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NEPC 2011 Market Update

Asset Allocation Assumptions – Challenges and Opportunities

January 24, 2011

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Today's Speakers



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Tim McCusker, FSA, CFA, CAIA

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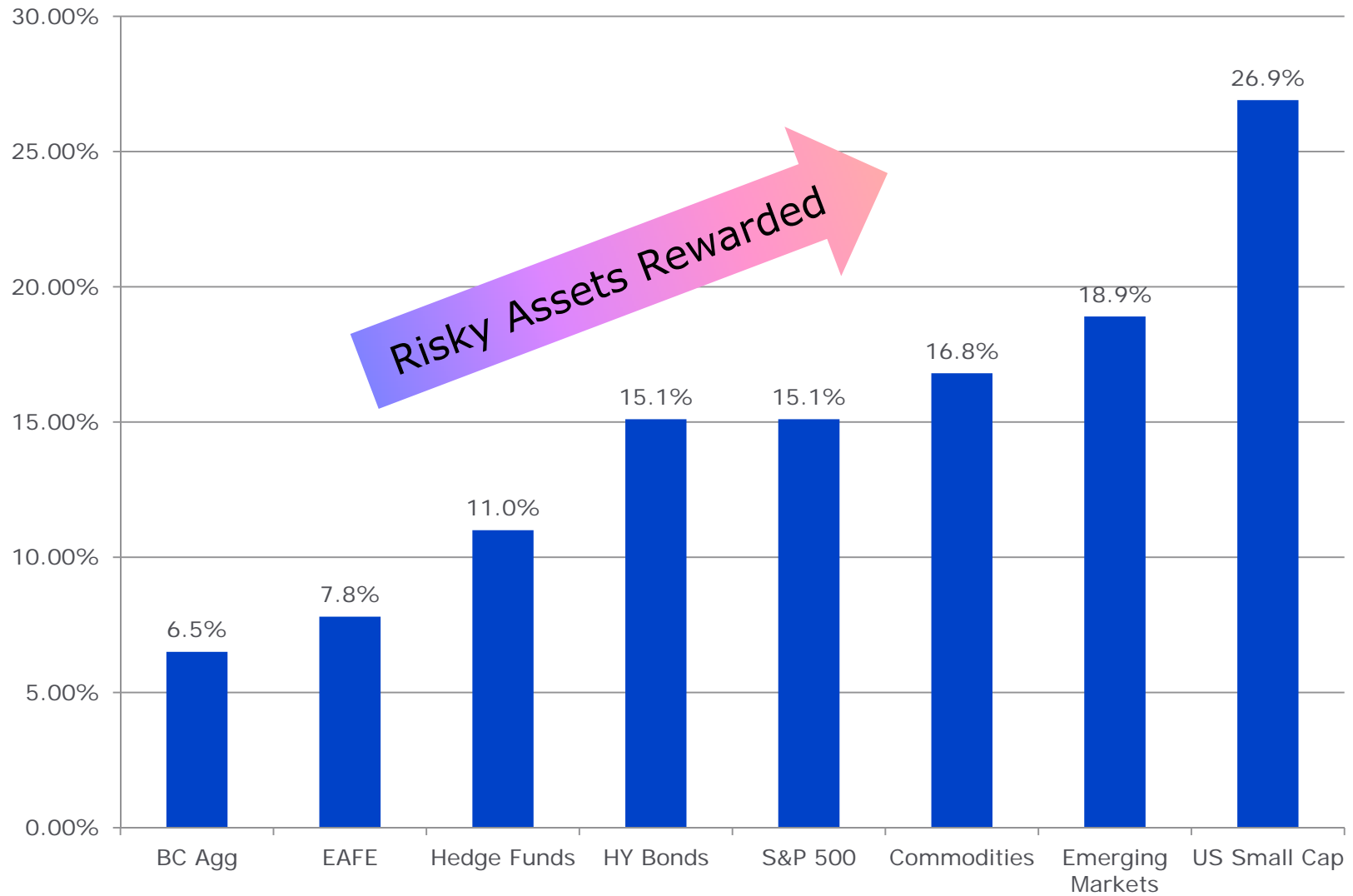
Agenda

- **Introduction and NEPC Update**
- **Market and Economic Background**
- **2011 Observations and Recommendations**
- **Key Themes – Opportunities and Risks**
- **Your Questions**

NEPC Update

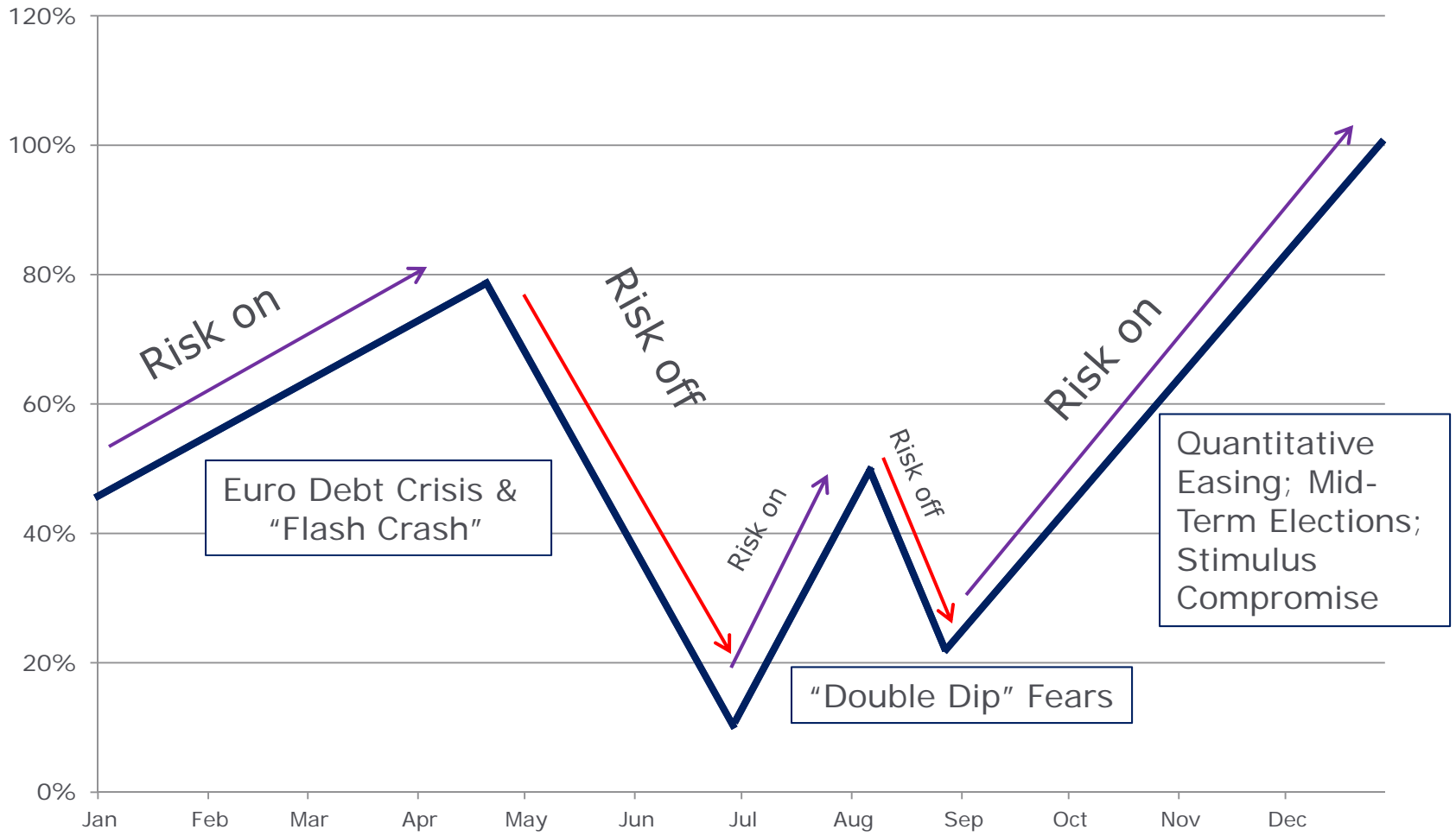
- **NEPC celebrates its 25th Anniversary this year**
- **We remain focused on our client commitment**
 - Continue to add research and consultant staff resources
- **We continue to grow and invest in the business**
 - 24th consecutive year of double digit revenue growth
 - Opened offices in Atlanta and Chicago
- **Please join us at our 2011 Client Conference**
 - May 18th and 19th in Boston, MA (Dates Updated From Call)
- **The market and economic environment remains challenging...**
 - Lower expected returns in major investment categories
 - Heightened risks
 - Selective opportunities
- **...And we look forward to helping our clients successfully manage their investment programs for the next 25 years!**

Market Background – 2010 Returns

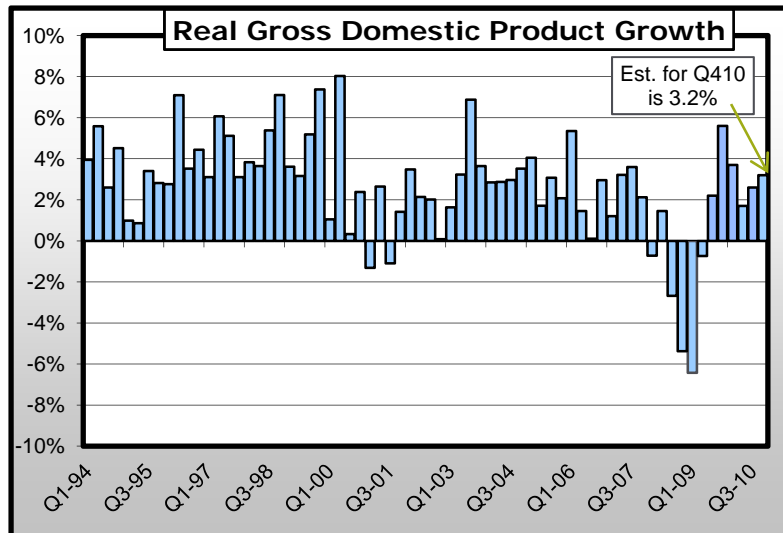


Return Drivers – Global Macro Themes

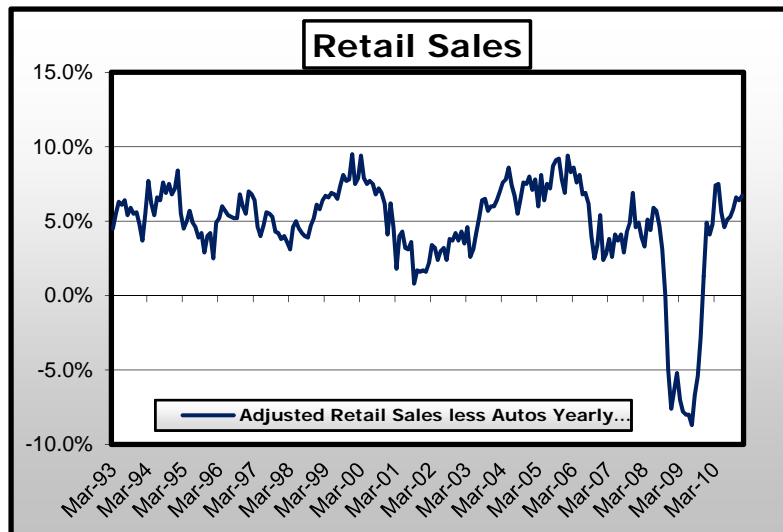
S&P 500 Total Return (%)



Economic Backdrop – Growth and Confidence Returning



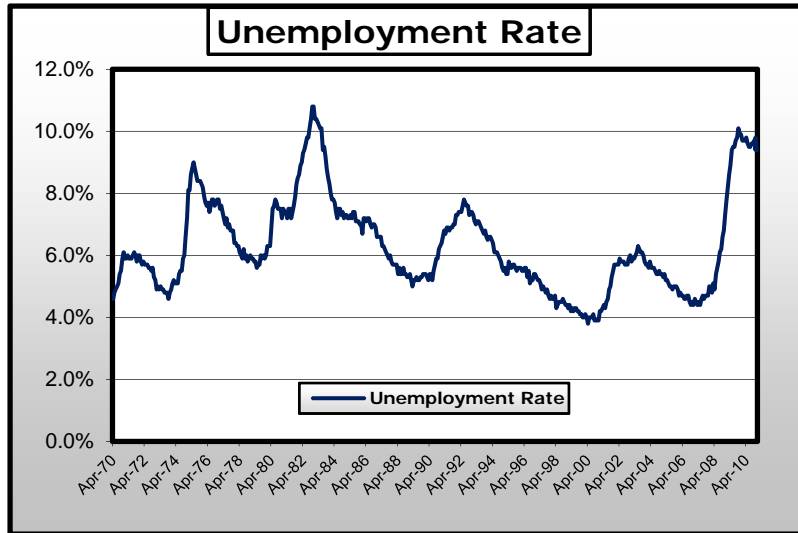
Source: Bloomberg



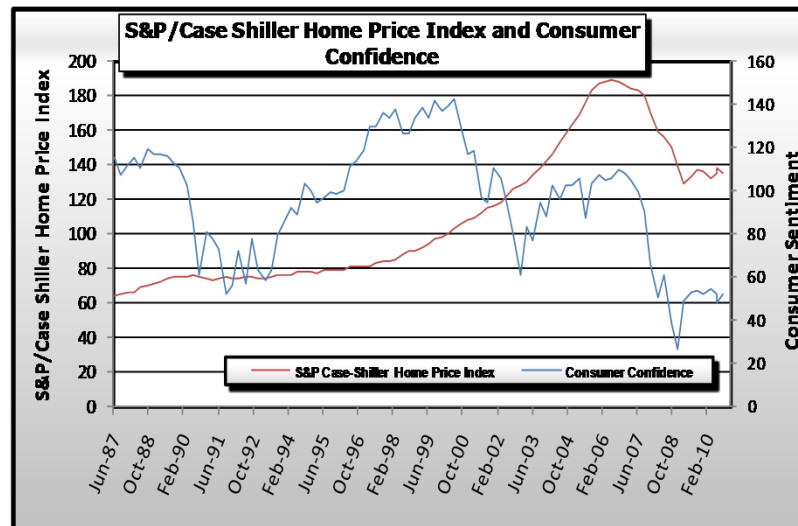
Source: Bloomberg

- US GDP growth is proving to be robust
- 2011 forecast is for 3+% growth
- 11th-hour stimulus package combined with low interest rates providing a strong boost
- Corporate profits have rebounded
- Consumers beginning to spend

Economic Backdrop – Challenges Remain



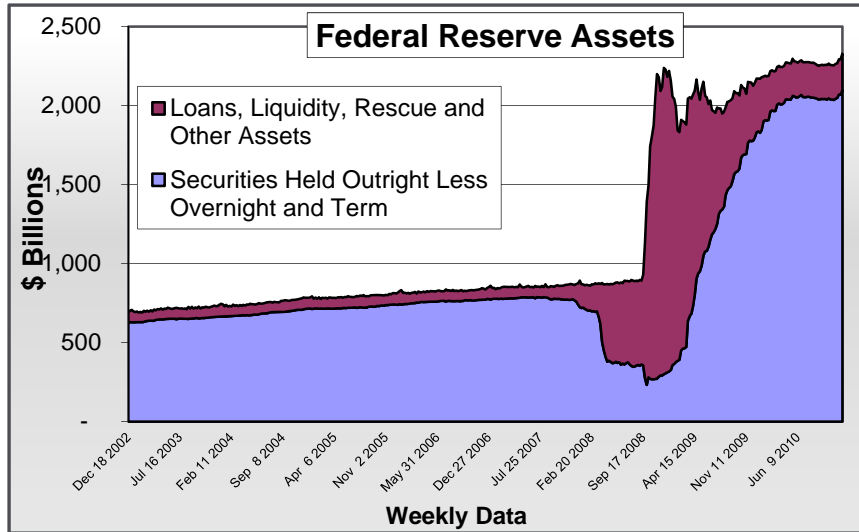
Source: Bloomberg



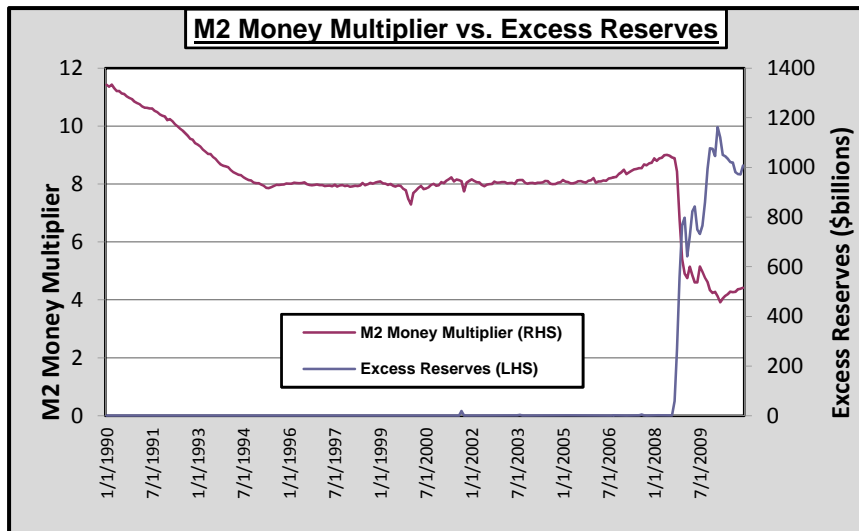
Source: Bloomberg

- Unemployment remains at secular high levels
- Job growth expected to be modest
- Home prices are low and may push lower
- Consumer and small business confidence remain muted
- High debt levels represent long-term challenge

What About Inflation?



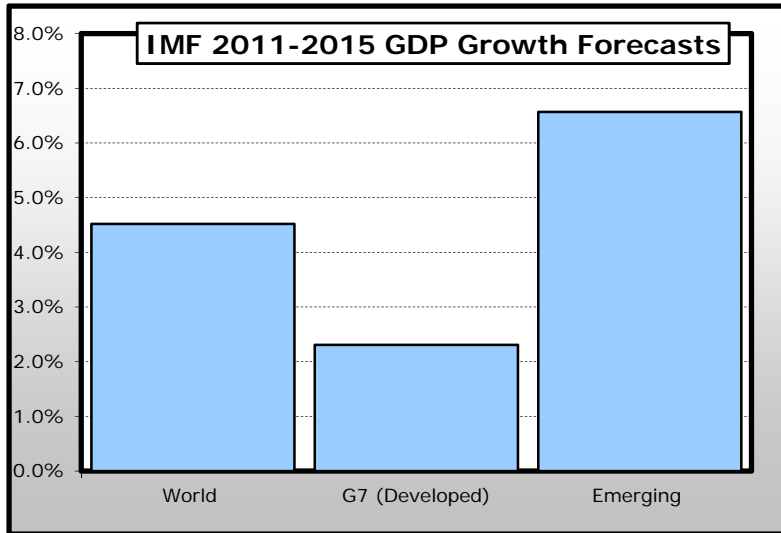
Source: United States Federal Reserve



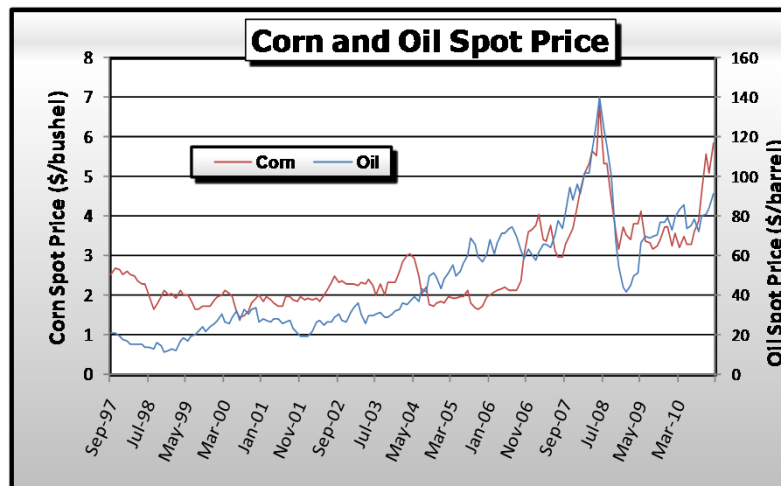
Source: St. Louis Fed

- **Federal Reserve has significantly expanded balance sheet to stimulate economy**
 - With another \$600B to come
- **This has not translated into inflation...yet**
- **High unemployment and significant excess capacity also act against price increases**

Potential Inflationary Drivers



Source: IMF



Source: Bloomberg

- High growth rates in Emerging Markets are putting pressure on resource prices
- Agricultural commodity prices have risen 50+% in the last six months
- Oil is rising toward \$100/barrel
- Developed world countries have incentives to depress their currencies and reflate their economies

NEPC 2011 Capital Market Observations

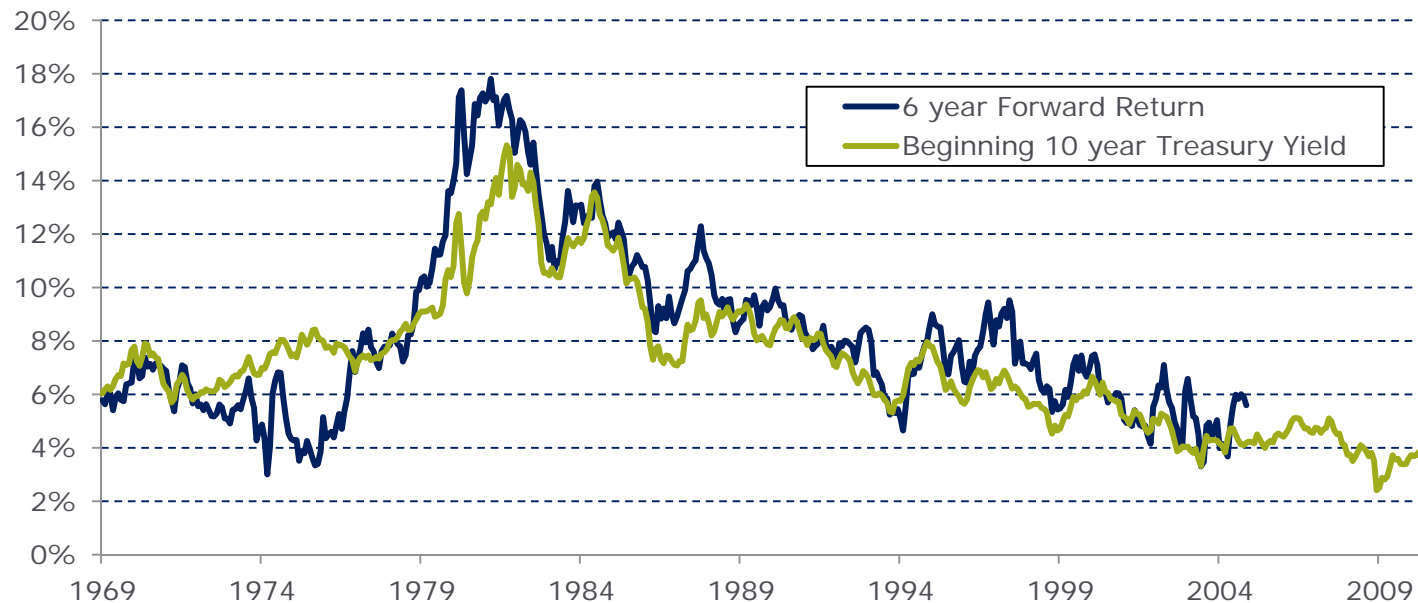
- **Investors face an even lower market return environment**
- **Most markets have been driven by macro/top-down factors**
- **Quantitative easing by Federal Reserve dominates markets**
- **Global currency regime under stress**

NEPC 2011 General Actions for Clients

- **Maintain asset allocation discipline**
- **Examine portfolio structure – the implementation within each asset class**
- **Continue to build illiquid strategies – illiquidity premium remains attractive**
- **Consider hedging of developed market currency to reduce uncompensated risk**

Starting Yields Signal Bond Returns

- Starting yield is the key building block for future performance
- Yields have had a 30 year secular decline
- Low current yields will challenge forward looking returns



Source: St. Louis Fed, Ibbotson, Research Affiliates

Themes for 2011 Asset Class Assumptions

- Returns are lowest ever
- 30-year returns are roughly consistent with 2010 assumptions
- Little return distinction in developed market equities
- Adding hedged developed international classes
- Adding local currency emerging market debt

Major Asset Class Review (Geometric)

Asset Class	Historical Long Term Geometric Average ¹	5-to-7 Year NEPC Assumptions							30-Year
		2005	2006	2007	2008	2009	2010	2011	2011
Cash	3.6%	3.50%	3.75%	4.00%	4.00%	3.00%	2.00%	2.00%	4.50%
Core Bonds ²	8.3%	4.50%	5.00%	5.00%	5.00%	5.50%	3.75%	3.00%	5.50%
Large Cap	9.9%	8.50%	8.50%	8.50%	8.50%	9.25%	7.75%	7.00%	8.50%
International ³	9.4%	9.50%	9.00%	8.75%	9.00%	9.75%	8.00%	7.00%	9.00%

1. Reflects average since inception (1926 except as noted below) of the respective index through 12/31/2010
2. LB/BC Aggregate reflects average compound annual return since 1976
3. International reflects average annual return since 1970

Summary

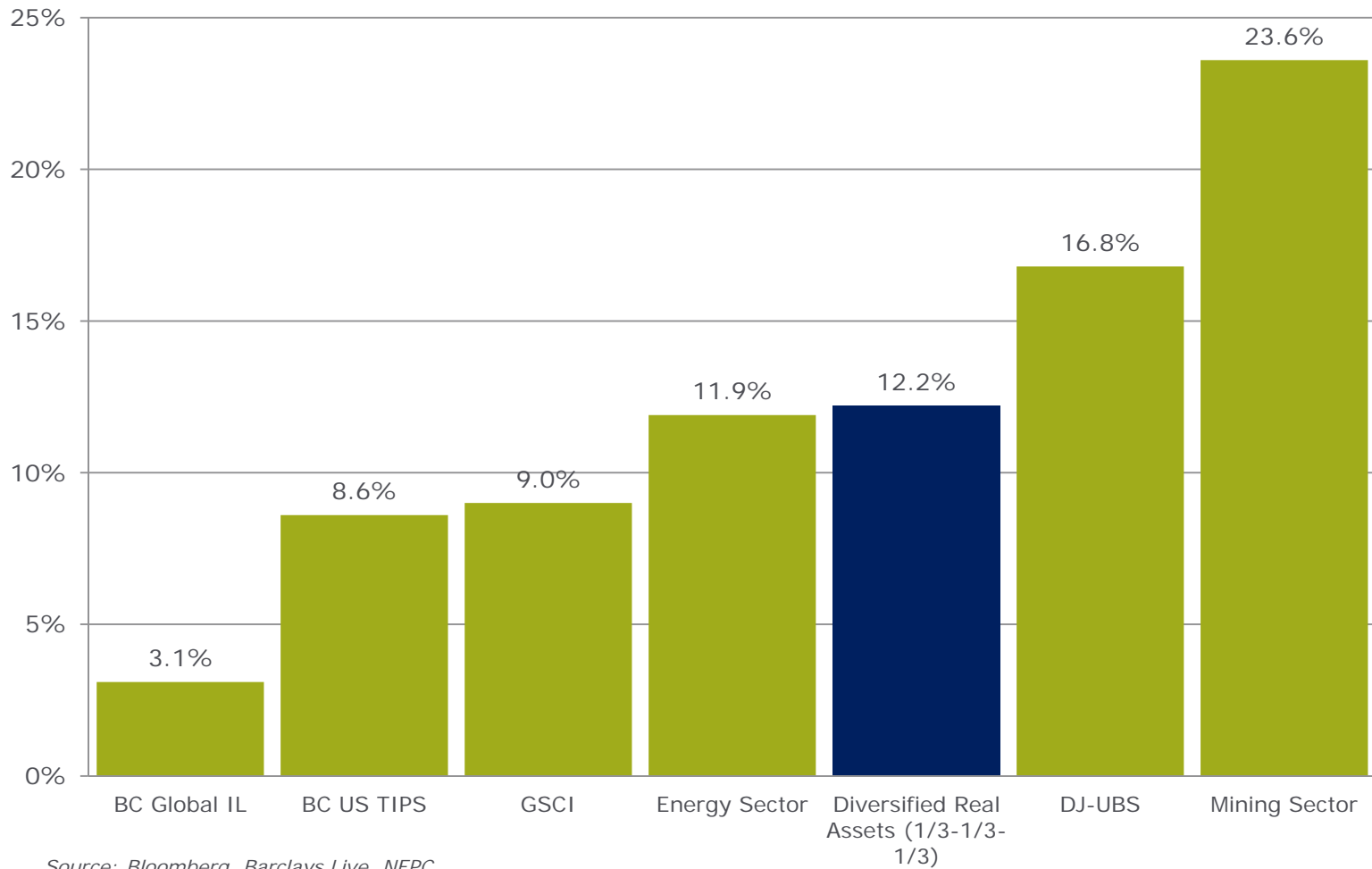
- **Asset allocation opportunities are limited in traditional asset classes**
- **Higher risk-adjusted returns exist in pockets of the capital markets**
 - By taking on reasonable exposure to illiquidity (especially distressed)
 - By increasing exposure to emerging markets
 - By considering less directional approaches to portfolio structuring, i.e. equity long short as equity substitute
- **Expected returns will be lower**
 - 30 year returns can support long-term expectations but do not create medium-term upside
- **Global economic uncertainty remains elevated**
 - Developed asset class returns will remain challenged
 - High volatility currency regime expected to continue
 - A risk balanced approach can lead to improved outcomes as portfolios reduce concentrated exposure to economic growth

Opportunities Among Risks

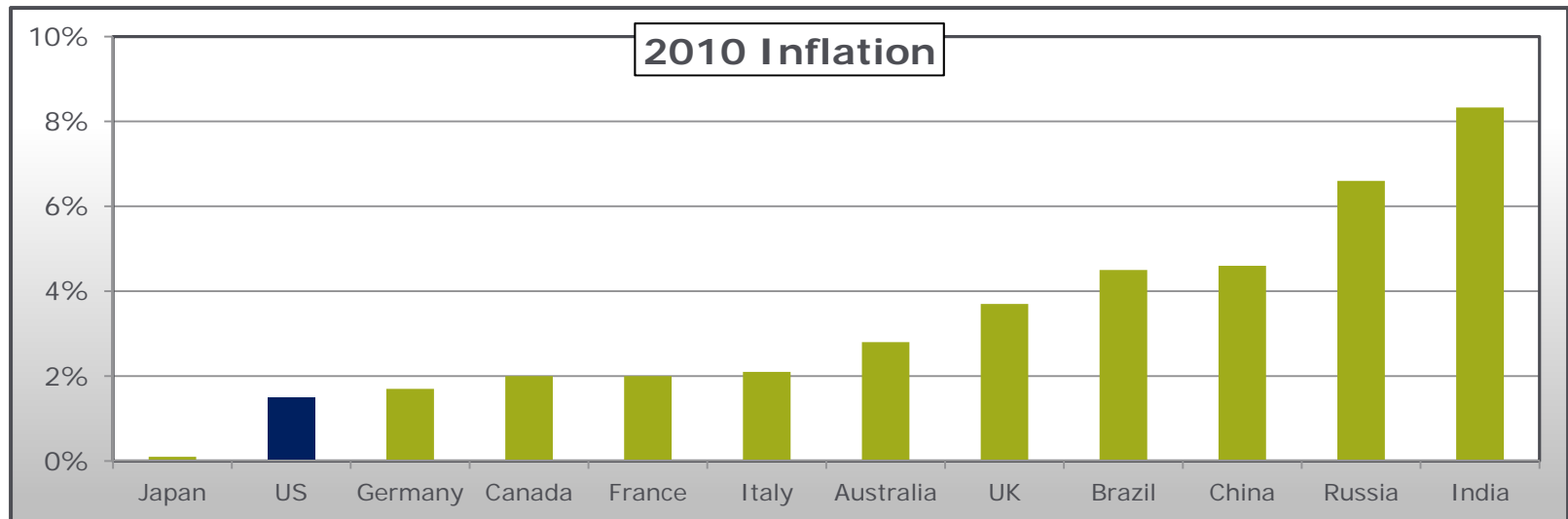
- **Inflation Hedging Assets**
- **Illiquid Assets**
- **Active Management**
- **Emerging Markets**

Real Assets Have Participated in Risky Assets Rally

Calendar Year 2010 (Preliminary/Estimated)



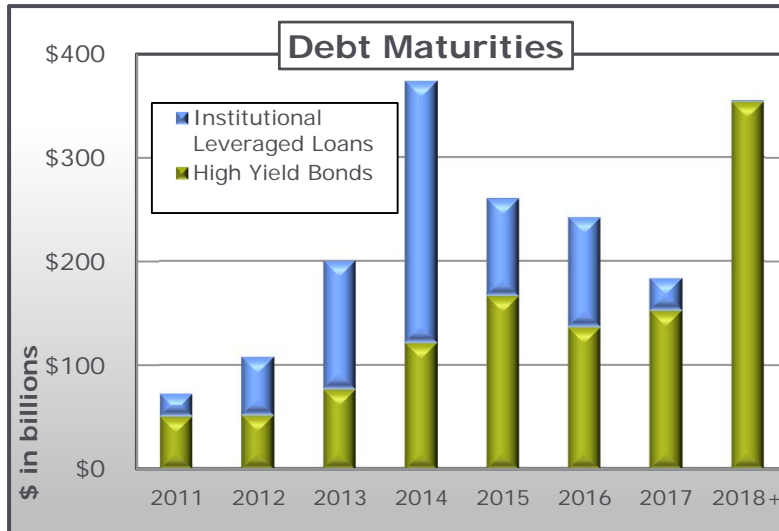
Global Inflation



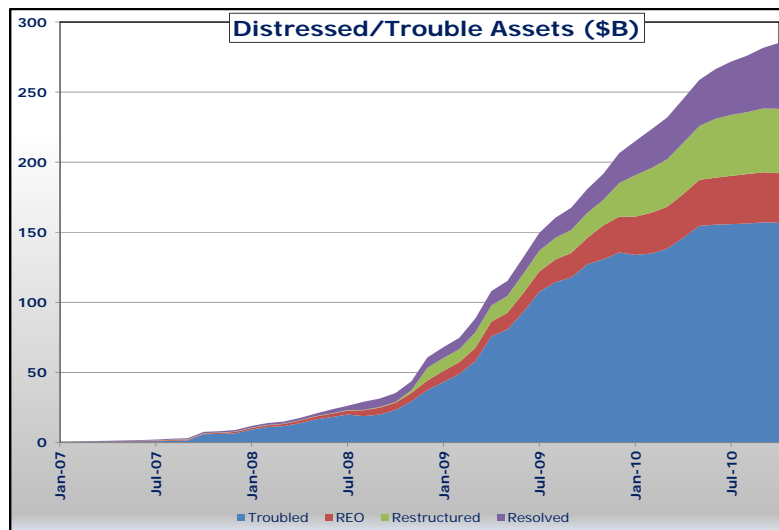
Source: Bloomberg

- **Inflation remains low in US, Japan, and Europe**
- **However, inflation has been higher in emerging countries**
 - Beginning to flow into developed markets
 - Australia
 - UK
- **Inflation sensitive assets are expected to benefit from rising global inflation**

Illiquid Assets – Opportunities in Distressed Situations



Source: JP Morgan

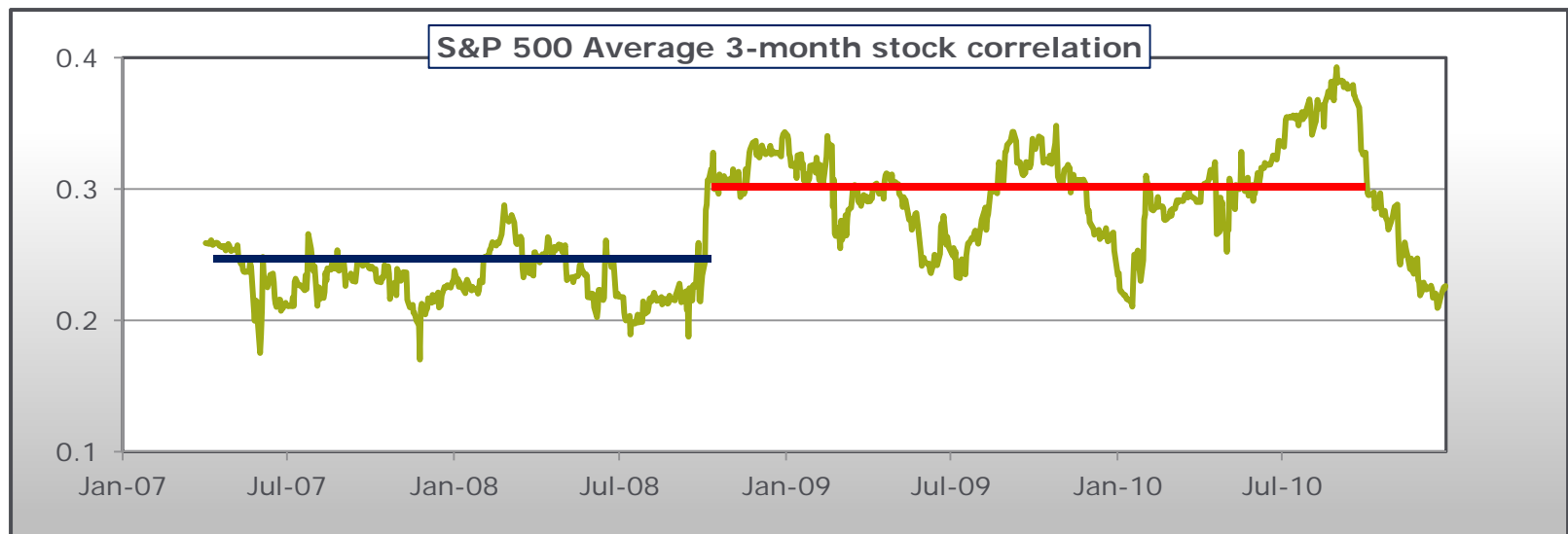


Source: Real Capital Analytics. Data through October 2010.

- **“Wall of debt maturities” has been pushed to 2014 and beyond**
 - Continued deleveraging should lead to attractive opportunities
 - Requires patient capital
- **Opportunities exist in distressed and opportunistic real estate**
 - Important to proceed with caution

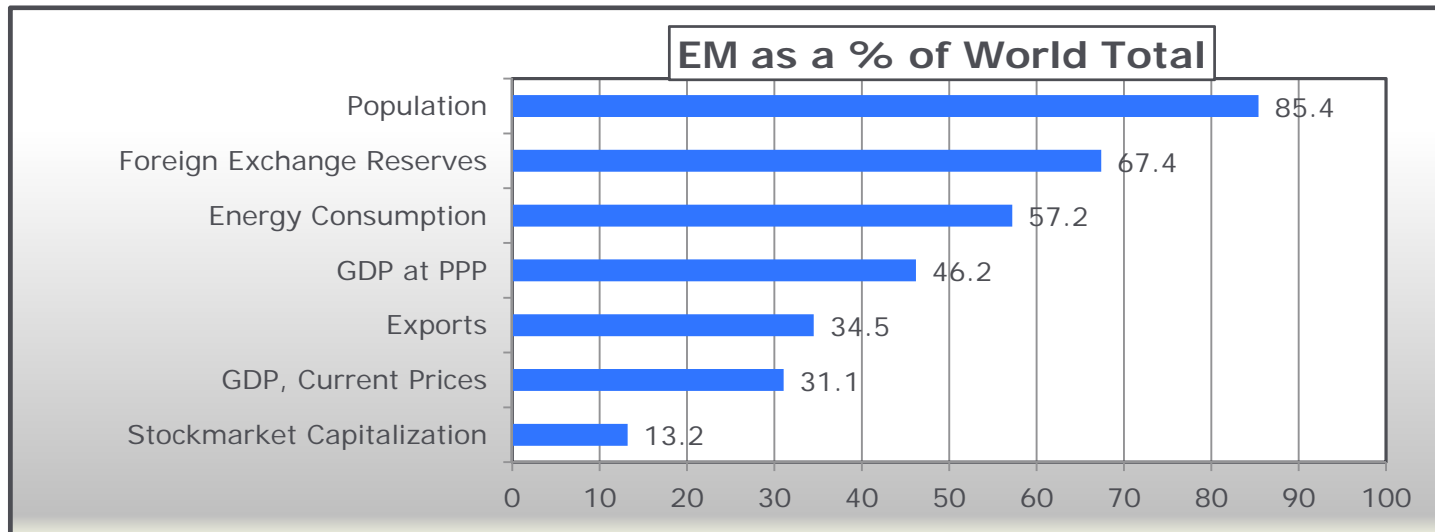
Active Management

- **Individual stock correlations to overall market remained elevated from onset of market crisis through Q3 2010**
 - In the fourth quarter of 2010, correlations subsided significantly
 - Greater differentiation in pricing of individual companies should benefit fundamental active management
- **Skilled active managers expected to add value**
 - Security pricing becomes influenced by underlying fundamentals instead of macro themes and flow of capital
- **Outperformance of active managers will be especially important in subdued return environment**



Source: Bloomberg, NEPC

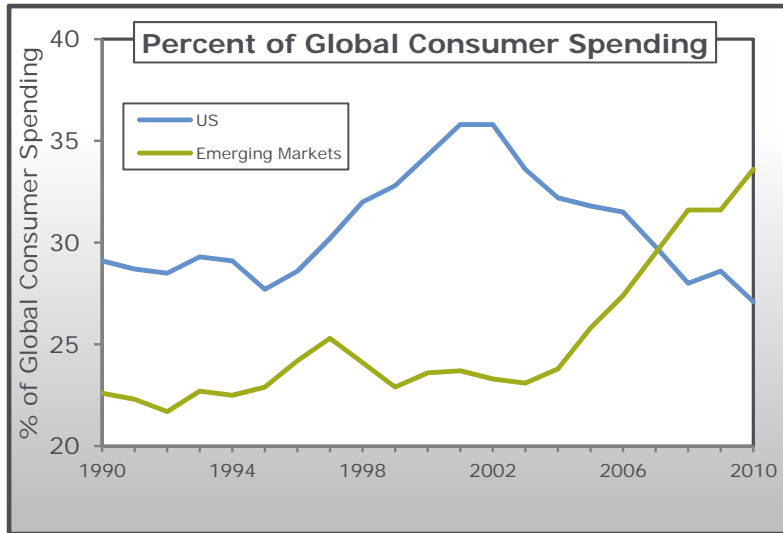
Emerging Market Equities Expected to Continue Strong Growth



Source: Artio, IMF

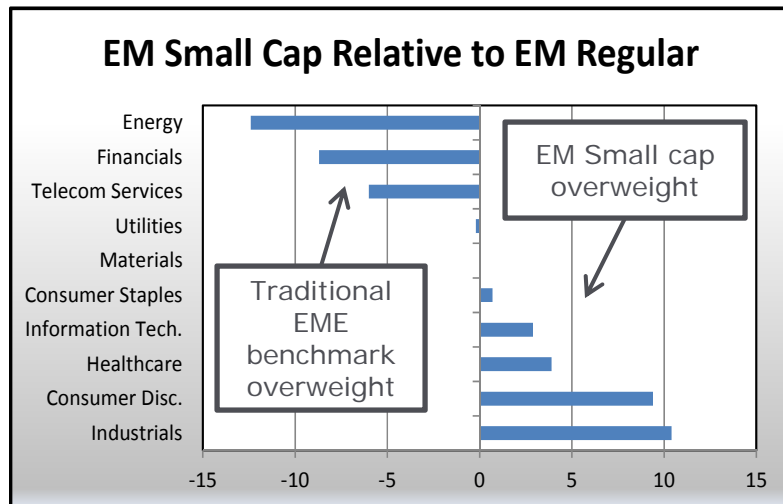
- **Emerging market equities are expected to increase as a percentage of global market capitalization to reflect emerging market's share of global economy**
- **Domestic consumption and commodity exposure expected to drive higher economic growth relative to developed markets**

Emerging Markets Small Cap



Source: JP Morgan, IMF

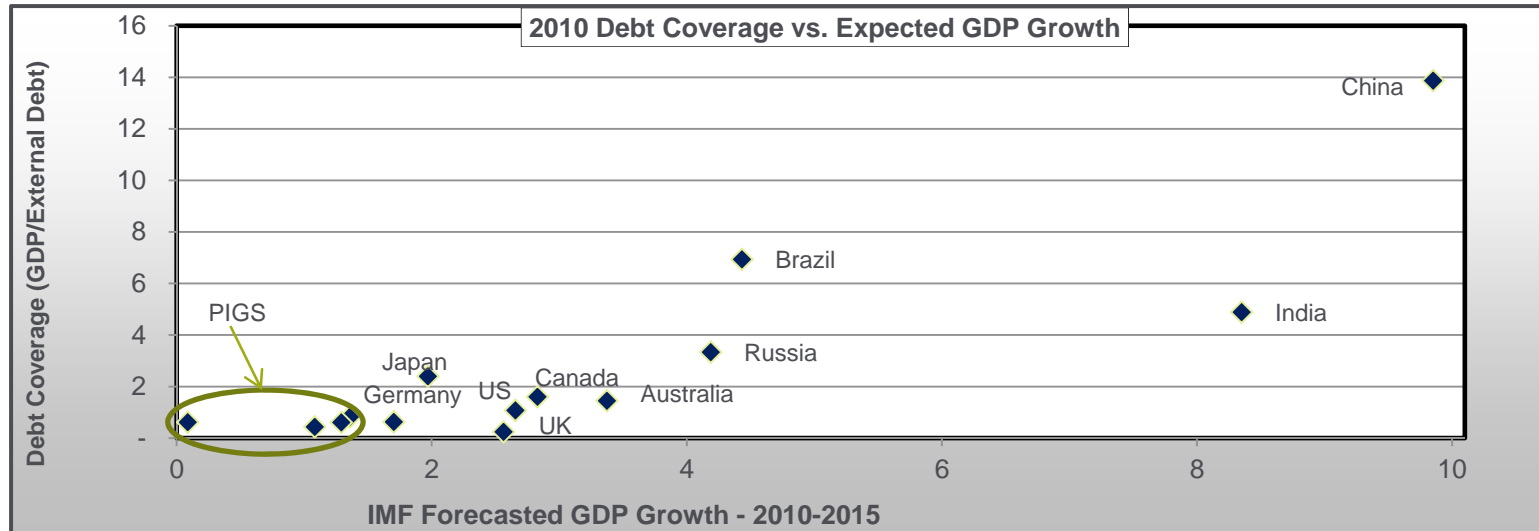
- **Domestic consumption in emerging economies has grown dramatically**
 - Expected to continue to rise



Source: MSCI

- **Emerging markets small cap strategies**
 - More focused exposure to domestic consumption
 - Meaningful exposure to internally focused sectors
 - Healthcare
 - Consumer
 - Industrials

Emerging Market Local Currency Debt – Poised for Appreciation



- **Emerging countries have better fiscal situations and higher growth prospects than developed countries**
 - More attractive credit structure for lenders
- **In addition to narrowing credit spreads, the development of major emerging economies will flow through to their currencies (relative to major developed currencies)**

Emerging Markets Across Capital and Liquidity Spectrum

- **Equities**

- Consider overweighting emerging equities as percentage of total equity allocation
 - Relative to 13% weight in MSCI ACWI
- Evaluate portfolio structure – consider more focused opportunities like emerging markets small cap

- **Fixed Income**

- Depth and attractiveness of emerging market debt suggest allocation sizing similar to high yield
- Local currency debt exposure provides access to both attractive credit situations and potential currency appreciation

- **Alternatives**

- Hedge funds
 - Inefficiencies still exist – many opportunities for active management
- Private markets
 - Expansion of equity markets will occur through both growth of public companies and public offerings of private companies

NEPC 2011 Focused Actions for Defined Contribution Clients

- **Lower forecasted returns mean different things to different stakeholders**

Stakeholder	Challenge	Strategy	Tools
Participant	Lower potential wealth generation	Save more, invest smarter, work longer	Education, advice, target date funds
Company	Aging workforce, higher benefit costs	Revisit benefit design	Benefit adequacy and cost analysis, auto enrollment, Roth feature
Fiduciary	Being under the microscope	Great structure, best in class managers, reasonable fees; educate & re-enroll	Vendor search, fee study, benchmark target date funds, custom target date funds

- **Take action**
 - Use available tools
 - Prepare for public disclosures of your program

Your Questions