

# 2016 Capital Market Assumptions

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Sellwood  
CONSULTING LLC

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## INTRODUCTION

Sellwood Consulting updates its capital markets assumptions on an annual basis. Our 2016 assumptions reflect information as of December 31, 2015, unless otherwise noted.

This report documents our process for creating these capital markets assumptions, and we provide detailed methodology for each. Several over-arching principles, however, inform all of our analysis:

1. We believe that forward-looking capital market assumptions are an important, but far from the only important, input for properly constructing portfolios. Great care should be taken not to rely only on mean-variance analysis when constructing portfolios. Generally speaking, an analysis that relies only on mean-variance analysis will over-allocate to assets with insignificantly superior risk/return estimates, and assets that are less liquid or less frequently priced.
2. Our assumptions are forward-looking in nature and reflect a ten-year horizon. They are appropriate for analysis of portfolios with long-term (10 year or greater) horizons. For portfolios with shorter horizons, alternate methods of analysis should be employed.
3. We purposefully use different methods to estimate return and risk. The first part of this paper explains the different methods we employ to estimate the future return of each individual asset class. Later in the paper, we explain a more standardized approach to estimating future risk of the same asset classes.
4. Our return assumptions utilize a build-up approach based on the current values of the individual drivers of expected return that are unique to each asset class.
5. For asset classes where the market provides a current view of forward-looking returns, our assumptions heavily weight the market view.
6. Where possible, all of our return assumptions incorporate current valuations. Where we have identified a current valuation and its long-term mean, our estimates consider a 50% reversion from the current valuation level to its long-term mean over the prospective ten-year period.
7. Our assumptions are presented in nominal terms. Where we have used historical returns in our input analysis, we have always transformed them to real, after-inflation, returns, so as to strip out historical inflation. At the end of the build-up process, where appropriate, we add the market's current measure of forward-looking inflation back to the assumptions to create nominal forward-looking return assumptions.
8. Our base return calculations are of and for compound returns. After calculating a compound return and a risk assumption, we combine the two mathematically to calculate

an arithmetic average expected return, which is a necessary input for mean-variance analysis.

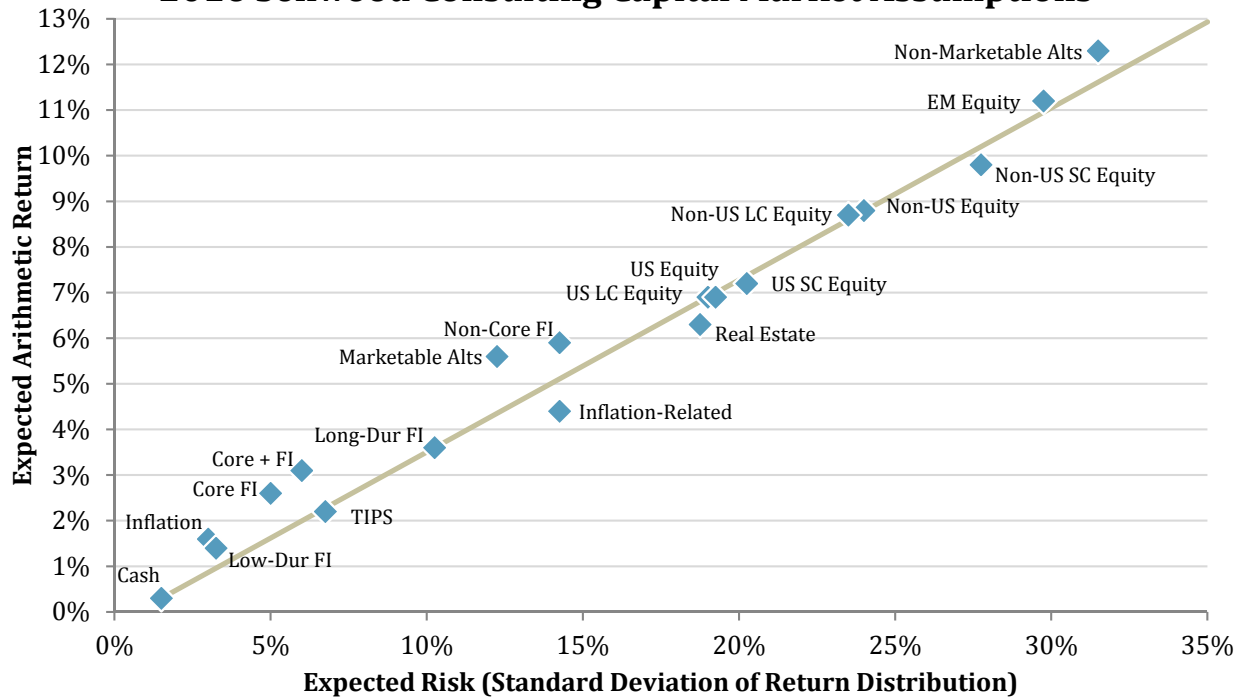
9. Our assumptions are passive in nature and assume no active management.
10. Our approach to modeling the expected risk of each asset category is multi-faceted. First, we examine the historical standard deviation of the returns for a proxy index for the asset category (both the full history and most recent 10 years). Next, we examine the historical worst-case annual return experience (or in the case of asset categories that are not priced to market, the maximum two-year peak-to-trough experience) for the asset class. If necessary, we adjust our risk estimates upward to ensure that the actual worst-case experience had at least a 2% probability of occurring (once every 50 years) under our assumed return and risk distribution parameters. Finally, for asset classes where our confidence in the data available for examination is limited, we qualitatively adjust our risk assumption to reflect this uncertainty.
11. Our correlation coefficient assumptions are mostly derived from history, with an emphasis on the recent past. We seek a proxy for each asset category we have modeled with as long a history as possible, and then calculate our correlation assumptions using a simple average of the following, for each pair of asset categories:
  - Longest-term correlation
  - 10-year correlation
  - 5-year correlation
  - 3-year correlation

This approach purposefully overweights the recent past, while acknowledging the long-term past. It is also a more conservative measure for correlation benefit to a portfolio, because recent correlations have been higher than they have been historically.

12. We round our assumptions to the nearest 10 basis points, in the case of arithmetic average return, and nearest 25 basis points, in the case of risk.
13. Our assumptions are applicable to US-based, non-taxable investors. For taxable clients located in the United States, we maintain a separate methodology that considers the effects of taxes on expected returns and risk.
14. We have strived to construct a set of assumptions that is straightforward, explainable, fully documented, and replicable by other researchers. Our assumptions are as complex as necessary but no more complex than necessary, and they have no hidden constraints. We could make them more complicated, but we do not believe that doing so would make them better.

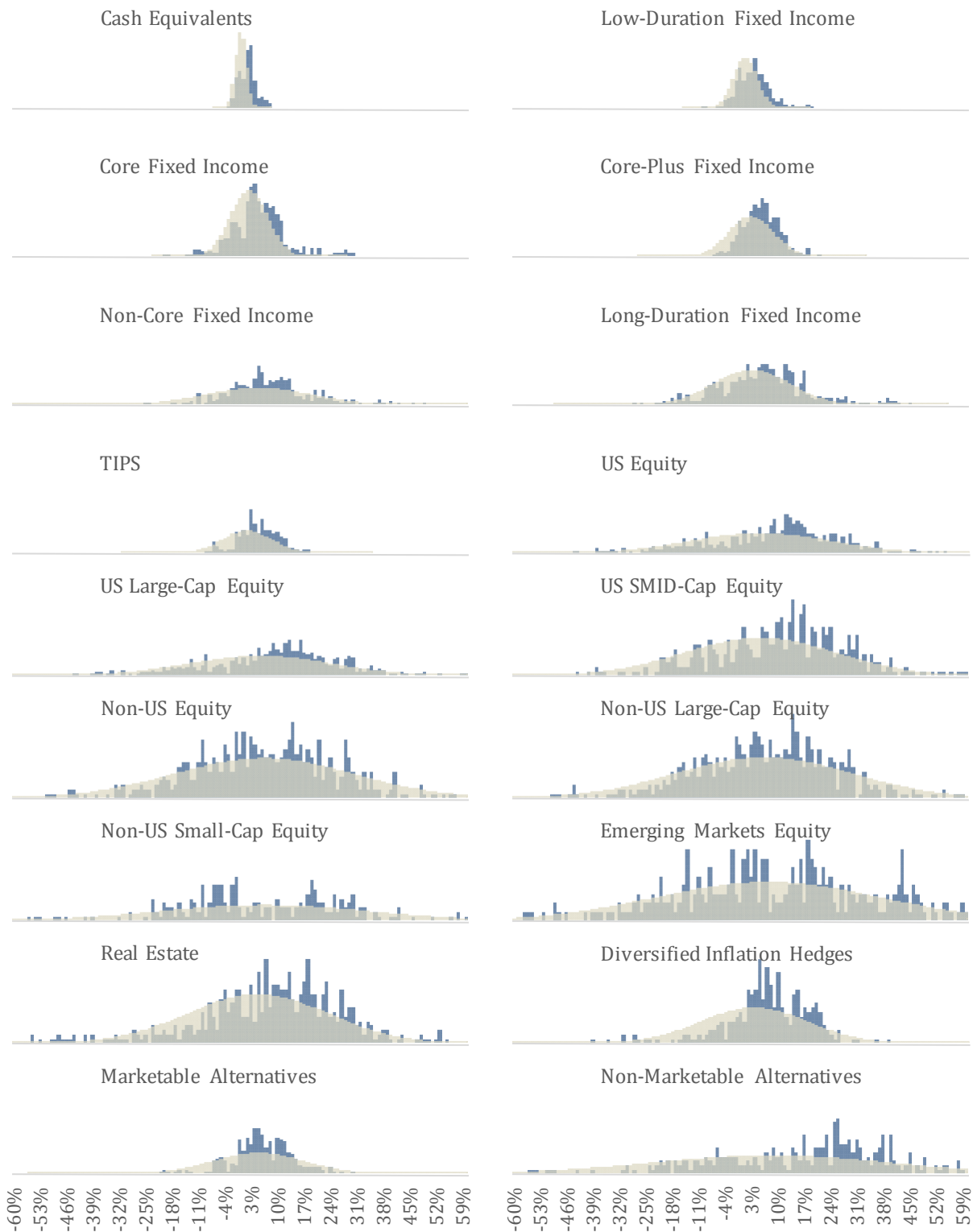
In summary form, our 2016 forward-looking assumptions follow on the next page.

## 2016 Sellwood Consulting Capital Market Assumptions



	Nominal Compound Return	Risk	Nominal Arithmetic Return	Sharpe Ratio
Inflation	1.54%	3.00%	1.60%	---
Cash Equivalents	0.30%	1.50%	0.30%	---
Low-Duration Fixed Income	1.39%	3.25%	1.40%	0.34
Core Fixed Income	2.45%	5.00%	2.60%	0.43
Core-Plus Fixed Income	2.95%	6.00%	3.10%	0.44
Non-Core Fixed Income	4.96%	14.25%	5.90%	0.33
Long-Duration Fixed Income	3.09%	10.25%	3.60%	0.27
TIPS	1.94%	6.75%	2.20%	0.24
US Equity	5.24%	19.00%	6.90%	0.26
US Large-Cap Equity	5.21%	19.25%	6.90%	0.26
US Small/Mid-Cap Equity	5.34%	20.25%	7.20%	0.25
Non-US Equity	6.30%	24.00%	8.80%	0.25
Non-US Large-Cap Equity	6.25%	23.50%	8.70%	0.25
Non-US Small-Cap Equity	6.50%	27.75%	9.80%	0.22
Emerging Markets Equity	7.40%	29.75%	11.20%	0.24
Real Estate	4.71%	18.75%	6.30%	0.24
Diversified Inflation-Related	3.46%	14.25%	4.40%	0.22
Marketable Alternatives	4.94%	12.25%	5.60%	0.38
Non-Marketable Alternatives	8.10%	31.50%	12.30%	0.25

Historical return distributions (historical real returns, plus our assumed future inflation) are depicted below in blue, and our forward-looking assumed return distributions are shown in tan:



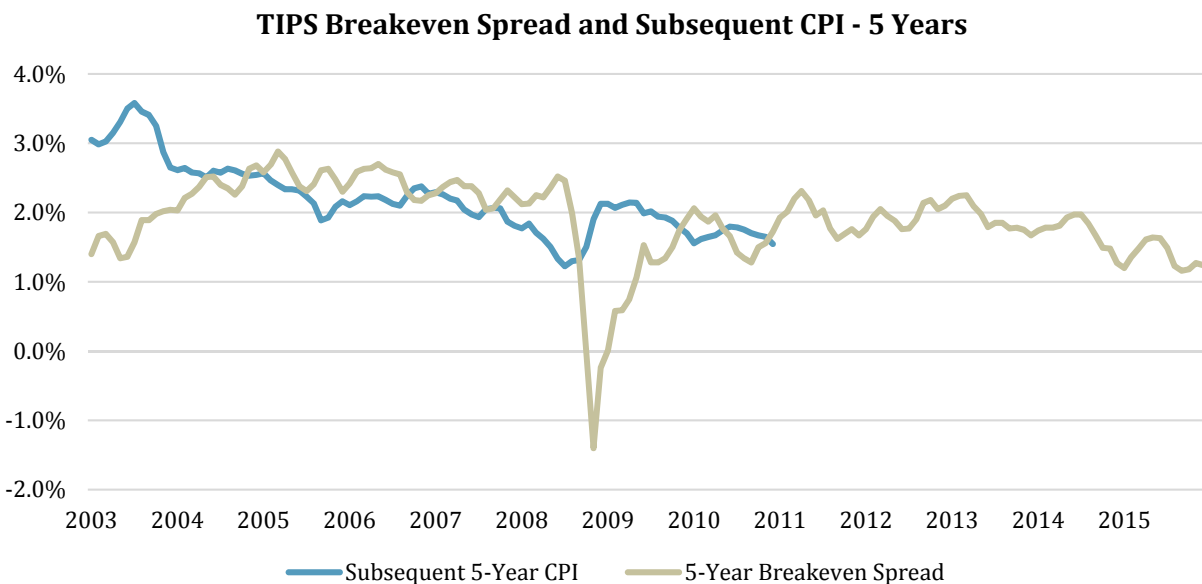
## INFLATION

*Modeled: US CPI-U Inflation*  
*Compound Return: 1.54%*  
*Arithmetic Average Return: 1.60%*  
*Risk: 3.00%*

The market tells us its expectation for forward-looking ten-year inflation, and our assumption reflects that market assumption.

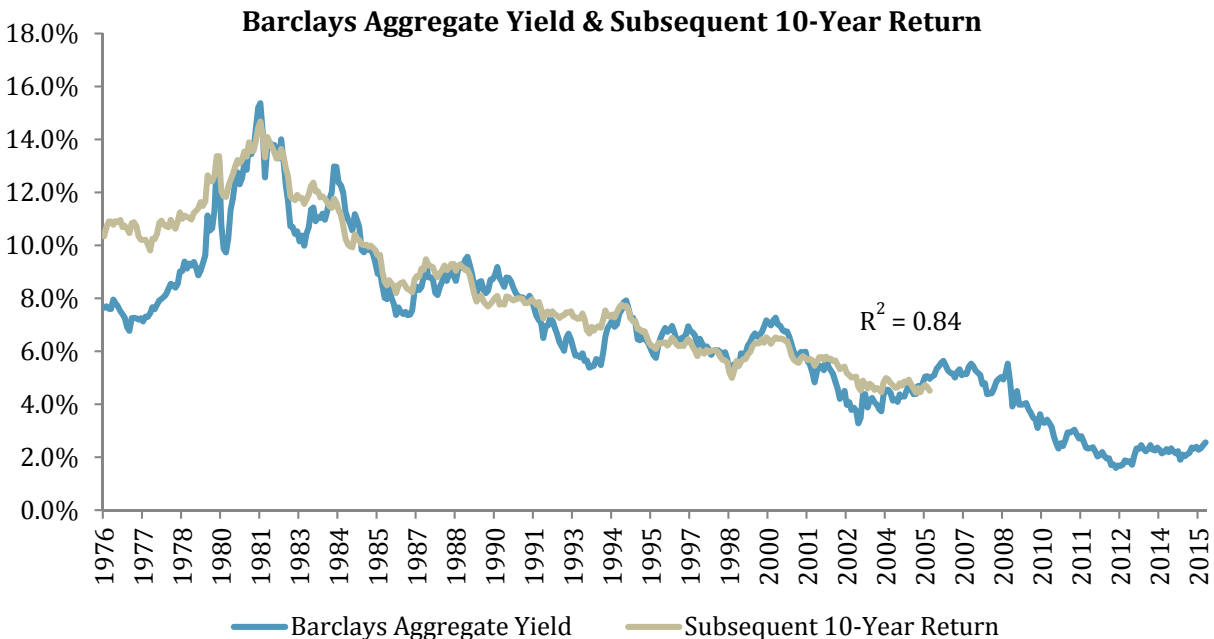
On December 31, 2015, the market's yield for a 10-Year US Treasury Bond was 2.27%, and the real yield for a 10-Year TIPS security was 0.73%. The difference between the two approximates the market's inflation expectation over the next ten years, 1.54%.

The Federal Reserve has published this inflation approximation – the so-called “TIPS breakeven spread” – since 2003. The following chart depicts the full history of this measure, laid against the actual subsequent inflation (as measured by CPI) that occurred. We have chosen to depict the five-year TIPS breakeven spread and subsequent five-year inflation, because the 10-year values do not yet offer sufficient information for evaluation. With the exception of especially illiquid market periods, which distort the measure because of liquidity differences between TIPS and nominal Treasury Bonds, the measure has done a fair job of predicting subsequent inflation and does not appear to be biased positively or negatively.



## FIXED INCOME

Fixed income returns are very dependent on entry yields. For the Barclays Aggregate Index, since 1976, yields have explained 84% of subsequent 10-year returns:



It would be tempting to simply set our bond-market assumptions as the current yield, but to do so would be to ignore prospects for changing interest rates, changing composition of the bond benchmarks, and the negative effects of bond defaults. Instead, we build a valuation model for each bond category for which we assume a return. Still, current yields anchor our analysis: in each case, the compound return assumption that we calculate with this model is close to the current nominal yield for the asset class.

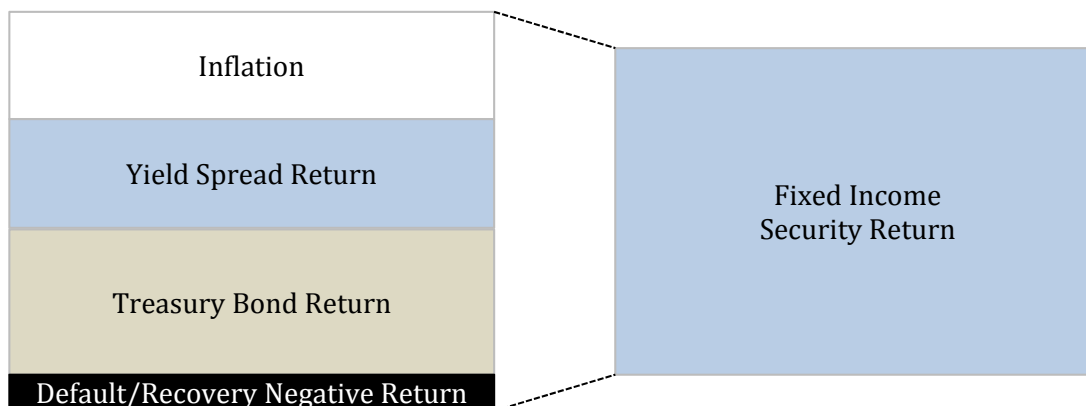
All of our fixed income assumptions use an identical building-block model as our base analysis, but we have made some qualitative adjustments to the analysis, where noted.

Our building block model begins with the fixed income asset class's current real yield and duration. We then examine the long-term average of the real yield, and assume that over the prospective ten-year period, the asset's real yield reverts halfway to that average. For asset categories that pay a yield spread as compensation for higher risk, we use similar calculations to assume the reversion of yield spread halfway to its historical average. For the most part, we assume that long-term average default and recovery rates will persist into the prospective ten-year period.<sup>1</sup> Given these inputs, we can calculate the asset's expected forward-looking 10-year return.

Rather than relying on historical return and yield information, this approach has the advantage of being responsive to the changing composition of several indexes we model.

<sup>1</sup> Our source for historical default and recovery rates for all bonds is Moodys.





In most cases, we have used the 5-Year Treasury Bond as our first fixed income building block – the block upon which we stack yield spreads and inflation. To calculate its forward-looking ten-year return, we begin with today’s real yield, 0.45%. We assume ten-year reversion halfway to the long-term average mean real yield of 2.08%. In order to capture the longest time horizon possible, we calculate all real yields by adjusting the nominal yield by an inflation series<sup>2</sup>. We assume that the reversion to a mean real yield will occur in even increments in each of the future ten years. We assume further that the security’s duration will stay constant over the ten-year period. The last building block, though it is assumed to be zero for a Treasury security, is an assumed default rate, adjusted for an assumed recovery rate. Finally, because all of this analysis is calculated in real terms, we add back the market’s inflation assumption to arrive at a nominal return assumption.

Our calculation for the 5-Year US Treasury Bond follows. Our assumptions are:

Maturity:	5 years
Current Real Yield:	0.45%
Duration:	4.76 years
Long-Term Average Real Yield:	2.08%
Cumulative Yield Change (10 Years):	+0.81% (halfway from current to long-term average)
Expected Default Rate:	0%
Expected Default Recovery Rate:	N/A

5-Year Treasurys -- Total Return

Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Real Yield	0.45%	0.53%	0.61%	0.69%	0.78%	0.86%	0.94%	1.02%	1.10%	1.18%	1.26%		
Duration	4.76	4.76	4.76	4.76	4.76	4.76	4.76	4.76	4.76	4.76	4.76		
Parallel Yield Change		0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.81%	
12-month return		0.06%	0.14%	0.23%	0.31%	0.39%	0.47%	0.55%	0.63%	0.71%	0.80%		
Compound Factor		100.06%	100.14%	100.23%	100.31%	100.39%	100.47%	100.55%	100.63%	100.71%	100.80%	4.37%	0.43%
												market 10-year inflation	1.54%
												nominal 10-yr annualized return	<b>1.97%</b>

<sup>2</sup> Since 2003, our real yields are based on the constant maturity TIPS yields calculated by the Federal Reserve for maturities longer than 2 years. Prior to 2003, in order to calculate real yields we adjusted the applicable yield with the prior 12-month core CPI index. For example, for a 5-year Treasury bond, we calculate a historical real yield series by subtracting prior 12-month core CPI from historical 5-year Treasury bond yields prior to 2003, and by using the then-current 5-year TIPS breakeven yield after 2003. Due to a more stable series, the core CPI index has proven a better predictor of subsequent CPI inflation than has the CPI index itself.

Under the assumptions we have outlined, the security expects to earn a real annualized compound return of 0.43% over the next 10 years. Adding our inflation assumption, we arrive at a compound return assumption for the security: 1.97% annualized.

We have made similar calculations for 10- and 20-year Treasury bonds, which are relevant to calculations of forecasts for certain bonds of longer maturities. Those calculations are as follows:

### 10-Year Treasury Bonds

Assumptions (10-Year Treasury):

Maturity:	10 years
Current Real Yield:	0.73%
Duration:	8.77 years
Long-Term Average Real Yield:	2.35%
Cumulative Yield Change (10 Years):	+0.81% (halfway from current to long-term average)
Expected Default Rate:	0%
Expected Default Recovery Rate:	N/A

#### 10-Year Treasurys -- Total Return

Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Real Yield	0.73%	0.81%	0.89%	0.97%	1.05%	1.13%	1.21%	1.30%	1.38%	1.46%	1.54%		
Duration	8.77	8.77	8.77	8.77	8.77	8.77	8.77	8.77	8.77	8.77	8.77		
Parallel Yield Change		0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.81%	
12-month return		0.02%	0.10%	0.18%	0.26%	0.34%	0.43%	0.51%	0.59%	0.67%	0.75%		
Compound Factor		100.02%	100.10%	100.18%	100.26%	100.34%	100.43%	100.51%	100.59%	100.67%	100.75%	3.91%	0.38%
												market 10-year inflation	1.54%
												nominal 10-yr annualized return	1.92%

Our projected nominal 10-year annualized return is 1.92%.

### 20-Year Treasury Bonds

Assumptions (20-Year Treasury):

Maturity:	20 years
Current Real Yield:	1.07%
Duration:	14.15 years
Long-Term Average Real Yield:	2.57%
Cumulative Yield Change (10 Years):	+0.75% (halfway from current to long-term average)
Expected Default Rate:	0%
Expected Default Recovery Rate:	N/A

#### 20-Year Treasurys -- Total Return

Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Real Yield	1.07%	1.15%	1.22%	1.30%	1.37%	1.45%	1.52%	1.60%	1.67%	1.75%	1.82%		
Duration	14.15	14.15	14.15	14.15	14.15	14.15	14.15	14.15	14.15	14.15	14.15		
Parallel Yield Change		0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%	0.75%	
12-month return		0.01%	0.08%	0.16%	0.23%	0.31%	0.38%	0.46%	0.53%	0.61%	0.68%		
Compound Factor		100.01%	100.08%	100.16%	100.23%	100.31%	100.38%	100.46%	100.53%	100.61%	100.68%	3.49%	0.34%
												market 10-year inflation	1.54%
												nominal 10-yr annualized return	1.88%

Our projected nominal 10-year annualized return is 1.88%.

## Cash Equivalents

Modeled: 91-Day T-Bills  
 Compound Return: 0.30%  
 Arithmetic Average Return: 0.30%  
 Risk: 1.50%

We use the model outlined above for Cash Equivalents.

### Assumptions (91-Day T-Bills):

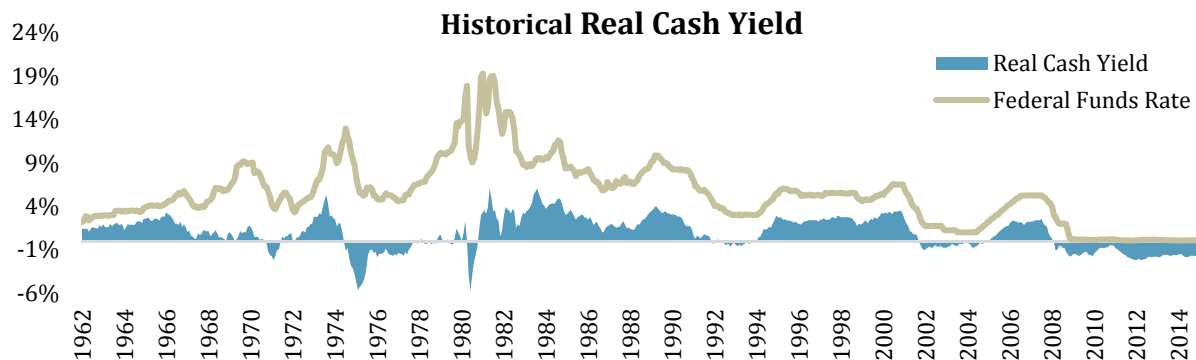
Maturity:	91 days
Current Real Yield:	-1.82%
Duration:	0.25 years
Long-Term Average Real Yield:	0.90%
Cumulative Yield Change (10 Years):	+1.36% (halfway from current to long-term average)
Expected Default Rate:	0%
Expected Default Recovery Rate:	N/A

These assumptions yield a nominal compound return expectation of 0.30%:

#### 91-Day T-Bills -- Total Return

Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Real Yield	-1.82%	-1.68%	-1.55%	-1.41%	-1.28%	-1.14%	-1.00%	-0.87%	-0.73%	-0.60%	-0.46%		
Duration	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25		
Parallel Yield Change		0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	1.36%	
12-month return		-1.85%	-1.72%	-1.58%	-1.45%	-1.31%	-1.17%	-1.04%	-0.90%	-0.77%	-0.63%		
Compound Factor		98.15%	98.28%	98.42%	98.55%	98.69%	98.83%	98.96%	99.10%	99.23%	99.37%	-11.76%	-1.24%
												market 10-year inflation	1.54%
												nominal 10-yr annualized return	<b>0.30%</b>

We caution that there is an inherent problem with forecasting a 10-year return for an asset that matures every 91 days. Nominal cash returns are highly sensitive to nominal short-term interest rates, which we expect to be as variable over the next decade as they have been historically. As illustrated in the chart below, while investors typically demand a positive real yield from cash, periods of negative real return to cash have existed for considerable periods of time – including the most recent period since 2008. Our risk assumption reflects an appropriate range of uncertainty around our return projection for cash equivalents.



## Low-Duration Fixed Income

*Modeled: 1-3 Year Aggregate Fixed Income*

*Compound Return: 1.39%*

*Arithmetic Average Return: 1.40%*

*Risk: 3.25%*

We use our base model for Low-Duration Fixed Income.

Assumptions for 2-Year US Treasury Bond:

Maturity:	2 years
Current Real Yield:	-1.01%
Duration:	1.96 years
Long-Term Average Real Yield:	1.73%
Cumulative Yield Change (10 Years):	+1.37% (halfway from current to long-term average)

These assumptions yield a nominal compound return expectation of 0.88%:

2-Year Treasurys -- Total Return													
Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Real Yield	-1.01%	-0.87%	-0.73%	-0.60%	-0.46%	-0.32%	-0.19%	-0.05%	0.09%	0.22%	0.36%		
Duration	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96		
Parallel Yield Change		0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	0.14%	1.37%	
12-month return	-1.28%	-1.14%	-1.00%	-0.87%	-0.73%	-0.59%	-0.46%	-0.32%	-0.18%	-0.05%			
Compound Factor	98.72%	98.86%	99.00%	99.13%	99.27%	99.41%	99.54%	99.68%	99.82%	99.95%		-6.42%	-0.66%
												market 10-year inflation	1.54%
												nominal 10-yr annualized return	<b>0.88%</b>

Our assumption reflects a 50% proportion of corporate bonds. For half the assumed portfolio, then, we add a spread for 1-3 year corporate bonds:

Assumptions:

Proportion in Corporates:	50%
Current Spread:	1.08%
Long-Term Average Spread:	1.32%
Spread Duration:	1.61 years
Cumulative Spread Change (10 Yrs):	+0.12% (halfway from current to long-term average)

1-3 Year Corporates -- Spread Effect (over Treasurys)													
Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Spread	1.08%	1.09%	1.10%	1.12%	1.13%	1.14%	1.15%	1.16%	1.18%	1.19%	1.20%		
Duration	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61		
Parallel Yield Change		0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.12%	
12-month return		1.06%	1.07%	1.08%	1.10%	1.11%	1.12%	1.13%	1.14%	1.16%	1.17%		
Compound Factor	101.06%	101.07%	101.08%	101.10%	101.11%	101.12%	101.13%	101.14%	101.16%	101.17%		11.72%	<b>1.11%</b>
												Proportion	50.00%
												Spread Effect (Total)	<b>0.56%</b>

Finally, we make assumptions for the expected default rate and recovery rate for defaulted securities. These calculations only apply to the proportion of the assumption pertaining to corporate securities. The following figures represent the historical average for the asset class:

Assumptions:

Expected Default Rate:	0.15%
Expected Default Recovery Rate:	<u>44%</u>
Default/Recovery Return Contribution:	<u>-0.08%</u>
Multiplied by 0.5 (half of portfolio);	-0.04%

In summary, our return assumption for low-duration fixed income builds up several sources of return:

2-Year Treasury Return	0.88%
Spread Effect	+0.56%
Default Effect	<u>-0.04%</u>
Return Assumption	<b>1.39%</b> (difference explained by rounding)

Combining the 2-Year Treasury Bond return and the expected return from spread, and then subtracting the expected default rate after adjusting for recovery, yields our return assumption of 1.39% in compound terms.

Core Fixed Income	
<i>Modeled: US Investment-Grade Aggregate and Hedged Non-US Aggregate Fixed Income</i>	
<i>Compound Return: 2.45%</i>	
<i>Arithmetic Average Return: 2.60%</i>	
<i>Risk: 5.00%</i>	

The base level of our building-block approach for Core Fixed Income is the 5-Year Treasury Bond, outlined above. To this expected return, we add an expectation for spread return:

Current Spread (BC Aggregate):	0.56%
Long-Term Average Spread:	0.56%
Spread Duration:	3.28 years
Cumulative Spread Change (10 Yrs):	+0.00% (halfway from current to long-term average)

BC Aggregate -- Spread Effect (over Treasuries)

Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Spread	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%		
Duration	3.23	3.23	3.23	3.23	3.23	3.23	3.23	3.23	3.23	3.23	3.23		
Parallel Yield Change		0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	
12-month return		0.57%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%	0.56%		
Compound Factor		100.57%	100.56%	100.56%	100.56%	100.56%	100.56%	100.56%	100.56%	100.56%	100.56%	5.78%	<b>0.56%</b>

Our assumptions for default and recovery rates are in line with history. We subtract a default contribution based on these input variables:

## Assumptions:

Expected Default Rate:	0.15%
Expected Default Recovery Rate:	<u>44%</u>
Default/Recovery Return Contribution:	-0.08%

## In summary:

5-Year Treasury Return	1.97%
Spread Effect	+0.56%
Default Effect	<u>-0.08%</u>
Return Assumption	<b>2.45%</b>

Adding the 5-Year US Treasury Bond return, the expected spread return, and adjusting for defaults yields a compound return expectation of 2.45%.

We believe that this approach works equally well for US Aggregate fixed income and for Non-US Aggregate fixed income where the currency exposure is hedged back to the US dollar. By stripping out currency exposure, the Non-US fixed income investor is left with a portfolio of fixed income securities expecting similar underlying characteristics to the US fixed income portfolio.

## Non-Core Fixed Income

*Modeled: US and Non-US Below-Investment-Grade & Emerging Markets Fixed Income*  
*Compound Return: 4.96%*  
*Arithmetic Average Return: 5.90%*  
*Risk: 14.25%*

Our Non-Core Fixed Income assumption combines US below-investment-grade (high yield) bonds and emerging markets sovereign bonds. We assume a 50% weighting to each asset class.

### *High Yield Bonds*

The maturity of the high-yield index is currently 6.2 years. To match this maturity, we calculate a spread over a weighted average of expected returns for 5- and 10-year US Treasury Bonds that yields an expected return for a 6.2-year Treasury Bond, then add our spread building block, and finally subtract a default building block.

Maturity:	6.2 years
6.2-Year Treasury Assumed Return:	1.96%
Current Spread:	6.95%
Long-Term Average Spread:	5.84%
Spread Duration:	3.78 years
Cumulative Spread Change (10 Yrs):	-0.56% (halfway from current to long-term average)

Expected Default Rate: 2.80%  
 Expected Default Recovery Rate: 39%

Our assumed return contribution from high yield spread building block, before accounting for defaults, is 3.45% (assuming 50% of the portfolio):

High Yield -- Spread Effect (over Treasurys)													
Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Spread	6.95%	6.89%	6.84%	6.78%	6.73%	6.67%	6.62%	6.56%	6.51%	6.45%	6.39%		
Duration	3.78	3.78	3.78	3.78	3.78	3.78	3.78	3.78	3.78	3.78	3.78		
Parallel Yield Change		-0.06%	-0.06%	-0.06%	-0.06%	-0.06%	-0.06%	-0.06%	-0.06%	-0.06%	-0.06%	-0.56%	
12-month return		7.16%	7.10%	7.05%	6.99%	6.94%	6.88%	6.83%	6.77%	6.72%	6.66%		
Compound Factor		107.16%	107.10%	107.05%	106.99%	106.94%	106.88%	106.83%	106.77%	106.72%	106.66%	95.06%	6.91%
												Proportion	50.00%
												Spread Effect (Total)	3.45%

### Emerging Markets Debt

The current maturity of an index of emerging markets sovereign bonds is 11.3 years. To match this duration, we calculate a spread over a weighted average of expected returns for 10- and 20-year US Treasury Bonds that yields an expected return for a 11.3-year Treasury Bond.

Maturity: 11.3 years  
 11.3-Year Treasury Assumed Return: 1.92%  
 Current Spread: 3.94%  
 Long-Term Average Spread: 3.56%  
 Spread Duration: 6.34 years  
 Cumulative Spread Change (10 Yrs): -0.19% (halfway from current to long-term average)

These assumptions yield an assumption for return contribution from emerging markets debt spread, before accounting for defaults, of 1.99% (assuming 50% of the portfolio):

EMD -- Spread Effect (over Treasurys)													
Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Spread	3.94%	3.92%	3.90%	3.88%	3.86%	3.85%	3.83%	3.81%	3.79%	3.77%	3.75%		
Duration	6.34	6.34	6.34	6.34	6.34	6.34	6.34	6.34	6.34	6.34	6.34		
Parallel Yield Change		-0.02%	-0.02%	-0.02%	-0.02%	-0.02%	-0.02%	-0.02%	-0.02%	-0.02%	-0.02%	-0.19%	
12-month return		4.06%	4.04%	4.02%	4.00%	3.99%	3.97%	3.95%	3.93%	3.91%	3.89%		
Compound Factor		104.06%	104.04%	104.02%	104.00%	103.99%	103.97%	103.95%	103.93%	103.91%	103.89%	47.68%	3.98%
												Proportion	50.00%
												Spread Effect (Total)	1.99%

Our final building block is an adjustment for expected default and recovery rates. The quality composition of the emerging markets debt universe has changed over time, so we do not apply historical universe-wide default and recovery rates. Instead, we examine the historical default and recovery rates by quality rating, and apply those rates to the current universe quality composition. Historically, investment-grade emerging markets issues have experienced 1.9% default rates. Speculative-grade emerging markets issues have experienced 17.2% default rates. The universe is currently 58% investment grade and 42% speculative grade. Weighting historical default rates by the current universe composition results in our assumption for future default rates. Historical recovery rates in default, regardless of rating, has been 63%.

Expected Default Rate:	8.4%
Expected Default Recovery Rate:	63%

We subtract the expected unrecovered default from the total yield:

	<u>Default Rate</u>	<u>Recovery Rate</u>	<u>Unrecovered Rate</u>	<u>Default Effect on Return</u>
High Yield	2.8%	39%	61%	-1.74%
EM Debt	8.4%	63%	37%	-3.10%

In summary:

	<u>High Yield</u>	<u>EM Debt</u>	<u>Combined</u>
Treasury Return	1.96%	1.92%	---
Spread Effect	+6.91%	+3.98%	---
Default Effect	<u>-1.74%</u>	<u>-3.10%</u>	---
Return Assumption	7.13%	2.79%	<b>4.96%</b>

We average the High Yield and Emerging Markets Debt assumptions to arrive at our forward-looking compound return expectation for non-core fixed income: 4.96%.

### **Core-Plus Fixed Income**

*Modeled: 80% US Investment-Grade Aggregate; 20% Non-Core Plus Sectors*  
*Compound Return: 2.95%*  
*Arithmetic Average Return: 3.10%*  
*Risk: 6.00%*

This return assumption expects a return calculated as follows:

80% of the expected return of Core Fixed Income  
+ 20% of the expected return of Non-Core Fixed Income

This process yields an expected compound return of 2.95%.

### **Long-Duration Fixed Income**

*Modeled: US Long-Term Government/Credit Fixed Income*  
*Compound Return: 3.09%*  
*Arithmetic Average Return: 3.60%*  
*Risk: 10.25%*

Our model assumes 50% each in (i) 10- and 20-Year US Treasury Bonds and (ii) long-duration US investment-grade corporate bonds. While the composition of most long-duration fixed income indexes differs slightly from this approach, we believe that most differences will cancel each other out.



### Treasury Component

For the Treasury component, we use our basic model to average the expected returns for 10- and 20-year Treasury Bonds (outlined above) to approximate the return of a 15-year Treasury Bond. This average expected return for the Treasury component is 1.90%.

### Spread Component

We add a spread component consisting of long-term US investment-grade corporate bonds:

Assumptions:

Proportion in Corporates:	50%
Current Spread:	2.25%
Long-Term Average Spread:	1.72%
Spread Duration:	11.96 years
Cumulative Spread Change (10 Yrs):	-0.26% (halfway from current to long-term average)
Expected Default Rate:	0.15%
Expected Default Recovery Rate:	44%

#### Long Corporates -- Spread Effect (over Treasuries)

Year	0	1	2	3	4	5	6	7	8	9	10	Cumulative	Annualized
Starting Spread	2.25%	2.22%	2.20%	2.17%	2.14%	2.12%	2.09%	2.07%	2.04%	2.01%	1.99%		
Duration	11.96	11.96	11.96	11.96	11.96	11.96	11.96	11.96	11.96	11.96	11.96		
Parallel Yield Change		-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.26%	
12-month return		2.56%	2.54%	2.51%	2.49%	2.46%	2.43%	2.41%	2.38%	2.35%	2.33%		
Compound Factor		102.56%	102.54%	102.51%	102.49%	102.46%	102.43%	102.41%	102.38%	102.35%	102.33%	27.34%	<b>2.45%</b>
												Proportion	50.00%
												Spread Effect (Total)	<b>1.22%</b>

In summary:

Treasury Return	1.90% (average of 10- and 20-year Treasuries)
Spread Effect	+1.23% (50% proportion)
Default Effect	<u>-0.04%</u> (50% proportion)
Return Assumption	<b>3.09%</b>

Our return assumption for the combined Treasury and corporate Long-Duration Fixed Income basket assumes 50% in each category. This compound return assumption is 3.09%.

### US Treasury Inflation Protected Securities (TIPS)

*Modeled: US TIPS*  
*Compound Return: 1.94%*  
*Arithmetic Average Return: 2.20%*  
*Risk: 6.75%*

Given that the first US TIPS issuance was in 1997, we are hesitant to rely on any “long-term” yield or spread averages to further model the asset class. Instead, we model a proxy for the Barclays US TIPS Index, which currently has a maturity of 8.5 years.

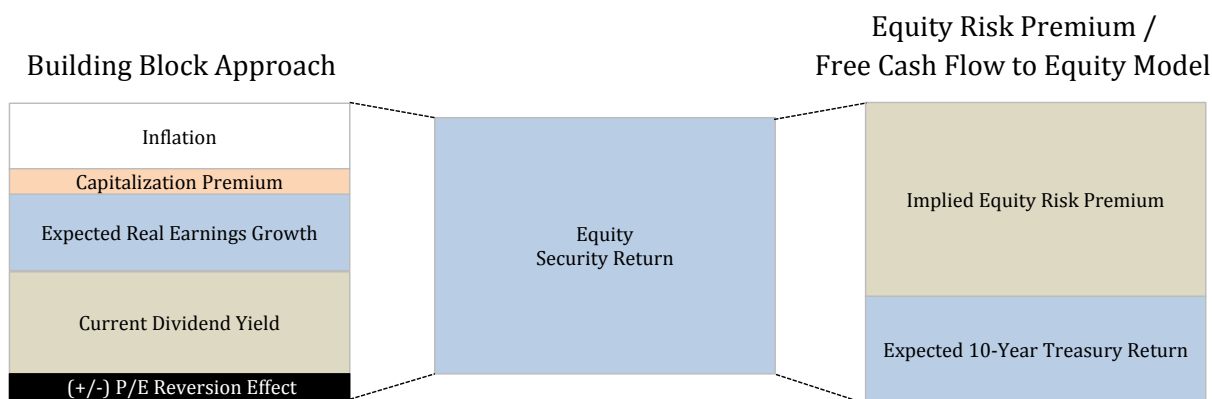
A portfolio of 30% 5-year Treasury Bonds, and 70% 10-year Treasury bonds results in a hypothetical Treasury bond with 8.5-year maturity. Assuming our inflation expectation of 1.54% per year for the prospective 10-year period, the expected TIPS return is simply a weighted average of our return expectations for the nominal 10-year and 5-year Treasury bonds.

Applying these weights to our return projections for those bonds results in a 10-year TIPS return assumption of 1.94%:

$$(30\% \times 1.97\%) + (70\% \times 1.92\%) = \mathbf{1.94\%}.$$

## EQUITY

To derive our equity return assumptions, we evaluate two methodologies: (i) a building-block approach using the so-called Shiller price-to-earnings (P/E) measure and (ii) an equity risk premium estimate that averages the current implied equity risk premium based on a free cash flow to equity model and the historical average equity risk premium.



Where our building blocks call for a P/E measure, we assume that this current valuation metric will revert halfway to its long-term mean over the prospective ten-year period. Our approach employs “Shiller earnings,” which represent a ten-year average, adjusted for inflation. We believe that this approach appropriately smoothes the impact of year-to-year earnings volatility, and research shows that of all the varied ways to calculate a P/E ratio, the Shiller P/E measure has historically shown the highest predictive power over future 10-year returns.<sup>3</sup>

Our building block approach is consistent across equity categories:

- Assumed (Expected) US Inflation
- + Current Dividend Yield
- + Expected Real Earnings Growth
- + Reversion effect of P/E (halfway to long-term mean, over 10 years)
- + Capitalization Premium (if applicable)

These inputs are available with reliable and robust data for the US large-cap stock market, but not for US small/mid-cap equities or for global equities. For this reason, we have chosen to anchor our US small/mid-cap and global equity assumptions to our US large-cap equity assumption in several ways.

<sup>3</sup> Vanguard. Forecasting stock returns: What signals matter, and what do they say now?  
<https://personal.vanguard.com/pdf/s338.pdf>

## US Large-Cap Equity

*Modeled: US Mid- and Large-Capitalization Equities*

*Compound Return: 5.21%*

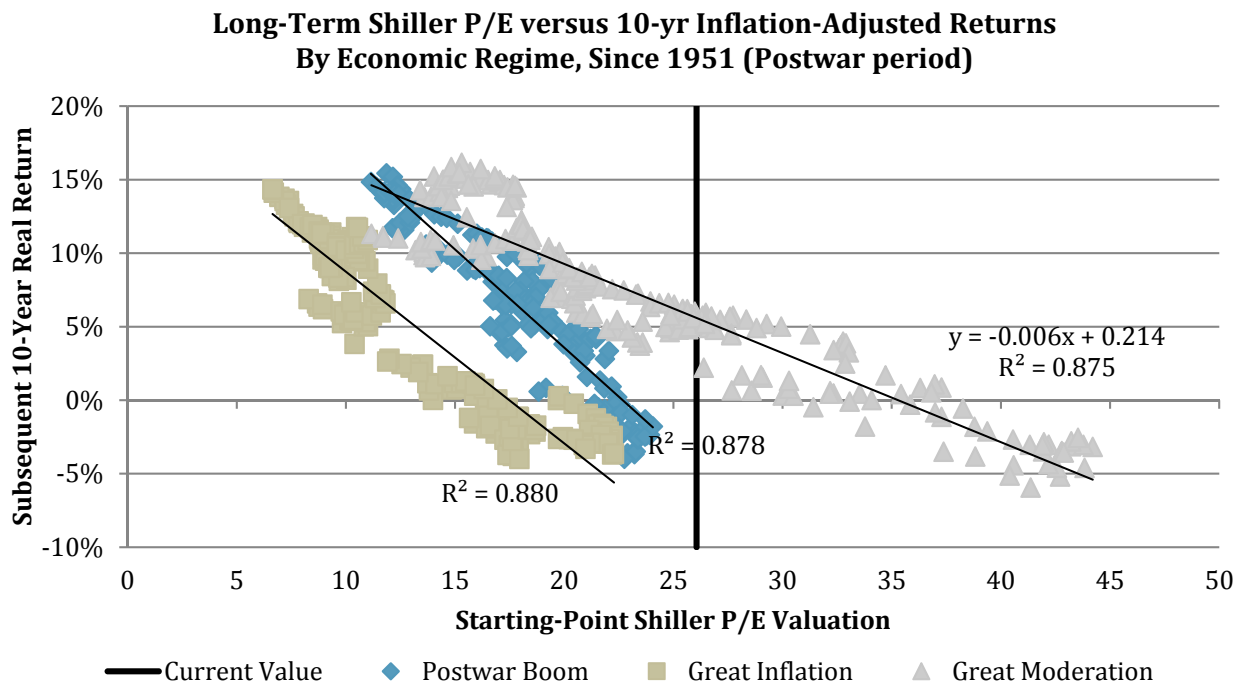
*Arithmetic Average Return: 6.90%*

*Risk: 19.25%*

Our return assumptions for US large-cap equity are the average of two separate approaches: a valuation-based building-block approach, and a modified Damadoran free cash flow to equity model.

### *Building Block Approach*

We find the Shiller P/E metric to be the most useful of various valuation metrics from the perspective of utility in forecasting returns. The following chart depicts the Shiller P/E metric for the US market, since 1951 (the post-WWII period). The Shiller P/E at a given point in time is depicted on the horizontal axis, and the subsequent 10-year inflation-adjusted return is depicted on the vertical axis. We have decomposed the data array into three economic regimes – the post-war boom (in blue; 1951-1965); the great inflationary period (in tan; 1966-1984); and the great moderation (in grey; 1985-2015). Examining the data this way yields useful insights and, importantly, high predictive power for the Shiller P/E metric over subsequent real return. The S&P 500's current position on the chart is indicated by the bold vertical line.



For the valuation-based building block approach, we create our building blocks from the S&P 500 Index:

- 1.54% Inflation
- 2.11% Current Dividend Yield
- 1.74% Long-Term Compound Average Real Earnings Growth (Since 1871)

We measure expected P/E reversion halfway to long-term mean:

	<u>Shiller P/E</u>	
Current	26.06	
Long-Term Average	16.65	
Annual Reversion Effect	-2.19%	(halfway to long-term average)

The building blocks approach results in an expected compound return for US Large-Cap Equity of 3.20%. This approach represents half of our calculation for Large-Cap US Equity.

*Equity Risk Premium / Discounted Free Cash Flow Model*

For the implied equity risk premium, we reference and modify a discounted free cash flow model created by Professor Aswath Damodaran of the Stern School of Business<sup>4</sup> that uses a free cash flow to equity approach to account for dividends as well as stock buybacks.

Our modified free-cash-flow-to-equity model employs several input variables:

Beginning (current) S&P 500 level =	2043.94
Base year free cash flow to equity, S&P 500 =	\$106.09 <sup>5</sup>
Expected S&P 500 earnings growth over next 5 years =	4.80% <sup>6</sup>
Expected S&P 500 earnings growth for years 5-10 =	1.92% <sup>7</sup>

We apply a standard discounted cash flow methodology to these variables and solve for the rate of growth that makes the discounted forecasted value of the S&P 500 identical to today's value.

$$2043.94 = \frac{106.09(1.0480)^1}{(1+r)^1} + \frac{106.09(1.0480)^2}{(1+r)^2} + \frac{106.09(1.0480)^3}{(1+r)^3} + \frac{106.09(1.0480)^4}{(1+r)^4} + \frac{106.09(1.0480)^5}{(1+r)^5} + \frac{106.09(1.0480)^5(1.0192)}{(r-0.0192)(1+r)^5}$$

Solving for  $r$  yields the expected nominal return for the S&P 500 over the next 10 years, under these assumptions. That rate of return is 7.92%. Subtracting our assumed 10-Year Treasury return of 1.92% results in an expected equity risk premium of 6.00%.

This implied equity risk premium is higher than what history has delivered. To correct for this, we average the current implied forward-looking equity risk premium (6.00%) and the long-term historical geometric average realized equity risk premium (4.60%) to derive an equity risk

<sup>4</sup> <http://pages.stern.nyu.edu/~adamodar/>

<sup>5</sup> 2015 S&P 500 Dividends = \$42.66 + buybacks = \$63.43.

<sup>6</sup> I/B/E/S analyst consensus earnings growth over the next year is 5.55%. Historically, the I/B/E/S consensus analyst forecast has overstated subsequent actual earnings growth by 15.6%. We reduce our assumption for earnings growth by 13.5% (1-(1/1.155)) accordingly.

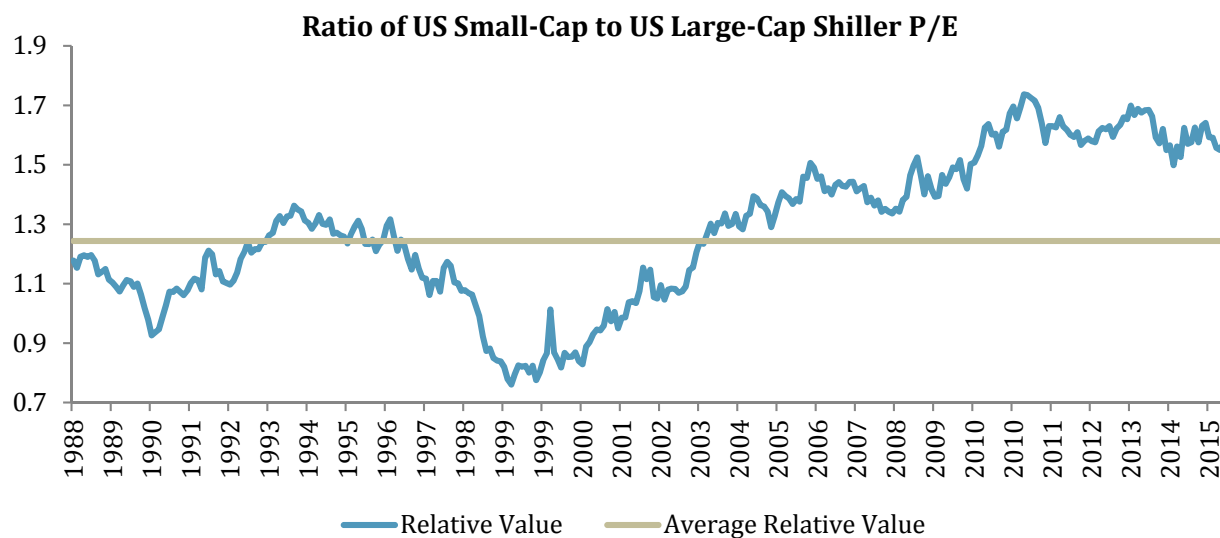
<sup>7</sup> Our forecasted return for the 10-year Treasury Bond, as a proxy for the ten-year risk-free rate.

premium estimate of 5.30% for US Large-Cap Equity. Substituting this assumed equity risk premium into the model results in a return estimate of 7.22%.

Averaging the expected returns generated by the building-blocks approach and the discounted free cash flow model yields an expected compound return of 5.21%.

<b>US Small/Mid-Cap Equity</b>	
<i>Modeled: US Small- and Mid-Capitalization Equities</i>	
<i>Compound Return: 5.34%</i>	
<i>Arithmetic Average Return: 7.20%</i>	
<i>Risk: 20.25%</i>	

To our US Large-Cap Equity assumption, we add a small/mid-cap compound return premium. Historically, small-cap securities have experienced a return premium of 0.25% annualized. US small-cap stocks have also historically traded at a higher average valuation than US large-cap stocks – in a ratio of approximately 1.2:1, as indicated by the horizontal line in the following chart. The current valuation premium, as indicated by the blue line, is higher at approximately 1.5.



While we are disinclined to read too much into this valuation metric, given its limited history (since 1979), we do use this valuation insight to reduce our expectation for small-cap return premium by half. As such, we add 0.125% to our large-cap equity assumption to yield a compound return assumption for US small/mid-cap equity securities of 5.34%.

<b>US Equity</b>	
<i>Modeled: US Equities, All Capitalizations</i>	
<i>Compound Return: 5.24%</i>	
<i>Arithmetic Average Return: 6.90%</i>	
<i>Risk: 19.00%</i>	

Our return assumption for US Equity is intended to model the entire US equity market. It assumes the current weighting of large- and small/mid-capitalization equities in the US equity market – 81%

large, and 19% small/mid<sup>8</sup>. These weights are applied to the underlying US Large-Cap and US Small/Mid-Cap Equity assumptions to yield 5.24% in compound terms:

$$(81\% \times 5.21\%) + (19\% \times 5.34\%) = 5.24\%.$$

### Non-US Large-Cap Equity

*Modeled: Non-US Large-Capitalization Equities, Developed and Emerging*  
*Compound Return: 6.25%*  
*Arithmetic Average Return: 8.70%*  
*Risk: 23.50%*

We build separate assumptions for developed and emerging non-US markets, and then weigh them according to current market weights to construct our Non-US Large-Cap Equity assumption, which is intended to model equities of both developed and emerging markets. Because of data limitations, we have relied less on actual historical experience for international markets than we have on qualitative adjustments to more robust US market data.

For developed markets, our assumed building blocks are as follows:

- 1.54% Inflation
- 3.17% Current Dividend Yield
- 1.35% Compound Average Real Earnings Growth (Since 1988)

We measure expected P/E reversion halfway to long-term mean:

	<u>Shiller P/E</u>
Current	14.10
Long-Term Average	13.70 <sup>9</sup>
Annual Reversion Effect	-0.12% (halfway to long-term average)

This approach yields an expected compound return for developed-markets non-US large-capitalization equities of 5.94%.

Our emerging markets equity approach is detailed below. Its compound return assumption is 7.40%.

Developed markets currently comprise 79%, and emerging markets 21%, of the non-US total equity market capitalization. Applying those weights to our developed and emerging markets assumptions yields a non-US large-capitalization compound return assumption of 6.25%.

<sup>8</sup> Russell, [http://www.russell.com/indexes/documents/US\\_Indexes\\_comparison.pdf](http://www.russell.com/indexes/documents/US_Indexes_comparison.pdf).

<sup>9</sup> Over the longest common period for which we have both US (S&P 500) and Developed Non-US (MSCI EAFE) earnings series (since 1995), EAFE has traded at an average valuation level approximately 82.6% of the level of the S&P 500. We apply this fraction to our assumption for the long-term P/E of US large-capitalization stocks to arrive at our assumed long-term average valuation level to which we expect non-US large-capitalization stocks to revert.

## Non-US Small-Cap Equity

*Modeled: Non-US Small-Capitalization Equities, Developed and Emerging  
Compound Return: 6.50%  
Arithmetic Average Return: 9.80%  
Risk: 27.75%*

To our Non-US Large-Cap Equity assumption, we add a compound return premium building block of 0.25%, the same undiscounted historical premium we used for US small-cap equities. This yields a compound return assumption of 6.50%. Given very limited data for non-US small-capitalization equities, we are not inclined to make a valuation adjustment based on reversion to an average.

## Emerging Markets Equity

*Modeled: Emerging Markets Equity  
Compound Return: 7.40%  
Arithmetic Average Return: 11.20%  
Risk: 29.75%*

Our assumed building blocks are as follows:

1.54% Inflation  
2.81% Current Dividend Yield  
1.32% Real Earnings Growth<sup>10</sup>

We measure expected P/E reversion halfway to long-term mean:

	Shiller P/E	
Current	10.50	
Long-Term Average	14.70 <sup>11</sup>	
Annual reversion effect	1.74%	(halfway to long-term average)

Adding this P/E reversion measure to the other building blocks yields an expected compound return of 7.40%.

<sup>10</sup> Over the longest common period for which we have data on developed (MSCI EAFE) and emerging (MSCI EM) markets earnings (1995), the emerging markets have averaged 98% of the earnings growth rate of developed markets. We apply this proportion to our assumed long-term earnings growth rate for developed markets to yield an assumed emerging markets earnings growth rate of 1.32%.

<sup>11</sup> Since 1995, the longest data series available for non-US market earnings, the average Shiller P/E ratio for emerging markets has been 19.8. We note that the period since 1995 has globally been a period of higher valuations than have historically been experienced. For this reason, we do not assume that emerging markets earnings will revert to the relatively high level— instead, we assume that emerging markets will command an average P/E ratio 1.00 higher than developed non-US markets will.



## Non-US Equity

*Modeled: Non-US Equities, All Regions & Capitalizations*

*Compound Return: 6.30%*

*Arithmetic Average Return: 8.80%*

*Risk: 24.00%*

Our return assumption for Non-US Equity is intended to model the entire Non-US equity market. It assumes the current weighting of large-cap and small-cap markets equities in the international equity market – 80% large-cap and 20% small-cap. These weights are applied to the underlying Non-US Large-Cap Equity and Non-US Small-Cap Equity assumptions. This weighting yields a compound return assumption of 6.30%:

$$(80\% \times 6.25\%) + (20\% \times 6.50\%) = \mathbf{6.30\%}.$$

## ALTERNATIVES

Alternative assets share a common element of not easily being modeled with public-market index proxies. As well, we are more reluctant to rely on their long-term history, given growth in assets allocated to such strategies over the last several decades and the dynamic nature of strategies employed.

### Real Estate

*Modeled: Public (US Equity REITs) and Open-Ended Private Core Real Estate*

*Compound Return: 4.71%*

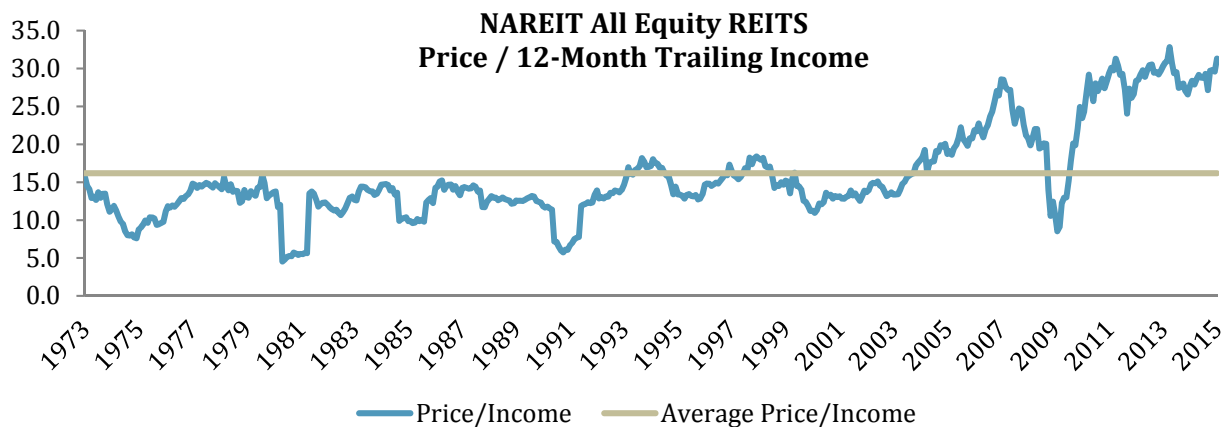
*Arithmetic Average Return: 6.30%*

*Risk: 18.75%*

Our expected return reflects going-in cap rates for public equity and core private real estate.

For public equity REITs, we calculate the current cap rate, defined as income divided by price, of the FTSE NAREIT All Equity REITS Index: 3.72%.

The following chart depicts the inverse of the cap rate for the equity REIT benchmark: its historical price-to-income ratio. The present low cap rate is explained by high valuations relative to the index's own history.



Our cap rate assumption for core private real estate is based on the Urban Land Institute consensus estimate of the NCREIF capitalization rate as of December 31, 2015: 5.7% in compound terms.<sup>12</sup> This cap rate reflects current income return on an unlevered basis and excludes capital appreciation.

Averaging these two cap rates yields a return assumption of 4.71%.

<sup>12</sup> Urban Land Institute. <http://uli.org/research/centers-initiatives/center-for-capital-markets/barometers-forecast-and-data/uli-real-estate-consensus-forecast/>

We note that the primary driver of return for core real estate over the long term has been income, not appreciation. For equity REITS, in real terms since 1973, historical price appreciation has averaged 0.23% per year, and income has averaged 3.30% per year.

### Diversified Inflation-Related

*Modeled: Diversified portfolio containing 1/3 each: Real Estate, Commodities, and US TIPS*  
*Compound Return: 3.46%*  
*Arithmetic Average Return: 4.40%*  
*Risk: 14.25%*

We assume a diversified portfolio containing 1/3 each in US TIPS, Real Estate, and Commodities.

The US TIPS component is simply our expected return for US TIPS, as outlined above: 1.94%, in compound terms.

The Real Estate component is our Real Estate Assumption: 4.71% in compound terms.

For the Commodities component, we build a model assuming that commodity return can be decomposed into three sources: collateral reinvestment yield, commodity spot return, and roll yield.

We assume 0% for roll yield, knowing that it has been positive and negative over various historical periods, as the buying and selling balance between commodity investors and commodity consumers has shifted. Over the last decade, roll yield has been negative.

For spot return, we calculate a series of the last 10 years of real prices for the Bloomberg Commodity Index and assume that the current real price of the index will revert halfway to its 10-year average, in even increments over the next 10 years. The current real spot price for the Bloomberg Commodity Index is 81.2, and its 10-year average real price is 157.9. Reverting halfway to this average real price implies a compound real spot return of 3.44% per year.

In summary, for the Commodities component:

Collateral:	0.30% (our assumed nominal return for Cash Equivalents)
Spot return:	3.44%
<u>Roll yield:</u>	<u>0.00%</u>
Commodity return:	<b>3.74%</b>

For the Diversified Inflation-Related assumption, we assume a compound return of:

$$1/3 (1.94\%) + 1/3 (4.71\%) + 1/3 (3.74\%) = \mathbf{3.46\%}$$

## Marketable Alternatives

*Modeled: Hedge Funds of Funds, Global GTAA, Daily-Valued Alternative Strategies*

*Compound Return: 4.94%*

*Arithmetic Average Return: 5.60%*

*Risk: 12.25%*

We assume a diversified portfolio that will tend to approximate the following market exposures over time:

- 30% US Equity
- 30% Non-US Equity
- 20% Core Fixed Income
- 20% Non-Core Fixed Income

Weighting those assumptions accordingly results in a compound return assumption of 4.94%.

This approach does not explicitly reflect the use of leverage in marketable alternatives strategies. Alternatives vehicles that employ leverage can earn higher returns, but due to the mechanics of performance-based fee schedules, also subtract higher fees from those returns. Given that our assumption set is intended to be passive in nature and not reflect active management, for hedge funds, we are assuming an industry average hedge fund of funds.

## Non-Marketable Alternatives

*Modeled: Venture Capital, Private Equity, Distressed Credit, in Lockup Vehicles*

*Compound Return: 8.10%*

*Arithmetic Average Return: 12.30%*

*Risk: 31.50%*

We assume a diversified portfolio that will tend to approximate the following market exposures over time, plus a premium for illiquidity:

- 50% US Equity
- 50% Non-Core Fixed Income
- + 3.00% illiquidity/leverage premium

Weighting those assumptions accordingly results in a compound return assumption of 8.10%.

Given that our assumption set is intended to be passive in nature and not reflect active management, we are assuming an industry-average active manager or collection of active managers.

## RISK

Our risk assumptions are mostly derived from history, but we have enhanced historical metrics with qualitative overlays in several asset categories.

For each asset category, we began by examining the following historical annual returns:

Inflation	US CPI
Cash Equivalents	91-Day T-Bills
Low-Duration Fixed Income	Barclays 1-3 Year Government/Credit
Core Fixed Income	Barclays US Aggregate
Non-Core Fixed Income	50% ML High Yield Master II, 50% JP Morgan EMBI back to 1994; 100% ML High Yield Master II before 1994
Long-Duration Fixed Income	Barclays Long Government/Credit
TIPS	Barclays US TIPS
US Equity	Russell 3000 back to 1979; S&P 500 before 1979
US Large-Cap Equity	Russell 1000 back to 1979; S&P 500 before 1979
US Small-Cap Equity	Russell 2000
Non-US Equity	MSCI ACWI ex US IMI back to 1994; MSCI EAFE before 1994
Non-US Large-Cap Equity	MSCI ACWI ex US back to 2001; MSCI EAFE before 2001
Non-US Small-Cap Equity	MSCI ACWI ex US Small Cap
Emerging Markets Equity	MSCI Emerging Markets
Real Estate	FTSE NAREIT, NCREIF Property, and NCREIF ODCE (separately)
Diversified Inflation-Related Marketable Alternatives	1/3 each: FTSE NAREIT, Barclays US TIPS, Bloomberg Commodity HFRI Fund of Funds; and 30% our US Equity series, 30% our Non-US Equity series, 20% our Core Fixed Income series, and 20% our Non- Core Fixed Income series (separately)
Non-Marketable Alternatives	Average of 2x our US Equity series and 2x our Non-Core Fixed Income series

In each case, we calculated the longest-term standard deviation of returns possible for the category. Then, we calculated the standard deviation of annual returns over the last ten years. The average of these two figures represents our base-case risk assumption.

Next, we examined the worst annual return for each proxy index, going back as far as possible into history. We assumed this return as the worst-case scenario. In some cases, the normal return distribution implied by our return and risk assumptions suggested that the worst-case scenario had less than a 2% probability (1 in 50 years) of occurring. In those cases, we adjusted our risk assumption upward until the worst-case scenario had at least a 2% probability of occurring under our assumed normal return distribution. To perform this probability analysis for private real estate, we examined rolling two-year periods to account for the fact that declines, as measured by appraisals and illiquidity, occur more slowly than in public markets.

Finally, based on this analysis and our qualitative assessment of the quality and longevity of our return data, we made several qualitative adjustments, where noted.

The results of this risk analysis follow.

The following table depicts actual standard deviations of annual return, measured in the long term (as far back as history will allow), for the last ten years, and the average of those two figures.

Adding or subtracting our qualitative adjustment results in the Risk Assumption at the far right.

	<u>Standard Deviation of Returns</u>			Qualitative Adjustment	Risk Assumption
	Long Term	10 Years	Average		(Rounded)
Inflation	4.94%	1.21%	3.08%		3.00%
Cash Equivalents	3.26%	1.93%	2.59%	-1.00%	1.50%
Low-Duration Fixed Income	4.57%	2.14%	3.36%		3.25%
Core Fixed Income	6.89%	3.06%	4.98%		5.00%
Core-Plus Fixed Income	5.41%	4.43%	4.92%	1.00%	6.00%
Non-Core Fixed Income	12.98%	15.65%	14.31%		14.25%
Long-Duration Fixed Income	11.16%	9.47%	10.32%		10.25%
TIPS	6.30%	7.15%	6.72%		6.75%
US Equity	17.42%	19.57%	18.50%	0.50%	19.00%
US Large-Cap Equity	17.47%	19.51%	18.49%	0.75%	19.25%
US Small/Mid-Cap Equity	18.44%	21.82%	20.13%		20.25%
Non-US Equity	22.98%	24.77%	23.88%		24.00%
Non-US Large-Cap Equity	22.50%	24.40%	23.45%		23.50%
Non-US Small-Cap Equity	26.11%	30.23%	28.17%	-0.50%	27.75%
Emerging Markets Equity	34.73%	36.42%	35.58%	-5.75%	29.75%
Real Estate	19.08%	22.92%	21.00%	-2.25%	18.75%
Diversified Inflation-Related	12.74%	15.12%	13.93%	0.25%	14.25%
Marketable Alternatives	10.05%	10.02%	10.04%	2.11%	12.25%
Non-Marketable Alternatives	30.40%	32.55%	31.48%		31.50%

The following table examines the probability of the actual experienced worst case occurring under our assumed normal distribution of returns, as implied by our expected return and standard deviation of returns, after accounting for qualitative adjustments to risk.

We measure the actual worst-case scenario in “sigmas,” or standard deviations from our assumed mean return. Measuring this way, we ask, “How likely was the actual experienced worst case, according to the distribution parameters we have assumed?” We have qualitatively adjusted several asset classes to ensure that the probability of the actually experienced worst case is always greater than 2%, meaning we assume that the experienced worst case has at least a one-in-fifty-year chance of happening under our assumptions.

	Worst Year	Actual Worst Case, in Sigmas from Assumption	Implied Probability of Actual Worst Case Occurring
Cash Equivalents	0.02% (2011)	0.18	85.7%
Low-Duration Fixed Income	0.55% (1994)	0.27	78.9%
Core Fixed Income	-2.92% (1994)	1.10	27.0%
Core-Plus FI	-4.26% (1994)	1.25	21.2%
Non-Core Fixed Income	-18.86% (2008)	1.73	8.3%
Long-Duration Fixed Income	-8.83% (2013)	1.20	22.9%
TIPS	-8.61% (2013)	1.60	10.9%
US Equity	-37.31% (2008)	2.33	2.0%
US Large-Cap Equity	-37.60% (2008)	2.31	2.1%
US Small/Mid-Cap Equity	-36.79% (2008)	2.18	2.9%
Non-US Equity	-45.99% (2008)	2.30	2.2%
Non-US Large-Cap Equity	-45.24% (2008)	2.30	2.1%
Non-US Small-Cap Equity	-50.01% (2008)	2.16	3.1%
Emerging Markets Equity	-53.33% (2008)	2.16	3.1%
Real Estate	-37.34% (1974)	2.33	2.0%
Diversified Inflation-Related	-28.61% (2008)	2.33	2.0%
Marketable Alternatives	-21.37% (2008)	2.22	2.6%
Non-Marketable Alternatives	-56.17% (2008)	2.17	3.0%
Alternate benchmarks for Real Estate and Non-Marketable Alternatives:			
NCREIF Property (2 Years)	-22.23% (2008-9)	1.52	12.8%
NCREIF ODCE (2 Years)	-36.79% (2008-9)	2.30	2.1%
Marketable Alternatives (build-up)	-27.71% (2008)	2.75	0.6%

Our qualitative adjustments to Risk were as follows:

#### Cash Equivalents (-1.00%)

While the long-term standard deviation of returns to cash has been greater than 3%, that volatility was experienced at higher levels of cash return. We believe it is unlikely for the distribution of returns to cash equivalents to be as wide as historically evident, given its current low level of return. We qualitatively adjust the risk to cash equivalents downward by 100 basis points.

#### Core-Plus Fixed Income (+1.00%)

While because of diversification effects long-term volatility for our modeled Core-Plus series has been lower than that for Core Fixed Income, recent (last 10 years) volatility has been approximately 50% higher. Our modest adjustment acknowledges that the riskier elements inherent in plus sectors provide a wider distribution of returns, regardless of their measured year-over-year volatility.

#### US Equity, US Large-Cap Equity (+0.50%, +0.75%)

These categories were adjusted upward to make their actual worst-case experience greater than a 2% probability of occurring under the assumed distribution.

#### Non-US Small-Cap Equity, Emerging Markets Equity (-0.50%, -5.75%)

Given the limited history for a public-market proxy for each asset class, we are reluctant to rely too heavily on historically measured volatility. As such, we adjusted the risk downward such that each asset class's actual worst case (2008) represents an approximately 3% probability of occurrence under the assumed distribution.

#### Real Estate (-2.25%)

This downward adjustment acknowledges that the public market proxy we have chosen to represent Core Real Estate includes some riskier non-core elements. We have adjusted the assumption such that the 1974 experience for public REITs, and the combined 2008/2009 experience for core open-ended private real estate funds, each represent an approximate 2% probability of occurrence under our assumed distribution.

#### Diversified Inflation-Related (+0.25%)

We adjusted the assumed risk upward to make the category's actual worst-case experience greater than a 2% probability of occurring under the assumed distribution.

#### Marketable Alternatives (+2.11%)

This adjustment averages our two approaches for modeling the history for this asset category. The upward adjustment makes the risk assumption halfway between the historically measured volatility of each approach.



## CORRELATION COEFFICIENTS

Our forward-looking correlation assumptions are mostly derived from long-term history but emphasize the recent past. Our process first identifies a reasonable proxy for each asset category, typically an index that represents the asset class. For several asset classes, we have used our judgment to construct a proxy return stream for the asset class that either has a longer history for evaluation, or to construct a marketable proxy for a non-marketable asset.

Our correlation assumptions are based on these return streams:

Inflation	US CPI
Cash Equivalents	91-Day T-Bills
Low-Duration Fixed Income	Barclays 1-3 Year Government/Credit
Core Fixed Income	Barclays US Aggregate
Non-Core Fixed Income	50% ML High Yield Master II, 50% JP Morgan EMBI back to 1994; 100% ML High Yield Master II before 1994
Long-Duration Fixed Income	Barclays Long Government/Credit
TIPS	Barclays US TIPS
US Equity	Russell 3000 back to 1979; S&P 500 before 1979
US Large-Cap Equity	Russell 1000 back to 1979; S&P 500 before 1979
US Small-Cap Equity	Russell 2000
Non-US Equity	MSCI ACWI ex US IMI back to 1994; MSCI EAFE before 1994
Non-US Large-Cap Equity	MSCI ACWI ex US back to 2001; MSCI EAFE before 2001
Non-US Small-Cap Equity	MSCI ACWI ex US Small Cap
Emerging Markets Equity	MSCI Emerging Markets
Real Estate	FTSE NAREIT, NCREIF, and NCREIF ODCE
Marketable Alternatives	HFRI Fund of Funds
Diversified Inflation-Related	1/3 each: FTSE NAREIT, Barclays US TIPS, Bloomberg Commodity
Non-Marketable Alternatives	Average of 2x the Non-Core Fixed Income series and 2x the US Equity series

Using those streams, we constructed a correlation matrix that takes the simple average of four other correlation matrices – constructed with 3 years, 5 years, and 10 years of data, and one with as much data as possible going back to each series' inception. Averaging these four measures gives acknowledgement to the long-term history while emphasizing the recent past, when correlations have been higher than long-term history has delivered. This approach is therefore conservative in the diversification benefit that will appear from correlation in our modeling.

We qualitatively adjusted only the real estate correlation coefficients. Our assumed coefficients for real estate average the calculated coefficients for public REITs and private real estate.

Finally, we ran our calculated correlation coefficients through the Ibbotson statistical correlation matrix tester, which made slight adjustments to ensure that the matrix is positive semi-definite.

Our assumed return correlation matrix follows:

**Sellwood Consulting 2016 Correlation Coefficient Assumptions**

Inflation	1.00	0.03	-0.06	-0.19	-0.09	0.11	-0.26	0.01	0.08	0.08	0.11	0.10	0.09	0.13	0.09	-0.03	0.13	0.14	0.09
Cash Equivalents	0.03	1.00	0.21	0.00	-0.06	-0.14	-0.06	-0.02	-0.17	-0.17	-0.16	-0.10	-0.10	-0.07	-0.03	-0.06	0.02	-0.11	-0.17
Low-Duration Fixed Income	-0.06	0.21	1.00	0.76	0.70	0.33	0.54	0.64	0.00	0.00	0.00	0.13	0.14	0.12	0.16	0.28	0.38	0.06	0.12
Core Fixed Income	-0.19	0.00	0.76	1.00	0.91	0.41	0.93	0.80	-0.04	-0.04	-0.05	0.07	0.07	0.07	0.10	0.39	0.39	0.01	0.13
Core-Plus Fixed Income	-0.09	-0.06	0.70	0.91	1.00	0.74	0.83	0.83	0.27	0.28	0.25	0.40	0.40	0.39	0.42	0.55	0.63	0.27	0.47
Non-Core Fixed Income	0.11	-0.14	0.33	0.41	0.74	1.00	0.33	0.54	0.68	0.69	0.65	0.79	0.79	0.76	0.78	0.50	0.76	0.60	0.83
Long-Duration Fixed Income	-0.26	-0.06	0.54	0.93	0.83	0.33	1.00	0.72	-0.10	-0.09	-0.11	0.00	0.00	-0.01	0.03	0.34	0.30	-0.05	0.06
TIPS	0.01	-0.02	0.64	0.80	0.83	0.54	0.72	1.00	0.08	0.09	0.08	0.26	0.25	0.27	0.30	0.41	0.57	0.15	0.26
US Equity	0.08	-0.17	0.00	-0.04	0.27	0.68	-0.10	0.08	1.00	1.00	0.93	0.85	0.86	0.80	0.73	0.44	0.60	0.74	0.93
US Large-Cap Equity	0.08	-0.17	0.00	-0.04	0.28	0.69	-0.09	0.09	1.00	1.00	0.92	0.86	0.86	0.79	0.73	0.43	0.60	0.74	0.93
US SMID-Cap Equity	0.11	-0.16	0.00	-0.05	0.25	0.65	-0.11	0.08	0.93	0.92	1.00	0.79	0.79	0.77	0.69	0.44	0.61	0.74	0.88
Non-US Equity	0.10	-0.10	0.13	0.07	0.40	0.79	0.00	0.26	0.85	0.86	0.79	1.00	1.00	0.96	0.90	0.40	0.70	0.77	0.88
Non-US Large-Cap Equity	0.09	-0.10	0.14	0.07	0.40	0.79	0.00	0.25	0.86	0.86	0.79	1.00	1.00	0.95	0.90	0.41	0.70	0.76	0.88
Non-US Small-Cap Equity	0.13	-0.07	0.12	0.07	0.39	0.76	-0.01	0.27	0.80	0.79	0.77	0.96	0.95	1.00	0.88	0.37	0.69	0.78	0.83
Emerging Markets Equity	0.09	-0.03	0.16	0.10	0.42	0.78	0.03	0.30	0.73	0.73	0.69	0.90	0.90	0.88	1.00	0.36	0.68	0.67	0.79
Real Estate	-0.03	-0.06	0.28	0.39	0.55	0.50	0.34	0.41	0.44	0.43	0.44	0.40	0.41	0.37	0.36	1.00	0.78	0.38	0.63
Diversified Inflation-Related	0.13	0.02	0.38	0.39	0.63	0.76	0.30	0.57	0.60	0.60	0.61	0.70	0.70	0.69	0.68	0.78	1.00	0.49	0.72
Marketable Alternatives	0.14	-0.11	0.06	0.01	0.27	0.60	-0.05	0.15	0.74	0.74	0.74	0.77	0.76	0.78	0.67	0.38	0.49	1.00	0.74
Non-Marketable Alternatives	0.09	-0.17	0.12	0.13	0.47	0.83	0.06	0.26	0.93	0.93	0.88	0.88	0.88	0.83	0.79	0.63	0.72	0.74	1.00

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