



MARKET THOUGHTS

FOURTH QUARTER 2008

VOLUME 17 · ISSUE 4

QUARTERLY EQUITY INDICATOR



Down 22%

QUARTERLY BOND INDICATOR



Up 5%

QUARTERLY HEDGE FUND INDICATOR



Down 10%

QUARTERLY PENSION LIABILITY INDICATOR



Up 29%

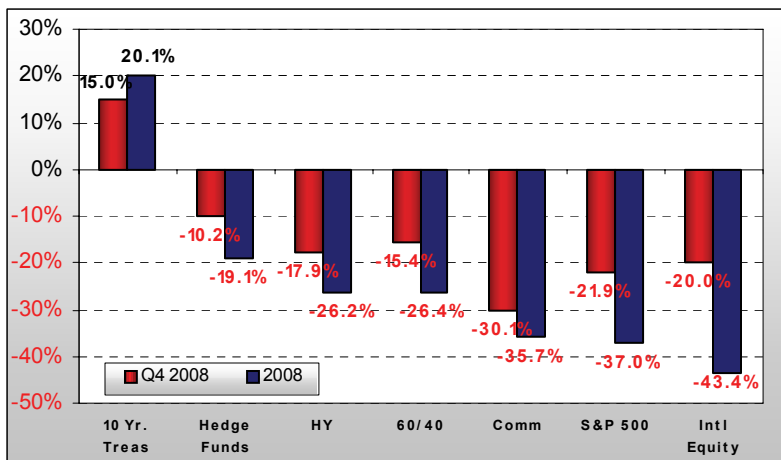
NEPC is an independent, full service investment consulting firm, providing traditional and alternative asset manager search, asset allocation, performance evaluation and investment policy services to institutional investment programs. We offer our market letters to provide insight into recent market 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.

A Crisis of Confidence

A blizzard of negative adjectives, adverbs and other modifiers have been applied to the performance of every risky asset category and investment strategy in the fourth quarter and throughout 2008. Systematic de-leveraging, financial institution failures, credit market paralysis, hedge fund redemption and fraud, economic recession, residential real estate devaluation, and, above all, fear have a share of the blame in this unprecedented and unparalleled year of market turmoil. All risk assets - from stocks, to credit, to commodities and hedge funds - declined precipitously in value. The only market segments that preserved value in the quarter (and, once again, the year) were U.S. Treasuries and developed market sovereign bonds. It was a shocking blow to the confidence that is the foundation for the global financial system.

As we look into 2009, the critical question facing investors is: will the markets return to providing a normal relationship between risk and reward? More specifically, are we poised on the brink of another Great Depression (or Japan in the 1990s), or are we merely working our way through a deep recession, perhaps more severe than any

Exhibit 1 — Fourth Quarter & Full Year 2008¹



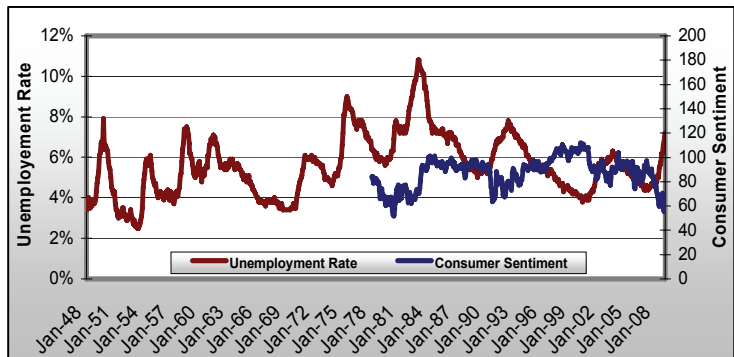
encountered in more than a generation, but one that will lead to an economic recovery as soon as the second half of the year? If depression is looming, then all risk assets will continue to decline in value, even from current reduced levels, and investors have few places to earn positive returns beyond developed market sovereign debt and gold. While we acknowledge that there is a meaningful possibility of this depression/deflation scenario, we do not view this as the most likely outcome.

The current environment differs from the period at the outset of the Great Depression or Japan in the 1990s in important fundamental ways. First, policy makers - both monetary and fiscal - around the world continue to pursue aggressive and innovative

stimulus and relief programs. Interest rates have been pushed to record low levels in the U.S., the U.K, Europe, and other nations. Global economic integration, while encouraging the transmission of the credit crisis, means that global trade, although experiencing declining volumes recently, enjoys significantly lower barriers than in the 1930s when governments pursued "beggar thy neighbor" policies. In fact, many emerging economies enjoy healthy budget and current account surpluses and are pursuing their own stimulus programs. Also, the sharp decline in commodity prices will act as a stimulus in developed markets as consumers benefit from, for example, sub-\$2.00 per gallon gasoline in the U.S.

We do believe that the current recession will persist well into the year as the de-leveraging process continues. The recovery, which we expect is unlikely to begin before the second half of the year, at the earliest, may not follow

past patterns. We expect volatility to continue as markets assess the new financial and regulatory landscape, and digest a steady drumbeat of dour economic news such as weak corporate earnings, further distress in the residential and commercial real estate market, rising unemployment, and declining consumer sentiment (see Exhibit 2). While the biggest short-term risk is deep recession and deflation, we expect that high inflation is the most likely longer-term outcome of the massive stimulus being injected into the system. Regulation will increase, bringing some beneficial boost in investor confidence, but increasing frictional costs. Lastly, long-term weakening of the U.S. dollar may be matched by other currencies as governments “race to devalue” their currencies.

Exhibit 2—Unemployment & Consumer Sentiment²

Global Equity Markets

The markets continued their downward spiral in the fourth quarter as the financial crisis spread around the world. Despite a modest positive return in December, the S&P 500 posted large negative returns for both the fourth quarter (-21.9%) and the year (-37.0%). US small caps stocks finished the year marginally better than large cap stocks, and value outperformed growth across the board. Not surprisingly, the financial sector was the worst-performing sector for the year. Economically-sensitive sectors such as materials, consumer discretionary, and technology were significantly impacted by reports of falling economic growth and declining consumer confidence. Defensive sectors such as telecommunications, consumer staples, and health-care fared better in both the fourth quarter and the calendar year, but were still down double digits. Performance by sector varied wildly throughout 2008 due to extreme volatility, with technical factors driving performance, an environment that led many active managers to underperform.

Equity Index Returns (12/31/08)	Quarter	1 Year	3 Yrs	5 Yrs
Global Equity				
MSCI World	-21.8%	-40.7%	-8.1%	-0.5%
US Equity				
S&P 500	-21.9%	-37.0%	-8.4%	-2.2%
Dow Jones Industrial Average	-18.4%	-31.9%	-4.1%	-1.1%
NASDAQ Composite	-24.6%	-40.5%	-10.6%	-4.7%
Russell 1000 Growth	-22.8%	-38.4%	-9.1%	-3.4%
Russell 1000 Value	-22.2%	-36.9%	-8.3%	-0.8%
Russell 2000	-26.1%	-33.8%	-8.3%	-0.9%
Russell 2000 Growth	-27.4%	-38.5%	-9.3%	-2.4%
Russell 2000 Value	-24.9%	-28.9%	-7.5%	0.3%
International Equity				
MSCIEAFE	-20.0%	-43.4%	-7.4%	1.7%
MSCI Emerging Markets Free	-27.6%	-53.3%	-4.9%	7.7%
MSCI Europe	-22.8%	-46.4%	-6.6%	1.5%
MSCI UK	-26.4%	-48.3%	-9.9%	-1.3%
MSCI Japan	-9.0%	-26.2%	-10.4%	0.9%
MSCI Far East	-10.6%	-32.4%	-9.7%	1.3%

International markets sold off more than the US, with the global sell-off led by energy, materials, and financials. For the year, emerging markets underperformed developed markets as commodity production and exports to developed countries waned due to the ongoing global recession. Within emerging markets, energy producing countries were hurt the most. Most notably, Russia was the weakest performing country for the year, trading off approximately 74%. China's performance was helped with an end of year rally but still finished 2008 off 50%.

Global Fixed Income

US and global interest rates fell dramatically during the fourth quarter, contributing to positive returns in core and global fixed income indices. The Fed and Treasury took unprecedented actions to instill confidence in capital markets, slashing short-term interest rates from 4.25% to a target range of 0.0-0.25%, while announcing lending facilities and guarantees to financial institutions in an effort to add liquidity to the market. Foreign central banks took similar dramatic and unprecedented actions. The Barclays Capital US Aggregate Index returned 4.6% in the fourth quarter, driven by US Treasuries (+8.0%), and finished the year up 5.2%. Likewise, global sovereign bonds benefited from falling rates; the Citi WGBI finished the fourth quarter up 8.8% and posted a 10.9% return for 2008. Investment grade credit and Agency MBS posted positive returns in the fourth quarter, although spreads generally widened, contributing to underperformance relative to Treasuries. Many active core bond managers, typically overweight spread sectors, faced considerable head-winds during the quarter due to investor risk-aversion. High Yield bonds returned -17.9%, posting the worst quarterly return for the asset class in recent memory. The chal-

lenging markets in many non-Treasury sectors have created opportunities for managers to potentially add value in the future as markets eventually recover.

Currency Markets

The US dollar was volatile during the fourth quarter, opening the quarter with a rally on global investor risk aversion and ending with a decline on concerns over its fundamental value. High demand for Treasuries as a safe haven for investors helped the US dollar against developed currencies such as the sterling and euro, as well as commodity-dependent currencies including Canada, Australia, and many emerging markets. Rising unemployment, slowing economic growth, relatively low short-term rates, and inflationary implications of a bailout package of historical magnitude will likely have

long-term implications on the dollar's relative value. Elsewhere, the Swiss franc rallied, as an alternative source of safety for global investors, and the Japanese Yen benefited considerably from the "carry trade" unwind as investors, especially hedge funds, sold liquid currency positions to meet margin calls elsewhere in their portfolio.

Commodity Markets

After the run-up in commodity prices through the first half of 2008, the commodity bubble burst in the third quarter and continued its decline through the end of the year, experiencing significant volatility and unprecedented declines, falling 47% for the fourth quarter of 2008. The correction was pervasive across commodity sectors, with the exception of precious metals, which provided a safe haven during a time of investor uncertainty. The energy and industrial metals areas fell sharpest, losing 55% and 43% respectively. Oil, the most widely followed commodity, hit record highs of \$147 a barrel in the first half of 2008, but finished the year at \$43. Commodities experienced heavy technical selling pressure during this flight to quality and broad negative sentiment as investors shed all risk asset in favor of cash and Treasuries. In lieu of rational fundamental drivers for returns, the global financial crisis provided most direction for commodity markets. Investor concerns centered on a weak global economy and rising fears of a global recession weakening demand for natural resources, though near-term inflation concerns have abated. These concerns will likely drive commodity pricing well into 2009 as supply and demand begin to equalize.

Pension Liability Experience

Corporate pension plan sponsors benefited materially from credit spread widening throughout the first ten months of 2008. Rising spreads led to an increasing discount rate and subsequent lower liability valuations through the third quarter, according to the Citigroup Pension Liability Index. Liability performance offset at least a portion of declining asset values, protecting funded status to some extent. Unfortunately, the fourth quarter was a second "perfect storm": further declines in asset values combined with sharply falling discount rates led to significant deterioration in funded status, especially for corporate plans without a liability hedging strategy in place. As evidence, the Citigroup Pension Liability Index dropped from 7.50% at September 30, 2008 to 5.87% at December 31, 2008.

The sharp decline in funded status will create challenges for plans trying to reach the current Pension Protection Act (PPA) required funding target of 94% and will likely lead to increased contributions for many plan sponsors under the PPA. While the PPA Technical Corrections passed by Congress in December did allow for increased smoothing of assets, it was not a broad funding relief law that would significantly benefit most corporate plan sponsors. More comprehensive funding relief will likely be a heavily debated topic by the new Congress in 2009.

Plan sponsors who have implemented Liability Driven Investing (LDI) programs saw a positive return in these strategies, especially those implemented with US Treasuries or swaps instead of corporate bonds. These plan sponsors will need to consider rebalancing back to target hedge ratios, while those plan sponsors who have not yet implemented LDI will need to weigh the timing of implementing LDI, while considering opportunities in long duration investment grade credit. Lastly, plan sponsors using the Citigroup Pension Liability Index as a proxy for li-

Fixed Income Index Returns (12/31/08)				
	Quarter	1 Year	3 Yrs	5 Yrs
Global Fixed Income				
Citi World Gov. Bond	8.8%	10.9%	9.3%	6.0%
Domestic Fixed Income				
BC Aggregate	4.6%	5.2%	5.5%	4.7%
BC Government	8.0%	12.4%	8.1%	6.1%
BC U.S. Credit	4.0%	-3.1%	2.0%	2.7%
BC Mortgage Backed	4.3%	8.3%	6.8%	5.5%
BC Govt/ Credit	6.4%	5.7%	5.6%	4.6%
BC TIPS	-3.5%	-2.4%	3.1%	4.1%
BC High Yield	-17.9%	-26.2%	-5.6%	-0.8%
91 Day Treasury Bills	0.1%	1.5%	3.8%	3.2%
10-Year Bond Yields	Dec-08	Sep-08	Jun-08	Mar-08
U.S.	2.3%	3.9%	4.0%	3.5%
Europe	3.9%	4.4%	4.7%	3.9%
U.K.	3.4%	4.5%	5.2%	4.4%
Japan	1.2%	1.5%	1.6%	1.3%

ability performance should view these results cautiously as a reconstitution of its bond universe and use of spot rates instead of monthly smoothing led to materially different results than liabilities calculated using the PPA yield curve at the end of 2008.

Hedge Funds

Hedge funds continued to report poor performance in the fourth quarter as they lost an additional 10.2%, on average, most of which came in October and November. Only Dedicated Short Bias and Managed Futures strategies reported positive performance in the quarter. The worst performing strategy was Equity Market Neutral, which experienced the write-off of Madoff feeder funds previously included in the universe.

As the deterioration in the broad equity markets continued in the fourth quarter, managers reduced both their long and short exposures in an effort to take risk off the table and wait for fundamental analysis to again become the driver in determining market prices. In corporate credits, the High Yield, CMBS and Bank Loan markets continued to weaken as a result of anticipated corporate financial difficulties. Even as the indiscriminate forced selling of assets abated somewhat near the end of the year, most managers continued to position their portfolios defensively. Generally speaking, most managers are focused on mitigating potential investor redemptions and, for those strategies that rely on it, securing financing going forward.

While precise figures are not available, the estimated 15-20% of net industry assets that were redeemed in 2008 coupled with a 19% loss for the average hedge fund, has caused the industry to contract from approximately \$1.9 trillion at the beginning of the year to the currently estimated \$1.2 trillion. While it is estimated that approximately 20% of funds are restricting withdrawals by either invoking gates or suspending redemptions, there is some uncertainty as to how much of the demand for redemptions will spill into the first quarter redemption period in 2009. As a result, investors continue to favor strategies that minimize counterparty exposure and have attractive underlying liquidity factors. Once managers have more visibility into how these factors will evolve, the industry should regain its footing and again focus on the search for alpha. While 2008 was an extraordinarily challenging year for hedge funds and hedge fund investors, we believe that this investment category, while damaged in the short-term, is not permanently broken, and will represent opportunities for excess return as the marketplace evolves.

Hedge Fund Index Returns (12/31/08)	Quarter	1 Year	3 Yrs	5 Yrs
Composite				
CS Tremont Hedge Fund Composite	-10.2%	-19.1%	1.2%	4.1%
Relative Value				
CS Tremont Convertible Arbitrage	-15.1%	-31.6%	-6.3%	-4.0%
CS Tremont Fixed Income Arbitrage	-19.5%	-28.8%	-7.1%	-2.9%
CS Tremont Equity Market Neutral	-41.3%	-40.3%	-10.2%	-3.9%
Event Driven				
CS Tremont Event Driven	-9.3%	-17.7%	2.5%	6.1%
CS Tremont Event Driven - Distressed	-12.7%	-20.5%	-0.1%	5.2%
CS Tremont Event Driven - Risk Arbitrage	-1.5%	-3.3%	4.4%	4.3%
CS Tremont Event Driven - Multi-Strategy	-7.3%	-16.3%	4.4%	6.8%
Equity Hedge				
CS Tremont Long-Short Equity	-7.5%	-19.8%	1.4%	5.0%
CS Tremont Emerging Markets	-15.1%	-30.4%	0.3%	5.9%
CS Tremont Dedicated Short Bias	11.1%	14.9%	4.4%	4.2%
Tactical				
CS Tremont Multi-Strategy	-12.6%	-23.6%	-1.2%	2.2%
CS Tremont Global Macro	-2.6%	-4.6%	8.3%	8.5%
CS Tremont Managed Futures	10.9%	18.3%	10.7%	7.5%
Traditional Markets				
S&P 500	-22.0%	-37.0%	-8.4%	-2.2%

Private Markets

Private equity managers are unlikely to realize sales on mature portfolios in a market that is experiencing multiple contraction, slowing EBITDA growth, and lack of available debt. Fund managers are taking steps to preserve portfolio company value by reserving more capital for follow-on financings and implementing cost reduction programs with the hope that company sales will be more viable in better times. Exits are not likely to happen until current market conditions improve. Funds that have capital and are focused on turn-around, distressed, secondaries and mezzanine strategies will have the best opportunity to make money in this environment.

The global recession is causing a contraction in available debt, a major concern for Real Estate managers. This is coming at a time when both operating income and valuations are falling. In particular, the falloff in discretionary consumer spending is having an adverse impact on the retail and hotel/leisure sectors. Cost and workforce reduction programs are putting pressure on the office sector, as tenants seek to sublet their space, increasing the supply of office space and opportunities to negotiate rents. These issues are expected to continue pressuring valuations downward well into 2009.

Final Thoughts

We believe the markets are in the process of returning to a state of normalcy as defined by a functioning credit market, long-term relationships between risk and return, and prices being driven by fundamentals (as opposed to “normal” levels of liquidity and leverage circa early 2007). While the timing of this return to normalcy is unclear, we expect that it will happen at different times for different markets; for example the credit markets need to recover before equity markets, and stocks usually act as a leading indicator of economic growth. While there is a small, but credible risk of a long-term deflationary spiral such as Japan in the 1990s or the global economy in the 1930s, we see long-term inflation as more likely, given the extraordinary monetary and fiscal stimulus currently underway. In this environment, we believe it is critical for investors to assess their programs using an array of tools that complement traditional mean-variance asset allocation analysis including risk-budgeting, scenario analysis, and liquidity analysis to answer “what if” questions arising out of the current market environment and to provide more information to decision-makers.

The market results of the last year have been painful for investors, and significant uncertainty around future market direction remains. We encourage investors to focus on their long-term investment time horizon and not overreact to short-term volatility. Investors with patient capital can provide liquidity to profit from the opportunities in the current environment. Each investor’s response to the current environment—the risks and the opportunities—will be unique, driven by current portfolio positioning, liquidity constraints, return targets, and risk tolerance. In general, we recommend clients rebalance toward asset allocation targets, while considering opportunistic investments in credit markets and continued diversification into strategies that can perform well in adverse economic environments such as deflation (developed sovereign bonds) or high inflation (TIPS and real assets). We look forward to working with our clients to offer the perspective and guidance needed to navigate these turbulent markets.

Footnotes:

1 - 2008 performance information:

10 Yr. Treas - Barclays Capital 10 Year Treasury Index

Hedge Funds - CS Tremont Hedge Fund Composite

HY - Barclays Capital High Yield Index

60/40 - 35% S&P 500, 10% Russell 2000, 12% MSCI EAFE, 3% MSCI Emerging, 25% Barclays Agg, 5% Barclays HY, 5% Citi WGBI, 5% S&P REIT Index

Commodities - Dow Jones AIG Commodity Index

Domestic Equities - S&P 500

International Equities - MSCI EAFE

2 - Sources: Standard & Poors/St. Louis Federal Reserve