



"Advancing Your Investments"

When Opportunity Knocks

NEPC Asset Allocation Committee

Introduction

At the start of this year we indicated in our annual letter that the current market volatility would create investment opportunities. Today, we believe severe dislocations in the credit markets have created the potential for compelling risk-adjusted returns. As a result, we recommend that clients consider increasing their credit market exposure in the near future.

This recommendation is consistent with key themes we have emphasized over the years. These themes represent attributes we find among the best investors, including:

- Broad diversification and reduced dependency on any one asset class;
- Willingness to invest in undervalued asset classes and to rebalance out of overvalued asset classes;
- Willingness to add money to talented but out of favor managers;
- Ability to withstand some short term volatility for longer term payoffs;
- Willingness to lead; and,
- Willingness to be flexible and to take advantage of timely opportunities

Our message for this letter focuses on opportunities. Historically we've recommended timely increases to international equity, high yield bonds, global asset allocation, and numerous other types of diversifying asset classes. As part of our recommendation to invest in the credit markets at this time, we also want to suggest a broader consideration of opportunistic investing.

"Severe dislocations in the credit markets have created the potential for compelling risk-adjusted returns."

Is Opportunistic Investing Appropriate for Your Portfolio?

For most long-term investment portfolios we believe that some form of opportunistic investing is appropriate. We recognize that taking advantage of near-term opportunities can be outside the more traditional asset allocation process. Therefore, we will be asking you to consider adjusting your investment policy to include an "Opportunistic Investment" category as part of your strategic allocation. We understand that great opportunities won't always exist and will structure the policy accordingly. For example, you might create a target range of 0 - 10% for these strategies. Because each plan has specific needs, your consultant will work with you to determine what is appropriate for your circumstances.

The Credit Markets

As mentioned above, we believe there are attractive opportunities in the credit markets. Over the past nine months we've seen the sub-prime meltdown, the credit contagion, and a broad-based repricing of risk for all asset classes. Indeed, much of the crisis seems warranted; a direct reaction to a housing and lending bubble. As a result, the times of easy money and lax lending practices came to an abrupt end. Most recently, credit standards have tightened as over \$250 billion in write-downs and losses have been realized due to bad loans.

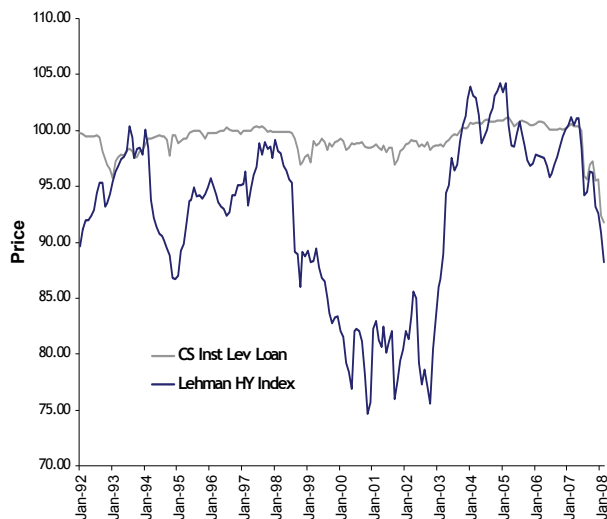
While we may not have seen the bottom yet, we do know that numerous niches of the credit markets

have sold off to seemingly irrational levels. “Throwing the baby out with the bath water” is an idiom that applies in the investment world following virtually every short-term crisis. Eventually, fundamentals do return to the market and those willing to act quickly reap the rewards.

In our opinion, there are many areas in the credit market that have been thrown out with the proverbial bath water, including: bank loans, areas of distressed debt and structured credit, and segments of mezzanine financing. As an example of an extreme in valuation, we include a graphic showing Bank Loan prices, which are now priced at levels approaching high yield, despite their superior position in the capital structure. This unusual relationship should not be sustainable.

“Consider adjusting your investment policy to include an ‘Opportunistic Investment’ category.”

New Technical Relationship Between Bank Loans and High Yield



Bank Loan and High Yield Cash Prices

Data source: Credit Suisse & Lehman Brothers, through 2/29/08

Building Exposure to Credit Markets

There are many investment products available in the credit space structured to take advantage of this current dislocation. Some products capture diversified exposure to the credit markets while others focus on a specific niche. These products range from very liquid, long-only investments to private equity-type investments with lockup periods of 6 years or greater. We recommend that clients gain access to credit opportunities with a diversified approach and with products that are consistent with the risk tolerance, liquidity needs, and time horizon of their specific investment program.

We have asked members of our research group to focus specifically on the products in their area that are designed to capitalize on the current market environment. We have created a special research task force to identify opportunistic credit investments across traditional fixed income strategies, hedge funds, and private markets. This team will be working directly with client consulting teams to present the most relevant strategy and products to address individual client needs.

For those clients considering an allocation to these strategies, we think that it is important to highlight the following:

1. It will be difficult to follow the “standard” due diligence process. Many of the products are relatively new or in the process of being launched. This means that investors may not have the benefits of a long, product-specific track record to reinforce the investment decision. Instead, investors will need to understand the manager’s underlying skill sets and how those skills are applicable for the new opportunity they are trying to exploit.
2. Because products in this area vary widely, it may be hard to do an “apples-to-apples” comparison of different managers, strategies, and structures. Many of the investments will need to be made based on their own merits and not relative to other comparable managers. This highlights the need for diversification.

3. The opportunity may improve after you invest. In other words, prices may still decline after you begin to deploy capital. Investors should be prepared for this and can take steps to mitigate the risk. We suggest building smaller initial positions and being prepared to add to the position if the markets continue to slide.
4. Timing may be important. We are always cautious when providers say that you have to hurry to get in or you will miss your chance. We do, however, anticipate that the investment window may be short as markets may correct quickly and many manager fund-raising cycles may be compressed. We don't think that investors should forego appropriate due diligence, but we do encourage them to act as quickly as their process and structure allows.

"Eventually, fundamentals do return to the market and those willing to act quickly reap the rewards."

Conclusions

We have tried to highlight three major points. First, we feel that investors benefit from being willing to deploy assets opportunistically to take advantage of market dislocations. Second, we recommend that you consider adjusting your investment policy to allow for more effective capitalization on future opportunities. Finally, we believe that segments of the credit markets currently present investors with compelling risk/return characteristics and that you should consider increasing your exposure to those areas.

We look forward to discussing these ideas at our next meeting with you. Opportunities in the credit markets will also be a presentation topic at our Client Conference in Boston on May 14th and 15th. If you would like to speak about this sooner, please give your consultant a call.

NEPC, LLC is an employee owned, full service investment consulting firm. Founded in 1986, NEPC is one of the largest independent firms in the industry. We are headquartered in Cambridge, Massachusetts and have additional offices in Detroit, Michigan; Las Vegas, Nevada; and San Francisco, California. You can reach us at (617) 374-1300. www.nepc.com

OPPORTUNISTIC INVESTING IN THE STRATEGIC ASSET ALLOCATION FRAMEWORK¹

Erik Knutzen, CFA
Chief Investment Officer

Introduction

In the spring of 2008, NEPC sent a letter to all of our clients entitled, “When Opportunity Knocks”. We recommended that clients create a new Opportunistic category in their Strategic Asset Allocation policies to take advantage of the remarkable dislocation in the global credit markets as well as other opportunities that may present themselves in the future. We recommended that clients allocate 5-10% of their assets to credit strategies, funded with a reduction in equity exposure. This is an example of NEPC’s approach to opportunistic investing, where we seek to identify occasional major market valuation extremes and recommend actions for clients over a medium-term horizon.

Opportunistic Investing – A General Framework

At NEPC, we seek to add value through active investment decision-making at multiple steps in the investment process. To do so, we group investment decisions into three categories – strategic, opportunistic, and tactical. Strategic allocations are long-term and reflect forecasts of asset class returns, risks, and correlations over a five-to-seven year time horizon. These allocations shift gradually through time reflecting changes in asset class assumptions and in an investment program’s risk and return parameters. We expect strategic asset allocation to drive the majority of an investment program’s risk and return.

For most long-term portfolios we believe that some form of opportunistic investing is appropriate, although we recognize that taking advantage of near-term opportunities can be outside the

traditional asset allocation process. We also understand that outsized opportunities do not always exist in global markets. Therefore we recommend that funds establish an Opportunistic category with a maximum allocation of 10% and a target allocation of 0%. We recommend that allocations in this category be made with a time horizon of one-to-three years. They should be made to asset classes that are large enough and at sufficient extremes in valuation that price movements can have a meaningful impact on a fund’s risk and

WE RECOMMEND MOST FUNDS ESTABLISH AN OPPORTUNISTIC ASSET ALLOCATION CATEGORY WITH A MAXIMUM ALLOCATION OF 10% AND A TARGET OF 0%.

return profile. Also, the opportunity must be actionable in terms of investment vehicles and strategies, and within an investor’s normal decision-making process.

Lastly, tactical opportunities are those that are of a short-term nature (less than one year time horizon) and/or in relatively small segments of the global capital markets. Tactical opportunities should be pursued by active managers within an overall investment program.

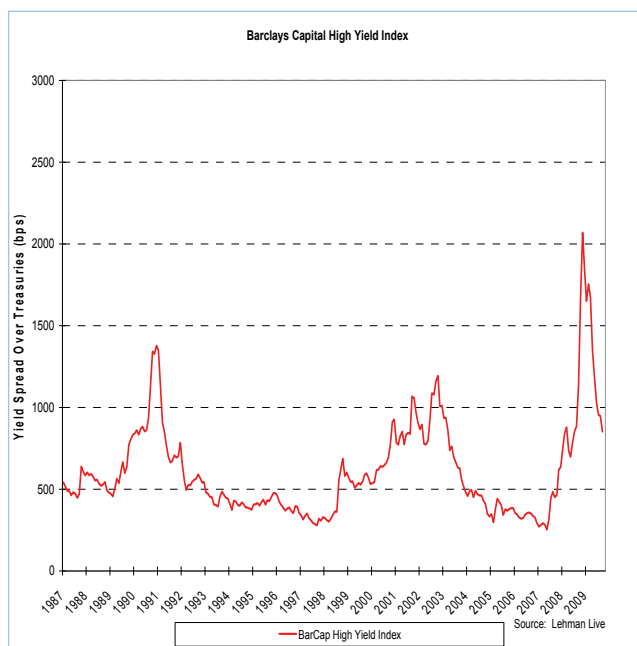
Credit Opportunities

In the case of the recent dislocation in the bond market, we recommended that clients build exposure to the credit markets beginning in the sum-

¹This article appeared in “Marketsmedia, Foundation and Endowment Investing Annual Review and Outlook 2010”.

mer of 2008. This unique opportunity was created by the global credit upheaval catalyzed initially by the sub-prime mortgage meltdown and then cascading across financial markets. As an example, Exhibit I shows U.S. high yield bond spreads, which by the fall of 2008, had widened to more than twice the previous record levels. In framing this opportunity, we indicated to clients: 1) the horizon for the investment should be two-to-three years; 2) it would be hard to follow “standard” due diligence procedures to evaluate the new products coming to market; 3) it would be difficult to make “apples-to-apples” comparisons of these products so diversification by strategy was important; and, 4) the opportunity may improve after the initial investment e.g. prices may continue to fall before they rise.

Exhibit I



We identified, evaluated, and vetted an array of credit products across the liquidity and expected return spectrum from bank loan, convertible, high yield, and opportunistic liquid credit strategies to credit-oriented hedge funds and longer lock-up distressed vehicles. In Exhibit II we show the returns in 2008 and the first ten months of 2009 of three credit benchmarks representative of the

liquid strategies pursued by clients as well as common equity benchmarks. The table demonstrates that an allocation to credit strategies added value relative to equities with less volatility throughout the period.

Exhibit II

Index	2008	YTD 2009 (through 10/31/09)	7/1/08- 10/31/09 (cumulative)
<i>Barclays Inv. Grade Bond</i>	-3.1%	15.5%	12.5%
<i>Barclays High Yield</i>	-26.2%	51.7%	13.5%
<i>S&P LSTA Lev Loan</i>	-30.5%	46.8%	5.2%
<i>S&P 500</i>	-37.0%	17.0%	-16.3%
<i>MSCI EAFE</i>	-43.4%	27.4%	-19.0%

Source: State Street Analytics

The recovery in credit markets in 2009 has been remarkable; indeed the rebound has happened faster than we expected. In the fourth quarter of 2009 we began recommending that clients begin reducing their liquid-market opportunistic credit exposures. The credit opportunity appears to be evolving toward a longer-term distressed cycle. Investors can take advantage of this through less-liquid strategies such as distressed, mezzanine, and secondaries.

In the increasingly complex investing environment, NEPC works with clients to add value. We believe opportunistic investing can be an important component of this process.



REVISITING THE ACTIVE VS. PASSIVE DECISION— MOVING BEYOND THE DATA-DRIVEN FRAMEWORK

Erik Knutzen, CFA
Chief Investment Officer

Executive Summary

Over the last several decades, the debate around active versus passive investment strategies has consumed countless hours of investment professional time, involved endless analyses of troves of historical data, and, ultimately, led to untold gallons of ink spilled in articles and books. For some investors, undo focus on hiring and firing active managers in pursuit of elusive “alpha” has kept them from paying attention to the more important, higher impact components of investment program structure.

We suggest that backward-looking, data-driven attempts to resolve the argument can only go so far and in some cases can be misleading. Instead, we propose that investors consider some straightforward intuitive hypotheses for the assessment of active vs. passive strategies and then frame the decision on an asset-class by asset-class basis in the context of their overall investment program design. Most importantly, we recommend placing the active vs. passive decision in the context of optimal allocation of investors’ scarce resources – capital, risk, fees, and time.

In this paper, we will lay out a basic framework for considering the active vs. passive decision. We will outline the intuitive hypotheses for evaluating active vs. passive strategies by asset category. We will then take a look at historical data to test these hypotheses in general terms. We will also highlight the example of fixed income after 2008, when retrospective analysis could have led investors to mis-identify embedded market or sector exposure (beta) as active performance (alpha), and draw the wrong conclusion at

the worst time. We will then provide a roadmap for assessing an investment program for active vs. passive decisions.

A New Approach

At NEPC we believe there are opportunities to add value through active investment decision-making at multiple steps in the investment process. These steps include asset allocation, portfolio structuring and positioning, and investment manager selection and monitoring. We believe that skilled investment managers can provide alpha - additional return in excess of the broad market - and that pursuit of this excess return can make a meaningful difference in an investment program over time.

Our consulting process, however, focuses on developing client-driven investment solutions. As a result, we do not believe there is one “right” answer to the active vs. passive decision. We suggest that the answer to the decision depends on an assessment of: 1) the specific attributes of an investment program including governance structure and available resources; 2) individual asset classes; and, 3) the market environment.

The first step in this process is an assessment of an investor’s appetite for taking risk relative to the least risky investment alternative. For a pension fund, this least risky position may be a bond portfolio matched to a liability stream. For an endowment or foundation this neutral-risk position may be a long-duration inflation-hedged instrument such as a Treasury Inflation Protected Security (TIPS). For other investors, the risk-free position may be cash. Most investors choose to take risk to seek a return above this risk-free rate,

and as such, they must depart from their risk-free position. We believe the first and most important step in this process is to build a diversified portfolio of risky asset-classes. Over the long-term, the majority of the difference in return between the investment program's portfolio and the risk-free position will be driven by the strategic asset allocation (the so-called "beta" decision).

Once a strategic asset allocation is set, the investor can focus on a series of additional decisions including: how best to structure the portfolio and whether to make opportunistic allocations in response to significant dislocations or imbalances in markets; and selection of investment managers to gain exposure to the appropriate asset classes and, potentially, to seek excess return through active management. This series of decisions can be organized into a hierarchy according to impact on a total portfolio as shown on the left side of Exhibit 1.

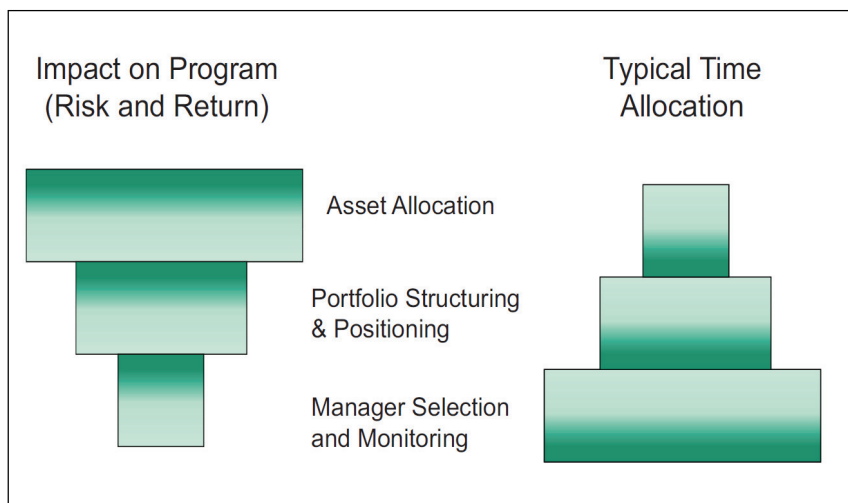
Many investors spend a great deal of time seeking, evaluating, and monitoring investment managers, while spending relatively little time and resource on the higher value-added decisions. As a result, we often see investors' time-commitment organized in a hierarchy more like that on the right side of the exhibit. Taken to an extreme, this can lead to an investment decision-making process where so much time is devoted to individual manager evaluation and monitoring that higher value-added decisions are neglected and overall program performance is affected. In extreme cases investors may get so bogged down in a cycle of hiring and firing traditional active managers, that they are not able to pursue attractive opportunities in less efficient (and, often, more diversifying) strategies such as hedge funds, private equity, and real assets.

We recommend that investors align their decision-making process and, importantly, the allocation of their limited resources according to this value hierarchy. As a result, it is important to en-

sure that proper time is focused on the asset allocation decision, portfolio structuring, and ensuring that the portfolio is positioned to take advantage of (or hedge against) any macro-level opportunities (or risks) in the environment. Only then should investors turn to individual investment manager selection, and consideration of active vs. passive strategies.

In addressing the active vs. passive decision, we suggest a similar approach to resource allocation: that of focusing scarce time and resource on investment categories where the probabilities of active management success are highest and the rewards from active management are sufficient to warrant putting scarce resources at risk. For some investors, this may mean devoting time and effort to seeking active management in each component of their investment program. For others, this may mean passive investing in more efficient areas of the capital markets while focusing active risk, active management fees, and oversight time to less efficient areas of the markets.

Exhibit 1: A Challenge of Investment Program Management



Active vs. Passive Assessment – Comparing Data Driven and Intuitive Approaches

There have been many analyses of active vs. passive strategies. These analyses have typically evaluated databases of investment manager returns, comparing performance to market benchmarks to assess the probability and magnitude of out- or under-performance after consideration of fees and expenses. We argue that all historical

analyses—including the one we will present below—need to be taken with a grain (or more) of salt. Historical data-driven analyses of active vs. passive management are subject to shortcomings associated with universe selection, time-period (or end-point) sensitivity, and survivorship bias. These analyses tend to be constructed to prove the hypothesis of a particular interested party (whether a purveyor of active or passive management services, or an academic with a particular point of view). As a result, it can appear that either side of the argument can be proved depending on: 1) how the question is framed; 2) the data set chosen; and, 3) the time period used. We think that the effort to prove empirically, beyond a reasonable doubt, one side or the other of this argument is fruitless. Importantly, overly focusing on these types of analyses risks draining important time and resources from more important investment decisions.

opportunity sets, fewer constraints, relatively less liquidity, and where there are not inexpensive index vehicles available to capture the underlying “beta” easily and efficiently. These hypotheses are summarized in Exhibit 2.

Finally, we suggest (and the data seem to demonstrate) that there are trends in performance of active vs. passive management. This pattern is indicative of consistent manager exposures representing embedded betas. These exposures can create the appearance that alpha is cyclical. This phenomenon can also lead to apparent performance persistence only to be followed by longer-term reversion of the trend. As an example, in a later section of this paper, we will consider the case of the recent performance of fixed income managers.

Testing the Intuitive Hypotheses

Despite having indicated that investors should not take data-driven historical analyses at face value, we will go ahead and perform one in order to test our hypotheses. To do so we will use the Independent Consultants Cooperative (ICC) universe of manager investment performance. This is one of the largest and most robust comparative universes of investment manager performance in the industry. It encompasses data from over 900 investment programs, with 16,200 portfolios from 1,270 different investment managers.

Performance is calculated by independent consultants directly from custody statements (as opposed to manager-reported results). In an attempt to minimize survivorship bias and end-point sensitivity bias, we performed two analyses. The first compares the median active manager to benchmark performance for rolling one, three, and five-year periods beginning as early as 1991. The second analysis ranks the performance of the benchmark in uni-

Exhibit 2: Active vs. Passive – Intuitive Hypotheses

<ul style="list-style-type: none"> • Characteristics of more efficient investment categories: <ul style="list-style-type: none"> – Smaller, more homogeneous opportunity set – Well-researched – Highly liquid – Tightly constrained – Inexpensive index vehicles and derivatives readily available • Examples: <ul style="list-style-type: none"> – U.S. Large Cap Stocks – U.S. Core Bonds (particularly Treasuries & Agencies) <p><i>Active management less likely to add value</i></p>	<ul style="list-style-type: none"> • Characteristics of less efficient investment categories: <ul style="list-style-type: none"> – Larger, more heterogeneous opportunity set – Not well-researched – Poor/intermittent liquidity – Less constrained – Index vehicles and derivatives unavailable, expensive, and/or involve high tracking error • Examples: <ul style="list-style-type: none"> – U.S. small company stocks – Non-US stocks, including Emerging Markets – High yield bonds/bank loans – Hedge funds – Private equity and real estate <p><i>Active management more likely to add value</i></p>
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We suggest instead that investors follow a series of basic hypotheses about active vs. passive management consistent with common understandings about relative market efficiency, and allocate their resources accordingly. Simply put, the intuitive hypotheses propose that active management has a higher probability of adding value and providing a larger margin of reward in investment categories characterized by less efficiency of information, more diverse and broader investment

verses of active managers on a calendar year basis for the most recent ten years. The ICC universe is calculated gross of fees, so in order to make an appropriate comparison we netted the average fee for a \$25 million mandate in the eVestment Alliance database 2008 fee study from the median manager performance (in the first analysis) or added the fee to the benchmark performance (in the second analysis). This assumption sets a high hurdle for active management, as the actual fees that investors pay would likely be lower than this level as average institutional portfolio sizes are generally greater than \$25 million. Furthermore, the analyses assume no cost associated with the index, whereas investors would have to pay some level of fees and expenses to gain such exposures.

The analyses are framed to limit survivorship bias, as it evaluates time periods of one, three, and five years. Over one year horizons, only a small percentage of managers will leave a typical sample through termination. Over three year horizons, the number will also be relatively small. Over a five year time period few, but some, managers may be terminated (the average manager tenure across institutional investment programs is seven-plus years). The analyses also encompass multiple market environments including the bull markets of the 1990s and mid-2000s, and the sell-offs of 2000-2002 and 2007-2008, thereby minimizing end-point sensitivity.

We evaluated nine investment categories and styles including U.S. large cap and small cap, core, growth and value stocks, international stocks, emerging market stocks, and fixed income. The results of the analyses are shown in Exhibits 4-21, at the end of this paper. An overview of the results by broad investment category follows.

U.S. Large Company Stocks

To begin, we review the performance of U.S. large cap core equity managers over rolling one, three, and five-year periods since 1991 (see Exhibit 3). Over this time period the median large cap core manager has outperformed the S&P 500, net of fees, in 32 of 71 rolling one year periods (45% of the time), 35 of 63 rolling three year periods (56% of the time) and 38 of 55 five-year periods (69% of the time). The margin of outperformance has

varied, with a period of sizeable underperformance in the late 1990s associated with the momentum-driven and strongly directional bull market of that period, followed by significant outperformance in the ensuing crash when holding any cash and avoiding certain sectors led to a rebound for active management. On average, and during more “normal” periods, the margin of outperformance, to the extent it was observed, was relatively modest. Considering the rank of the benchmark (Exhibit 4), the S&P 500 placed below median in seven out of the last ten years. We repeat the study for large cap growth and value stocks in Exhibits 5-8 where the data demonstrate similar patterns.

In aggregate, these analyses make a tepid, but modestly supportive case for active management in the U.S. large company segment of the market. There does appear to be some pattern to the relative performance of active vs. passive management. This indicates to us that there are common factors or betas (e.g. capitalization-bias, momentum, etc) that lead to performance trends, and we observe that these trends tend to mean-revert.

In summary, we agree with the intuitive hypothesis (and common assertion) that the US large capitalization segment of the global capital markets is relatively efficient. While we believe there are managers who can add value in this space, it is a lower probability game – especially given the generally tighter constraints placed on traditional long-only investment managers – and the expected rewards are modest. If a plan sponsor chooses to index one component of their program (or use derivatives to gain the exposure synthetically and “port” another, higher-probability alpha exposure onto it), U.S. large cap stocks are a good candidate for this approach.

U.S. Small Company Stocks

Over most time periods median US small company stock managers appear to have added value relative to benchmarks. This investment segment is more diverse than US large company stocks, with more companies and fewer analysts following the companies. In addition, small cap stock benchmarks can be harder and more costly to replicate. This category, therefore, appears rela-

tively inefficient and a good candidate for active management. There also appears to be strong trends to the out-performance or under-performance cycles. For example, in 2008, most small cap growth and value managers struggled to outperform the Russell 2000 benchmark (or the styled benchmarks), yet over longer time periods the median small cap manager has been able to provide value net of fees.

Non-U.S. Stocks

Median non-US stock managers have been able to demonstrate value-added, net of fees, over most time periods. During the 1990s, this was largely driven by the popping of the Japanese bubble and the primarily underweight position held in this market by most managers. More recently, managers have been able, on average, to outperform the most common benchmarks by a meaningful margin. We believe that the diversity of the non-U.S. equity markets and the wide array of tools available to managers for adding value (country and currency, sector, and stock decisions across a universe of 1000+ companies) provide a strong basis for active management success. This highlights a key element of seeking active management results: The wider the universe of securities and the broader the number of decisions available to managers increases the probability of active management adding value. Exposure to higher-performing (and out-of-benchmark) emerging markets stocks contributes to this outperformance, but the median manager in this category also tends to outperform benchmarks with a portion of emerging markets such as the MSCI All Country World index ex-US.

In the dedicated emerging markets equity category, the data present something of a conundrum. The shorter-term “batting average” of managers has not been high, especially in more recent years, although historically, and over five-year rolling periods, managers have shown an ability to add value versus the benchmark. The emerging markets are not viewed as highly efficient and gaining passive exposure is not cheap, although it can be done. This is an area for further research, as we are not ready to recommend passive allocations to emerging markets equities. We do observe that country allocation decisions tend to

outweigh security selection decisions in these markets. As a result, consistent manager country biases relative to the index may lead to trends in relative performance, an issue to be discussed further in the review of fixed income, below.

Fixed Income

For periods ending in 2007 most fixed income managers outperformed the benchmark, providing relatively modest levels of outperformance (see Exhibits 19 and 20). This pattern changed dramatically in 2008, when the credit crisis caused historic spread-widening across virtually all non-Treasury sectors of the bond markets. The associated “flight to quality”, accompanied by the Fed lowering short rates to stimulate the economy, drove a remarkable rally (and decline in yields) of Treasury securities. As most active fixed income managers are consistently overweight “spread sectors” and underweight Treasuries, this predictably led to underperformance. The magnitude of the underperformance, and the degree to which one year’s results damaged long-term track records, however, was unprecedented. This experience reversed itself in 2009 with an equally impressive rally in credit markets. We view the results of the analysis of fixed income managers as being a particularly illustrative example of the danger of mistaking embedded beta for alpha. We consider this in greater detail in a later section of this paper.

General Observations

The data, overall, appear consistent with the intuitive hypotheses: 1) U.S. large cap stock managers exhibit the lowest probability of active management outperformance while outperformance margins, on average, are relatively tight; 2) Active managers in U.S. small cap and non-U.S. stocks exhibit higher probability of outperformance and larger margins of outperformance; and 3) Fixed income managers demonstrated modest and fairly consistent outperformance until a big fall-off in 2008, and subsequent recovery in 2009.

Importantly, the data indicate that lower active management success rates in one-year periods do not preclude success over longer-term periods. While this may indicate some modest survivorship bias creeping into the data set, it may also indi-

cate that consistent application of investment process can compound results favorably over longer periods – an incentive for investors to avoid judging managers over shorter time horizons.

Another observation from the analyses is that active management has trending characteristics. This can be the result of consistent factor-biases of active managers versus indexes. Said another way, the trending nature of active management success indicates that some alpha may actually be disguised beta.

Finally it is important to observe that these analyses cover a significant portion of the liquid global market portfolio. The balance of the global market portfolio includes high yield bonds, bank loans, and emerging markets bonds. These categories tend to be hard to replicate, fairly inefficient, and generally pursued through active management. Illiquid components of the global investment opportunity set such as private equity and direct real estate and real assets are harder to access, and not subject to indexation. Strategies investing in these markets, therefore, need to be pursued with active managers.

Hedge funds are a category of investing that represents, by its nature, active management. To the extent that hedge funds add value above a risk free rate, they serve as evidence of the ability of active managers to add value. Despite experiencing surprisingly negative returns in 2008, as a category, hedge funds have provided positive absolute and risk-adjusted returns over most multi-year periods, as discussed in our 2009 white paper, *Hedge Funds, Broken or Damaged*, available at www.nepc.com. The relative merits of nascent passive hedge fund strategies is beyond the scope of this paper.

Alpha as Disguised Beta – Fixed Income Managers in 2008-9

An example of the cyclicity of active performance, and a short-coming of retrospective analysis, is illustrated by the historical performance of the active fixed income manager universe. As described above, for the periods ending 2007, the median core fixed income manager provided a moderate probability and modest levels of ex-

cess returns. This changed dramatically in 2008 when the credit crisis led to unprecedented spread widening of virtually all non-Treasury securities and corresponding negative absolute and relative performance. The majority of active fixed income managers were overweight these spread sectors, many significantly so. This caused not just the median manager to under-perform by a wide margin in 2008 (Exhibits 19 and 20), but also drove most managers to under-perform the benchmark on a trailing three-year and five-year trailing basis. A histogram of active manager excess returns in 2008 from eVestment Alliance (Exhibit 21), as reported by investment managers, shows the magnitude of the “tail” of severe under-performance during 2008. Over this period, 72% of managers trailed the benchmark.

As a result, an historical analysis of fixed income manager performance at the end of 2008 would have revealed a very damaging case for active management. So what are we to make of this? If the vast majority of managers under-perform—and by a significant margin—then it appears obvious that fixed income benchmarks must represent the most efficient way to gain exposure to these markets and plan sponsors would be well-advised to index their bond portfolios.

A common-sense assessment of the fixed income markets and benchmarks, however, highlights the potential problems with this argument. The most common broad US fixed income benchmark, the Barclays Capital Aggregate Bond Index (the “Aggregate”) is a capitalization-weighted index comprised of an extremely broad sample of investment grade dollar-denominated bond issues across Treasury, agency, mortgage-backed, asset-backed, and corporate sectors. As of December 31, 2008, most market observers agreed that Treasury bonds were at a secular extreme in over-valuation, just as most spread sectors were significantly under-valued relative to historical levels. Furthermore, the implications of U.S. monetary and fiscal authorities’ policy responses to the credit crisis at the time (and still) included a significant expansion of the national debt in order to finance the various stimulus programs. As a result, the government was (and is) in the process of issuing massive amounts of debt in the form of Treasury bonds, notes, and bills. Likely outcomes

of this activity include: 1) Treasuries increasing as a percentage of the benchmark; and 2) Treasury yields rising in order to attract buyers of the greatly increased issuance. Therefore, moving from an actively managed portfolio to an indexed strategy at the end of 2008 would have entailed selling corporate bonds and other spread sectors and buying Treasuries—a significant reallocation from undervalued to overvalued sectors.

Of course, most investors and investment managers did not make a wholesale move to indexed fixed income strategies, and Exhibit 22 shows the subsequent results. Again using the eVestment Alliance manager-reported returns for 2009, 80% of active fixed income managers outperformed the benchmark, most by a wide margin.

This example illustrates how an embedded beta – consistent overweight to higher-yielding spread sectors relative to the benchmark – masqueraded as alpha for years of modestly positive performance. In 2008, this bet relative to the benchmark led to disastrously negative results, followed in 2009 by a rebound that was nearly as dramatic. This experience also highlights how the active vs. passive decision should be evaluated not purely through a retrospective data-driven process, but must be considered in the overall context of underlying manager exposures and market dynamics.

As an aside, we suggest that the 2008-2009 fixed income results highlight the shortcomings of the BarCap Aggregate index as a benchmark for the fixed income portion of a portfolio of risky assets. The Aggregate represents a combination of interest rate exposure, credit exposure, and other potential “betas” including convexity and liquidity. We recommend that investors consider disaggregating (as it were) their fixed income exposures into their representative factors and build their portfolio according to the asset allocation process we described in the first section of this paper.

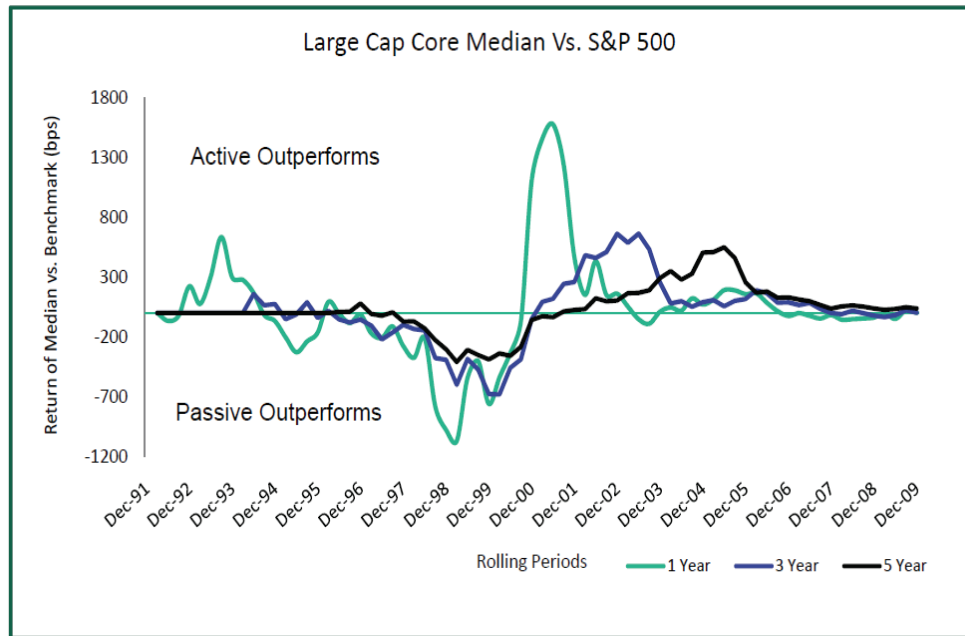
Conclusion – A Roadmap for Investors

As we work with investors to assess the active vs. passive decision for their investment programs, we apply the basic intuitive hypotheses described above to each of the investment categories in

their program. This can provide a roadmap for how best to apply scarce resources to build and oversee an investment program, and is summarized in Exhibit 23. We include recommendations and comments for investment categories ranging from traditional to alternatives.

In conclusion, at NEPC we seek to add value at every step in the investment management process. Our approach encompasses asset allocation, portfolio structuring and positioning (including opportunistic strategies) and selecting the best mix of active and passive (if any) investment managers. How each investor chooses to apply this process depends on 1) their governance structure and ability to apply limited resources of capital, risk budget, fees, and time to the hierarchy of investment decisions; 2) individual asset classes; and, 3) the market environment. We agree with, and the data appear to support, the generalized hypotheses that active management is more likely to add value in less efficient and less liquid markets, and that exposures to more efficient areas of the market may be better suited for passive management or financially-engineered exposures such as portable alpha. Finally, the cyclicity of active vs. passive management reminds us that oversight of investment programs is a dynamic process involving assessments that transcend narrow data-driven historic analyses. As markets become increasingly complex, placing growing demands on investor’s limited resources, it is critical to ensure alignment of those resources with those decisions that will have the greatest impact on overall investment

Exhibit 3: U.S. Large Cap Core Equity - Rolling Periods

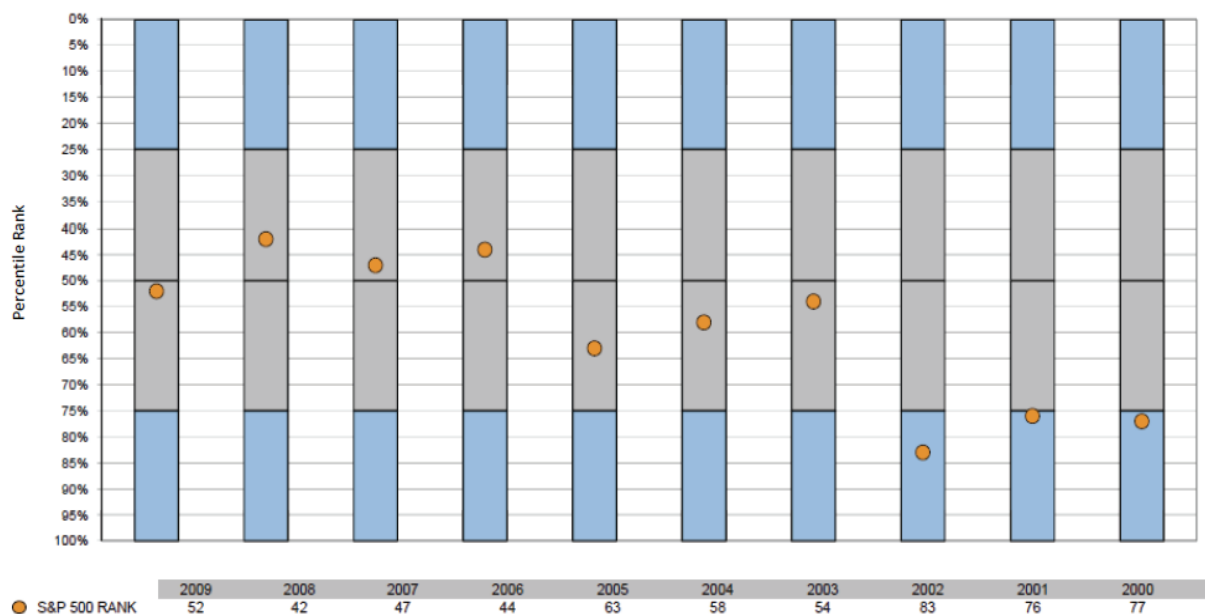


The median large cap core equity manager has outperformed the S&P 500, net of fees¹, in:

- 32 of 71 rolling one-year periods (or, 45% of the time)
- 35 of 63 rolling three-year periods (or, 56% of the time)
- 38 of 55 rolling five-year periods (or, 69% of the time)

Exhibit 4: U.S. Large Cap Core Equity - Benchmark Rank

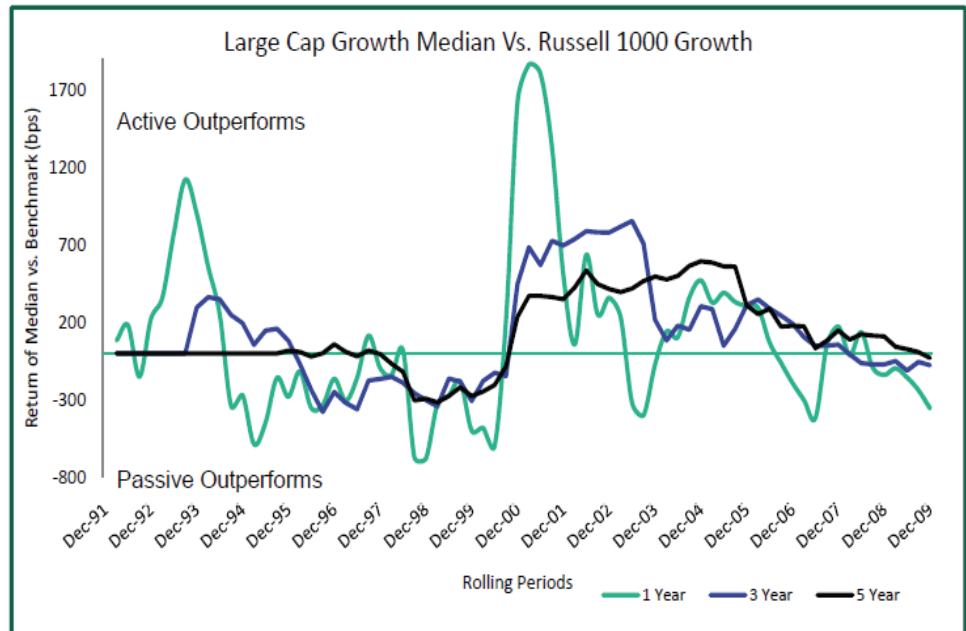
Annual Periods Ending December 31



The S&P 500 ranked below median 7 out of the last 10 years



Exhibit 5: U.S. Large Cap Growth Equity - Rolling Periods



The median large cap growth equity manager has outperformed the Russell 1000 Growth, net of fees¹, in:

- 35 of 72 rolling one-year periods (or, 49% of the time)
- 38 of 65 rolling three-year periods (or, 59% of the time)
- 42 of 57 rolling five-year periods (or, 74% of the time)

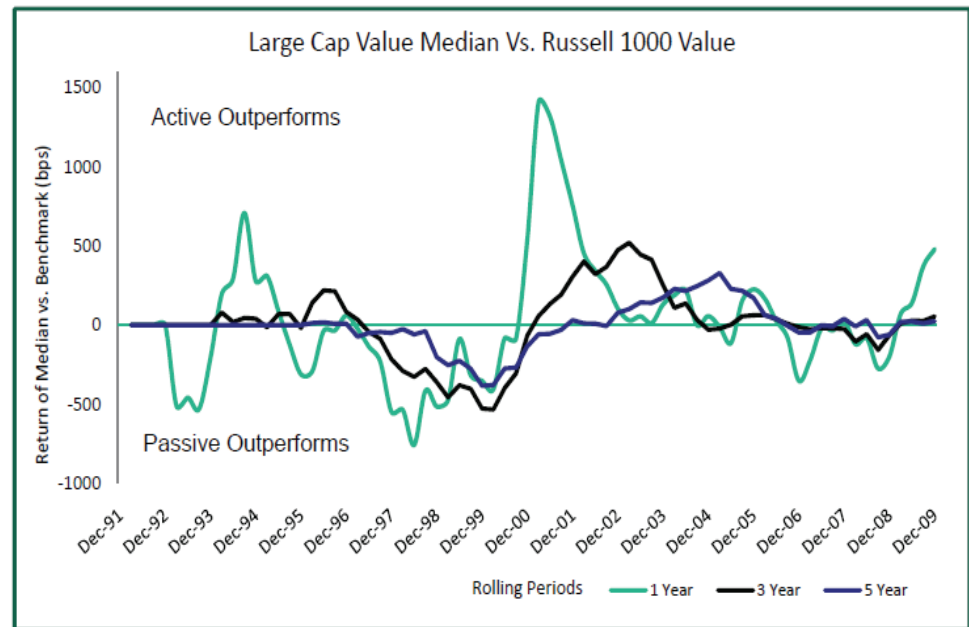
Exhibit 6: U.S. Large Cap Growth Equity - Benchmark Rank

Annual Periods Ending December 31



The Russell 1000 Growth ranked below median 6 out of the last 10 years

Exhibit 7: U.S. Large Cap Value Equity - Rolling Periods

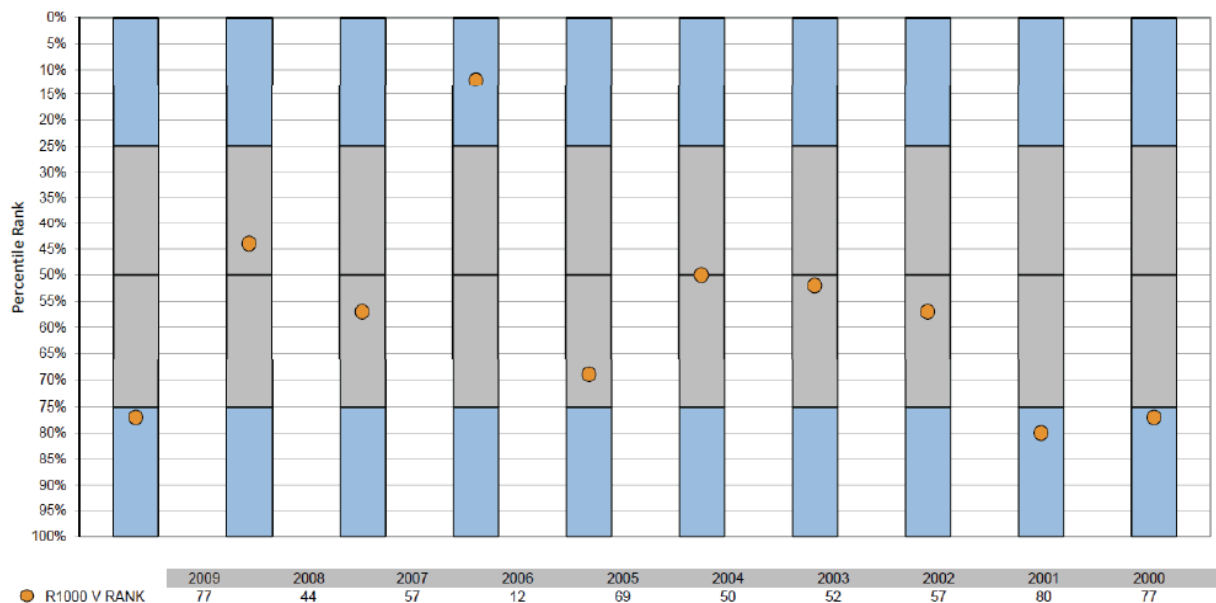


The median large cap value equity manager has outperformed the Russell 1000 Value, net of fees¹, in:

- 32 of 68 rolling one-year periods (or, 47% of the time)
- 36 of 64 rolling three-year periods (or, 56% of the time)
- 28 of 56 rolling five-year periods (or, 50% of the time)

Exhibit 8: U.S. Large Cap Value Equity - Benchmark Rank

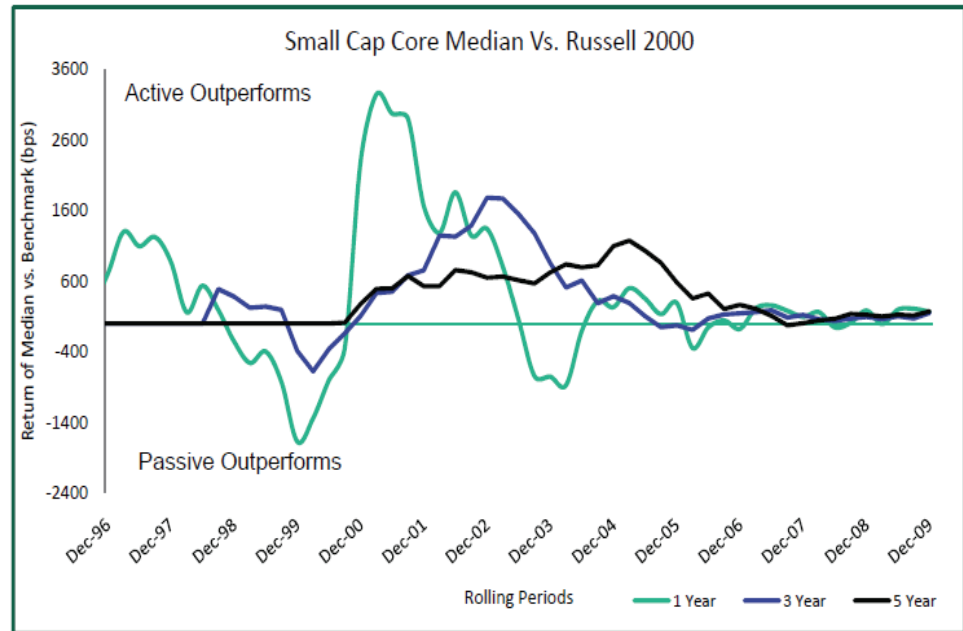
Annual Periods Ending December 31



The Russell 1000 Value ranked at or below median 8 out of the last 10 years



Exhibit 9: U.S. Small Cap Core Equity - Rolling Periods

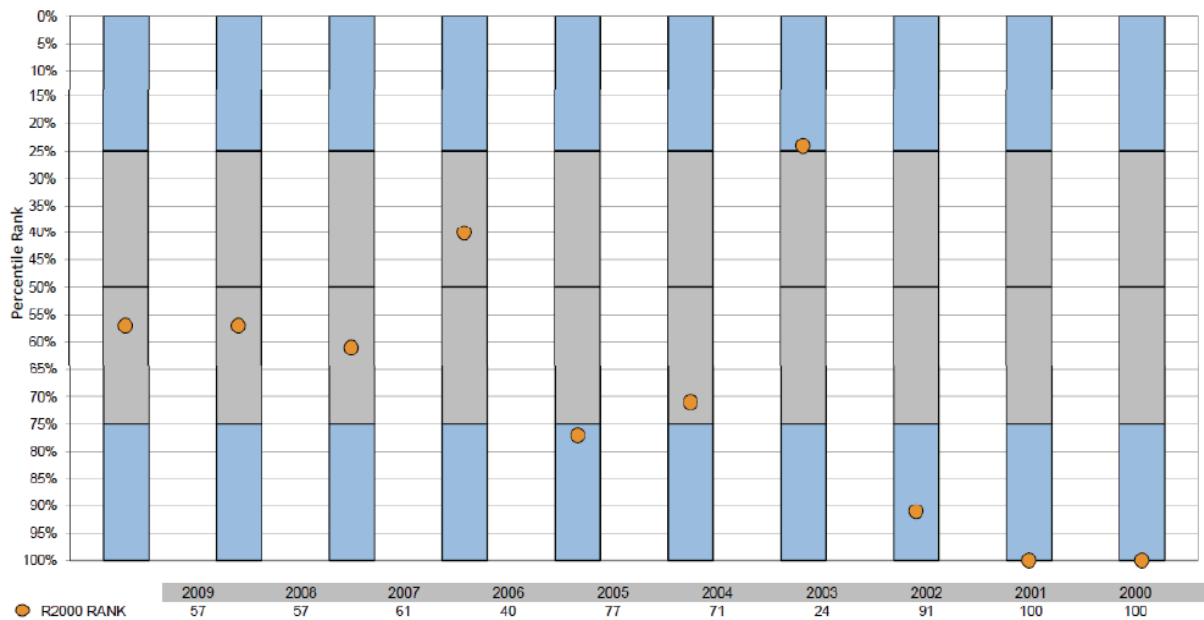


The median small cap core equity manager has outperformed the Russell 2000, net of fees¹, in:

- 38 of 56 rolling one-year periods (or, 68% of the time)
- 39 of 46 rolling three-year periods (or, 85% of the time)
- 37 of 38 rolling five-year periods (or, 97% of the time)

Exhibit 10: U.S. Small Cap Core Equity - Benchmark Rank

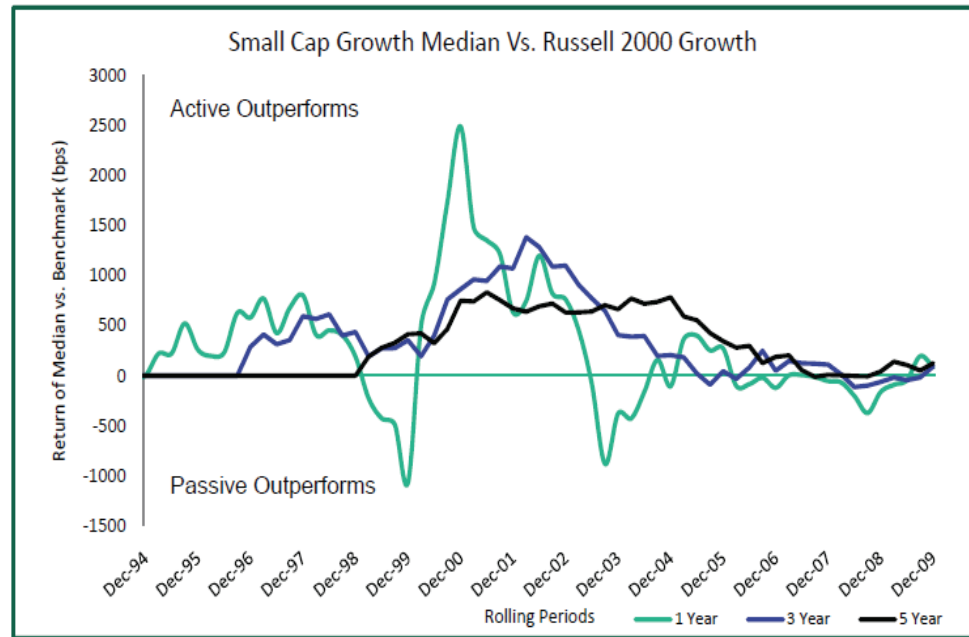
Annual Periods Ending December 31



The Russell 2000 ranked below median 8 out of the last 10 years



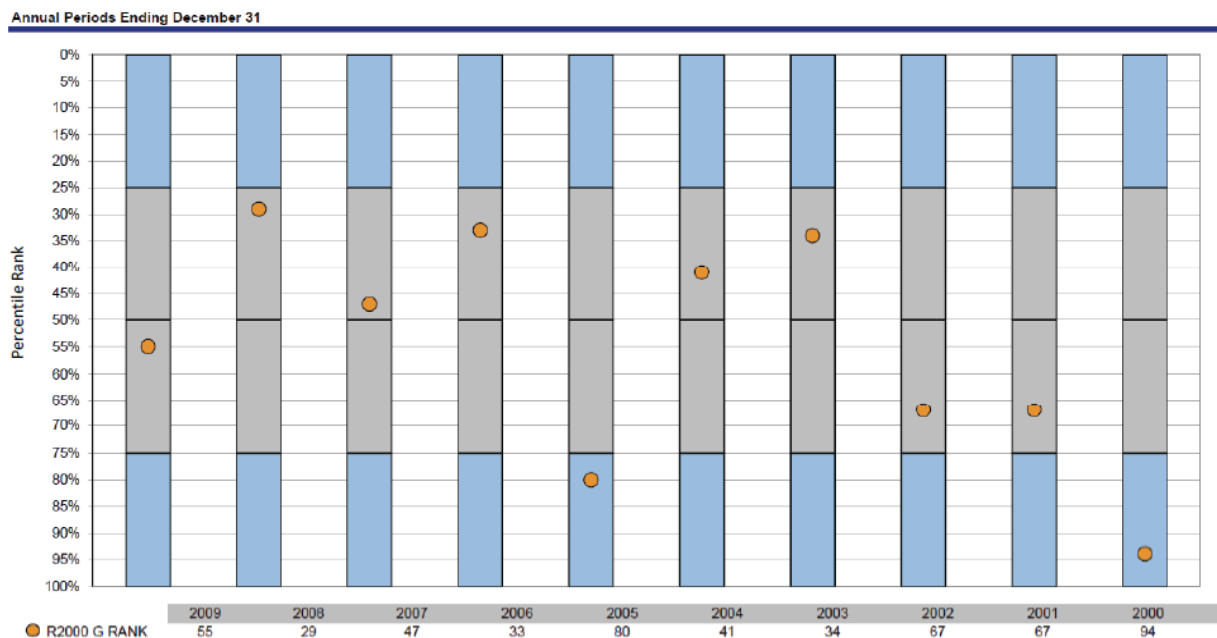
Exhibit 11: U.S. Small Cap Growth Equity - Rolling Periods



The median small cap growth equity manager has outperformed the Russell 2000 Growth, net of fees¹, in:

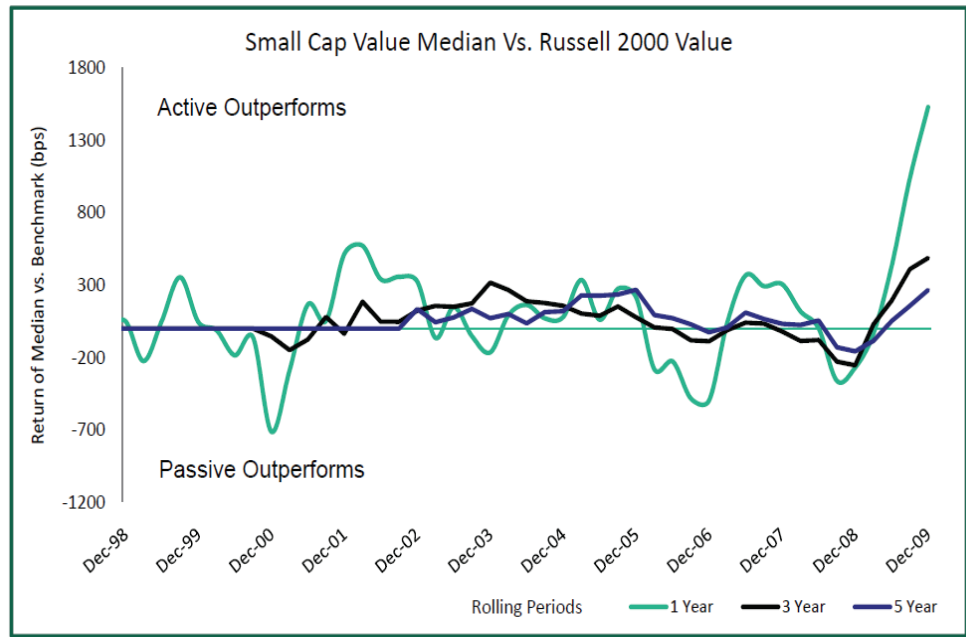
- 39 of 61 rolling one-year periods (or, 64% of the time)
- 45 of 53 rolling three-year periods (or, 85% of the time)
- 41 of 44 rolling five-year periods (or, 93% of the time)

Exhibit 12: U.S. Small Cap Growth Equity - Benchmark Rank



The Russell 2000 Growth ranked below median 5 out of the last 10 years

Exhibit 13: U.S. Small Cap Value Equity - Rolling Periods

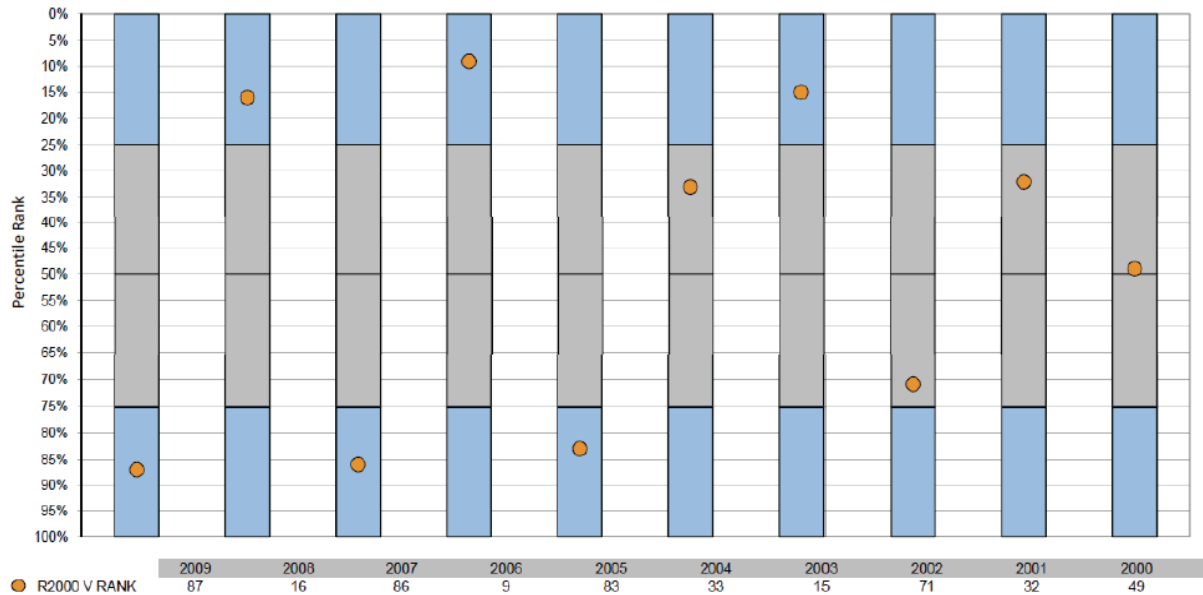


The median small cap value equity manager has outperformed the Russell 2000 Value, net of fees¹, in:

- 29 of 45 rolling one-year periods (or, 65% of the time)
- 24 of 37 rolling three-year periods (or, 65% of the time)
- 25 of 29 rolling five-year periods (or, 86% of the time)

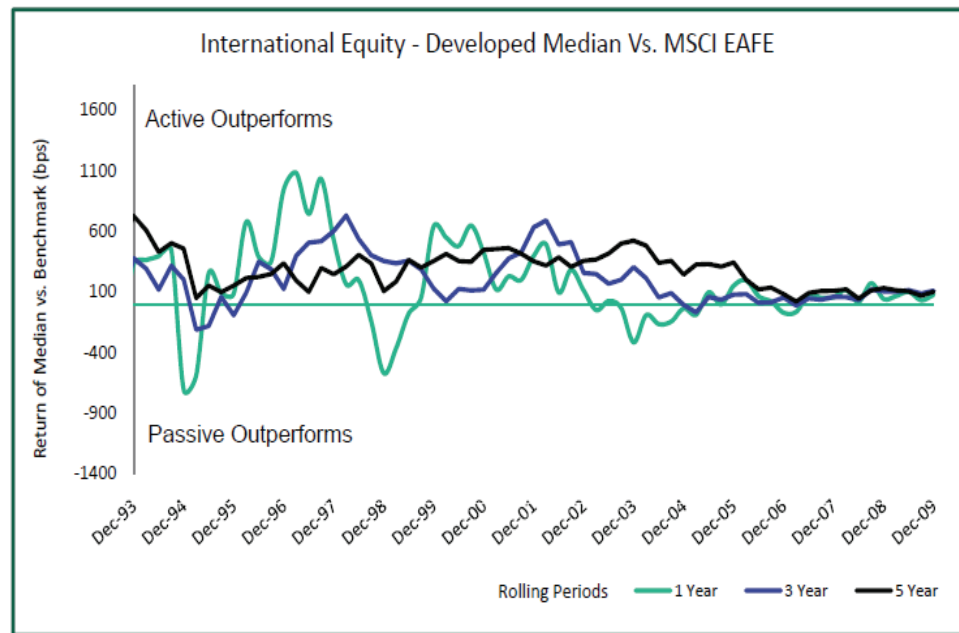
Exhibit 14: U.S. Small Cap Value Equity - Benchmark Rank

Annual Periods Ending December 31



The Russell 2000 Value ranked below median 4 out of the last 10 years

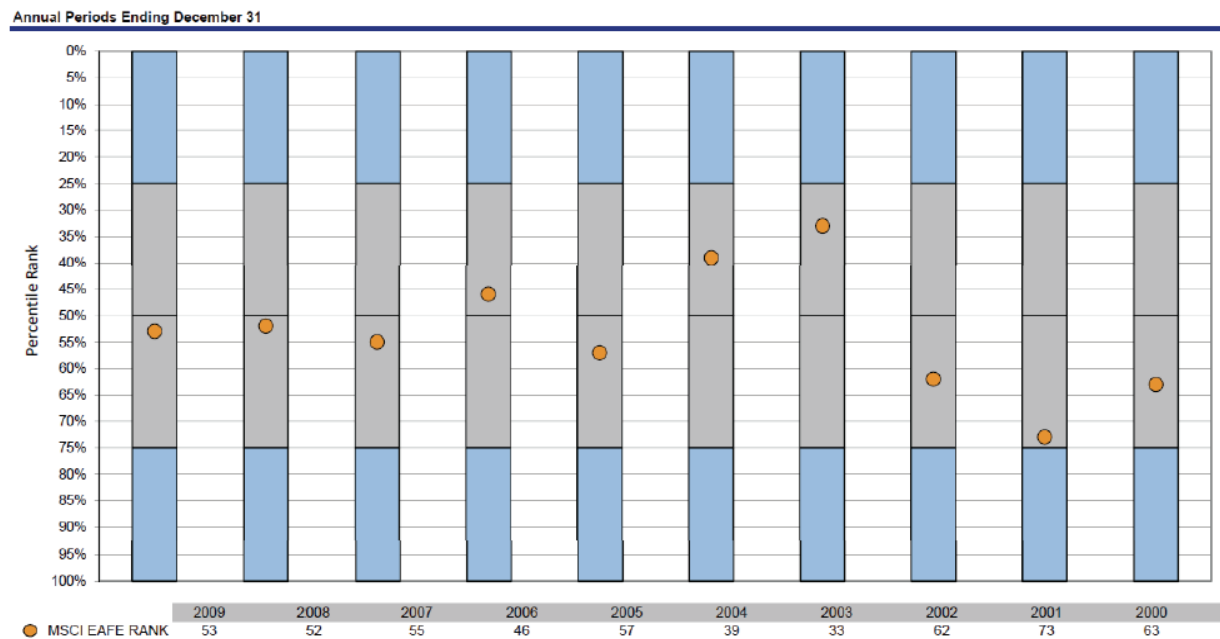
Exhibit 15: International Equity - Rolling Periods



The median international equity developed manager has outperformed the MSCI EAFE, net of fees¹, in:

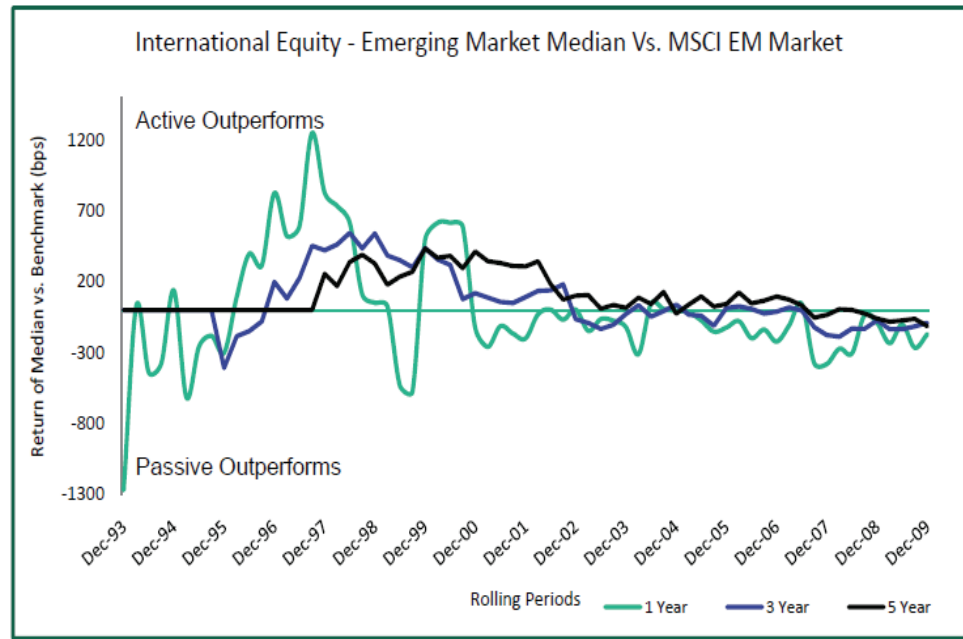
- 52 of 72 rolling one-year periods (or, 72% of the time)
- 65 of 72 rolling three-year periods (or, 90% of the time)
- 72 of 72 rolling five-year periods (or, 100% of the time)

Exhibit 16: International Equity - Benchmark Rank



MSCI EAFE ranked below median 7 out of the last 10 years

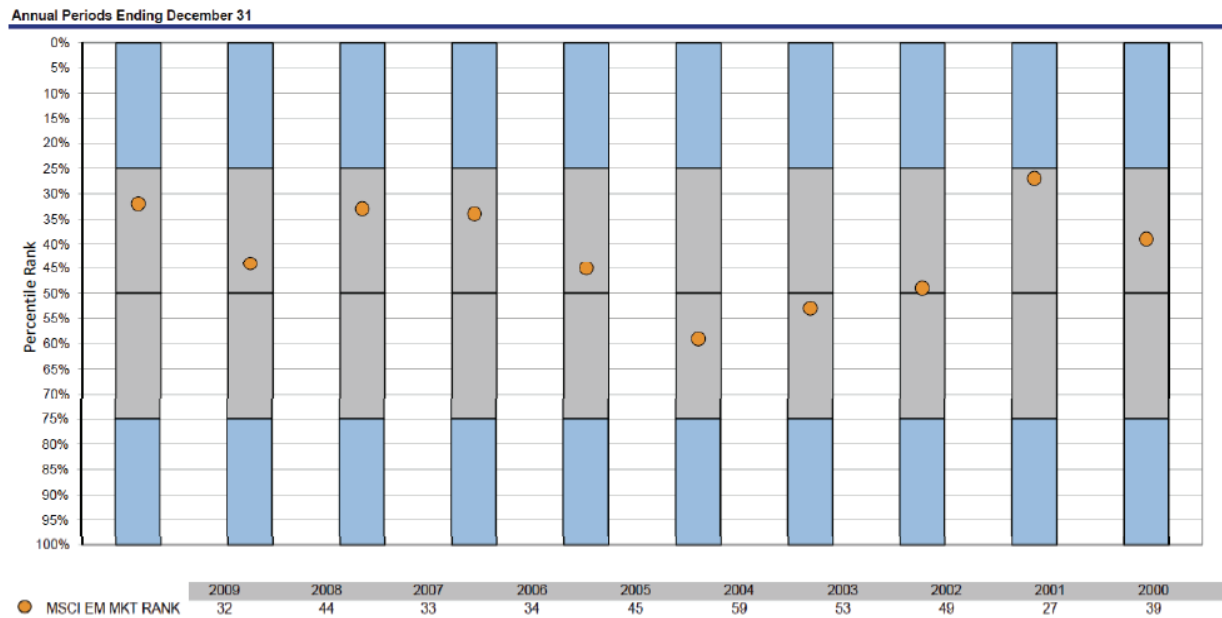
Exhibit 17: Emerging Market Equity - Rolling Periods



The median international equity emerging manager has outperformed the MSCI EM Market, net of fees¹, in:

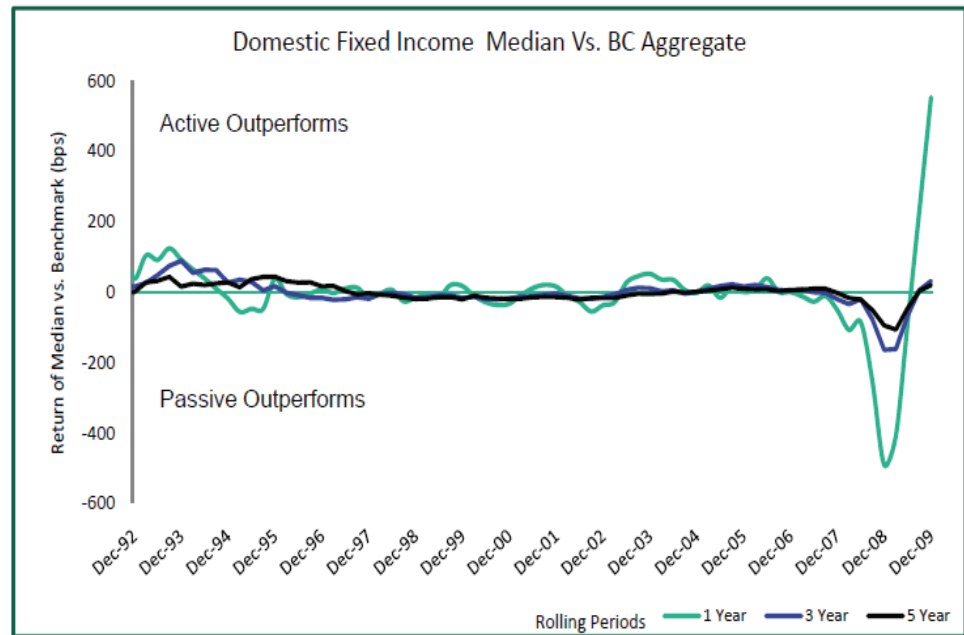
- 24 of 65 rolling one-year periods (or, 37% of the time)
- 30 of 57 rolling three-year periods (or, 53% of the time)
- 40 of 49 rolling five-year periods (or, 82% of the time)

Exhibit 18: Emerging Market Equity - Benchmark Rank



MSCI EM Index ranked below median 2 out of the last 10 years

Exhibit 19: Domestic Fixed - Rolling Periods

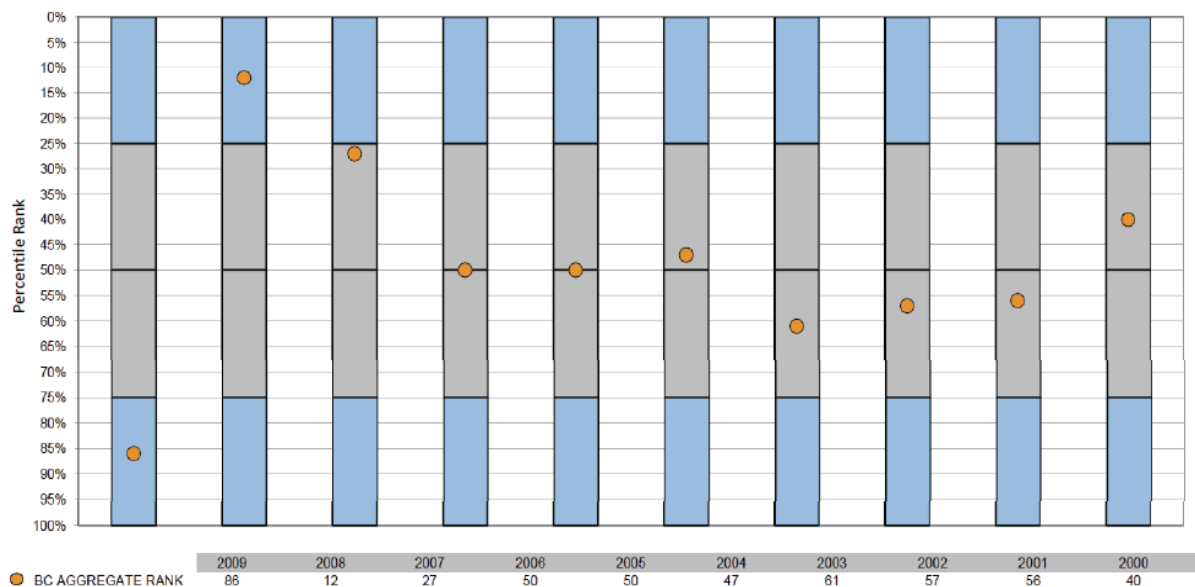


The median domestic fixed income manager has outperformed the BC Aggregate, net of fees¹, in:

- 36 of 72 rolling one-year periods (or, 50% of the time)
- 33 of 72 rolling three-year periods (or, 46% of the time)
- 33 of 68 rolling five-year periods (or, 49% of the time)

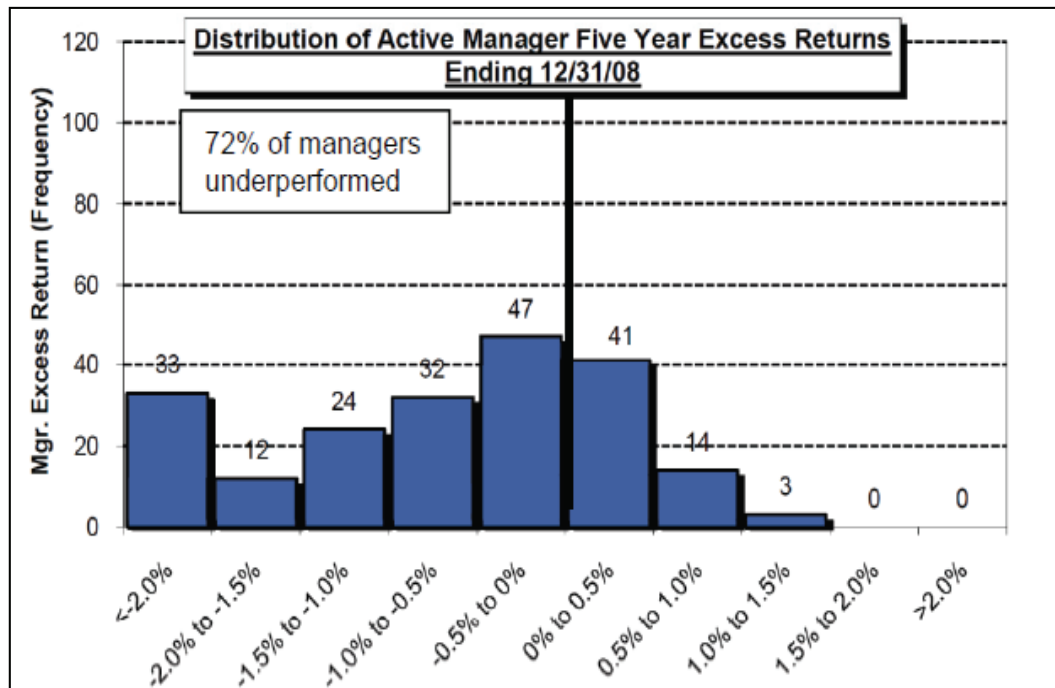
Exhibit 20: Domestic Fixed - Benchmark Rank

Annual Periods Ending December 31



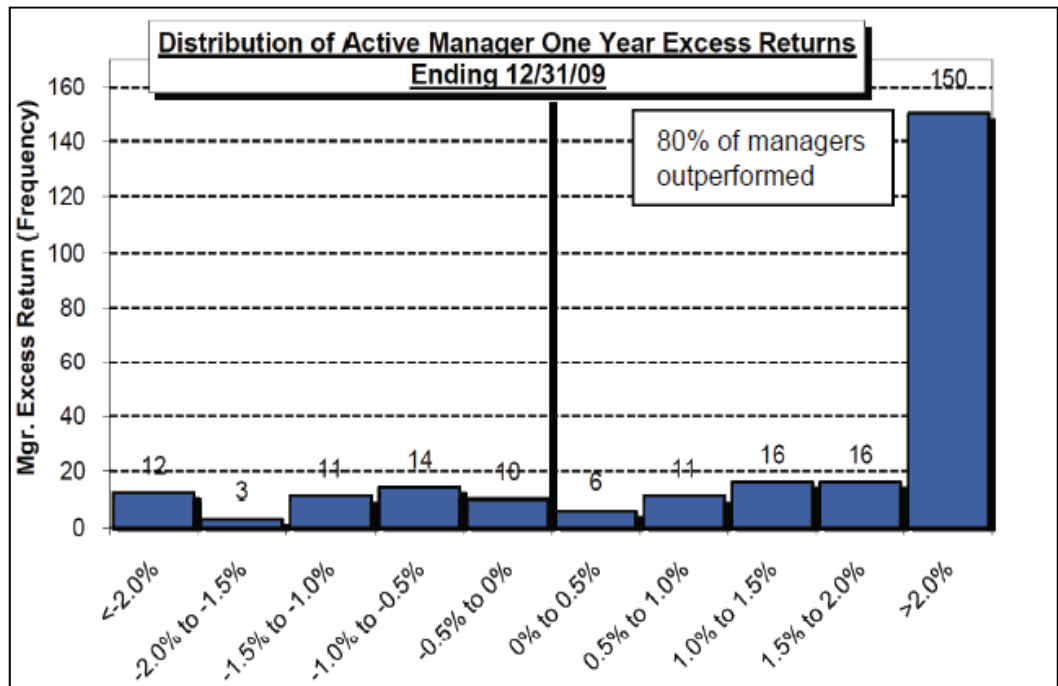
BC Aggregate ranked at or below median 6 out of the last 10 years

Exhibit 21: Domestic Fixed Income Active Manager Returns –
5 Years ending 12/31/08



Source: eVestment Alliance

Exhibit 22: Domestic Fixed Income Active Manager Returns –
One Year ending 12/31/09



Source: eVestment Alliance

Exhibit 23: Active vs. Passive—An Asset Class-Level Assessment

Asset Class	Market Efficiency	Diversity of Opportunity Set	Active Constraints	Excess Return Expectation	Ease of Indexing	Comments/Recommendation
US Large Cap Stocks	High	Low	High	Low	High	Most obvious choice for indexing (and /or portable alpha)
US Small Cap Stocks	Moderate	Moderate	Moderate	Moderate	Moderate	In general seek active; can index core exposure
Non-US Developed Market Stocks	Moderate	Moderate	High	Moderate	Moderate	In general seek active; can index core exposure
Emerging Market Stocks	Moderate	Moderate	Moderate	Moderate	Moderate	In general seek active; can index core exposure
Core Bonds (Gov't/Credit)	High/Moderate	Low/Moderate	High	Low / Moderate	Moderate	Evaluate index components; potentially seek active in less efficient sectors
Emerging Market Bonds	Moderate	Moderate	Moderate	Moderate	Low	Seek active
High Yield/Bank Loans	Low	High	Moderate	Moderate	Low	Seek active
Hedge Funds	Low	High	Low	High	Low	Hedge fund beta replication emerging, but unproven; seek active
Private Equity	Low	High	Low	High	N/A	Must use active
Real Estate	Low	High	Low	High	N/A	Must use active

Footnotes

¹ Annualized net-of-fee results are calculated by subtracting the average manager fee, respective of asset class and style, from the ICC gross-of-fee performance. The average manager fees used were obtained from the 2008 eVestment Alliance manager fee study.

² The ICC universe data shown includes only actively managed portfolios. The minimum sample size used for each time period is 20 portfolios.

³ Benchmark rankings are relative to the respective ICC actively managed gross-of-fee universe. Rankings reflect the gross-of-fee results of the benchmark. Results were calculated by adding the respective asset class and style annual fee as obtained from the 2008 eVestment Alliance manager fee study to the annual benchmark return.

