



“Advancing Your Investments”

NEW ENGLAND PENSION CONSULTANTS

To: NEPC Clients
From: NEPC Asset Allocation Committee
Date: January 31, 2006
Subject: New Year, Same Theme: Leadership!

Calendar-year 2005 offered investors limited return opportunities from the headline US stock and bond benchmarks. However, there were opportunities for outsized gains in other markets such as the international equities, real estate and emerging market debt. Many clients were well positioned to take advantage of these asset class themes; however, the outsized opportunities in many of these diversifying asset classes have dissipated to a large extent. While these asset classes will continue to provide diversification within your program, we must expand our search for tomorrow's opportunities.

Last year was an excellent reminder that in every investment environment, opportunities exist for clients who are *willing to lead*. With the traditional domestic stock/bond portfolio producing a disappointing 3% to 4% total return, most NEPC clients were able to earn double those rates due to the correct *forward positioning* of our client portfolios into those pockets of opportunity. Our clients have now collectively exceeded national averages in 17 of the 20 years that NEPC has been in business.

Each January, after considerable preparatory work by our staff, our entire consulting group spends a day locked in a classroom on the MIT campus finalizing our asset class forecasts and assessing the major trends likely to impact our client programs over the intermediate term. We are relieved to see higher yields on the short and intermediate portions of the yield curve. On the downside, we have marginally trimmed our expectations for the international markets, given the long streak of out-performance relative to domestic markets and the normalization of valuations between the two. However, the bottom line remains unchanged: *We expect generally subdued returns relative to long term averages*.

With subdued return expectations and reduced opportunities in the diversifying asset classes, where should clients be focused in 2006? We believe there are seismic shifts occurring in the investment industry in three key areas:

1. Portfolio construction (separation of alpha and beta),
2. Generating manager value added (relaxing constraints),
3. Asset/liability management (interest rate hedging through overlays),

Prioritizing and focusing on these three issues is our primary message to clients in 2006.



Portfolio Construction - Separation of Alpha and Beta

One of the most important exercises that NEPC conducts with its clients is the establishment of a policy portfolio. The policy portfolio defines the opportunity set of asset classes at the desired risk level. The first step in implementing the policy portfolio is to identify the structural market exposure, or “beta”, that represents each asset class. For example, the S&P 500 is the market index, the “beta,” that represents US large cap stocks. The second implementation step is to determine whether and how active management will be utilized in each asset class. The technical term used to represent manager value added is “alpha.”

The major historic constraint of this process was the bundling of active management risk budgeting within the beta decision. For example, US large cap stocks are generally the largest individual asset class allocation for most institutional programs. History has shown that large cap US stocks are the most efficient of all global equity markets. The magnitude and consistency of manager value added is less than optimal in this asset class *relative* to other active management opportunities in small cap or international stocks, leading many to throw in the towel and opt for passive management.

The significant innovations that have been achieved in modern financial markets now allow investors to completely separate structural policy (beta) decisions from active management (alpha) decisions. The technique, called portable alpha, first identifies an attractive alpha source, wherever it can be found, and then *transports, or overlays,* that *alpha* source onto the policy portfolio. This technique can nicely augment the returns of the more efficient asset classes.

Generating Manager Value Added - Relaxing Constraints

Constraints have their place in an investment program, primarily to control risk and ensure the implementation of structural diversification. However, we believe some common constraints are residuals of the great bull market of the 1980s and 1990s. The inadequacy of overly rigid constraints becomes blindingly obvious in a bear market.

We start off 2006 once again celebrating the Dow’s passing through 11,000, seven years after it pierced this level the first time. That’s right, seven years of nothing from the Dow but a 2% to 3% dividend yield. When structural diversification cannot deliver the necessary returns, we must rely on managers to provide the excess returns.

The thought leaders in the investment community understand the hurdles each of you face. They are responding with creative and innovative solutions for your specific challenges. These innovative products include:

1. A wider opportunity set through active asset allocation,
2. The ability to go both long and short, under carefully prescribed policy guidelines,
3. The inclusion of asset classes beyond stocks and bonds,



4. Broader mandates (i.e. global equities, all cap value, etc.), and
5. The prudent use of risk-controlled leverage.

However, these solutions require us to break down the artificial walls erected during the twenty-year bull market. We believe investment committees should challenge us to provide the educational background, and if successful, those clients should be willing to lead by allocating assets to these innovative strategies.

Asset/Liability Management

Legislative and regulatory initiatives are changing the way corporations view the risks associated with their defined benefit plans. Among other things, these initiatives make it clear that interest rates pose the largest risk to DB plan sponsors. However, in a low interest rate environment, it is clear that a liability-matched portfolio consisting largely of bonds cannot achieve even moderate return goals. Now, with the increased sophistication and depth of financial markets, there exist methods to both hedge interest rate risk and maintain return objectives. The challenges currently facing corporate plan sponsors are not unique; public and Taft-Hartley plan sponsors need to consider the impact of these trends as well.

We have quite a bit more to say about this topic. Asset/liability management techniques, and the customized needs of each client sector, are too voluminous to adequately cover in this letter. NEPC will soon be publishing a white paper that explores this topic in much greater detail.

Conclusion

Change and uncertainty surround our client investment programs. Collectively, you face a myriad of fundamental challenges, some new and others that have been dormant for an entire generation.

Calendar-year 2006 is the time to step back and reassess. Are you spending enough time thinking about the big decisions that drive your performance? Are you maximizing the manager value added opportunities? What limits and restrictions, that seemed reasonable in the past, now prove to be obstacles? Is your investment program sufficiently flexible to succeed in an environment of fleeting opportunities?

As a leading edge consulting firm, we must be designing solutions for the future. As your consultant, we are required to proactively deliver these value adding solutions. All of our consultants will be reviewing these concepts with you in 2006. Happy New Year!