Callan Associates Inc.
Investment Measurement Service
Quarterly Review

San Diego City Employees' Retirement System
June 30, 2008

SDCERS
San Diego City Employees' Retirement System

PERFORMANCE SUMMARY
PERIODS ENDED JUNE 30, 2008

General Market & Economic Conditions

World financial markets remained volatile during the second quarter of 2008. Fears of rising inflation and slowing growth triggered memories of 1970s style stagflation and sent equity markets reeling in June. Commodity prices soared again, led by oil and corn, which both rose to all time highs by the close of the quarter. Fixed Income results were mixed. Investors recovered some of their appetite for risk thus supporting corporates and mortgages, but rising interest rates negatively impacted U.S. Treasuries and Agencies.

In a marked recovery after the end of the weak first quarter, equity markets rallied around the globe in April and May — some areas posted double digit gains and all major indices were in the black for the first two months of the quarter. However, that was short lived as June turned out to be one of the worst months in recent memory for many indices.

Domestically, mid cap stocks were the place to be during the quarter, with both benchmark indices managing to rise (S&P 400: +5.4%, Russell Midcap: +2.7%). Small caps were volatile, but managed to post gains as well (S&P 600: +0.4%, Russell 2000: +0.6%). Large cap issues (S&P 500: -2.7%, Russell 1000: -1.9%, Russell Top 200: -3.7%), particularly mega cap stocks (Russell Top 50 Index: -5.4%), fared the worst. From a style perspective, growth trumped value in all capitalization ranges except for the mega caps. The 6.6% spread advantage for growth is the largest since the early part of the decade (Russell 1000 Growth: +1.3%, Russell 1000 Value: -5.3%).

Within the GICS sector demarcation of the S&P 500, returns varied wildly during the second quarter. Not surprisingly, Financials (-19%) were hardest hit due to a string of balance sheet write downs propagated by mortgage defaults and credit concerns. The Industrials (-10%) and Consumer Discretionary (-8%) sectors sank as recession fears took their toll on companies leveraged to consumer and corporate spending. On the positive side, soaring commodity prices propelled the Energy sector (+18%) higher.

Overseas, both developed (MSCI EAFE US$: -2.3%) and emerging markets (MSCI EMF: -0.8%) followed a similar pattern as their domestic equity counterparts — an early recovery after the first quarter malaise followed by sharp declines in June. From a style perspective, growth outperformed value by more than 4% (EAFE Growth: unchanged, EAFE Value: -4.5%). On a country basis, Norway (+13%) led developed countries, thanks to its significant commodity exposure, while Belgium (-19%) came in last. Performances diverged widely among emerging countries as well: Argentina (+35%) and Brazil (+18%) climbed, while Pakistan (-27%) and India (-20%) crumbled.

The fixed income markets were mixed. While the yield on the 10-year U.S. Treasury rose by more than 50 basis points from 3.45% to 3.99% at quarter end, investors regained some appetite for credit risk as spreads narrowed from the first quarter's gap outward. Specifically, the Lehman Aggregate Index fell 1.0% during the three month period, while the Lehman High Yield Cash Pay Index rose 1.8%.

As mentioned above, commodity markets, led by oil and corn, were very volatile during the quarter. Rising energy prices threaten economic growth and fan inflation fears. For the quarter, the S&P Goldman Sachs Commodity Index (GSCI) was rose 28.7%, with much of that gain due to oil prices spiking above $140 per barrel. With more than 65% of the index weight attributed to oil, and nearly 80% in energy broadly, the GSCI is essentially a proxy for energy prices.

	2Q08 Returns
S&P 500	-2.7%
Dow Jones	-6.9%
NASDAQ	0.8%
Russell 1000 Growth	1.3%
Russell 1000 Value	-5.3%
Russell 2000	0.6%
MSCI EAFE	-2.3%
MSCI Emerging Markets	-0.8%
Lehman Aggregate	-1.0%

Asset Allocation

As of quarter end, the assets of the Fund were valued at $4,660 million. This represents a decrease from the March 31 value of $4,712 million. Approximately $63 million was paid out during the quarter. In addition, the Fund experienced a net investment gain of about $10 million. 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 0.2% followed a negative first quarter return of -5.8% (excluding private real estate, whose valuations are lagged one quarter) and was ahead of the Total Fund Benchmark's -0.9% return. For the one year ended June, the System was down -4.7%, lagging the total fund benchmark return of -3.5% and ranking in the 47th percentile of the public fund universe. The last year was particularly difficult given the financial market crisis brought on by problems in subprime mortgages and the weak housing market. Equities in general, and small cap in particular, suffered.

Longer-term results for the System are very strong relative to the benchmark and the public fund universe. For the trailing ten years ended June, the Fund returned +8.0% on an annualized basis, which ranks in the 4th percentile of the public fund universe and exceeds the total fund benchmark by approximately 1.1% on an annualized basis. The System's volatility in returns over all of this period has been similar to the public fund median, the result of which has created excellent risk-adjusted returns as well.

Domestic Equity

SDCERS' domestic equity portfolio posted a small positive return for the quarter. The portfolio returned 0.2%, outperforming the benchmark return of -0.4% and ranking 7th percentile in the public fund universe. In a continuing trend, the value managers struggled across all market capitalizations as financials continued to weigh on performance. For the most part, the growth managers had a good quarter, beating their benchmarks and ranking above the 25th percentile. For the trailing five years ended June 2008, in what has been a dynamic environment for the US stock markets, the domestic equity portfolio exceeded its benchmark by 1.0% per annum and ranks in the 14th percentile of the public fund universe. For the trailing ten-year period, the portfolio has compounded at +6.2% on an annualized basis (ranking 6th percentile).

International Equity

International equity markets experienced a negative quarter as the prospect of global growth slowed. The MSCI All Country World ex-U.S. was down -0.9% for the quarter with emerging markets down -0.8%. Developed markets returned -1.2% (EAFE+Canada). The System's international equity composite exceeded the total international benchmark with a return of 0.2% ranking 4th percentile versus the public fund universe for the period. All but one (Brandes) of the international equity managers outperformed their respective benchmarks. Brandes lagged the index by 0.9% ranking 57th percentile as holdings in telecom services and commercial banks detracted from performance. McKinley handily exceeded the index, posting a gain of 2.3%. For the trailing year, the international portfolio returned -11.2% (underperforming the target benchmark) and ranking 84th percentile. This was a particularly difficult environment for Brandes whose style is to buy out of favor stocks. Longer-term results for the international equity portfolio for periods measured are strong 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 +10.7%, outperforming its benchmark by 2.3% per annum and ranking in the top decile versus other public funds.

Domestic Fixed Income

Bond prices fell (treasury yields rose) and spreads narrowed in all sectors during the quarter. The yield curve flattened as the difference between the 2 and 30 year declined to 220 basis points from 280 at the end of March. The overall domestic fixed income portfolio posted a +1.2% return, outperforming the blended benchmark of -0.8% for the period and ranking in the 1st percentile of the public fund universe. PIMCO lagged the Aggregate for the June quarter returning -1.2% (79th percentile). PIMCO's underweight in spread sectors, the source of recent outperformance, was the reason for the relatively weak performance in the second quarter as spreads tightened on ABS, CMBS and investment grade credits which had been hard hit in the liquidity crisis. For the year, PIMCO delivered strong outperformance relative to the benchmark and peers with a return of 11.0% (4th percentile). MetWest also lagged in the quarter with a return of -1.7% ranking 90th percentile. For the year, MetWest returned 5.5% ranking 30th percentile.

The market neutral equity program was a large positive contributor for the quarter with Pyramis, Salus and SSI up 10.2%, 5.3% and 2.5% respectively. The convertibles portfolio managed by Nicholas Applegate added as well with a return of 2.3%. The total domestic fixed income portfolio's return of +7.7% (compared to +7.1% for the Lehman Aggregate) over the trailing year is 2.0% greater than the benchmark and ranks in the 7th percentile of the public fund universe. Performance for the trailing three and five year periods has exceeded objectives, outperforming both the Lehman Aggregate and the blended benchmark. Additionally, the risk-adjusted performance for the portfolio remains very attractive. For the trailing ten year period ended June 2008, the portfolio has compounded annually at +6.2%, placing in the 8th 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. On April 14, Rogge announced that they are acquiring the high yield division of ING Ghent. We expect this acquisition will deepen Rogge's credit research capabilities. Slowing global growth and inflation fears weighed on the markets The dollar was flat against the Euro and fell versus the Yen The Citi Non-US Government Bond Index fell -4.7% during the quarter. Rogge's portfolio returned -4.1% outperforming the index placing them 23rd percentile against peers. Results for the last year lag the benchmark by 2.1% and ranked 63rd percentile. Longer-term results for Rogge since inception are favorable compared to the index and place the portfolio above median 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, fueled mainly 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 real estate portfolio have been strong. The overall real estate portfolio remains one of the best performing asset class for SDCERS for the trailing five years, returning 18.6% annualized over this period. This has been driven to a large extent by SDCERS' public real estate portfolio, which has returned 16.6% per annum for the five years ended June.

Comments on Watch List Managers

TCW Large Cap Growth – placed on watchlist for performance on 11/20/06 and organizational change on 2/8/08). Performance rebounded in the second quarter after a weak first quarter. Year-to-date the portfolio lags the Russell 100 Growth by 1.1%. A significant overweight in technology and an underweight in energy has weighed on performance. For the year ended June, the portfolio returned -5.3% vs. the -6.0% for the Russell 1000 Growth and ranked 59th percentile. Over 3 and 5 year periods the portfolio lags the benchmark, however, it is significantly ahead since inception. 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 quartile of the large growth style. This strategy requires further monitoring.

TCW Mid Cap Core Value – placed on watchlist for performance on 11/20/06 and organizational change on 3/27/08. The portfolio has performed well on a relative basis year-to-date, returning -2.1% (vs. -8.6% for the Russell Mid Cap Value Index) and ranking in the 1st 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. Weak stock selection in consumer discretionary and technology contributed to the underperformance. We believe this relative underperformance is more the result of their investment style being out-of-favor than any particular issues at the firm. Long-term results for the strategy remain very strong. This strategy requires further monitoring.

Brandes International Value – placed on watchlist for performance 12/10/07. Brandes follows a strict Graham and Dodd value approach in constructing portfolios which has been out of favor in the recent market turmoil. For the quarter, the portfolio returned -1.7% compared to -0.9% for the MSCI ACW ex-U.S. index and ranked 34th percentile. For the last year, the portfolio is down 14.5% underperforming the benchmark by 8.3% and ranking 88th percentile. Consistent with their investment style, Brandes has been overweight financials and underweight energy and commodities which has hurt performance. Over 10 years, the portfolio has performed well with 458 basis points of outperformance relative to the benchmark. While recent performance is disappointing, it is consistent with the style and philosophy of the product.

SSI Market Neutral Equity – placed on watchlist for performance. After a difficult first quarter, SSI's performance staged a modest recovery in the second quarter, up 2.5% ranking 65th percentile against Market Neutral peers. The portfolio's modest growth tilt was a positive contributor as growth generally outperformed value. For the last year, the portfolio returned 3.5% compared to 6.6% for TBills plus 3% and 7.1% for the ML 1-5 index.

Salus Market Neutral Equity – Placed on watch list for performance 6/6/08. After three very weak quarters, the Salus portfolio recovered in the June quarter with a return of 5.3% compared to -1.0% for the ML 1-5 Gov/Corp ranking 34th percentile in the Market Neutral Style Group. Returns for 5 years and since inception continue to lag the benchmark and peers. Brad Ebner and Casey Jones presented at the July 17 Investment Committee meeting to provide an update on the organization and recent performance. Callan advises continued close monitoring of this portfolio.

Summary and Conclusions

While absolute returns were very modest, SDCERS active managers in the domestic equity and international equity arena added value. The Market Neutral managers contributed as the Lehman Aggregate posted a negative return. The annualized return on the overall portfolio for the trailing five-year period remains 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.

As always, we greatly appreciate our relationship with SDCERS. Please do not hesitate to contact 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,

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