

**Callan Associates Inc.  
Investment Measurement Service  
Quarterly Review**

**San Diego City Employees' Retirement System  
June 30, 2007**

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**PERFORMANCE SUMMARY**  
**PERIODS ENDED JUNE 30, 2007**

**General Market & Economic Conditions**

During the second quarter, the S&P 500 Index eclipsed the historical peak it set in March 2000. However, investor concerns over rising interest rates, a slowing housing market, the run-up of crude oil and the continuing subprime implosion resulted in a late-quarter slide that pushed the index down from its record high. As a counter-punch to the gloom of declining market sentiment, job growth was strong during the quarter and average hourly earnings were up from a year ago.

The broad U.S. equity markets, as represented by the Russell 3000 (+5.8%) benchmark, advanced for the fourth consecutive quarter. The largest capitalization stocks in the Russell Top 50 (+6.2%) outperformed the smaller cap Russell 2000 (+4.4%) and the Russell MidCap (+5.3%). The S&P 500 rose 6.3%. Based on the Russell style indices, growth-oriented stocks topped value-oriented stocks across all capitalization ranges for the first time in six quarters.

With crude oil again exceeding \$70 per barrel again, Energy (+13.2%) led all sectors for the quarter. Industrials (+10.1%) moved higher on broad-based results led by Capital Goods (+11.5%). Technology (+10.0%) also experienced also a strong quarter, aided by the buzz around Apple's (+31.4%) release of the iPhone. Financials (+1.1%) was a mixed bag for the quarter as both REITs (-8.7%) and Banks (-2.2%) began to feel the impact of higher interest rates. Falling consumer confidence may have hurt both Consumer Discretionary (+3.5%) and Consumer Staples (+2.9%), which posted mixed results for the quarter.

Non-US equity markets, as represented by the MSCI EAFE Index, climbed 6.4% in the second quarter. Global markets continued to benefit from strong economic growth, healthy M&A activity and solid corporate earnings. Continuing the trend from previous quarters, dollar-based returns were boosted by weakness in the U.S. dollar. For the second consecutive quarter, growth (+6.6%) beat value (+6.1%). However, small cap (+4.2%) significantly underperformed the larger cap EAFE Index — a rare occurrence during the past five years.

Regionally, the MSCI Europe Index led developed regions, advancing 8.3% in dollar terms. M&A activity continued to support prices, while June's monetary tightening caused increased volatility. Central banks across the region tightened further. The MSCI Pacific Basin Index (+2.2% in dollar terms) lagged the broader market, with a weakening yen detracting from performance. Japan, up +3.9% in local terms, was down -0.6% in U.S. dollar terms; Japan was the only developed country with a negative dollar-based return.

Surpassing all regions, the MSCI Emerging Markets Index rose an impressive 15.1% in the second quarter, as domestic economies, robust earnings and strong currencies outweighed inflationary pressures and rising interest rates. In a repeat of last quarter, Latin America (+19.8%) led the way, thanks to a strong Materials sector. Brazil (+23.9%) benefited from a soaring real and the continuing global commodity boom. China (+24.5%) and India (+20.8%) posted 11.1% and 9.1% annualized increases in GDP growth, respectively. Russia was flat (+0.3%) with fears of rising oil production costs offsetting strong steel demand.

The U.S. fixed income market had a tumultuous quarter marked by remerging interest rate volatility, a surge in economic optimism and inflation concerns. The U.S. investment grade bond market, as measured by the Lehman Aggregate, fell 0.5%. The 10-year U.S. Treasury experienced an increase in volatility in the quarter, with yields reaching a high of 5.30%, before ending the second quarter at 5.03%. The Fed remains hawkish amid tight labor markets and strong capacity utilization. Initially, Fed watchers expected interest rates to ease by year-end, but by mid-June that sentiment had changed to a rate hike, only to revert back to neutral by quarter-end.

The subprime mortgage market continues to dominate the headlines but it only modestly affected asset-backed securities, which advanced 0.1%, as measured by the Lehman ABS Index. Mortgage-backed securities had the toughest quarter among spread sectors, underperforming US Treasuries by 56 basis points. Housing woes, increased volatility and a lack of foreign interest in the market created unfavorable supply and demand dynamics. Commercial mortgage-backed securities (CMBS) also struggled in the second quarter, trailing US Treasuries by 44 basis points. Corporates ended the quarter slightly ahead of US Treasuries, facilitated by solid fundamentals, strong earnings, good economic data and robust equity markets. High yield, as represented by the Lehman Brothers High Yield Index, returned 0.2% for the quarter.

Beyond high yield, non-benchmark or “plus” sectors did not fare as well. Treasury inflation-protected securities (TIPS) declined 0.8% this quarter, based in part on an increase in real rates. Non-US and emerging markets debt declined as bond yields rose around the globe in response to a rebounding U.S. economy and continued strength in Europe. The Citi Non-U.S. World Government Bond Index fell 1.6% in local terms and 1.8% in U.S. dollar terms. The dollar-denominated emerging debt market, as measured by the JPMorgan EMBI Global Index, lost 1.4% during the quarter.

There was an inversion between the public and private real estate markets during the second quarter. The domestic REIT market, as measured by the FTSE NAREIT Equity Index, fell 9.0% during the three-month period and 5.9% year-to-date, which many cited as a much needed pricing correction. Specialty (+2.1%) was the only sector in the black and the weakest sectors were Self Storage (-17.3%) and Retail (-14.6%). Private capital continued to chase the “overpriced” public markets at unprecedented levels. Global real estate securities also experienced a downturn, albeit less rampant, due to differing dynamics in each region. The FTSE EPRA/NAREIT Global Real Estate Index declined 5.9% for the quarter.

Conversely, the private real estate landscape looked as solid as ever. The NCREIF Property Index advanced 4.6% and the NCREIF Open-End Diversified Core Equity Index rose a healthy 5.2%. All NCREIF property sectors exhibited positive returns. The best performing sectors were Office (+5.9%), Industrial (+5.1%) and Hotel (+5.0%). All NCREIF regions reported positive returns as well. The top regions were the East (+4.3%) and West (+5.6%). It remains to be seen whether the public real estate turmoil will spill over into the broader direct market, and whether pricing and supply swells will shake the fundamental balance.

### **Asset Allocation**

As of quarter end, the assets of the Fund were valued at \$4.916 billion. This represents an increase from the March 31 value of \$4.769 billion. While over \$41 million was withdrawn from the System during the quarter, the System experienced a net investment gain of over \$188 million due to the combination of income and realized and unrealized gains/losses. The Fund ended the quarter closely tracking its long-term strategic target of 38% Domestic Equity, 17% International Equity, 30% Domestic Bonds, 4% International Bonds, and 11% Real Estate.



## **Total Fund Performance**

SDCERS' second quarter return of +3.9% followed a modest first quarter return of +2.6% (excluding private real estate, whose valuations are lagged one quarter) and exceeds the Total Fund Benchmark's +3.7% return. For the fiscal year ending June 30, the System gained 16.2%, an excellent return on an absolute basis. On a relative basis, the System was essentially flat to its benchmark's return of 16.3% and ranks in the 69<sup>th</sup> percentile of the public fund universe. Contributions to this strong absolute trailing year came from many sources. In particular, both international equities (particularly small cap) and real estate have been strong contributors to performance over the year. Domestic equities, which returned a strong 18.9%, were the biggest detractors to relative performance over the trailing year.

Longer-term results for the System continue to be very strong relative to the benchmark, the public fund universe, and the long-term actuarial return target of 8.0%. The System ranks in the top decile of the public fund universe for the ten-year period ended 6/30/2007 while outperforming the benchmark. For the trailing ten years ended June 2007, the Fund returned +9.9% on an annualized basis, which ranks in the 2<sup>nd</sup> percentile of the public fund universe and exceeds the total fund benchmark by approximately 1.2% on an annualized basis. The System's volatility in returns over all of this period has been slightly less than the public fund median, the result of which has created excellent risk-adjusted returns as well.

## **Domestic Equity**

SDCERS' domestic equity portfolio improved on a relative basis in the second quarter. During the quarter ended June, the portfolio returned +6.8%, outperforming the benchmark return of +5.8% and ranking 8<sup>th</sup> percentile in the public fund universe. Second quarter relative outperformance came from TCW (both large and mid-cap), Delta, GlobeFlex, Wall Street and Putnam (small cap value). Continued weakness from INTECH's large cap core portfolio, which missed the benchmark by 2.2%, weighed on relative performance. For the year, a mid and small cap bias combined with underperformance from several managers contributed to the below median ranking relative to the public fund universe. For the trailing five years ended June 2007, in what has been a dynamic environment for the US stock markets, the domestic equity portfolio exceeded its benchmark by 1.9% per annum and ranks in the 4<sup>th</sup> percentile of the public fund universe. For the trailing ten-year period, the portfolio has compounded at +9.9% on an annualized basis.

## **International Equity**

International equity continues to be a strong contributor to the absolute and relative returns of the Fund. SDCERS' international equity portfolio advanced 7.7%, trailing the benchmark return of +7.9% but ranking in the 37<sup>th</sup> percentile in the public fund universe for the period. In their first full quarter of performance, McKinley posted a strong return of +8.9% compared to the MSCI ACW ex-US Index of 8.4%. The small cap managers were mixed with Nicholas Applegate returning +16.2% while GlobeFlex returned +5.5%. Subsequent to the end of the quarter, Nicholas Applegate announced that the international small cap team had been acquired by UBS. As a result of the departures, the assets were transitioned to GlobeFlex in July. For the trailing year, the international portfolio returned an impressive +32.3%, outperforming the benchmark and ranking in the 5<sup>th</sup> percentile of the public fund universe. Longer-term results for the international equity portfolio for periods measured are also quite favorable relative to the benchmark and peer universe. The portfolio ranks in the top decile of the public fund universe over the trailing five-year period. For the trailing ten-year period, the portfolio has compounded at an impressive +13.0%, outperforming its benchmark by 4.0% per annum and ranking in the top decile versus other public funds.



## **Domestic Fixed Income**

Bond yields rose during the quarter as investor consensus changed from anticipating a Fed easing to no change or a modest tightening. Increasing concerns over the troubles in the sub-prime mortgage area hit the market particularly hard in June. The overall domestic fixed income portfolio returned +0.7% for the period, ahead of the benchmark's +0.2% return and ranking in the 5<sup>th</sup> percentile of the public fund universe. The market neutral equity program was a significant positive contributor for the quarter with Pyramis and Salus up 3.1% and 2.1%, respectively. SSI continues to underperform relative to the benchmark and peers. For the quarter, the convertibles portfolio managed by Nicholas Applegate contributed as well with a return of +6.0%. The portfolio's return of +7.3% (compared to +6.1% for the Lehman Aggregate) over the trailing year is 0.4% greater than the benchmark and ranks in the 17<sup>th</sup> percentile of the public fund universe. Performance for the trailing three and five year periods has also met objectives. Additionally, the risk-adjusted performance for the portfolio remains very attractive. For the trailing ten year period ended June 2007, the portfolio has compounded annually at +6.5%, placing in the 21<sup>st</sup> percentile of the public plan universe while experiencing considerably less volatility in return than the benchmark and the median public plan.

## **International Fixed Income**

The international fixed income portfolio is managed by Rogge International. During the quarter global interest rates moved up while the dollar fell. Rogge's portfolio returned -1.1%, outperforming the Citigroup Non-US Government Bond Index return of -1.7%. This places the portfolio in the 26<sup>th</sup> percentile of the peer universe for the quarter. Results for the last year are ahead the benchmark, and SDCERS' longer-term results for Rogge since inception are favorable compared to the index and place the portfolio in the top quartile of the non-US fixed income peer group. Also worth noting, SDCERS' non-U.S. bond portfolio has generated a meaningful premium over U.S. bonds over the past five year period, mainly fueled by a weakening U.S. dollar as well as the strong contributions from the emerging market debt sector.

## **Real Estate**

Given data timing issues, the returns on the private real estate assets of SDCERS are lagged one quarter. Through March, the long-term returns on the overall real estate portfolio have been stellar. The overall real estate portfolio remains one of the best performing asset class for SDCERS for the trailing five years, returning +19.9% annualized over this period. This has been driven to a large extent by SDCERS' public real estate portfolio, which has returned +22.1% per annum for the five years ended June.

## **Comments on Watch List Managers**

- Delta Large Cap Core – Delta has been placed on the watchlist due to their three-year relative rank to peers. A significant reason for this poor relative ranking has been the higher capitalization of the Delta portfolio when compared to peers. Delta has consistently ranked in the top decile of the large cap core style group in terms of weighted median market capitalization for the past several years. As has been discussed with the Board previously, the majority of this period has been marked by meaningful outperformance from smaller stocks. Over the trailing year, large cap stocks have reversed the longer-term trend and have outperformed smaller stocks. In this environment, we have seen Delta's performance improve. For the trailing year, the portfolio has outperformed the S&P 500 by 1.0% and ranks in the 33<sup>rd</sup> percentile of the large cap core style group. It was important to see how the portfolio would respond to a change in size leadership within the market, and we are pleased to see the positive results.



- TCW Large Cap Growth – after a very poor 2006 and difficult first quarter of 2007, the TCW large cap growth portfolio rebounded with a stellar +9.6% return for the second quarter, ranking in the 1<sup>st</sup> percentile of the large cap growth style group. The calendar year to date number is now 1.0% ahead of the Russell 1000 Growth Index and the portfolio is performing close to the top quartile of the style group. The trailing one and three year returns still rank well into the bottom quartile. TCW's concentrated portfolio of 25-30 stocks and lower turnover approach tends to produce a volatile return pattern over time. Since their inception for SDCERS, the portfolio has added significant value over the Russell 1000 Growth Index and ranks in the top decile of the large growth style. We do not recommend any changes with this strategy at this time, but we will continue to monitor performance and the team closely.
- TCW Mid Cap Core Value – like the large cap growth portfolio, TCW's mid cap core value portfolio has also tended to exhibit a more volatile performance pattern over time. The portfolio has performed admirably year-to-date, returning +10.5% and ranking in the 46<sup>th</sup> percentile of the mid cap value style group. However, since inception returns fall short of the index and style median in what has been a remarkable period for returns within the asset class. We believe this relative underperformance is more the result of their investment style being out-of-favor than any particular issues at the firm. The co-portfolio managers for this portfolio, Nick Gallucio and Susan Suvall, have been working together since the mid 1980's and have consistently applied their investment process since that time. Long-term results for the strategy remain very strong. We continue to monitor the portfolio closely, but we remain very comfortable with the team and its process.
- Putnam Small Cap Value and Growth – like the two TCW portfolios, we have seen a turnaround in year-to-date performance for both Putnam small cap portfolios. As you will recall from recent summaries and discussions with the Investment Committee, we have highlighted some concerns with these strategies as well as our belief that improvements in performance in 2007 are important. We are pleased to see both portfolios post very strong results during the first six months of the year. Additionally, we continue to monitor the impact of Putnam's sale (formally completed on Aug 3) to Great West Lifeco Inc., a subsidiary of Canadian-based Power Financial Corporation. We expect the impact to be minimal in the short term as Putnam will continue to be based in Boston and will retain its brand, operations, investment/business professionals and offices.
- Met West Core Plus Bonds – Met West Asset Management (MWAM) was added to the watchlist earlier this year for five year relative underperformance. This underperformance is solely attributable to the second and third quarters of 2002. Since that point in time, Met West has been one of the strongest performing bond managers in the marketplace, significantly outperforming the Lehman Aggregate Index and ranking in the top decile of the core plus bond style group. We remain very comfortable with MWAM in this role for SDCERS and do not recommend any changes at this time.
- SSI Market Neutral Equity – SSI's performance woes have continued so far this year. The portfolio has underperformed its 90 Day T-Bills plus 3% benchmark considerably and ranks in the bottom quartile of the market neutral style group. As we have mentioned before, SSI's return since their inception also falls well short of the benchmark and ranks in the bottom quartile of the style group. The portfolio has trailed median in four of the five calendar year periods. Our position has been to monitor performance closely each quarter but too date, we have not seen the improvements we were hoping to see. At this point we would encourage SDCERS to strongly consider alternatives for this assignment.

### Summary and Conclusions

Unexpected strong returns from the equity markets through the first six months of 2007 have driven SDCERS to a fine +6.9% returns over this period as the System continues to add to its admirable long-term performance record. The annualized return on the overall portfolio for the trailing three, five, and



ten-year periods is well in excess of the long-term actuarial expected return target of 8.0%, the total fund benchmark, and the median public plan. Equally important, SDCERS risk over this period has been comparable to its long-term benchmark, the result being very strong risk-adjusted returns over longer-term periods measured.

For the past five years we have witnessed a tremendous rebound in the performance of the global equity markets as well as in other riskier investments such as private equity, real estate, and hedge funds. The appetite for risk from the investment arena has been robust. Given the length and magnitude of this cycle, we think it is a particularly opportune time for our clients to focus on risk management. We continue to advocate discipline, diversification, and focus on the long-term. In September, we will have the opportunity to review the results of our asset allocation and liability study with you. This is a very important exercise in which we take a very close look at the expected future obligations for SDCERS and frame the risks associated with capital market behavior in meeting these obligations. We look forward to taking you through the process and conclusions and we encourage all the Board members to actively engage in the process. The establishment of the long-term asset allocation policy is the Board's primary statement of your risk tolerance.

As always, we greatly appreciate our relationship with SDCERS. Please do not hesitate either of us if you have any questions. We look forward to seeing you at the August meeting to discuss these results in greater detail.

Best Regards,

James A. Callahan, CFA  
Executive Vice President

Janet Becker-Wold, CFA  
Senior Vice President

Dated August 6, 2007

