

Quarterly EQUITY INDICATOR	Quarterly BOND INDICATOR	Quarterly HEDGE FUND INDICATOR	Quarterly PENSION LIABILITY INDICATOR
↓	↑	↓	↑
Down 11%	Up 4%	Down 2%	Up 13%

NEPC is an independent, full service investment consulting firm, providing asset allocation, traditional and alternative asset manager search, 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.

Regime Uncertainty and Its Implications

Many investors, including NEPC, expected stock and bond prices in 2010 to be driven by the underlying investment fundamentals. After two years of macro-driven markets (the credit crisis in 2008 sending all risky assets down, followed by an equally sharp recovery in 2009 beginning in March), 2010 was supposed to be a year when analysts and portfolio managers could distinguish themselves through fundamental and quantitative security analysis. Instead, broad thematic variables continue to drive markets – both positive (early in the year) and negative (more recently). After a relatively benign first quarter, volatility has returned to markets with a vengeance, along with steeply declining global stock markets (see Exhibit 1).

While sovereign risk and the resiliency of the economy have come into question recently, an additional source of uncertainty has arisen – the growing role of government in markets, both in the US and abroad. Over the last two years we have seen governments pursue unprecedented monetary and fiscal stimulus programs, engage in massive bailouts of financial institutions and corporations, and provide extensive sovereign debt support. On July 21st President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The 2,319 page financial reform and regulation bill is expected to have significant impact on markets and investors ranging from oversight of banks to transparency and settlement of derivatives to executive compensation.

There is no doubt that we are entering a new era of government regulation and intervention, both in the US and globally. The credit crisis of 2008 and the current debt crisis enveloping Europe have highlighted serious shortcomings in the global financial system. We do not believe that all government interaction with markets is necessarily problematic. Indeed, a well-functioning financial system requires a constructive relationship between market participants and those who ensure that appropriate rules are implemented and enforced. Nevertheless, a change in the regulatory regime creates significant uncertainty and uncertainty can be the enemy of investor (and business owner and operator) confidence.

This new regulatory environment comes at a time when central banks are engaged in historic interventions amidst unprecedented developed country debt levels fueled by cavernous fiscal deficits. In the US, minor provisions in the financial reform legislation could lead to major consequences for institutional investors. Understanding many of the specifics of the legislation will have to wait, however, as Congress delegated much of the actual law writing to individual regulatory bodies, including newly created entities such as the Consumer Finance Protection Bureau and the Financial Stability Oversight Council.

Exhibit 1—S&P 500 vs. VIX



Source: Bloomberg

We have been actively engaged in discussions with industry participants and legislative groups to address language in the bill that could impact the ability of retirement plans to use swap contracts to hedge liabilities in defined benefit plans and maintain book value accounting treatment for stable value portfolios in defined contribution plans. To our relief, the final bill softened some of these restrictions or pushed for further study of the issues, limiting the bill's influence in these important areas. The ultimate impact of the new legislation will play out over the coming months and years and be determined by numerous regulatory bodies. We will strive to stay abreast of these developments and update our clients on the key provisions of the current legislation as they unfold.

The increasing role of government in markets adds complexity to investment management, from challenging the traditional relationships of security prices to intrinsic value, to increasing sovereign credit risk, and, in the near-term, potentially elevating volatility. In this environment, we believe it is critical to maintain a risk-balanced approach to asset allocation to ensure broad diversification, and to have a portion of an investment portfolio invested with relatively unconstrained strategies that can take advantage of macro-driven themes across markets. Examples of these types of approaches include global asset allocation, global macro hedge funds, and less-constrained globally-oriented equity and fixed income strategies. Such flexible strategies strive to take advantage of shifting themes affecting global markets while seeking to mitigate associated risks.

Global Equity Markets

After a positive start to the second quarter, global markets reversed sharply amidst skepticism regarding the pace of economic recovery. Significant macro-economic events – the sovereign debt crisis in Europe and the Deepwater Horizon disaster in the Gulf of Mexico – as well as weakening consumer confidence and continued high levels of unemployment drove negative performance across developed markets. No segment of the equity markets was spared as major indexes declined between 9% and 15% for the period. In the US markets, large cap companies underperformed their smaller counterparts as US dollar strength hurt big companies' more global business results. From a sector perspective, those companies tied to a cyclical recovery (Materials, Energy, Financials, and Consumer Discretionary) lagged, while the more defensive groups (Utilities, Telecommunication Services, and Consumer Staples), performed relatively better.

Equity Index Returns (06/30/10)					
Global Equity	Quarter	YTD	1 Year	3 Yrs	5 Yrs
MSCI World	-12.7%	-9.8%	10.2%	-11.5%	0.1%
US Equity					
S&P 500	-11.4%	-6.7%	14.4%	-9.8%	-0.8%
Dow Jones Industrial Average	-10.0%	-6.3%	15.7%	-10.0%	-1.0%
NASDAQ Composite	-12.0%	-7.1%	14.9%	-6.8%	0.5%
Russell 1000 Growth	-11.8%	-7.7%	13.6%	-6.9%	0.4%
Russell 1000 Value	-11.2%	-5.1%	16.9%	-12.3%	-1.6%
Russell 2000	-9.9%	-2.0%	21.5%	-8.6%	0.4%
Russell 2000 Growth	-9.2%	-2.3%	18.0%	-7.5%	1.1%
Russell 2000 Value	-10.6%	-1.6%	25.1%	-9.9%	-0.5%
International Equity					
MSCI EAFE	-14.0%	-13.2%	5.9%	-13.4%	0.9%
MSCI Emerging Markets Free	-9.1%	-7.2%	20.6%	-4.7%	10.2%
MSCI Europe	-15.2%	-16.7%	5.7%	-15.0%	0.3%
MSCI UK	-13.9%	-14.4%	8.6%	-14.7%	-0.9%
MSCI Japan	-10.1%	-2.7%	0.8%	-12.0%	-0.2%

Globally, the debt crisis in the developed world, coupled with fears of a bubble in China, caused many investors to seek safety, helping the US dollar strengthen, but hurting the foreign equity holdings of US investors. The MSCI EAFE Index fell 14% in the second quarter, with 2.8% of that negative performance due to currency. Emerging markets outperformed developed markets, falling 9.1%.

Global Fixed Income

The flight away from risky assets into safer US dollar investments led to US investment grade fixed income posting mostly positive returns in the second quarter. Increased demand for safer assets pushed yields lower, testing the low levels previously observed during the crisis of 2008-2009. The US Treasury yield curve remained steep, with short-term rates anchored near zero, despite the significant drop in the ten-year Treasury bond yield from 3.84% to 2.97% and the 30-year yield from 4.72% to 3.91%. Core US CPI slowed to 2.0% in May, reflecting more stable energy prices, weak demand, and excess capacity. Fixed income market pricing seems synched with equity investors' economic concerns, with little concern of rising interest rates in the near-term as deflation fears and low growth expectations influence investment sentiment.

The Barclays Aggregate Bond Index returned 3.5%, led by Treasuries (+4.2%). Agency mortgage-backed securities returned a robust 2.9% during the quarter, despite the federal government suspending the direct purchase program of mortgage-backed bonds in March. Credit quality seemed to matter finally in fixed income markets as investment grade credit performed well (+3.3%), BB credits posted positive returns (0.4%), and CCC rated credits suffered (-1.4%). The total high yield bond market, as measured by the BarCap High Yield Index, returned -0.1% as spreads widened. Nevertheless, while fundamentals in both consumer and corporate credit sectors continue to improve amidst ongoing deleveraging, the weak economic outlook clouds the trajectory of credit markets and leaves uncertainty, particularly regarding borrowers' ability to refinance debt at future dates.

Globally, the growing debt crisis in Europe reached a critical point when Greece was downgraded to below investment grade during the quarter. Other peripheral European countries such as Spain also faced the possibility of downgrade. The Citi WGBI returned 0.3% with currency eroding stronger performance in the local bond markets (Citi WGBI Hedged returned 2.4% for the period). Even as many developed countries struggle with high government debt levels and challenging fiscal deficits, many developing countries are benefiting from healthy national balance sheets and robust economic growth. As a result, we continue to research the emerging local currency market as an attractive way to diversify and to add yield to a portfolio.

Fixed Income Index Returns (06/30/10)					
Global Fixed Income	Quarter	YTD	1 Year	3 Yrs	5 Yrs
Citi World Gov. Bond	0.3%	-1.0%	3.0%	7.8%	5.1%
JPM EMBI Global Diversified	1.2%	5.6%	18.4%	8.3%	8.1%
Domestic Fixed Income					
BC Aggregate	3.5%	5.3%	9.5%	7.6%	5.5%
BC Government	4.2%	5.4%	6.5%	7.6%	5.4%
BC US Credit	3.3%	5.6%	14.7%	7.4%	5.3%
BC Mortgage Backed	2.9%	4.6%	7.6%	8.4%	6.3%
BC Govt/Credit	3.9%	5.5%	9.7%	7.4%	5.3%
BC TIPS	3.8%	4.4%	9.5%	7.6%	5.0%
BC High Yield	-0.1%	4.5%	26.8%	6.5%	7.2%
CSFB Leveraged Loan	-1.0%	3.3%	17.7%	1.6%	3.8%
91 Day Treasury Bills	0.0%	0.1%	0.2%	1.6%	2.8%
10-Year Bond Yields					
	Jun-10	Mar-10	Dec-09	Sep-09	Jun-09
US	2.9%	3.3%	3.8%	3.8%	3.5%
Germany	2.6%	3.1%	3.4%	3.2%	3.4%
UK	3.4%	3.6%	3.9%	4.0%	3.7%
Japan	1.1%	1.3%	1.4%	1.3%	1.4%

Currency Markets

The US dollar strengthened against most major currencies during the second quarter as global investors sought relative security from sovereign debt concerns in Europe. The euro dropped 10.5% against the dollar as some investors began to question the viability of the common currency. Concerns about slower demand for natural resources pressured the commodity-sensitive currencies of Australia (-8.7%) and Canada (-4.7%). The Japanese yen (+5.3%) benefited from its new status as a relative “safe-haven” currency, despite the economic and fiscal challenges facing that country. As fears of a double-dip recession compete with hopeful signs of economic recovery in the US, global investors also struggle with uncertainty elsewhere. China recently allowed the yuan to appreciate for the first time in two years, a signal that the government may be content with their fundamental outlook, yet some fear that moves to slow Chinese growth may go too far. Looking forward, markets remain skeptical about the European Union’s ability to solve deficit crises during a slow growth regime; fears of sovereign debt default continue.

Commodity Markets

Commodity prices fell in the second quarter (DJ UBS Commodities Index -4.8%) amid concerns that a global economic slowdown would weaken natural resource demand. The energy complex fell 6.2% despite the massive oil spill in the Gulf of Mexico and threatened restrictions on future off-shore drilling. While natural gas rose 11.3% as warmer weather increased electricity demand, rising petroleum inventories and concerns about US growth hurt oil prices (-13.6%). Industrial metals lost 19.1% amid worries of falling Chinese demand as government policies to slow the country’s robust growth continue. Rising demand for gold (+11.6%), particularly among European investors, drove precious metals higher (+10.3%) as investors sought safety from the risk of devaluation of fiat currencies.

Pension Liability Experience

Pension liabilities reversed direction in the second quarter and experienced an estimated liability increase of 13.2%, according to the Citigroup Pension Liability Index. The Citigroup published discount rate of 5.45% as of June 30, 2010 fell 69 basis points from 6.14% as of March 31, driven by falling Treasury yields as corporate yield spreads remained relatively unchanged.

Additional pension funding relief was signed into law by President Obama, allowing some companies to lower their pension contributions in the plan years 2008 to 2011 by extending amortization periods for unfunded liabilities. This adds some relief to cash-strapped corporations, but is by no means as potent as the 2009 pension funding relief, which resulted in increased funded status for most pension plans.

With discount rates as of June 30, 2010 and December 31, 2009 historically low, many plan sponsors will see a decline in pension funding in their 2010 valuations with either January 1 or July 1 measurement dates. Those clients who have implemented Liability Driven Investment (LDI) strategies have likely experienced a more modest funded status decline with a portion of the interest rate risk having been hedged.

NEPC continues to recommend consideration of LDI strategies for corporate clients to protect against declining interest rates, reduce surplus volatility and help maintain funded status. However, with interest rates at new historical lows a more tactical implementation approach may be appropriate. As always, your NEPC consultant can review LDI implementation strategies with you and discuss the amount of liability hedging to be maintained in your portfolio.

Hedge Funds

The hedge fund industry was not immune to the general equity market bloodbath that began in late April and lasted through the end of the quarter. The broad hedge fund market composite was down 2.4% during the second quarter, with most sub-strategies posting negative returns. The worst performing sectors were equity related strategies: long/short, market neutral, and emerging markets. While all three of these areas were down in excess of 3.3% for the quarter, they fared much better than the broader equity market. The only equity related strategy that posted meaningfully positive results for the quarter was dedicated short biased, which gained over 7%. The BarCap Aggregate Bond Index bettered all the hedge fund credit indexes as investor flocked to securities viewed as safe havens. Global Macro managers, on average, were able to post positive returns in this highly volatile period (+1.6%).

Year-to-date, the hedge fund industry composite is marginally positive, up 0.6%, with most equity related sub-strategies in negative territory. Standout sectors for the half-year include fixed income arbitrage, global macro and distress. Only fixed income arbitrage is ahead of the BarCap Aggregate Bond Index for the first six months of 2010. Structured residential mortgage-backed security (RMBS) trades were meaningful contributors to returns during the first half of the year, but it remains to be seen how much return potential is left in this area.

The current environment is once again dominated by large macro themes and risks such as sovereign credit issues in much of the developed world, global financial and regulatory reform, and a concern about the strength of the economic recovery in the US and Europe. With all these issues at play, the markets fluctuate from one inflection point to the next with each incremental macroeconomic data point. In higher volatility environments, short-term trading strategies are more effective than those of fundamentally based security selectors. Thus, as this highly volatile, macro-driven investing climate enters its third year, we are observing that even the most fundamentally driven managers and strategists are incorporating or adding dedicated macroeconomic research capabilities into their portfolio construction and risk management techniques. Overall, we find that hedge fund managers are cautiously positioned. This is reflected by low net exposures, strong preferences for highly liquid securities, and increased return hurdle rates.

Hedge Fund Index Returns (06/30/10)					
Composite	Quarter	YTD	1 Year	3 Yrs	5 Yrs
CS Tremont Hedge Fund Composite	-2.4%	0.6%	11.3%	0.0%	5.6%
Relative Value					
CS Tremont Convertible Arbitrage	-0.9%	2.6%	22.0%	1.1%	5.3%
CS Tremont Fixed Income Arbitrage	1.9%	5.5%	20.2%	-1.4%	1.9%
CS Tremont Equity Market Neutral	-3.9%	-4.6%	-1.8%	-14.9%	-5.5%
Event Driven					
CS Tremont Event Driven	-2.8%	1.8%	15.0%	1.0%	6.8%
CS Tremont Event Driven - Distressed	-2.0%	3.0%	17.1%	-0.6%	5.9%
CS Tremont Event Driven - Risk Arbitrage	-1.5%	-0.1%	5.2%	3.9%	5.4%
CS Tremont Event Driven - Multi-Strategy	-3.5%	1.0%	13.4%	1.8%	7.4%
Equity Hedge					
CS Tremont Long-Short Equity	-5.8%	-3.2%	6.9%	-1.3%	5.6%
CS Tremont Emerging Markets	-3.4%	-0.8%	13.9%	-0.4%	7.7%
CS Tremont Dedicated Short Bias	7.3%	-2.8%	-18.3%	-3.2%	-3.1%
Tactical					
CS Tremont Multi-Strategy	-2.1%	0.5%	11.5%	-0.9%	5.3%
CS Tremont Global Macro	1.6%	4.2%	12.4%	6.4%	9.4%
CS Tremont Managed Futures	-1.8%	0.3%	1.2%	3.1%	5.1%

For the second half of the year, we expect more of the same. Despite strong corporate earnings posted by many sectors including technology, transportation and industrials, the reality is that US consumer spending represents nearly 70% of US GDP and there are many headwinds affecting the consumer economy. Elevated unemployment, increased saving, and the moribund residential housing market are unlikely to change in the near future. There is a plethora of event-driven hedge fund assets waiting on the sidelines, hoping that the mergers and acquisitions market heats up as corporate coffers increasingly are stockpiled with cash amidst an uncertain internal growth environment. Also, to the extent that the refinancing debt markets dry up for an extended period of time, a new wave of distressed opportunities may arise. Nevertheless, many of the largest distressed candidates in the first quarter were able to execute refinancing, so one would expect that the overall corporate default rate will fall from the low teens at the end of 2009 to perhaps the low single digits by the end of 2010. This environment may favor those investors that have the fund structure and size to invest in less liquid small and midsize companies.

Private Markets

Private markets managers are in the midst of a perfect storm comprised of regulatory issues, lack of debt issuance, lack of exits and lack of job growth. A key element to a sustained recovery in private markets will be employment growth, which impacts real estate as well as sectors that are directly or indirectly related to consumer spending.

Financial reform and regulatory issues will impact the ability of financial institutions to invest in private markets strategies and hold those assets on their balance sheet. Although the reform bill has passed, many of its details regarding implementation remain to be clarified. As an example, when will certain banking owners be required to sell their private markets assets?

Both private equity and real estate managers have extended the maturities of their debt with the expectation that the loans will mature in better economic times. Leveraged loan defaults have tailed down from 2009 when the default volume reached \$90.1 billion. Currently, defaults are at \$6.7 billion through June 2010. The current default rate of 4.9% based on volume is high compared to the annual averages over the trailing five years (4.1%) and seven years (3.2%). Leverage loan issuance in 2009 through the first half of 2010 totaled \$102 billion—not sufficient to refinance the \$892 billion of loans that were issued during the 2005 – 2007 time period.

Vacancies, the decline in rental rates, and higher cap rates have caused real estate valuations to decrease substantially from the peak reached in August 2007. Additionally, loan delinquencies are rising. CMBS debt issuance in 2009 through the first half of 2010 totaled \$5.5 billion compared to the \$601.6 billion of CMBS that were issued from 2005 through 2007.

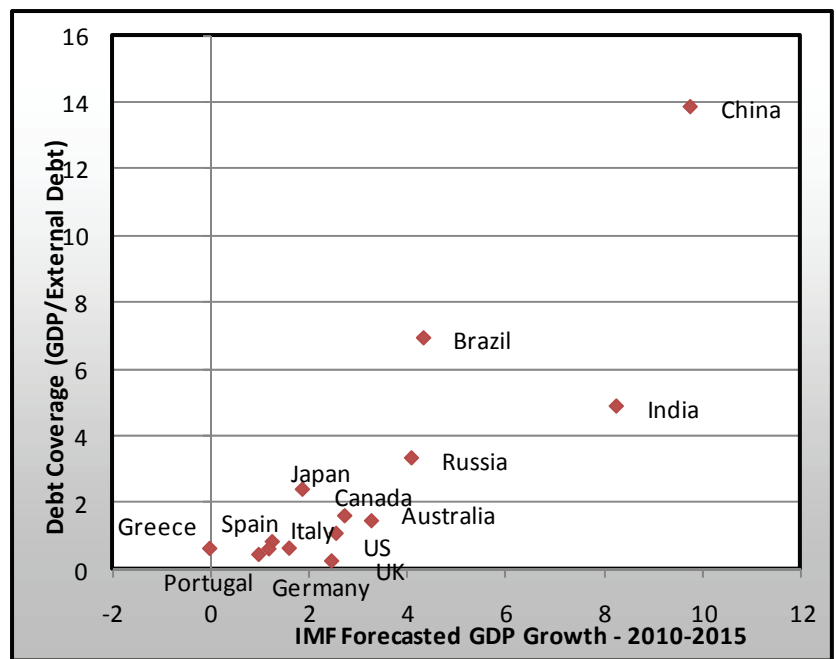
The financial strain is also impacting the banks. Year-to-date through July 10, 2010, 96 banks with \$74.8 billion in assets have failed. The current annual pace of failures should exceed the total amount of bank failures experienced in the fifteen years from 1993-2008 (148 bank failures with \$395.7 billion in assets).

Given the macro issues, the amount of debt coming due and the projected impact of financial reform, we continue to emphasize opportunities in distressed, mezzanine and secondary strategies.

Final Thoughts

Our first quarter Market Thoughts, entitled “Pondering Risks...Sovereign, Tail, and VIX”, highlighted the many risks still stalking the global market environment with a caution not to be “fooled by the current low level of volatility as measured by the VIX.” Frankly, we did not expect the kind of risks we saw emerge in the second quarter, from Wall Street’s “flash crash” on May 6th to the Deepwater Horizon disaster. In an echo of 2008, equity markets sold off and an investor flight to safety drove up the value of US Treasuries and the US dollar. Recent economic releases have been mixed, with strong corporate earnings balanced by faltering consumer confidence and continued focus on high debt burdens. The US equity market appears fairly valued to slightly cheap (the S&P 500 is trading at approximately fifteen times trailing earnings and twelve times forward earnings). On the other hand, with a 10-year Treasury yield dipping below 3.00%, the bond market is pricing in an assumption of very low economic growth for the foreseeable future.

Exhibit 2 - 2010 Debt Coverage vs. Expected GDP Growth



Source: IMF, CIA World Factbook

In this environment, the emerging markets appear relatively attractive as they continue to experience positive economic growth and display strong balance sheets. Exhibit 2 shows the higher projected growth rates and modest external debt coverage needs of some of the largest emerging markets relative to the developed world. Nevertheless, many investment programs are underweight emerging markets relative to the world market portfolio. We recommend that clients at least mirror the broad market weights in emerging market stocks, bonds, and currencies, and consider a longer-term strategic overweight to this broad asset category.

In this time of elevated uncertainty, fueled in part by a new regime of government interaction with the markets, a balanced approach to risk taking remains a critical underpinning for client investment programs. We also recommend pursuing scenario analysis to understand the impacts of extreme economic and market outcomes. As part of this process, we remain committed to helping our clients understand the implications of the changing environment and positioning their programs to meet their long-term investment objectives.