McMORGAN & COMPANY
INVESTMENT MANAGEMENT

FEBRUARY 2013

Perspectives

AN EVENTFUL YEAR

2012 was a milestone year for McMorgan. In July, my partners and I repurchased the firm from New York Life Investment Management LLC (NYLIM). Once again, we are an independent company. However, we maintain close ties with our former parent, as we continue to represent NYLIM's investment boutiques in the Taft-Hartley marketplace. In addition, we have formed strategic alliances with specialty managers that have expertise in private debt/direct lending and infrastructure investing. We anticipate more of these types of alliances in the future, consistent with our goal of providing clients with the best the market has to offer.

Another significant development in 2012 was the addition of Carmen Racy-Choy as our Chief Investment Officer (CIO). She joined us with strong experience from her previous roles as CIO at the City of San Jose Retirement Systems and Principal at Mercer Investment Consulting. Carmen's focus at McMorgan is to formulate our investment strategies, continue to build out our investment platform, and oversee client accounts and sub-advisory relationships. One of the areas in which Carmen has been most focused on is real assets. We are thrilled to have Carmen on board and hope you find her insights regarding how real assets might help Taft-Hartley plans valuable.

As we look ahead into the new year, we feel energized about the work we are doing for our clients and optimistic about the opportunities in the financial markets. On behalf of everyone at McMorgan, thank you for your continued support, and best wishes in 2013.

John F. Santaguida
Chief Executive Officer, Managing Partner

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EXPLORING REAL ASSETS

Carmen Racy-Choy, Chief Investment Officer

Today's low-yield environment has prompted many investors to shift asset allocations away from fixed income investments toward other asset classes. Consequently, McMorgan is focusing on new strategies with attractive risk-reward profiles—strategies that can offer an institutional portfolio diversification from traditional risk exposures, as well as attractive expected returns.

One area of particular interest is real assets. Some of the most common real assets are Treasury Inflation-Protected Securities (TIPS), real estate, infrastructure, and commodities. However, any investment that is likely to appreciate as inflation rises qualifies as a real asset. Real assets play a vital role in preserving purchasing power during inflationary periods. For example, regulatory policies and long-term service contracts often allow infrastructure asset owners to pass price increases through to their customers. This creates inflation-protected cash flow streams for investors.

On average, institutional investors currently allocate between 5% and 10% of their portfolios to real assets, largely by investing in real estate. Only a small minority has exposure to other types of real assets, and those that do typically have low allocations to either commodities or infrastructure. So while real estate is mainstream, other real assets are not. Real assets can protect against inflation, boost portfolio returns, and increase asset diversification. Given these potential benefits, we expect allocations to real assets to increase.

PROTECTING AGAINST INFLATION

Inflation in industrialized economies has been subdued over the past 15 years. However, the Federal Reserve and central banks around the world have pumped more than $11 trillion into the global financial system since 2007. Their goal has been to lower borrowing costs and jump-start economic growth in their respective countries. But the magnitude of their actions has sparked concerns about inflation. Within days of the Federal Reserve's September 13, 2012 announcement of a mortgage-bond buying program commonly referred to as "Quantitative Easing, Round Three," bond investors sent a key measure of U.S. inflation expectations – "breakeven inflation"[1] – to its highest level since 2008. The 10-year U.S. breakeven inflation rate rose from zero in the fourth quarter of 2008 to 2.6% on January 31, 2013.

So what is the impact of inflation on the assets of a pension plan? Nominal bonds respond negatively to an increase in future expected inflation, and the loss of real purchasing power is significant. Stocks, unfortunately, do not fare much better as inflation is not neutral in the real economy. An increase in expected inflation levels is typically associated with a negative shock to aggregate output – i.e., a recession, which is bad news for equities. Even if an investor has an allocation to real estate in addition to stocks and bonds, the investor will not see much relief in the short-term, as real estate only responds positively to inflation over long periods of time.

The good news is with a change in long-term asset allocation, the decision between a significant ramp up in contribution versus deterioration in the funding of the plan can be avoided. Based on my prior consulting experience with real assets, increasing the real asset allocation to approximately 15% to 20% of the portfolio would allow a typical plan in an inflationary environment to come close to the long-term expected return of 7.5%.

BOOSTING PORTFOLIO RETURNS

Real assets are not just about managing inflation risk; they are also about capturing return. At McMorgan, we are enthusiastic about the return potential of several types of real assets.

Commodities

In 2006, Gary Gorton and K. Geert Rouwenhorst[2] published a paper entitled "Facts and Fantasies About Commodity Futures." The paper moved commodities from a niche investment to a staple investment in an institutional portfolio. The authors compiled an equally weighted index of commodity futures and found that the passive index return with Treasury bills as collateral offered the same return as U.S. equities from 1959 to 2004, the 45-year period examined.

In addition, on a forward-looking basis, we believe several trends are creating strong performance tailwinds for commodities. One of the most powerful is economic development in emerging markets. Industrialization and urbanization in countries like China and India are driving demand for energy and industrial metals. Furthermore, improving wealth levels are leading to more protein-rich diets, benefiting commodities like corn that are used in animal feed.

Private Infrastructure

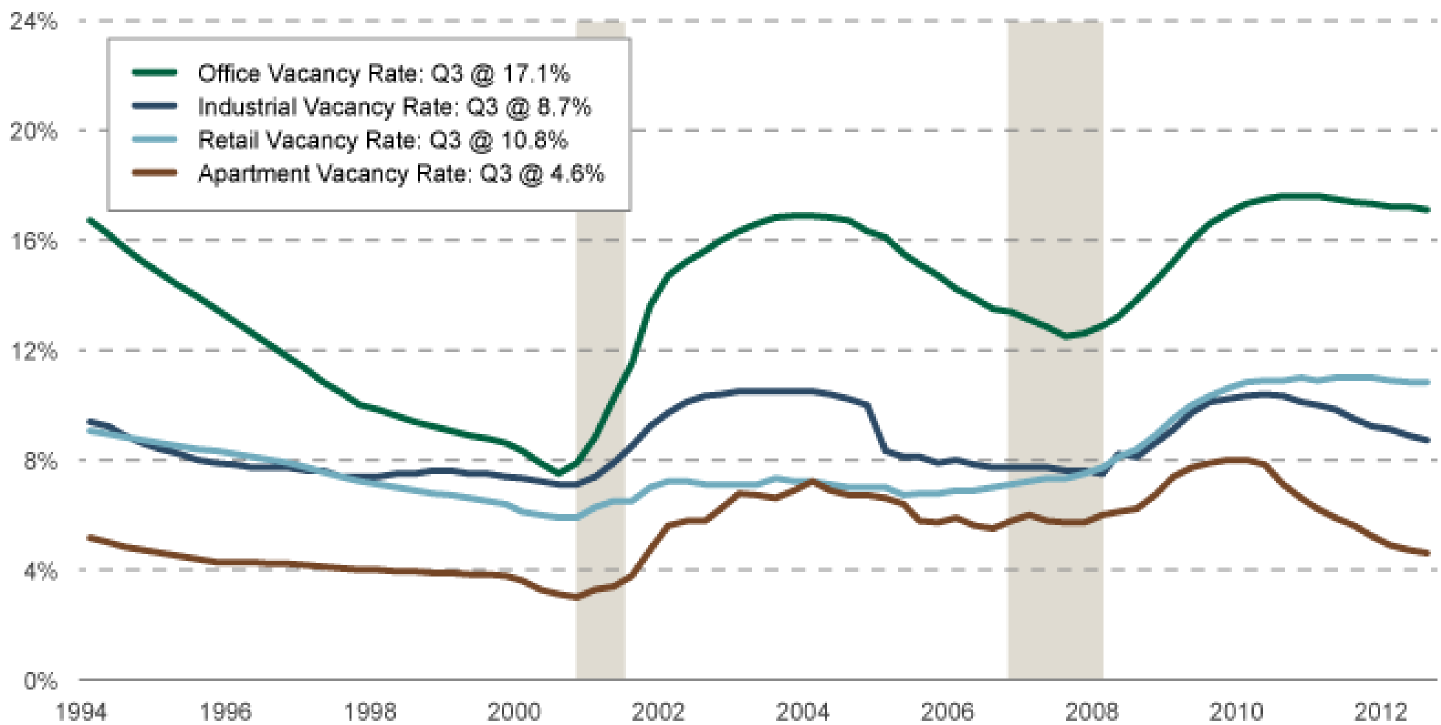
Private infrastructure is another real asset that we believe will perform well in the coming years. A myriad of factors have brought private infrastructure to the forefront, including robust global demand. According to consulting firm Booz Allen Hamilton, global infrastructure spending will be approximately $41 trillion between 2005 and 2030. In addition, the need for governments to maintain existing infrastructure with very tight budgets has led to a greater willingness to form public-private partnerships. Under these arrangements, a government body engages the private sector in the financing and operation of a public infrastructure facility.

Within infrastructure, we believe that large, private investments of $1 billion or more can deliver returns comparable to those of the equity market but with substantially lower volatility. Whereas, investments in smaller infrastructure projects will likely be aggressively bid given the influx of investors into this segment. Hence, they will likely have lower returns.

Real Estate

In the United States, the real estate market continues to recover. Demand for apartments is strong, even with new projects coming online. Limited new supply in commercial markets, combined with improving employment, has lowered vacancy rates in the office, industrial, and retail sectors. In 2013, prospects for all real estate sectors look better than in 2012, according to a recent survey from PwC and the Urban Land Institute.

Commercial Real Estate Vacancy Rates



Source: Real Capital Analytics, Reis, Inc., U.S. Department of Commerce and Wells Fargo Securities, LLC

INCREASING ASSET DIVERSIFICATION

In addition to providing inflation protection and return opportunities, real assets can increase portfolio diversification. Take commodities, for example. Commodity futures typically perform well in the early stages of a recession, a time when equity and bond returns are generally weak. The reverse is true in later stages of recessions—commodities tend to disappoint, while equity and bond performance is strong.[3] Investors who choose to add commodities to their portfolios may want to consider a relatively low-volatility approach. Although the broad commodity market, as measured by the Dow Jones-UBS Commodity Index, was tame in 2012, commodities can be volatile over short time periods.

Private infrastructure and real estate are also great portfolio diversifiers. These types of real assets are generally private investments whose values are model-driven as opposed to market-driven. They tend to exhibit low volatility and low correlation to other asset classes.

THE IMPORTANCE OF BEING EARLY

As with all investments, investing early is critical to achieving an adequate return. For example, an investor buying Treasury Inflation-Protected Securities (TIPS) in the middle of 2009 would have locked in approximately 2% annually over the rate of inflation. However, beginning in late 2010, TIPS began trading with negative yields, meaning investors were paying the U.S. government for the privilege of holding its debt rather than the other way around. Two factors drove the yield on TIPS below the rate of inflation. First, worries about the sovereign debt crisis in Europe triggered a flight to quality. Second, stimulative monetary policy from the Federal Reserve, including quantitative easing, raised concerns that inflation would accelerate in the years ahead.

As 2013 begins, yields on most TIPS maturities are still negative. So while it may be too late to invest in TIPS, opportunities in other real assets remain. The key is to act before inflation expectations move substantially higher. By then, the desired return will likely be out of reach.

TAKING A CLOSER LOOK

The potential benefits of investing in real assets are compelling. If they resonate with you, we would like to start a dialogue with you and your investment consultant. We have several ideas relating to real estate and infrastructure that we believe can help optimally position your portfolios for success.

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1. The U.S. breakeven inflation is the fundamental indicator of inflation expectation for a stated maturity; it is the yield spread between nominal and inflation-linked bonds.

2. Gary Gorton is a professor of management and finance at the Yale School of Management and, previously, was a research associate at the National Bureau of Economic Research. K. Geert Rouwenhorst is a professor of corporate finance at the Yale School of Management and Deputy Director of the University's International Center for Finance.

3. Gary Gorton and K. Geert Rouwenhorst, "Facts and Fantasies About Commodity Futures," National Bureau of Economics Research Working Paper Series, June 2004, revised March 2006.

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