



“Advancing Your Investments”

NEW ENGLAND PENSION CONSULTANTS

To: NEPC Clients
From: NEPC Consulting Staff
Date: January 31, 2005
Subject: The Importance of Leadership in Managing Tomorrow's Programs

2004 was another successful year for NEPC and our clients. Your success during the year was driven by a combination of market returns that exceeded expectations and the correct relative positioning of your portfolio based on NEPC's asset allocation recommendations. Our recommendations to overweight the traditional diversifying asset classes (i.e small cap stocks, international equities, global fixed income and high yield bonds) produced superior results across our client base. Furthermore, many of our clients made allocations to the alternative asset space. Hedge funds brought diversification to a new level. Global asset allocation managers were given greater flexibility and they delivered. Portable alpha strategies produced incremental returns to both S&P 500 stock and US Treasury bond commitments.

Our clients have now collectively exceeded national averages in 16 of the 19 years that NEPC has been in business. For the first 14 years, the success of all investment programs relied on the tail wind of the great bull market. In 2000, that tail wind turned and the marketplace began to separate value-adding consulting firms from the also-rans.

We believe each client requires forward looking, creative, value producing investment advice. That NEPC mindset generated recommendations to increase exposures to international (2001), high yield bonds (2002) and an array of diversifying asset classes and strategies (2003/2004). Of course, the recent discovery of these asset classes and strategies by the rest of the marketplace naturally diminishes the relative benefits to our clients going forward. So, as the crowd rushes into the asset classes that you have successfully employed, we look forward to reassessing current advice and suggesting the best opportunities for your program going forward.

We believe tomorrow's successful investment programs will include more diversification, particularly in the alternative investment arena. Importantly, the future success of your program will require greater leadership from both NEPC and our clients.



Investment Outlook for 2005

The 5-to-7 year secular outlook of subdued returns across a wide range of asset classes remains in place. With that said, opportunities will present themselves from time-to-time. For example, excellent opportunities were available in 2003 and 2004. In 2003, the opportunities were broad based, while 2004 required patience and correct relative asset class positioning.

The theme for 2005 is very similar to 2004 and that is to maximize your diversification. Clearly, the traditional diversifying asset classes are more fairly priced and less-likely to repeat their significant out performance of recent years. While we are recommending clients reduce their small cap and high yield positions to target weights (i.e. take some profits), our overriding advice is to hold steady and allow your diversification and discipline to do the work in 2005.

Tomorrow's Success

The successful investment programs of tomorrow will trace the roots of that success back to the fiduciary decisions of today. This is not an easy environment to be making fiduciary decisions. Given our subdued return expectations across a wide range of asset classes, *NEPC believes that many investors will have difficulty achieving their return goals.* Furthermore, through the desperate search for returns, we believe it likely that the average investment program will also *lose sight of its risk management responsibilities.*

Through the post-bubble tech crash, NEPC identified several opportunities for clients to exploit in the diversifying asset classes. Unfortunately, the enhanced return opportunity in some of these has been fully realized (small cap, high yield) and other positive trends are “long in the tooth” (established market international stocks and bonds). Hedge funds have seen enormous inflows of capital, leading us to scale back our return expectations for these strategies. As the benefits of our best ideas fade and our return expectations for the traditional asset classes become more subdued, *we see fewer intuitively compelling opportunities in the future, except for clients willing to lead.*

Defining Leadership

“Lead” is defined as: (1) To show the way by going in advance; (2) To be first; be ahead; (3) To go first as a guide; and, (4) To make the initial play.

Again, we believe that most investment programs will be hard pressed to achieve their return goals over the next decade. As such, NEPC’s advice and our client’s actions must be different and better than those of the average investment program.



To be Different from the Average Plan

The overriding factor that will drive the average plan to underperform is the inability to differentiate its investment allocations from the peer group. This unwillingness to “show the way by going in advance” or to “make the initial play” will result in the pursuit of fleeting trends and other “buy high, sell low” decisions.

Clients must customize their investment programs to their specific risk tolerances. If this inquiry leads one to a substantially different allocation than the peer group, than so be it. We believe the successful programs of tomorrow will lead the peer groups and the laggards will follow the peer groups.

Many innovative strategies are being brought to market to address specific client needs, especially in the area of financial engineering and risk management. Innovative products, by definition, do not provide the comfort of long track records. However, innovative products do come from experienced investment management firms with experienced investment professionals. Employing some of these innovative strategies should be near the top of your 2005 “to-do” list.

To be Better than the Average Plan

In return for your willingness to lead, NEPC must provide your program with better than average investment advice. Our 19-year track record demonstrates our historic success in providing value added investment advice. Going forward, we are challenging our entire consulting staff to redefine future excellence.

While diversification and discipline remain the cornerstones of your current investment programs, NEPC’s consulting and research staffs are fully engaged in evaluating the innovative products of tomorrow. We believe some of those products are ready for inclusion in your portfolio now. In the near future, we hope to introduce portable alpha, real return strategies, and liability benchmarking to more of our clients.

Conclusion

The strong market rebound of 2003 and 2004, has provided some relief to most investment programs. NEPC is pleased that our clients were quite proactive seizing the opportunities over the last few years. Your leadership has been rewarded by above-average performance. Keeping you ahead of the crowd and helping you meet your funding obligations are our primary missions as a proactive consulting firm. We embrace these challenges and look forward to working with you to continue to refine your plan structure, manager complement and strategy selection to ensure continued success in the years to come.