still believe portfolios should have their full compliment of these diversifying asset classes, but clearly the potential for these asset classes to repeat their recent outperformance has diminished somewhat.

We have constantly emphasized the need for rebalancing. At the beginning of 2003, we saw opportunity and recommended that our clients rebalance back *up* to their target weights in equities, high yield and non-US investments. Our advice for 2004 is to take some of the risk off the table by rebalancing back *down* to target weights. Most target portfolios have healthy exposure to risky assets. There is no need to over-expose your program to risk by failing to rebalance.

Investment Outlook for 2004

We begin 2004 with subdued long-term expectations from the traditional asset classes and moderated relative out-performance expectations from the diversifying asset classes. Rebalancing is always available to incrementally add value, but we believe that more work needs to be done going forward.

NEPC believes that clients will need to emphasize manager value added and make allocations to alternative strategies and asset classes in the coming years.

Manager Value Added

We believe that clients should emphasize active management on several levels, the first of which is the generation of incremental return in excess of benchmarks, i.e., alpha. Additionally, clients should review the constraints placed on managers to determine if more flexibility should be granted. For example, should manager-tracking error be increased? Do managers offer a more concentrated, “best ideas” version of their existing products? Should a manager’s cash limitations be relaxed? Clients should quiz their managers for thoughts on how each manager can improve the portfolio’s return or risk profile. Your managers may have additional diversifying or return-enhancing strategies that should be considered for inclusion in your investment program.



Another method for managers to add value is active asset allocation. We are seeing some interesting capabilities evolve, and NEPC believes that clients should strongly consider global tactical asset allocation strategies.

Adding value through active management is a key theme for 2004 and beyond.

Alternative Asset Classes and Strategies

Most clients have significant commitments to core stocks and high-grade bonds. If these asset classes were to experience a prolonged secular bear market, i.e. 1968 to 1982, achieving the necessary returns would be quite difficult.

Clients should consider diversification strategies that can succeed if the primary stock and bond markets do not deliver adequate returns in the future. Hedge funds and other “non-directional” strategies are a good start. Real asset classes such as real estate, timber, and commodities can perform well in an inflationary environment (make no mistake that government policy has changed to *reflation*). Treasury inflation protected bonds (TIPs) provide another arrow in the quiver. Many of our clients are now considering these strategies.

Broadened diversification into non-traditional investments is also a major theme.

Conclusion

When the markets hit their lows in September of 2002, investor pessimism was peaking. Every month, billions of dollars were redeemed from equity mutual funds as investors were warned of a bleak future. We begged to differ at that time and moved our clients forward by positioning them to capture the fruits of an economic rebound, with a heavy emphasis on the diversifying asset classes.

Our clients benefited from these recommendations in 2003. Now, as we head into 2004, the investor sentiment cycle is turning from pessimism to optimism. The ability of the diversifying asset classes to deliver strong returns is no longer a hidden opportunity. While we believe client programs can achieve positive returns in 2004, we have specific thoughts about where those returns are to be found. So, as the crowd storms back into the riskier areas of the market in the hope of another 2003, NEPC is counseling our clients to take profits through rebalancing and re-allocating those profits toward more attractive opportunities.

We believe investors will need to emphasize the levers of manager value added and alternative investments to be successful in 2004 and beyond. Keeping you more than a step ahead of the crowd is part of our mission as a proactive consulting firm. We hope to steer our clients to yet another successful year.