



MARKET THOUGHTS

THIRD QUARTER 2009

VOLUME 18 · ISSUE 3

QUARTERLY EQUITY INDICATOR



Up 16%

QUARTERLY BOND INDICATOR



Up 4%

QUARTERLY HEDGE FUND INDICATOR



Up 7%

QUARTERLY PENSION LIABILITY INDICATOR



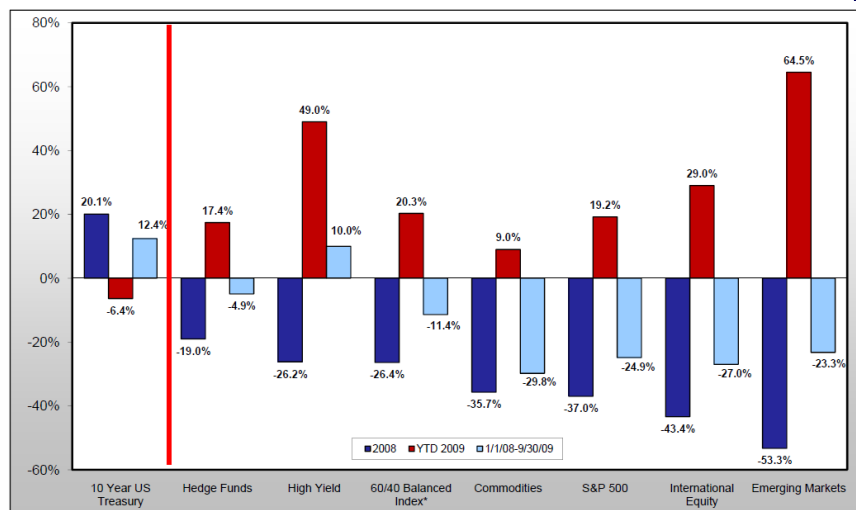
Up 13%

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.

Too Far, Too Fast

On September 30th, the S&P 500 completed its third best calendar quarter since 1970, up 15.6%. Nearly all risky asset classes have rebounded substantially from their March lows, with US stocks rising nearly 60%, and non-US stocks advancing even more robustly. Emerging markets stocks outpaced all major market categories, ahead 64.5% for the year-to-date period and up nearly 100% from their recent nadir. Credit markets also fared extraordinarily well, led by high yield bonds, returning 49% this year. Furthermore, measures of investor sentiment have bounced back from their unprecedentedly low levels of late 2008 with key “fear indicators” such as the VIX Index declining to the mid-20s (after breaking 80 last November), and LIBOR to 0.30%, near its all-time low. To some extent, subsiding investor fears were mirrored by the real economy, and the US is widely expected to have emerged from recession in the third quarter with the first positive GDP growth figure in over a year. The performance of global markets this year has validated the conviction of those who maintained discipline and avoided overreacting to short-term market concerns and uncertainty. Yet for all the robust market recovery, most risky asset classes have not come close to regaining all their losses (see Exhibit 1).

Exhibit 1 - Market Results January 1, 2008 - September 30, 2009



* 35% S&P 500, 10% Russell 2000, 12% EAFE, 3% MSCI Emerging Mkts Equity, 25% BarCap Agg, 5% BarCap HY, 5% Citigroup WGBII, 5% Wilshire REIT

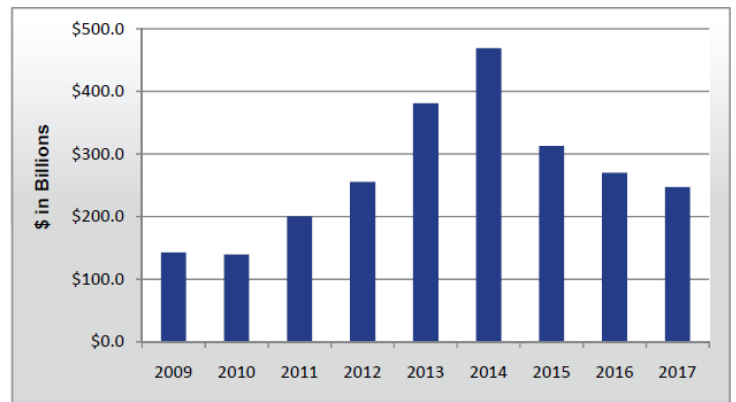
Source: Bloomberg

Despite such broad market resiliency, we must ask what level of future economic growth will be necessary to meet the market's current expectations as reflected in stock prices. With high unemployment headwinds, shrinking private credit and the ominous threat of inflation (or even, to the other extreme, deflation), we must ask—have markets come too far, too fast?

US corporations have aggressively cut costs and managed inventory to boost short-term profitability, but expectations of future earnings growth must soon square off with the reality of flat or muted top-line revenue growth. Eventually, above-trend economic growth must emerge to drive rising revenues and further stock market appreciation. While robust economic growth in the coming year or two is not impossible (and the market's expectations give it some credence), impressive growth in the near-term appears questionable given the continued deleveraging of the corporate and consumer sectors, increasing savings rates, high unemployment, and the exhaustion of short-term stimulus measures such as the “Cash for Clunkers” program. As a result, we remain cautious on the US equity market at this juncture.

Another component of the challenging environment is the significant overhang of commercial and residential real estate and corporate debt that must be paid down and/or refinanced in the coming years (see Exhibit 2). The majority of this debt comes due in 2011-2015, providing some breathing space in the near-term. Yet, absent very robust economic growth and a more favorable credit environment, this overhang will lead to rising level of defaults and distressed securities, including potentially involving some very significant real estate funds. While this represents another headwind to economic growth, it also presents an opportunity to those long-term investors who can provide liquidity. Early opportunities to take advantage of this new distressed cycle include participation in the government sponsored Public Private Investment Program (PPIP) as well as Debtor-In-Possession (DIP) financing vehicles. Longer-term we see significant opportunities in distressed, secondary, mezzanine, and other strategies that can earn excess returns by providing liquidity to these troubled markets.

Exhibit 2 - Projected Maturities of Commercial Real Estate Debt, Leveraged Loans and High Yield



Source: Credit Suisse Leveraged Finance Outlook, Goldman Sachs

Lastly, when considering the inflation/deflation debate, the markets have responded positively to the wave of unprecedented government intervention, essentially eliminating the deflation/depression scenario in the pricing of securities. We agree that the probability of catastrophic economic decline has diminished significantly, though the outlook for economic growth in the US remains quite dreary, raising the possibility of economic stagnation similar to Japan's experience in the 1990s. The Fed has recognized this possibility and expressed a desire to keep rates low well into the future, giving the economy time to catch up with the optimistic expectations of the equity market. A more likely outcome, in the wake of deficit spending exceeding 40% of government outlays, appears to be a below-trend economic growth environment and higher levels of inflation, a situation that could persist for a number of years. While we view a very high inflation environment as a "tail risk" event, we recognize it as a credible risk that can inflict significant damage on many investment programs. As a result, we recommend building inflation-hedging real asset exposures to help hedge against this possibility. Finally, in this challenging environment, the dollar will likely remain under pressure making non-US assets relatively attractive.

Global Equity Markets

Anxious for an end to the recession and a beginning to a global recovery, investors focused on encouraging employment, housing, and manufacturing statistics. Many companies also reported better than expected earnings, a function of cost-cutting and inventory control rather than top-line growth, as noted earlier. The combination of positive economic data and rising corporate earnings helped boost US equity markets in the third quarter. All broad segments of the domestic equity market posted double digit returns. Mid caps led the way, followed by small caps and then large caps. Value stocks beat growth stocks. From a sector perspective, the economically-sensitive and cyclical groups (financials, technology, materials and processing, producer durables) outperformed their defensive counterparts (healthcare, utilities, telecommunications). Notably, however, domestic quality stocks trailed their counterparts.

Equity Index Returns (9/30/09)					
Global Equity	Quarter	YTD	1 Year	3 Yrs	5 Yrs
MSCI World	17.4%	24.9%	-2.3%	-4.3%	3.5%
US Equity					
S&P 500	15.6%	19.2%	-6.9%	-5.4%	-0.1%
Dow Jones Industrial Average	15.8%	13.5%	-7.4%	-3.3%	1.9%
NASDAQ Composite	15.7%	34.6%	1.5%	-2.0%	2.3%
Russell 1000 Growth	14.0%	27.1%	-1.9%	-2.5%	-2.6%
Russell 1000 Value	18.2%	14.8%	-10.6%	-7.9%	2.6%
Russell 2000	19.3%	22.4%	-9.5%	-4.6%	4.9%
Russell 2000 Growth	16.0%	29.1%	-6.3%	-2.6%	1.1%
Russell 2000 Value	22.7%	16.4%	-12.6%	-6.6%	8.0%
International Equity					
MSCI EAFE	19.5%	29.0%	3.2%	-3.6%	6.1%
MSCI Emerging Markets Free	20.9%	64.5%	19.1%	7.9%	17.3%
MSCI Europe	22.9%	31.6%	1.6%	-3.6%	6.4%
MSCI UK	18.5%	34.0%	-1.3%	-6.1%	3.4%
MSCI Japan	6.5%	9.3%	-0.6%	-8.0%	2.2%

In the global equity markets, the themes sparking the stock market rally in the first and second quarters continued to provide positive momentum in the third quarter. Lower quality, smaller capitalization stocks and those stocks hurt the worst in 2008 led the rebound. Financial issues were the strongest, followed closely by the cyclical materials and industrial sectors. The healthcare, utilities,

and defensive sectors continued to lag. Depending on the metric, developed markets stocks appear fairly valued or rich. Given how far the market has moved in such a short period of time, it would seem that future appreciation will need to be justified by continued improvements in fundamentals and not from speculation.

Within developed markets, Europe and Asia ex-Japan performed the best. Emerging markets continued to experience double digit gains, returning close to 21% for the quarter and 64.5% year-to-date. Markets were led by strong returns within Latin America, in particular Brazil, as well as South Korea and Taiwan. Emerging markets have rallied close to 100% since the market bottom in October of last year on strong country balance sheets, low labor costs and higher demand. Valuation metrics appear cheap or in-line with long-term averages. Investors will need to see earnings growth within these markets for them to continue their upward movement.

Global Fixed Income

All major fixed income sectors posted positive results in the third quarter, as investor confidence and liquidity returned to non-Treasury sectors of the market and interest rates fell across the yield curve. Short-term interest rates, anchored at near zero, continued to drive investors to seek yield, pushing down rates at the longer end of the curve and narrowing spreads in credit and mortgage-backed securities. The short end of the curve did flatten out slightly in the third quarter but tightening continues to be priced in starting one year out — despite the Federal Open Markets Committee reiterating its view that economic conditions warrant an exceptionally low level of the federal funds rate for an extended period. Indeed, investors will likely continue to seek yield, shunning short-term Treasuries in favor of spread sectors. Government support of US financial institutions also improved liquidity in the banking system, increasing credit flows and improving liquidity in bond markets. The Barclays Capital Aggregate Index returned 3.7% in the quarter, led by investment grade credit, which returned 7.5%. Much like equities, the riskiest portion of the bond market—high yield bonds—performed best, returning an impressive 14.2%. At this time last year, credit markets were hopelessly illiquid. Patient investors who have taken advantage of this unique opportunity have continued to benefit from improvements in overall market conditions.

Fixed Income Index Returns (9/30/09)					
Global Fixed Income	Quarter	YTD	1 Year	3 Yrs	5 Yrs
Citi World Gov. Bond	6.2%	4.6%	13.8%	9.4%	6.7%
Domestic Fixed Income					
BC Aggregate	3.7%	5.7%	10.6%	6.4%	5.1%
BC Government	2.0%	-1.2%	6.7%	6.8%	5.2%
BC US Credit	7.5%	14.9%	19.5%	5.8%	4.7%
BC Mortgage Backed	2.4%	5.2%	9.9%	7.4%	6.0%
BC Govt/Credit	4.2%	4.7%	11.5%	6.3%	4.9%
BC TIPS	3.1%	9.5%	5.7%	5.6%	4.8%
BC High Yield	14.2%	49.0%	22.3%	5.3%	6.1%
91 Day Treasury Bills	0.1%	0.2%	0.4%	2.8%	3.1%
10-Year Bond Yields	Sep-09	Jun-09	Mar-09	Dec-08	Sep-08
US	3.3%	3.5%	2.8%	2.4%	3.9%
Europe	3.2%	3.4%	3.0%	3.6%	4.0%
UK	3.6%	3.7%	3.2%	3.0%	4.5%
Japan	1.3%	1.4%	1.2%	1.6%	1.5%

Liquidity in securitized sectors of the bond market (asset-backed, commercial mortgage-backed and non-agency residential mortgage-backed) improved with the launch of several programs backed by the Federal Government. The Term Asset-Backed Securities Loan Facility (TALF) program restored liquidity and new issuance in ABS, driving spreads tighter. The Public-Private Investment Program (PPIP) was inaugurated to improve liquidity in troubled real estate related securities markets. We have researched the nine PPIP funds that will invest in non-agency RMBS and CMBS, and view the program as an attractive credit market opportunity for our clients.

Globally, a combination of falling yields and US dollar deterioration led to a 6.2% return from developed sovereign bonds. Exposure to emerging markets debt was beneficial to investors as well, as those markets returned 10.2%.

Currency Markets

The US dollar declined in relative value during the third quarter. The dollar's depreciation against major global currencies was broadly-based as investors expressed concerns about our growing deficit, high unemployment, and slow economic growth. Market appetite for more risky assets also weighed on the dollar. By contrast, commodity-intensive currencies such as the Canadian dollar (+7.6%) and Australian dollar (+8.4%) gained against the US dollar as demand for commodities and real assets rose amid expectations for relatively stronger economic recovery outside the US and the threat of rising inflation.

Commodity Markets

Global commodity prices rose in the third quarter, gaining 4.2% as measured by the DJ/UBS index. The index is up 9.1% for the year-to-date period ended September 30th. Commodity market volatility continues as fundamental supply/demand imbalances compete with technical factors and investor sentiment to create price movement. Results were mixed among commodity market sectors during the quarter as investors digested various economic developments and production figures. Despite a falling US dollar, prices in the Energy complex dropped 4.3% on elevated inventories, particularly in natural gas. Rising production in areas like wheat and lean hogs impacted prices in Agriculture (+0.8%) and Livestock (-5.6%). Meanwhile, Industrial Metals (+20.1%) rose on increased demand amidst recent supply curtailments. Precious Metals also did well during the quarter, gaining 12.5% as the US dollar lost value and investor concerns about higher future inflation mounted.

Pension Liability Experience

Pension liabilities increased significantly during the third quarter. Treasuries rallied over the quarter, with 30-year Treasury yields down 26 basis points, while corporate spreads tightened 59 basis points, according to the Barclays Capital Long Credit Index. As a result, discount rates based on corporate yields declined. One proxy measure, the Citigroup Pension Liability Index, decreased 66 basis points from 6.20% as of June 30, 2009 to 5.54% as of September 30, 2009. This decline in discount rates is estimated to have increased the costs of funding pension liabilities by 12.8% for the quarter and 10.5% year-to-date.

Interest rate risk affecting liabilities and plan funded status can be hedged through various Liability Driven Investment (LDI) solutions. We continue to recommend consideration of LDI strategies for corporate clients in particular to protect against declining interest rates, to reduce surplus volatility, and to help maintain funded status. However, there is no perfect vehicle for implementing this hedge. Clients who would like to manage assets relative to liabilities but have not yet implemented LDI may find an averaging approach attractive to mitigate market timing risk given continued yield volatility. A "trigger-based" program, extending duration through LDI after significant increases in yields, may also be appropriate. As always, the implementation and amount of hedging maintained in your portfolio should be reviewed with your consultant.

Hedge Funds

Hedge funds continued their positive streak, reporting a 7.3% return for the third quarter and 15.0% year-to-date, according to the CS Tremont Hedge Fund Composite. For the quarter, every strategy, except for Dedicated Short Bias, reported positive performance, led by the double digit returns of Convertible Arbitrage and Emerging Markets. Over almost all trailing periods, hedge funds have typically reported positive returns in contrast to the S&P 500, which remains negative over those time frames.

Returns were boosted by managers exploiting structural inefficiencies in the market, primarily driven by investors with a strong need to raise cash, and the reduced presence of proprietary trading desks of banks that were natural competitors to hedge funds. Managers are maintaining a defensive posture in spite of the strong rally in risky assets and are moving their portfolios from lower quality assets, which have performed well this year, into higher quality assets. Hedge fund gross exposures are growing to near historic average levels while net exposures remain low by historical measures. This is the result of the increasing dispersion among individual stocks and sectors, which generally benefits hedge fund performance.

Hedge Fund Index Returns (9/30/09)					
Composite	Quarter	YTD	1 Year	3 Yrs	5 Yrs
CS Tremont Hedge Fund Composite	7.3%	15.0%	3.2%	3.5%	6.3%
Relative Value					
CS Tremont Convertible Arbitrage	12.9%	40.0%	18.9%	1.3%	2.6%
CS Tremont Fixed Income Arbitrage	9.1%	22.0%	-1.8%	-2.6%	0.3%
CS Tremont Equity Market Neutral	4.1%	5.3%	-38.2%	-11.1%	-3.9%
Event Driven					
CS Tremont Event Driven	7.6%	14.7%	4.1%	4.2%	7.6%
CS Tremont Event Driven - Distressed	7.9%	14.8%	0.3%	1.6%	6.4%
CS Tremont Event Driven - Risk Arbitrage	3.7%	10.3%	8.6%	6.2%	6.1%
CS Tremont Event Driven - Multi-Strategy	7.3%	14.6%	6.3%	6.0%	8.5%
Equity Hedge					
CS Tremont Long-Short Equity	7.8%	16.7%	8.0%	4.4%	7.5%
CS Tremont Emerging Markets	10.1%	24.7%	5.9%	4.4%	9.5%
CS Tremont Dedicated Short Bias	-13.6%	-23.0%	-14.4%	-5.1%	-2.4%
Tactical					
CS Tremont Multi-Strategy	7.5%	20.7%	5.5%	2.4%	5.4%

For the quarter, managers were able to profit from long positions in equities, primarily financials and consumer-driven companies; steep global yield curves; short dollar positions; long-short credit trades; and, the improving conditions in the convertible bond market. The thawing of the credit markets, coupled with the subsiding operational pressures on hedge funds, present a fertile landscape for hedge funds going forward.

Private Markets

The environment for most private equity and real estate strategies remains very challenging. Fundraising has declined to 2003 levels as general partners struggle with troubled existing portfolios and investors remain concerned about long redemption queues and their own liquidity issues. According to Preqin, 90 private equity funds have halted or canceled their fundraising efforts so far this year and the average time to final close has extended to 18.3 months (12 months more than typical). The story is similar for real estate partnerships. On the private equity side, purchase price multiples have contracted from their 2007 highs and debt multiples have also fallen significantly. Many firms are focused on restructuring portfolio companies and renegotiating debt with an eye to rising loan maturities, which will reach a peak in 2014 when \$290 billion in leveraged loans come due. Market conditions will need to further improve for this debt to be refinanced. Bankruptcies are also increasing. PE Hub reports that 52 private equity-backed companies filed for bankruptcy in the first half of 2009 compared to 49 private equity-backed company bankruptcies in all of 2008. Real estate fund managers face many of the same challenges as their private equity counterparts, with rising vacancies, pressure on rents and increasing tenant bankruptcies. Furthermore, the supply of new debt to finance property purchases or refinance existing properties has dried up. New issuance of CMBS fell to \$1.8 billion in the first three quarters of 2009 from \$230 billion during 2007. The decline in operating income combined with the lack of available debt is raising cap rates, lowering valuations and increasing the probability of defaults.

During periods of illiquidity and financial distress, those investors with assets to deploy can seek a premium for providing risk capital. Over-allocated and liquidity-starved institutional investors are pursuing secondary sales of private equity and real estate funds to improve their current and future cash position. We believe these conditions make secondary investment strategies attractive. Experienced distressed company or property managers are well positioned to capitalize on depressed asset prices. Also, as debt financing for new investments is scarce, mezzanine providers are able to fill a much needed capital gap at very favorable terms. We continue to believe that there are good managers that have the experience to take advantage of these conditions. As such, we are advising private market investors to take advantage of the current market dislocation and consider adding commitments to secondary, distressed and mezzanine investment strategies.

Final Thoughts

The rebound of risky assets and reduction of fear in the global capital markets, along with the first signs of recovery from severe recession, are greatly reassuring for long-term investors. We are pleased that markets appear to have normalized and that long-term relationships between risk and return have begun to reappear. But we do not believe this is a time for complacency, as significant risks of slow economic growth, a jobless recovery, rising interest rates and inflation, and significant pressure on the dollar remain. Furthermore, as we start developing our five-to seven-year asset class assumptions for the new year, return expectations for the coming period will likely decline, reflecting the tremendous recent market gains in much the same way that 2009 return expectations generally rose to reflect valuations following the drastic market losses of 2008.

We recommend that investors evaluate how their portfolio would perform in a variety of economic regimes, including low growth and inflationary environments and even a possible "stagflation" scenario. To protect against these possible outcomes, investors can build exposure to inflation-hedging assets, as well as to economies that may be better positioned for growth, including non-US developed and emerging stock, bond, and currency markets. We recommend that long-term investors with available liquidity consider opportunities in the distressed area including PPIP, DIP financing, and other illiquid strategies. While some value still remains in areas of the liquid credit markets such as bank loans and high yield, in recognition of the sizeable gains already realized in these markets year-to-date, investors may consider trimming positions to fund allocations to real assets and/or distressed strategies.

We greatly appreciate the trust our clients have placed in us during these challenging times. We remain committed to providing the high level of service you expect and bringing forward our best ideas to help balance the risks and opportunities in the global markets.