Your Quarterly Update on the Financial Markets
March 31, 2007

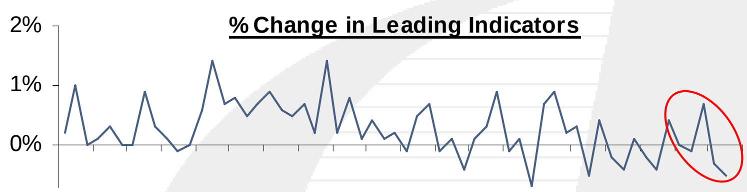
1st Quarter

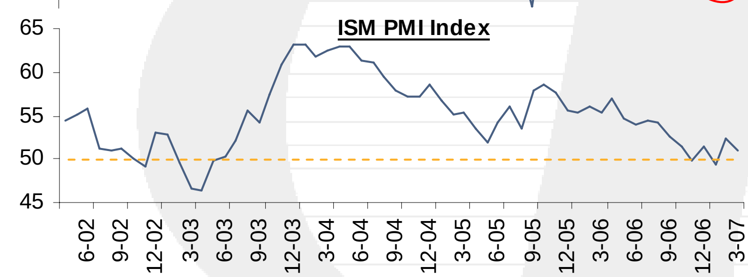
MARKET Recap

The Economy: *"Consumer Spending Overshadows Slowness"*

The U.S. economy finished the 2006 at an even pace, with annualized real growth of 2.5% for the fourth quarter. Personal consumption expenditures surged by 4.2% compared to 2.8% in the third quarter, explaining nearly all of the relatively robust growth observed. Most other segments of the economy contracted or showed signs of slowing growth; for example, motor vehicle output subtracted 1.18% from real GDP growth, corporate equipment and software purchases decreased 4.8%, and real residential fixed investment decreased 19.8%.

The Conference Board's index of leading economic indicators turned negative again in the first quarter, driven by increases in initial claims for unemployment insurance and decreases in consumer expectations, vendor performance, and building permits. Manufacturing activity as tracked by the Institute for Supply Management declined after a surge in February, hovering around the 50.0 level (the index is calibrated so levels below 50.0 indicate contraction). Business sentiment indicates expectations of slowness – yet the U.S. consumer demonstrates unabated appetite for spending. How long can it continue? The best answer we can offer is, "until it stops."





Signs of stress emerged in the subprime mortgage market, as the long-awaited surge in defaults arrived – more suddenly than expected, and with greater magnitude than expected. So far analysts have focused on the impact on the housing market. Fed Chairman Bernanke stated in his March 28 testimony before the Joint Economic Committee of Congress that "...the ongoing tightening of lending standards, although an appropriate market response, will reduce somewhat the effective demand for housing...", and that "...weakness in housing and in some parts of manufacturing does not appear to have spilled over to any significant extent into other sectors of the economy." We expect that it will, gradually with occasional upside and downside surprises, throughout 2007. Americans cannot continue to spend 102% of their disposable income, month after month, without access to a bottomless pit of cheap credit; and with continued inflationary pressures in the factor markets, the Fed should (and probably will) be reluctant to cut rates. The most likely outcome is some amount of contraction, as spending slows or the cost of borrowing rises.

The U.S. Bond Market

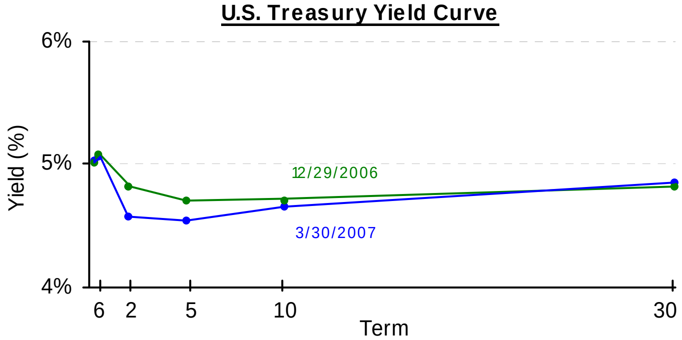
Bond yields ended the first quarter of 2007 down slightly on the mid-range of the curve, with the short durations flat, mid durations falling about 20 basis points, and the long durations flat as well. The yield curve remained inverted and relatively flat with the 2-year yield about 30 basis points below the 30-year yield. Compared to the fourth quarter close, the first quarter of 2007 ended with the yield on the 3-month bill up 2 basis points to 5.03%. The yield on the 10-year treasury closed the quarter down 5 basis points to 4.65%, and the yield on the 30-year treasury ended up 4 basis points at 4.85%.

Bond Indices - Total Return	
	1Q07
Lehman Aggregate	1.50%
Lehman Interm. Gov't	1.53%
Lehman Long Gov't	1.02%
Lehman Interm. Credit	1.69%
Lehman Long Credit	0.94%
Lehman High Yield	2.64%

Even with the flat and inverted yield curve, intermediate bond funds attracted $12 billion in net inflows in the first two months of 2007, more than every other category of stock, bond, or hybrid fund, making it appear that investors are reacting to the uncertainty in the market by moving to more conservative investments.

In the first quarter of 2007, the Federal Open Market Committee met twice, on January 31 and March 21. After each meeting the federal funds rate remained at 5.25%. While comments from the January meeting noted indications of "somewhat firmer economic growth" and "tentative signs of stabilization" in the housing market, by the March meeting indicators were cited as being "mixed" and an ongoing "adjustment in the housing sector" was noted. While inflation pressures were seen as "likely to moderate over time," core inflation was described as "somewhat elevated." Although these comments seem to express more, not less concern about rising inflation, the statement as a whole was generally taken by the market as indicating a move away from any near-term increase to interest rates.

U.S. Treasury Yield Curve



Source: Bloomberg LP

With all the talk of mortgage defaults and the problems in the sub-prime market, it's hard not to wonder what impact a mortgage meltdown would have on mortgage-related bond debt in the US. At the close of 2006 it totaled $6.5 trillion (not surprising when you consider that mortgage issuance has doubled over the past 3 years to $1.1 trillion in 2006). Although various mortgage-related debt structures have made their way into almost every type of portfolio from individual to institutional, from pension fund to hedge fund, the impact of continuing defaults will depend on whether the default trend extends beyond the sub-prime market and what MBS or CMO tranches are held by a specific portfolio. (Currently only the riskiest tranches – those with sub-prime mortgages, appear to be at risk.) One indication of trouble to come was reports of increasing defaults in "Alt-A" mortgages. Issued to borrowers unable to document regular income (like doctors) and generally considered less risky than sub-prime, an increasing default rate in this segment may be the first indication of a wider problem in the MBS market.

The U.S. Stock Market

US stocks ended the first quarter of 2007 up across the board despite a harrowing market slide on February 27th. Ignited by a big decline in Chinese stocks and fueled by worries about economic growth at home, the Dow Jones industrial average, the S&P 500, and the NASDAQ fell 3.3%, 3.5%, and 3.9% respectively, the biggest one-day drops since March of 2003. Another slide followed on March 13th, this time driven by reports that a record number of homes entered into foreclosure in the fourth quarter of 2006. Ultimately market volatility was not a deterrent to individual investors, as net inflows into stock mutual funds over the three week period ending March 28 totaled $10.3 billion, easily overcoming the $2.7 billion in net outflows triggered by the February 27th slide.

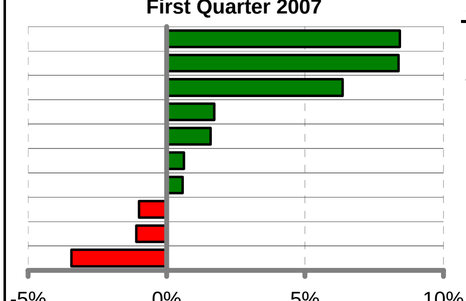
Stock Indices - Total Return

	1Q07		1Q07
Largecap Stocks		**Midcap Stocks**	
S&P 500	0.64%	S&P Midcap 400	5.80%
Russell 1000	1.21%	Russell Midcap	4.38%
Growth	1.19%	Growth	3.96%
Value	1.24%	Value	4.86%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	0.44%	S&P Smallcap 600	3.21%
DJ Wilshire 5000	1.48%	Russell 2000	1.95%
		Growth	2.48%
		Value	1.46%

With volatility on the rise, out-performance came from traditional defensive plays. Utilities, with their strong dividend-paying history and resistance to cyclical shocks, were the star. Not surprisingly, after the panic over default and foreclosure rates, financials ended the quarter at the bottom of the heap.

S&P 500 Economic Group Components - Total Return

First Quarter 2007



Sector	1Q07
Utilities	8.43%
Materials	8.38%
Telecom	6.36%
Energy	1.72%
Consumer Staples	1.59%
Health Care	0.62%
Industrials	0.58%
Consumer Discretionary	-0.99%
Information Technology	-1.10%
Financials	-3.44%

Source: Standard & Poor's

And it appears volatility is here to stay, at least for the near future. Analysts are predicting a slow-down in corporate growth to about 5% after four years in the double-digits. Add this and all its potential ramifications (less hiring and capital expenditures and more layoffs leading to depressed consumer spending) to the looming specter of a mortgage-meltdown and it's not surprising that the market has a case of the jitters.

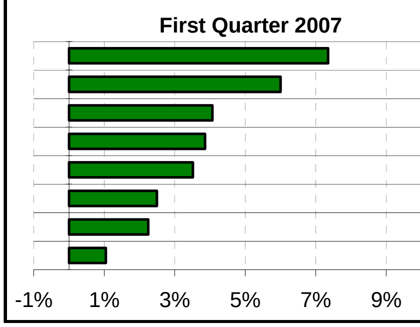
One surprise in the first quarter was the continued record-breaking pace of merger and acquisition activity. According to Thomson Financial, the value of corporate deals announced in the first quarter of 2007 ($1.08 trillion) was on pace to exceed the value of deals in the same quarter last year by 24%. Is this increase good or bad for the market? High merger and acquisition activity has been seen as a signal of a peaking business cycle. Looking back a few years, a previous peak in 2000 activity did precede a difficult market. Will history repeat itself? According to some analysts, recent statistics say no. They point to indications of value creation at a 10-year high and the percentage of companies overpaying at a 10-year low as signs of a more prudent approach to deal-making which should bode well rather than ill for the markets.

Overseas Markets

Global market performance by all appearances is moderating. The major developed markets finished the first quarter with modest gains as the Eurozone continued to outpace US domestic market performance. Emerging market performance was mixed with China losing some ground while Latin America showed mixed results.

In Europe, the European Central Bank (ECB) raised its key interest rate by a quarter point to 3.75% with growing concerns that continuing strong growth may begin to eat away at excess capacity. Inflation is running at 1.8%, slightly under the ECB target of 2%, but the ECB moved to try to stem the flow of liquidity even as Germany, France and Italy are showing economic improvement. Money growth in the zone is currently running at about 9.8%, well above the 4.5% target. In Germany the economic picture continues to improve. As 2006 came to a close unemployment rates fell into the single digits for the first time in a number of years. The unemployment level of 9.8% represented a drop of more than 1% from 2005 levels. At the same time, labor unions continue to push for wage increases that may hamper future economic and employment growth. The MSCI Germany Index was up 6.8% for the quarter. In France, GDP growth surged toward the end of 2006 although slow growth early in the year held annual GDP growth to 2%. The main driver appeared to be a trend of decreasing net exports, which has begun to turn around early in 2007. Business leaders in France appear to be more optimistic; France's composite business climate indicator rose to 109 from 108 in February. The MSCI France Index was up 2.8% for the quarter.

Net Total Return of Selected MSCI Regional Indices



Region	1Q07
Pacific ex Japan	7.35%
Latin America	6.00%
EAFE	4.07%
Europe	3.86%
Japan	3.51%
World Index	2.49%
Emerging Markets	2.25%
North America	1.04%

In Japan, economic direction and news continues to be mixed. Production and exports have been strong, but employment, sales and living expenditures are weak. Better than expected GDP growth in the fourth quarter of 4.8%, annualized, was the good news. Economists had expected a 3.9% annual rate. Growth was attributed to a surge in private consumption, an area of concern for the last few years given the historically high savings rates of Japanese consumers. Private consumption rose 1.1% in the fourth quarter, reversing a 1.1% decline from the previous quarter. Despite weak inflation, the Bank of Japan increased its overnight borrowing rate by 0.25% to 0.50% based on expectations of moderate growth and the economy's ability to handle the increase. Market reception of the increase was cool; with rates still low money continues to flow out of Japan to countries with higher yields. The large yield spread has been responsible for the high yen-carry trade which has sent the yen to historic lows.

In China, a mid-quarter sell-off based on fears that the government would intervene to slow down the economy set off a chain reaction of selling in global markets. The fear was caused by Chinese government officials commenting that the market may be overheating after soaring 36% in the fourth quarter of 2006. China's second highest trade surplus level was reached in February, $23.76 billion, nearly reaching last October's level of $23.83 billion. Exports to the U.S., China's largest trading partner, were up nearly 36% in the first two months of the year. China increased its one-year lending rate by 0.27% late in the quarter to 6.39% in a vain attempt to stem market acceleration. However, as we have seen recently these small incremental moves do not have enough weight to stem the on-going liquidity issue. In the first two months of the year bank lending totaled 980 billion yuan, nearly one third of the total lending in all 2006. Inflation spiked by 0.50% in February to 2.7%. The MSCI China Index was down 2.3% for the quarter.

Latin American emerging markets were mixed for the quarter. In Brazil inflation continues to moderate. Consumer prices rose only 3% between January 2006 and January 2007 and inflation expectations continue to remain low. Given all of the positive news and economic growth potential, Brazil's GDP growth rate of 3% lagged the Latin American growth rate average according to the IMF. The challenge for Brazil is how to increase growth without spurring additional inflation. The country has formed a plan to use public spending and tax incentives to try to boost growth over 4%. The MSCI Brazil Index was up 6.1% for the quarter. In Argentina, inflation seems to be the driving issue as the country reported a rate of 9.6% for the year ended February 28, the second highest rate in the region. Analysts believe that there is repressed inflation in the region hidden by strict price controls and that with an election upcoming in October the central government will attempt to keep a lid on prices. The MSCI Argentina Index fell 2.2% for the quarter.

Focus On: *Default Investments and Employee Engagement*

Heard enough about automatic enrollment for 401(k) and other participant-directed retirement plans? Alas, the debate over appropriate selection of default investment options for automatically-enrolled participants is just beginning to pick up. First out of the gate were age-based lifecycle funds, powered by gigantic marketing budgets and an alluring simplicity for participants and fiduciaries.

Time Horizon for Default Investments

Automatically enrolling employees into a defined contribution plan puts us, as fiduciaries, in an awkward position; we are required to make an investment decision for a person we've never met and know little about. How do we frame that problem so we can have a reasonable basis for our decision? Proponents of lifecycle funds base their argument on two fundamental assumptions:

- The objective of the investment decision is to build an appropriate portfolio for the employee to hold, without change, until their retirement, and;
- Portfolios with heavier allocations to equities and other risky investments are appropriate for longer holding periods, since investment risk declines with time.

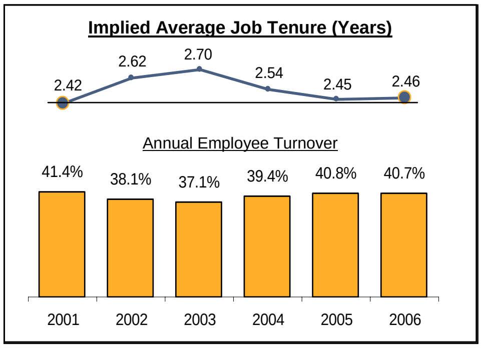
Given these two assumptions, the argument for lifecycle funds is compelling. Unfortunately, neither assumption is particularly sound. Many experts argue against the notion that time reduces risk. For a brief discussion of this issue, readers may wish to review our focus article in the 3/31/2006 issue of Market Recap, titled *The Default Option Dilemma*, or contact us for references to more rigorous treatment of the subject.

Less attention has been paid to the first assumption. When we select a default investment, are we in fact making a "hold to retirement" decision for the employee? Since automatic enrollment is a relatively new phenomenon, we do not yet have enough data to document participant behavior after being "defaulted" – but anecdotal evidence and a measure of common sense suggest that the time horizon for the default investment is much, much shorter.

Concept of Employee Engagement

Employee control over the investment decision is integral to the design of nearly all defined contribution plans. Unlike traditional pension plans, DC plans require the employee to get involved in the process and make decisions under risk. We use the term "engagement" to describe the act of becoming involved, even minimally, in the investment decision-making process. Under normal, positive-election enrollment, engagement automatically occurs because employees are forced to choose their investment mix.

Under negative-election, engagement occurs at some future point – the employee "wakes up" and performs an assessment of the situation. At that point, the employee will evaluate their own goals and risk tolerance, and will also evaluate the performance of their account to date under the employer's direction. Possible actions include affirming the default election, changing the investment mix, increasing or reducing their deferral rate, discontinuing participation, or rolling their proceeds out of the plan.



Source: US DOL Bureau of Labor Statistics, JOLTS Survey

What causes engagement to occur? Of course a host of individual, personal situations could serve as a catalyst – advice from friends, personal illness, marriage, divorce, birth of children, etc. Many employees are likely to engage simply because their account balance grows to a "material" amount, as they define the term. Natural maturity may lead to engagement, as can encouragement from the employer through statements, reminders, and "push" type educational programs. Any of these events are likely to occur much sooner than retirement age.

	Average # of jobs for persons age 18-40 in 1978-2004					
Characteristic	Total	18-21	22-25	26-30	31-35	36-40
Total	10.5	3.8	3.0	2.8	2.4	2.0
Less than high school diploma	10.6	3.3	2.8	2.8	2.4	1.9
High school graduates, no college	10.2	3.6	2.8	2.7	2.4	2.1
Some college or associates degree	10.9	3.9	3.0	2.9	2.4	2.2
Bachelor's degree or higher	10.7	4.1	3.5	2.9	2.2	2.0

Source: US DOL Bureau of Labor Statistics , National Longitudinal Survey

Perhaps the most common catalyst for engagement is employee turnover. Many fiduciaries, particularly those without an HR back-ground, are shocked to learn how often employees change jobs, particularly early in their careers; according to the best longitudinal data available from the DOL, the average person held over 10 different jobs between the ages of 18 and 40. Of course turnover is higher for younger employees, but one could argue they are the primary target of automatic enrollment programs. However, even middle-aged people are likely to change employers.

Finally, negative market events can themselves lead to engagement. When financial markets correct sharply, heavy media coverage increases concern in the general public; people who were content to blissfully ignore their retirement account may suddenly "check in" on their investments.

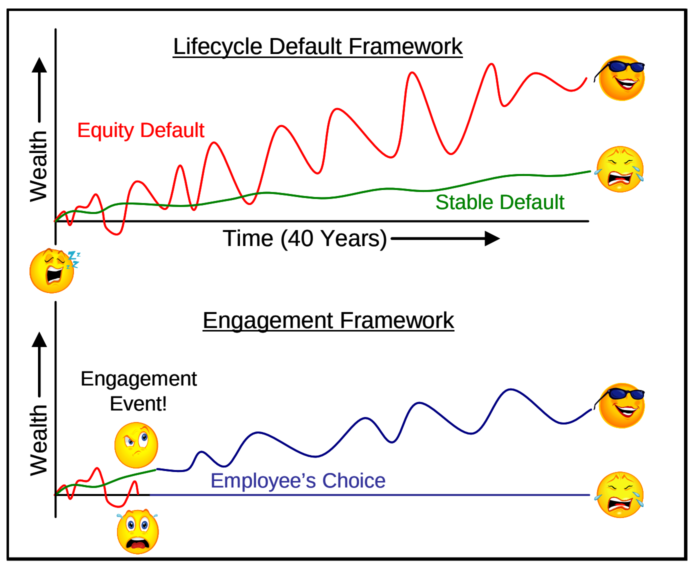
"Engagement Shock" and Negative Engagement

When engagement occurs, the current state of the portfolio may have a profound effect on the participant. Imagine waking up one day to discover that you're behind the wheel of a moving car! Your next action, and your long-term attitudes about driving, might reasonably depend on whether the car is speeding toward a cliff or creeping through a parking lot.

Similarly, a participant that "discovers" positive performance might reasonably be expected to be happier about their benefit plans, willing to increase their participation, and willing to enhance their potential future performance by changing their investment allocations. On the other hand, participants that discover poor performance might protect themselves from future losses by dropping out of the plan, reducing their contributions, or making suboptimal, fear-based investment decisions. The effect may extend beyond the plan to other pools of assets, and to the participant's savings behavior. To the plan sponsor, such "negative engagement" could lead to significant employee dissatisfaction – defeating the very purpose of sponsoring the plan.

Engagement under negative market conditions is more likely to occur when the time period between enrollment and engagement is short, since the total cumulative effect of market losses on a participant's account are much more dramatic, on a percentage basis, when the account balance is low. Also, negative market performance is itself a catalyst for engagement. Therefore, we would expect engagement shock to be a very common experience going forward.

Since engagement, not retirement, is by far the most common outcome of the default investment decision, we believe it is prudent to base the default investment decision on managing the engagement shock. The time horizon of this decision is much shorter than the retirement horizon – probably a few years at most on average.



Framing the "Default Option" Decision

Fiduciaries are more likely to enhance a participant's retirement income by reducing the risk of large losses during the relatively short period of time between enrollment and engagement – because the decisions a participant makes after engagement occurs have a much greater impact on their retirement wealth and income than the initial default decisions made by the employer. The alternative assumption, that participants will stand with the employer's default decision (through decades) until retirement, seems ridiculous upon examination.

On this basis, we suggest framing the default investment decision as, "What strategy maximizes the likelihood that employees will engage in a normal market environment, and minimizes the chance that participants abandon their retirement savings strategy due to engagement shock?" Two courses of action follow:

- Select a default allocation that provides a guarantee, or reasonable expectation of principal protection;
- Use ongoing, positive communications to encourage defaulted employees to take charge of their portfolios.

To us this seems much more sound than the common alternative – default employees to lifecycle funds with high equity allocations and hope they don't notice when the market tanks.

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