



Mendocino County Employees' Retirement Association

US Equity Manager Structure

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Guiding Principles of Investment Structure

- **Active management offers the potential to add value over the index and can be complementary to passive management.**
 - Excess returns are more difficult to achieve in efficient markets such as Large cap U.S. equity and U.S. Fixed Income (intermediate duration)
 - Potential for excess returns are compelling in Small/Mid Cap U.S. equity, Non-US equity, Emerging equity and Non-US Small Cap equity
- **Well-diversified market-neutral exposure with no unintended biases**
 - Avoid overlapping mandates
 - May wish to purposefully add bias to Small/Mid cap U.S. equity and Emerging Markets equity for potential return enhancement



Guiding Principles of Investment Structure (cont'd)

- **Callan's overriding philosophy is to keep the structure as simple as possible.**
- **Allocations to managers should be meaningful for the Plan.**
- **The appropriate number of managers must balance style and relationship diversification with the lower fees and more manageable monitoring.**
- **Primary influences on the appropriate number:**
 - Size of the allocation relative to the total Plan:
 - The higher the allocation, the greater the desired manager diversification.
- **Active versus passive decisions:**
 - Fewer managers may be suitable when the portfolio is managed passively.



Equity Terms

- **Stock (equity)** – ownership interest in a company.
- **Market Capitalization** - the value of all the shares of a company. (Current share price times outstanding shares)
- **Equity Styles** – commonly defined by valuation, growth and size.
- **Benchmark Unaware** – manager with large deviations from the index.

-----Multi Cap-----	Large Cap	> \$10 Billion
	Mid Cap	\$1.5 - \$10 Billion
	Small Cap	< \$1.5 Billion

-----Blend (Core)-----	Growth	expected to have above average growth in earnings and profitability
	Value	undervalued relative to their potential for capital appreciation

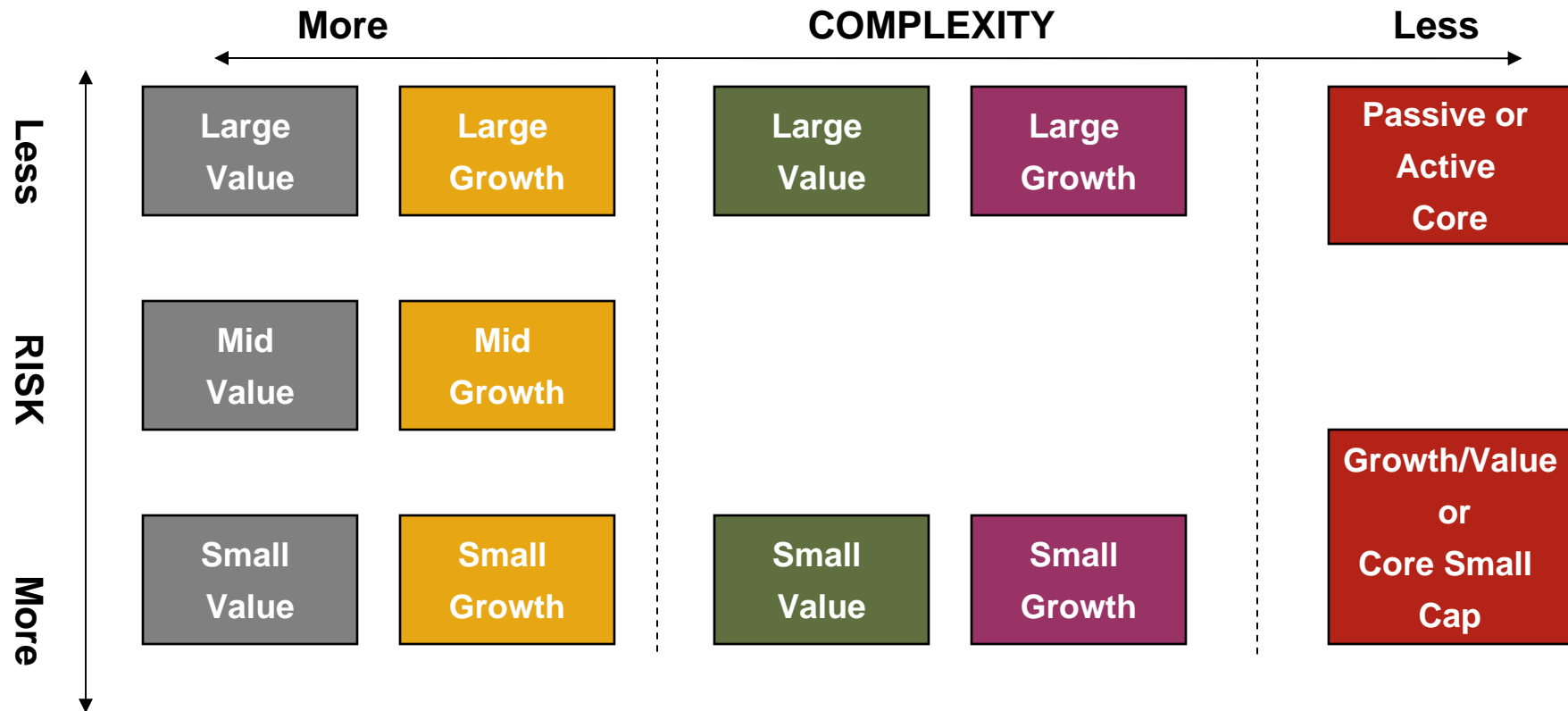


Domestic Equity Structure Guiding Principles and Best Practices

- **The total equity structure should be neutral to the broad market in regard to style and capitalization, unless the investor has a preference to tilt the structure**
 - 80% large cap + 20% small cap
 - Many plans have a small cap overweight (~70% large cap + 30% small cap) to capture the small cap risk premium over time
- **Active and passive management can be complementary**
 - Passive can be appropriate for large cap.
 - Active management is compelling for small cap.
- **Keep the structure as simple as possible given the circumstances.**



Conceptual Equity Structure



- Focus on relatively low tracking error
- Secondary objective of adding value over the benchmark



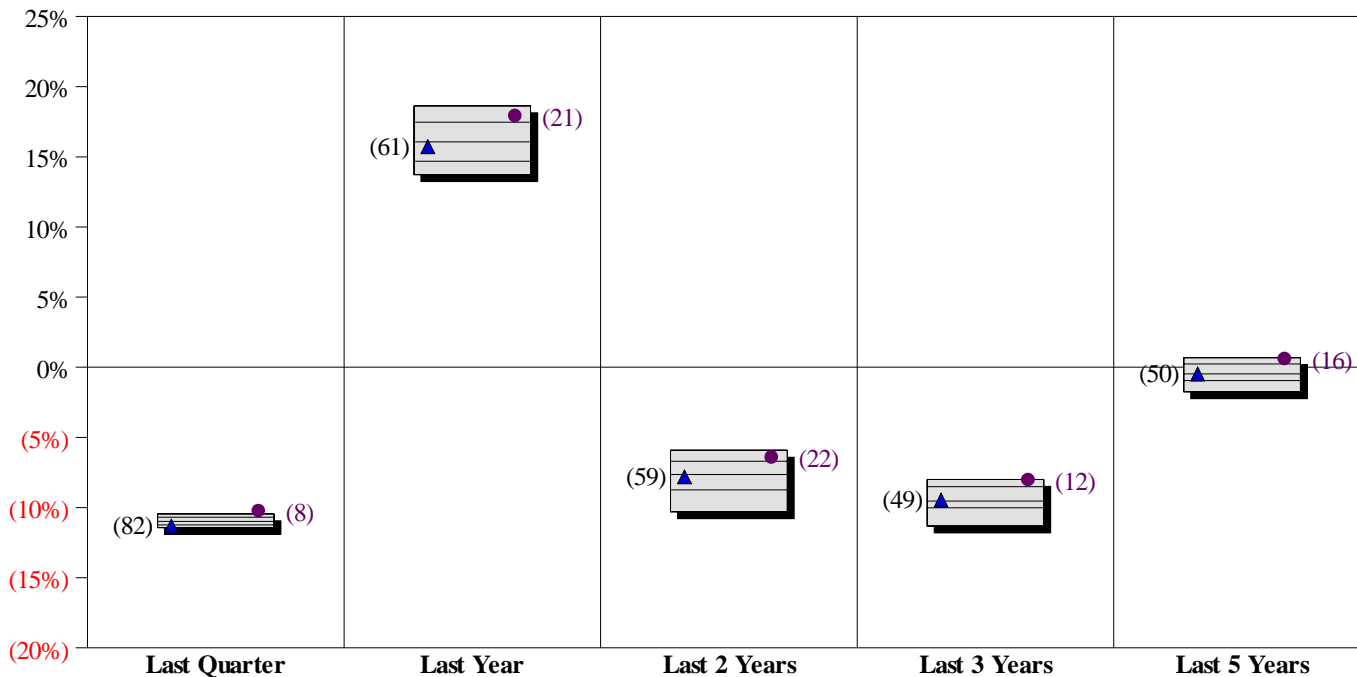
Current MCERA US Equity Structure Observations

- **MCERA US equity allocation has performed very well**
 - Top decile performance relative to other public funds over cumulative periods up to five years ended Q2 2010
 - Top 2% over three and five years ended Q2 2010
- **The overall structure has a growth bias and, to a lesser extent, a small cap bias**
 - More growth managers than value managers
 - Growth managers have more growth-oriented styles than value managers have value-oriented styles
- **The structure has a large number of managers**
 - Many managers have overlapping styles
 - Difficult to monitor



MCERA Historical US Equity Performance

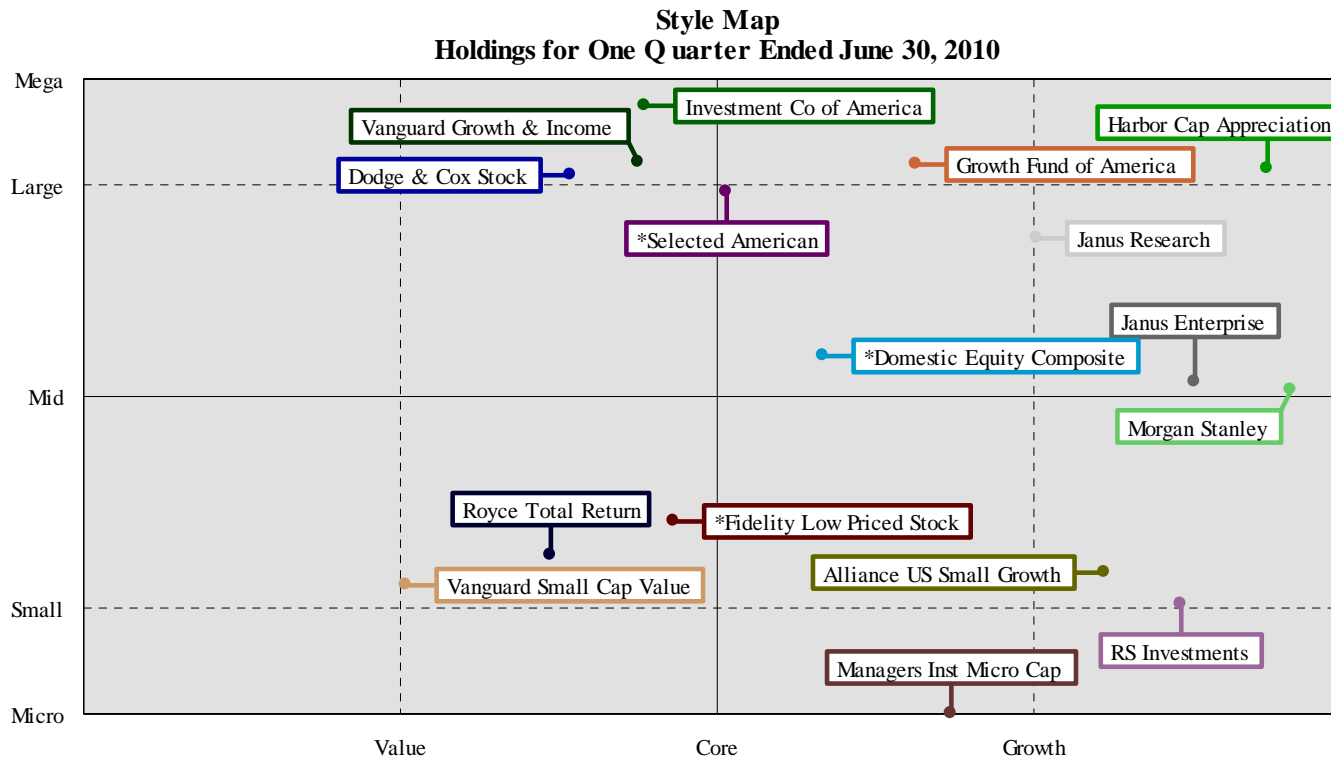
Performance vs Public Fund - Domestic Equity (Gross)



	Last Quarter	Last Year	Last 2 Years	Last 3 Years	Last 5 Years
10th Percentile	(10.45)	18.64	(5.92)	(8.00)	0.67
25th Percentile	(10.69)	17.47	(6.70)	(8.51)	0.23
Median	(10.99)	16.07	(7.64)	(9.54)	(0.47)
75th Percentile	(11.23)	14.68	(8.75)	(10.02)	(0.95)
90th Percentile	(11.43)	13.73	(10.30)	(11.32)	(1.75)
Domestic Equity Composite ●	(10.36)	17.82	(6.53)	(8.13)	0.48
Russell 3000 Index ▲	(11.32)	15.72	(7.81)	(9.47)	(0.48)



MCERA Style Biases

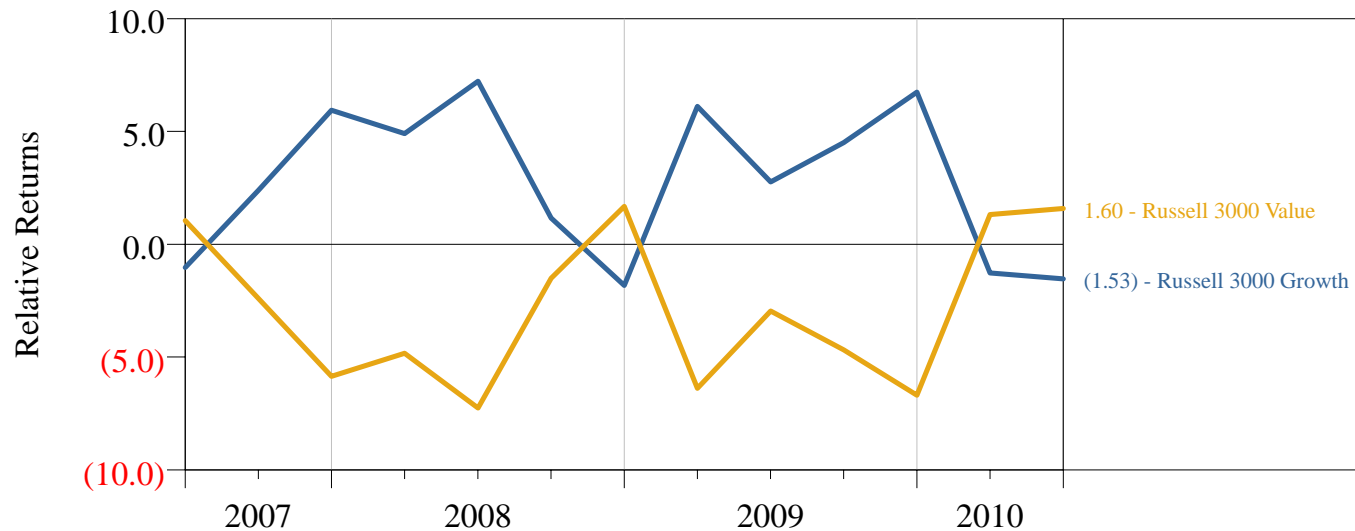


- **The current US equity structure has growth and small cap biases.**



MCERA Growth Bias Helped Performance

Rolling 4 Quarter Relative Returns Relative To Russell 3000 Index
for 3 Years Ended June 30, 2010

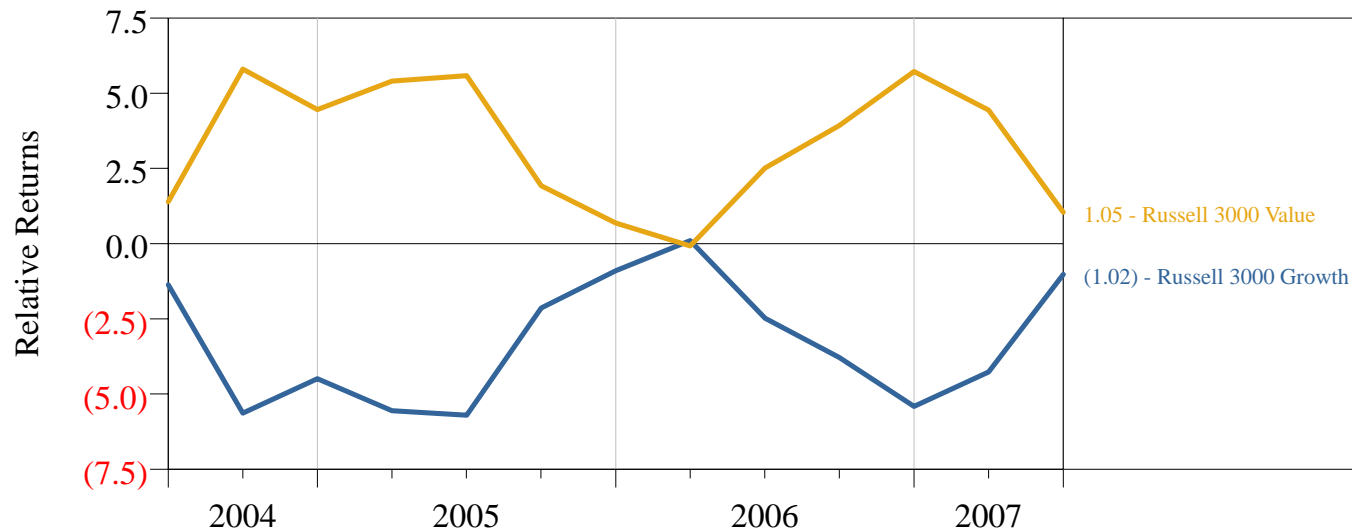


- **Growth has outperformed value over the last 3 years so the MCERA growth bias helped performance.**



A Growth Bias Would Not Have Worked in Other Periods

Rolling 4 Quarter Relative Returns Relative To Russell 3000 Index
for 3 Years Ended June 30, 2007



- For the 3-year period ended June 30, 2007, value significantly outperformed growth.
- It is virtually impossible to forecast style outperformance.
- A structure with balanced style exposures is preferred.



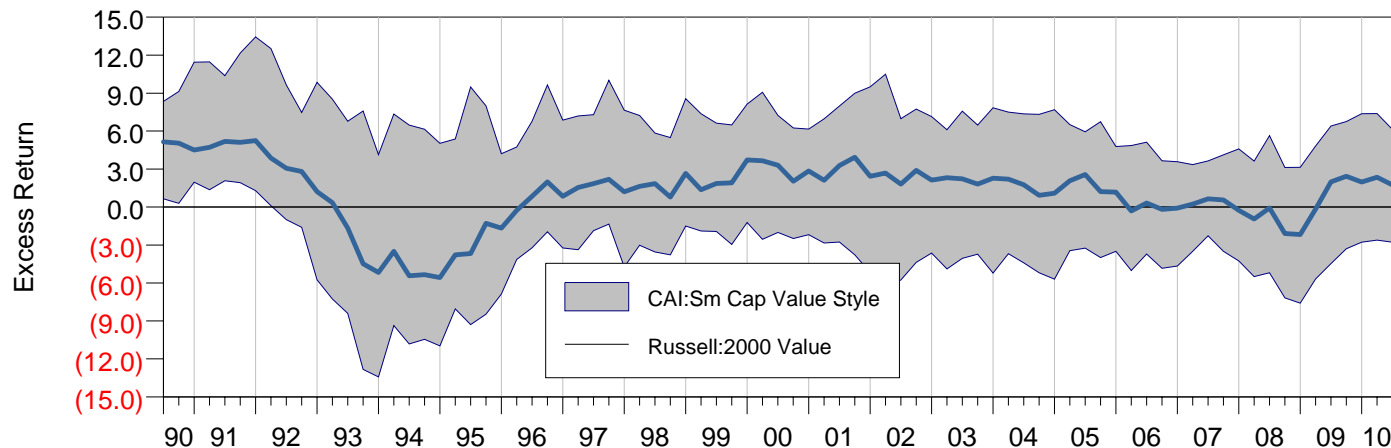
Small Cap Active Management Frequently Outperforms the Benchmark

Percent of Three-Year Periods where Manager Beat Benchmark by More than Hurdle - by Percentile

Hurdle	0.50%	0.55%	0.60%	0.65%	0.70%	0.75%	0.80%	0.85%	0.90%	0.95%
Median	70%	70%	69%	69%	68%	68%	66%	66%	64%	63%
45th Percentile	71%	71%	70%	70%	69%	69%	68%	68%	66%	66%
40th Percentile	80%	80%	80%	80%	79%	78%	78%	75%	74%	74%
35th Percentile	84%	84%	83%	83%	83%	83%	81%	81%	81%	81%
30th Percentile	91%	91%	91%	91%	90%	89%	89%	88%	88%	88%
25th Percentile	96%	96%	96%	96%	96%	96%	96%	96%	95%	93%

Average Annualized Excess Return - Median Manager: 1.09%

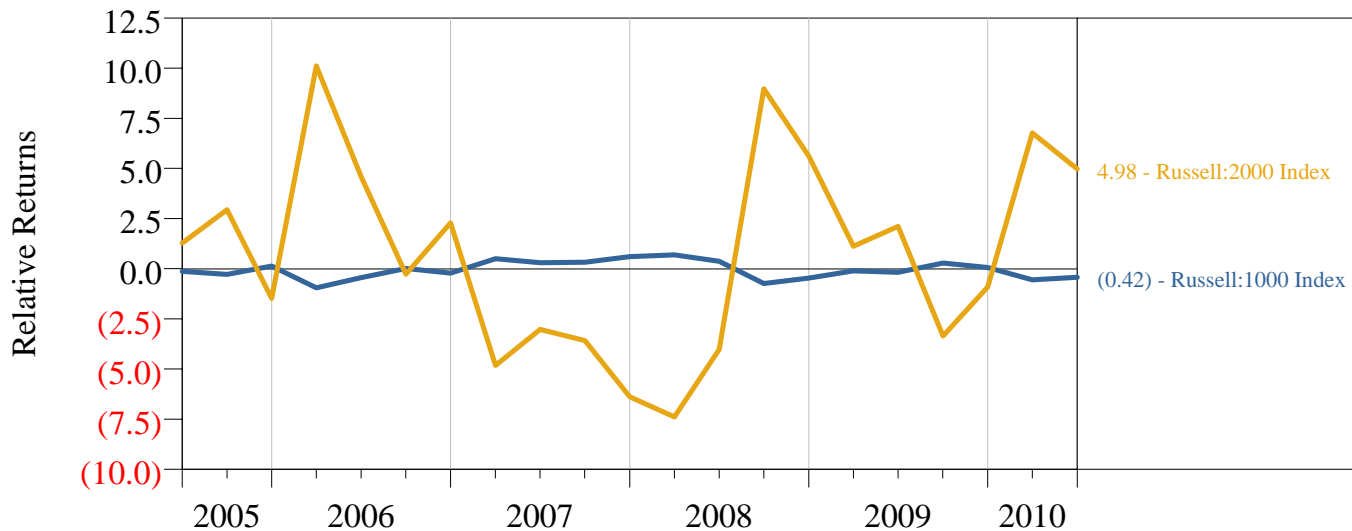
Rolling 12 Quarter Excess Return Relative To Russell:2000 Value for 20 Years Ended June 30, 2010





Small Cap Generally Outperforms Large Cap But at the Expense of Greater Volatility

Rolling 4 Quarter Relative Returns Relative To Russell 3000 Index
for 5 Years Ended June 30, 2010



- In most rolling 4 quarter periods, small cap outperformed large cap
- The range of relative performance is great which means that small cap can dramatically underperform large cap
- A small cap bias needs to reflect risk as well as return



Current MCERA Structure

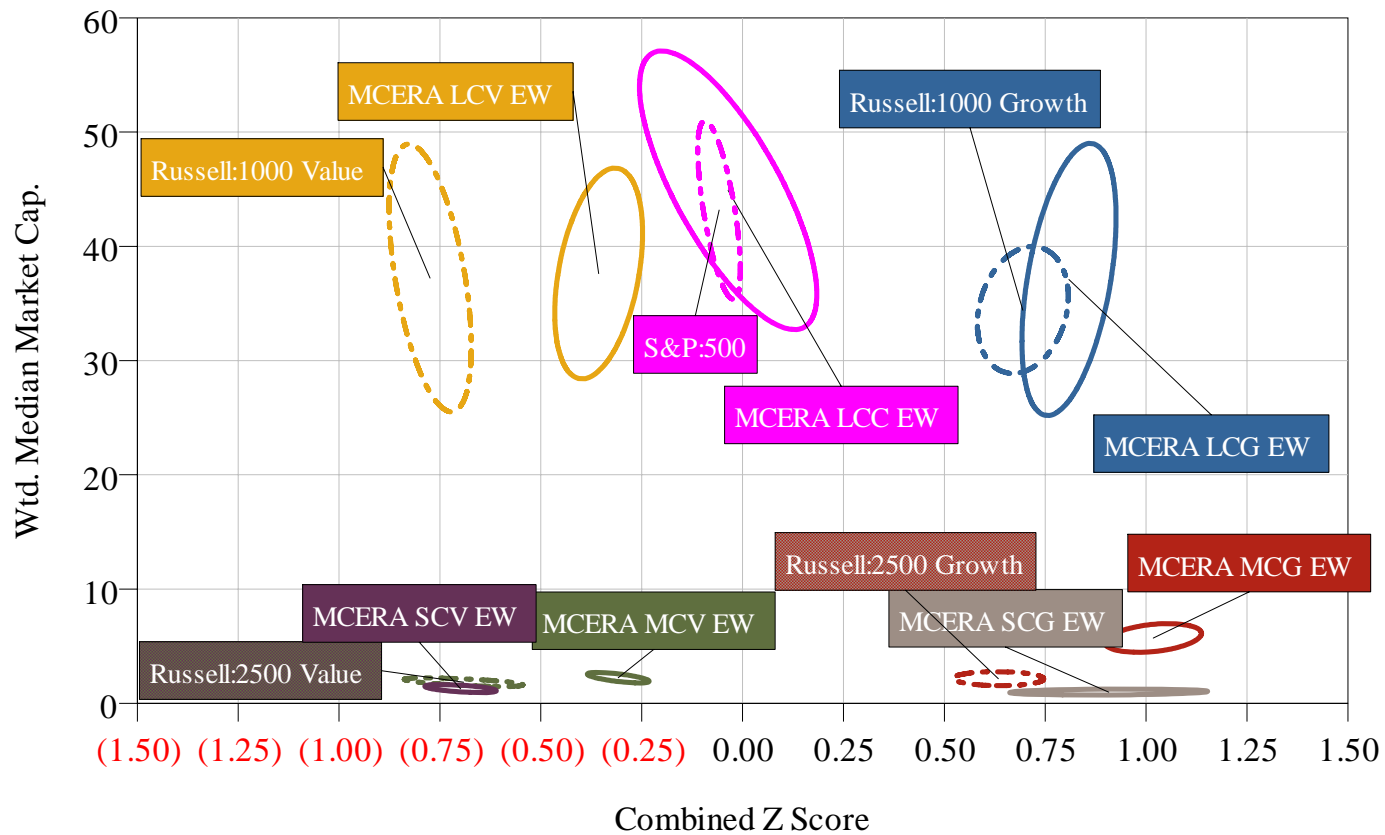
Style	Allocation (%, US Equity Assets)	Allocation (\$, mm)	Expense Ratios
Large Cap			
Passive Core	0.0%	0.00	
Active Core	26.8%	28.09	
Selected American	9.2%	9.59	0.61%
Investment Company of America	9.2%	9.63	0.33%
Vanguard Growth & Income	8.5%	8.87	0.21%
Value	5.5%	5.76	
Dodge & Cox	5.5%	5.76	0.52%
Growth	21.5%	22.49	
Growth Fund of America	6.4%	6.73	0.40%
Harbor Capital Appreciation	8.0%	8.32	0.69%
Janus Research	7.1%	7.44	0.85%
Small & Mid Cap			
Mid Cap Value	14.0%	14.70	
Fidelity Low-Priced Stock	7.1%	7.38	0.98%
Royce Total Return	7.0%	7.32	1.04%
Small Cap Value	10.5%	11.01	
Vanguard Small Cap Index	10.5%	11.01	0.08%
Mid Cap Growth	14.0%	14.65	
Morgan Stanley	7.2%	7.57	0.69%
Janus Enterprise	6.8%	7.08	0.81%
Small Cap Growth	7.6%	7.93	
Alliance	2.8%	2.98	1.10%
RS Emerging	2.4%	2.46	1.22%
Managers Institutional Micro Cap	2.4%	2.49	1.36%
Total	100.0%	104.63	

Capitalization	Style		
	Growth	Core	Value
Large	21.5%	26.8%	5.5%
Mid	14.0%	0.0%	14.0%
Small	7.6%	0.0%	10.5%



Growth Bias Due to Manager Strategies

Rolling 3 Month Scatter Chart
for 3 Years Ended June 30, 2010





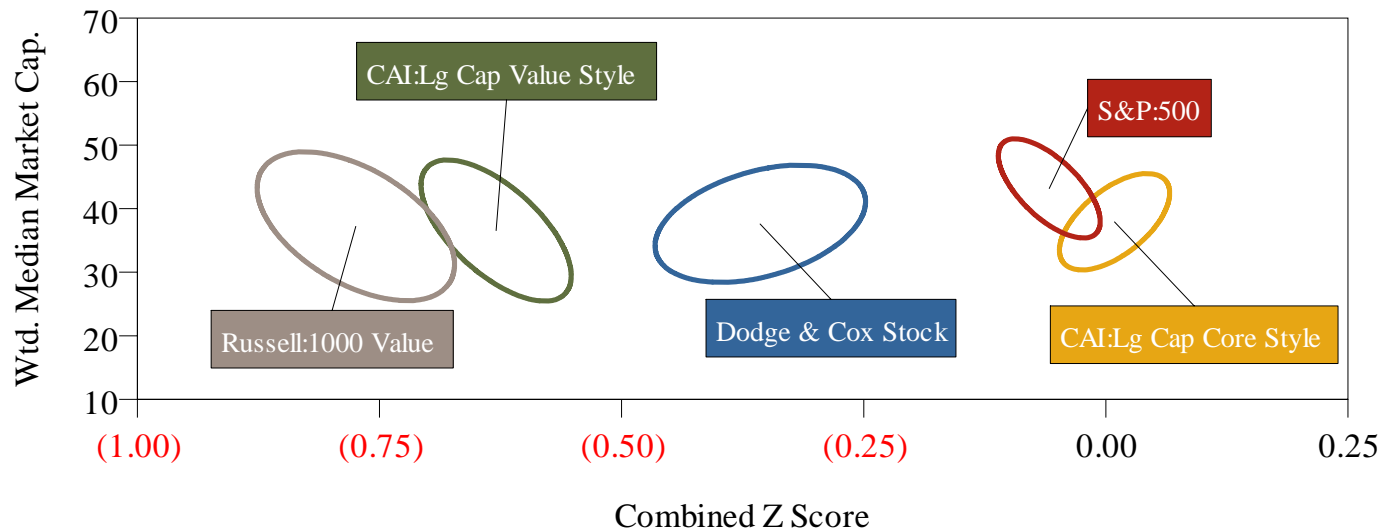
Growth Bias Due to Manager Strategies

- **All manager styles are equally weighted combinations of the constituent managers**
- **MCERA Large Cap Core Managers have a style score like the S&P 500 Index**
- **MCERA Large Cap Growth Managers have a style score like the Russell 1000 Growth Index**
- **MCERA Large Cap Value Managers have a style score that is less value oriented than the Russell 1000 Value Index**
- **MCERA Mid Cap Growth and Small Cap Growth managers have style scores that are more growth than the Russell 2500 Growth index**
- **MCERA Mid Cap Value and Small Cap Value managers have style scores that are less value than the Russell 2500 Value index**



Dodge & Cox Has a Modest Value Orientation

Rolling 3 Month Scatter Chart
for 3 Years Ended June 30, 2010

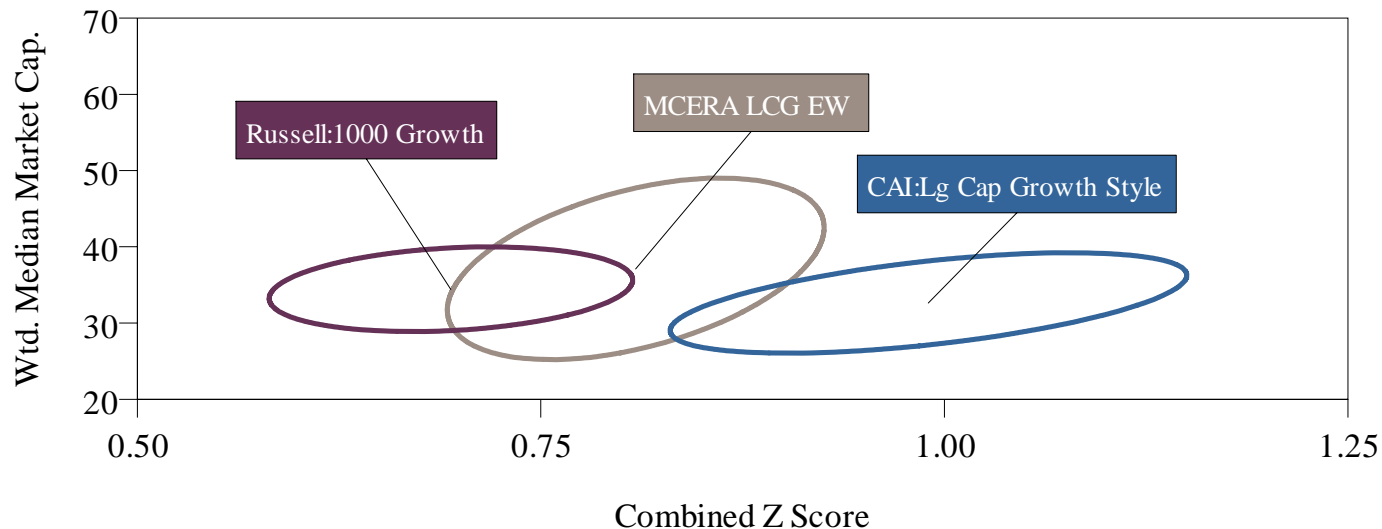


- **Dodge & Cox is more value oriented than the value managers benchmarked against the S&P 500.**
- **Dodge & Cox is not as value oriented as the Callan Large Cap Value Style nor the Russell 1000 Value index.**



Large Cap Growth Structure is Appropriate

Rolling 3 Month Scatter Chart
for 3 Years Ended June 30, 2010

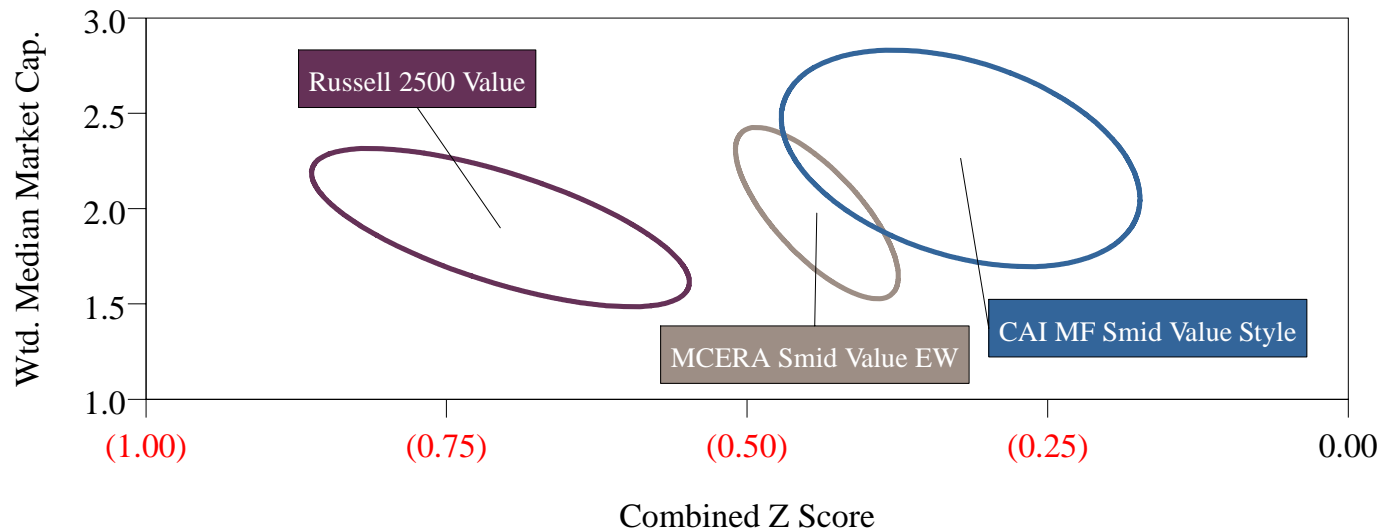


- **The combination of the 3 large cap growth managers are collectively between the Large Cap Growth style and the Russell 1000 Growth index consequently the large cap growth structure provides the appropriate level of exposure to this style.**



Smid Cap Value Structure is Appropriate

Rolling 3 Month Scatter Chart
for 3 Years Ended March 31, 2010

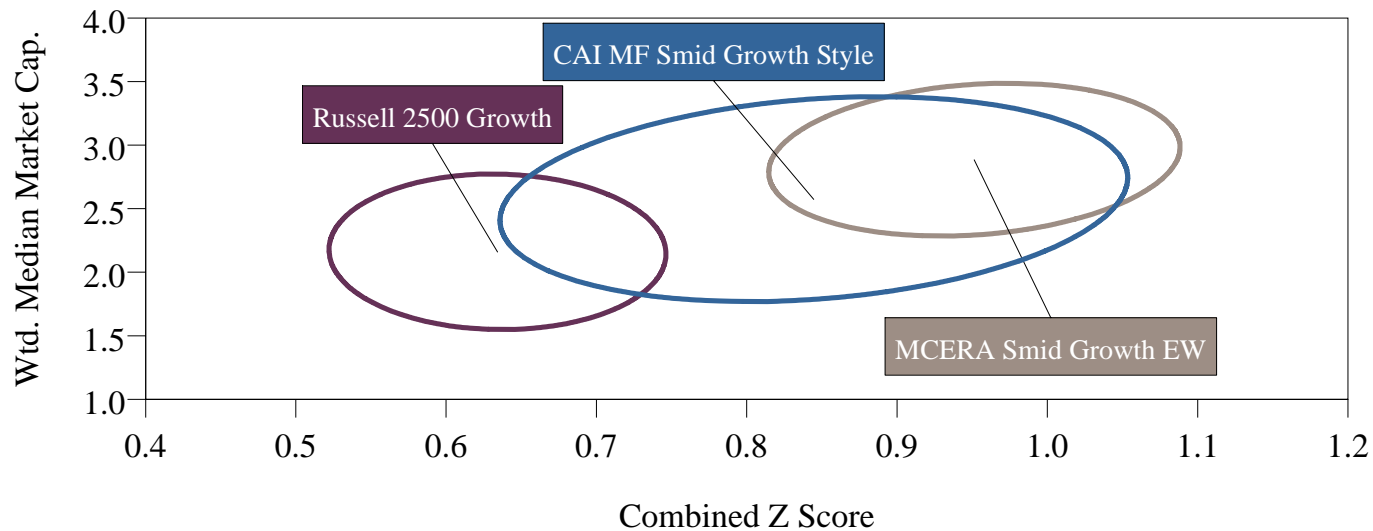


- **The smid cap value structure is about the same size but less value oriented than the Russell 2500 Value index.**
- **The smid cap value structure is about the same size but slightly more value oriented than the Callan Mid Cap Value style.**



Smid Cap Growth Structure is Appropriate

Rolling 3 Month Scatter Chart
for 3 Years Ended June 30, 2010

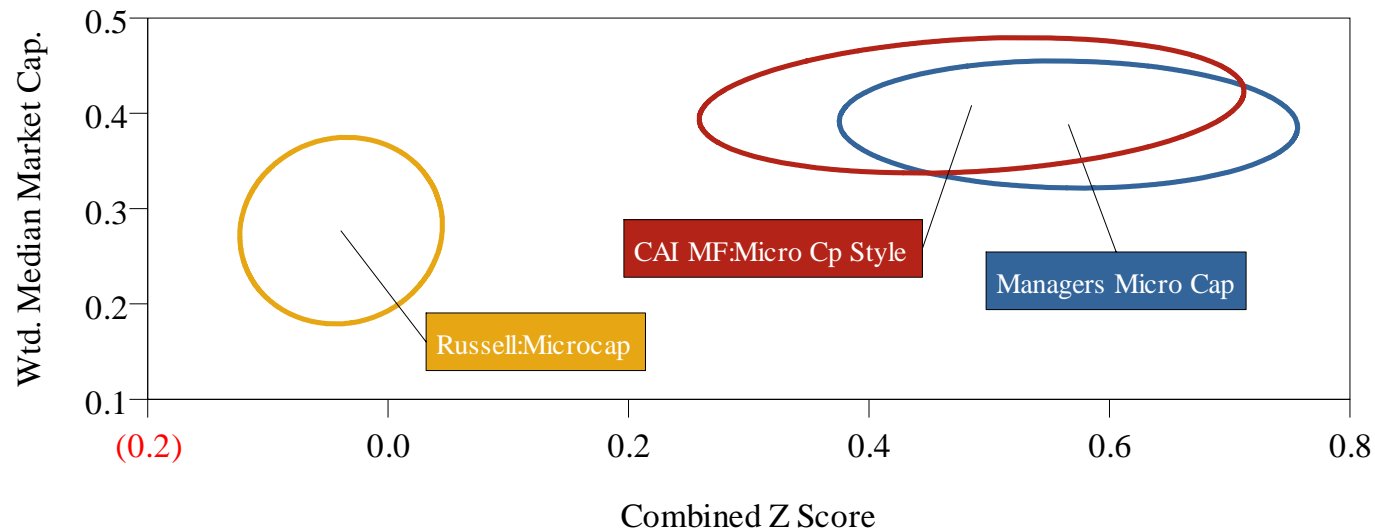


- **The smid cap growth structure is larger and more growth oriented than the Russell 2500 Growth index.**
- **The smid cap growth structure is slightly larger and more growth oriented than the Callan Mid Cap Growth style.**



Standalone Micro Cap

Rolling 3 Month Scatter Chart
for 3 Years Ended June 30, 2010



- **Managers Institutional Micro Cap has 4 sub-advising managers which provide style, strategy and business risk diversification.**
- **Micro cap can be used as an inexpensive liquid public substitute for private equity.**

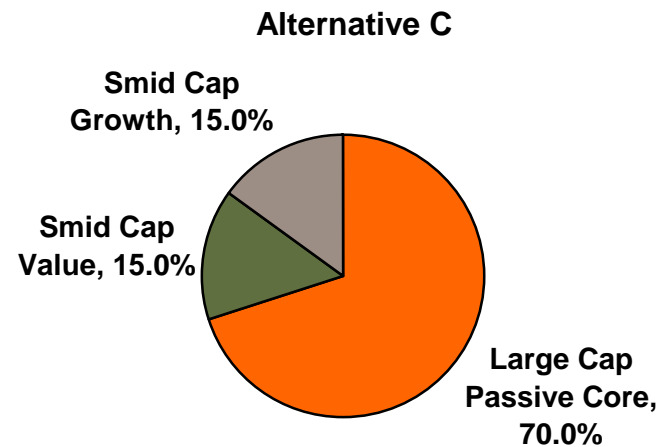
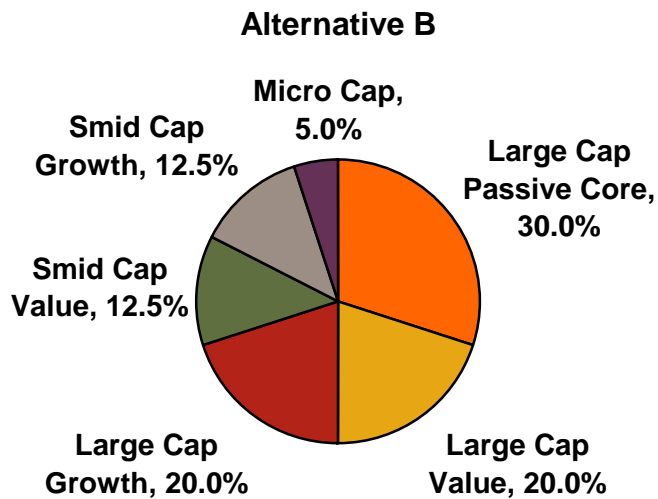
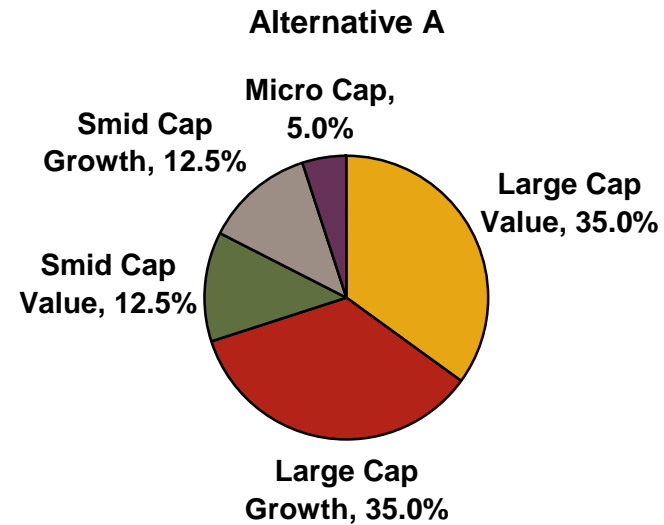
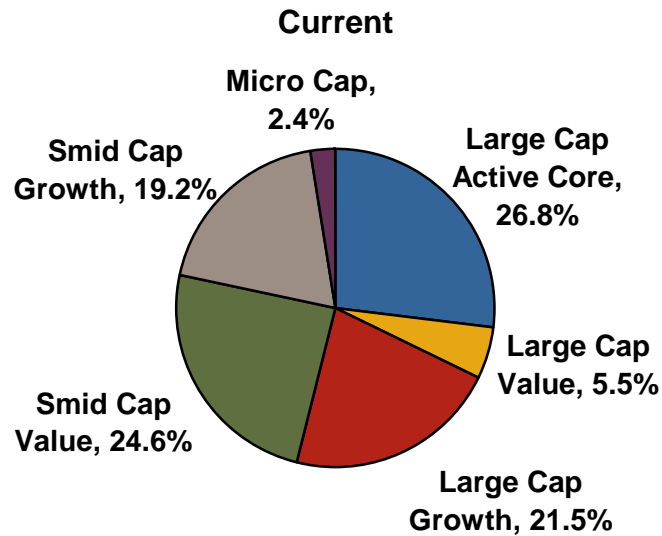


Current and Alternative Structures

Style	Current	Alternative A	Alternative B	Alternative C
Large Cap				
Passive Core	0.0%	0.0%	30.0%	70.0%
New Manager	0.0%	0.0%	30.0%	70.0%
Active Core	26.8%	0.0%	0.0%	0.0%
Selected American	9.2%	0.0%	0.0%	0.0%
Investment Company of America	9.2%	0.0%	0.0%	0.0%
Vanguard Growth & Income	8.5%	0.0%	0.0%	0.0%
Value	5.5%	35.0%	20.0%	0.0%
Dodge & Cox	5.5%	17.5%	10.0%	0.0%
New Manager	0.0%	17.5%	10.0%	0.0%
Growth	21.5%	35.0%	20.0%	0.0%
Growth Fund of America	6.4%	17.5%	10.0%	0.0%
Harbor Capital Appreciation	8.0%	17.5%	10.0%	0.0%
Janus Research	7.1%	0.0%	0.0%	0.0%
Small & Mid Cap				
Mid Cap Value	14.0%	7.5%	7.5%	7.5%
Fidelity Low-Priced Stock	7.1%	0.0%	0.0%	0.0%
Royce Total Return	7.0%	7.5%	7.5%	7.5%
Small Cap Value	10.5%	5.0%	5.0%	7.5%
Vanguard Small Cap	10.5%	0.0%	0.0%	0.0%
New Active Manager	0.0%	5.0%	5.0%	7.5%
Mid Cap Growth	14.0%	7.5%	7.5%	7.5%
Morgan Stanley	7.2%	7.5%	7.5%	7.5%
Janus Enterprise	6.8%	0.0%	0.0%	0.0%
Small Cap Growth	5.2%	5.0%	5.0%	7.5%
Alliance	2.8%	5.0%	5.0%	7.5%
RS Emerging	2.4%	0.0%	0.0%	0.0%
Micro Cap	2.4%	5.0%	5.0%	0.0%
Managers Institutional Micro Cap	2.4%	5.0%	5.0%	0.0%
Total	100.0%	100.0%	100.0%	100.0%
Total Number of Funds	15	9	10	5



Current and Alternative Structures





Structure Alternatives

■ Overview

- The alternative structures represent examples of structures which reflect different philosophical approaches to investing in US equity markets.
- These structures are certainly not the only structures that can be considered. Elements of each structure can be enhanced and/or combined with elements of other structures to get the right structure for MCERA.

■ Current Structure

- Reflects the existing managers at their Q2 allocations.
- This structure has the most managers with 15.
- The fact that all but one of the existing managers are held as mutual funds reduces the administrative burden of a large number of managers somewhat.
- Fees for this structure may be higher than another structure with fewer managers accessed through separate accounts but many of the managers have competitive mutual fund fees.
- Keeping track of 15 US equity managers (in addition to the managers in the other asset classes) is very difficult.



Structure Alternatives

■ **Alternative A**

- Alternative A reflects many of the existing managers and a more efficient structure.
- The S&P benchmarked active managers have been eliminated since active large cap core funds have not consistently added value in excess of fees historically in this efficient segment of the market.
- This alternative is preferred to the other alternatives if there is a strong belief that active style-specific managers can collectively outperform the broad market in excess of their fees.
- The existing microcap allocation is separated from the small cap growth managers to reflect its unique characteristics. It is increased in size to 5% in recognition of the need to have a meaningful influence on the performance of the portfolio as a whole to justify its inclusion.
- Alternative A has 9 managers which is 6 less than the current structure.



Structure Alternatives

■ **Alternative B**

- Alternative B differs from Alternative A by adding an allocation to passive large cap and reducing the allocations to the new large cap growth and value managers.
- Active management is reduced in an effort to control tracking error with passive investments while still looking for some value added from active management.
- Introducing an S&P index fund reduces the growth bias relative to Alternative A and the Current allocation.
- Alternative B also includes the allocation to micro cap consistent with this alternative maintaining emphasis on the pursuit of value added over the broad passive market through the use of active management.
- Alternative B has 10 managers which is 1 more than Alternative A with the addition of the S&P 500 index fund but 5 less than the Current structure.



Structure Alternatives

■ **Alternative C**

- Alternative C is the same as alternative B except that the four active large cap equity managers are eliminated in favor of the S&P 500 index fund. This change reflects the difficulty that active large cap managers can have in consistently adding value over the index.
- Active small and mid cap managers are retained in the belief that they can add value over the index after fees even if large cap managers cannot.
- This is the most streamlined structure with only 5 managers. Micro cap is eliminated in keeping with the simplicity of this structure.



Appendix



Hypothetical History of Alternatives

Returns for Periods Ended June 30, 2010

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years
MCERA Current	(10.33)	18.01	(7.49)	1.22	1.18
MCERA Alt A	(11.18)	15.41	(8.37)	0.55	1.47
MCERA Alt B	(10.80)	16.07	(8.40)	0.48	0.79
MCERA Alt C	(10.37)	17.33	(8.53)	0.35	0.07
Russell 3000 Index	(11.32)	15.72	(9.47)	(0.48)	(0.92)

- The following exhibits represent hypothetical returns based on the current MCERA structure and the three alternative US Equity structures presented in this presentation. These are not actual results for MCERA.



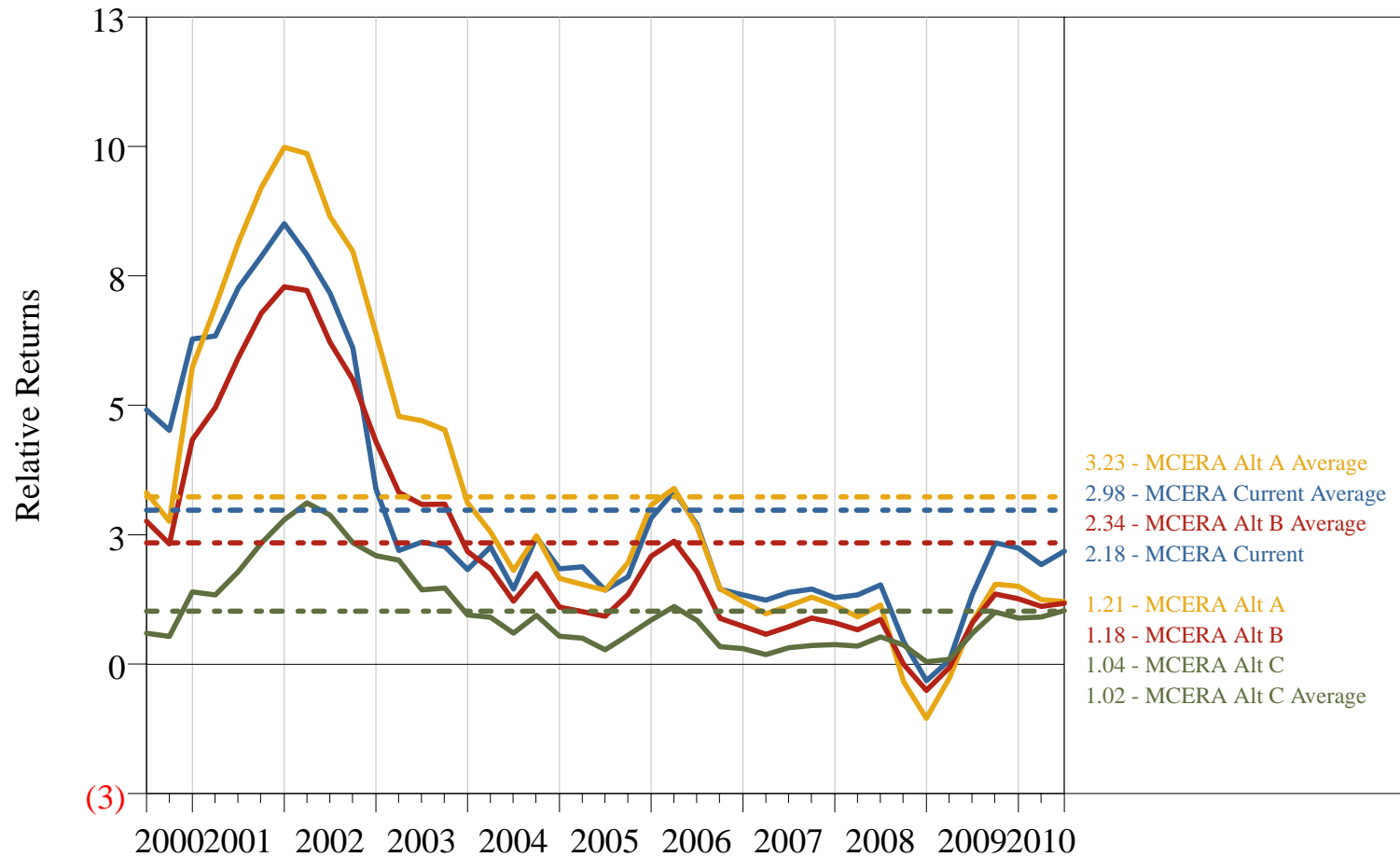
Hypothetical History of Alternatives

	Returns for Calendar Years 10 1/2 Years Ended June 30, 2010										
	2 Qtrs. 2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000
MCERA Current	(4.77)	35.83	(38.49)	8.22	13.48	9.22	15.43	34.24	(21.52)	(8.75)	(0.78)
MCERA Alt A	(6.08)	34.76	(38.90)	7.45	12.58	10.42	14.65	34.68	(21.68)	(5.36)	4.44
MCERA Alt B	(5.52)	32.89	(38.33)	7.18	13.65	8.54	13.91	33.97	(22.05)	(7.00)	0.62
MCERA Alt C	(4.79)	30.87	(37.71)	6.57	15.06	6.49	13.20	32.47	(21.99)	(9.36)	(3.24)
Russell 3000 Index	(6.05)	28.34	(37.31)	5.14	15.72	6.12	11.95	31.06	(21.54)	(11.46)	(7.46)



Hypothetical History of Alternatives

Rolling 12 Quarter Relative Returns Relative To Russell 3000 Index
for 10 Years Ended June 30, 2010





Hypothetical History of Alternatives

Rolling 12 Quarter Standard Deviation
for 10 Years Ended June 30, 2010

