



# ***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

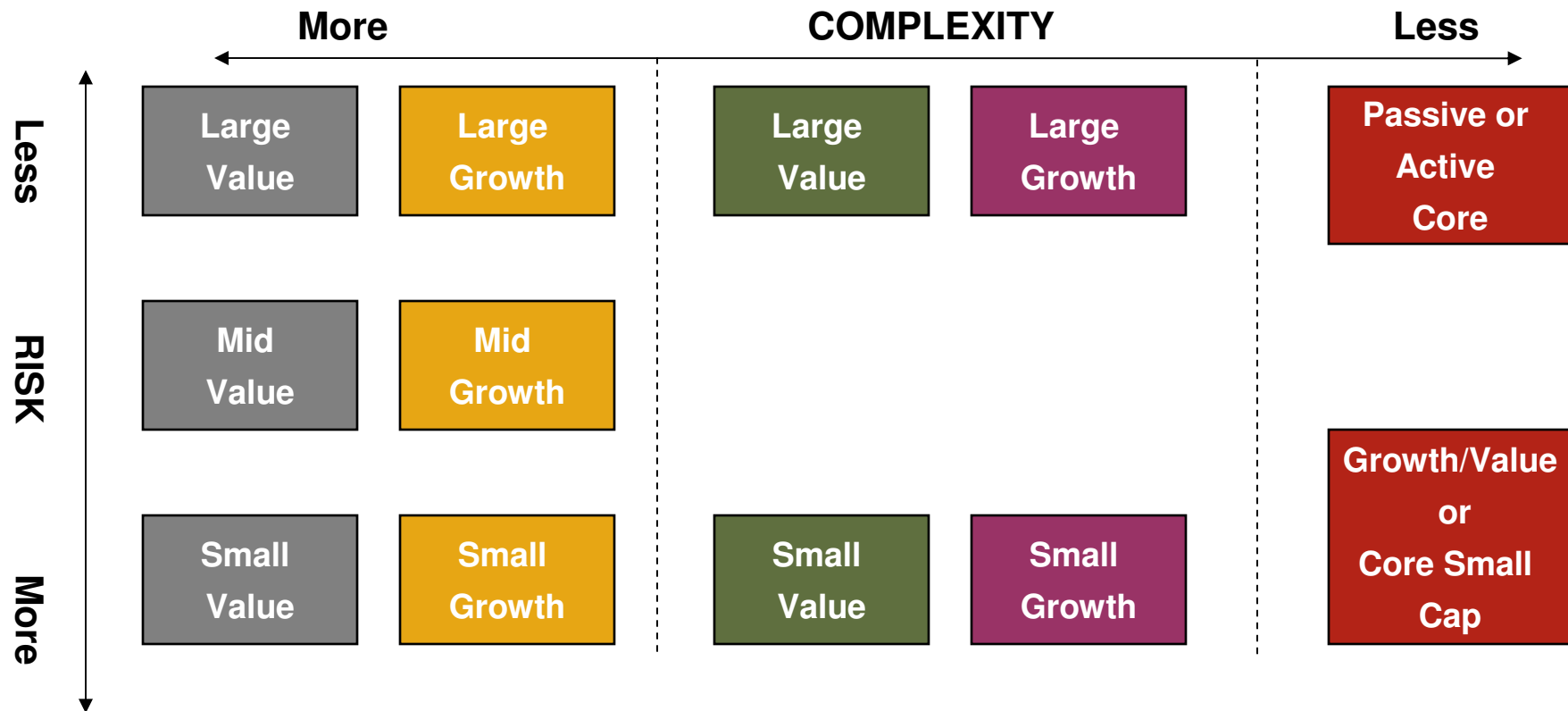


## ***Guiding Principles of Investment Structure (cont'd)***

- **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.
- **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



## Conceptual Equity Structure



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



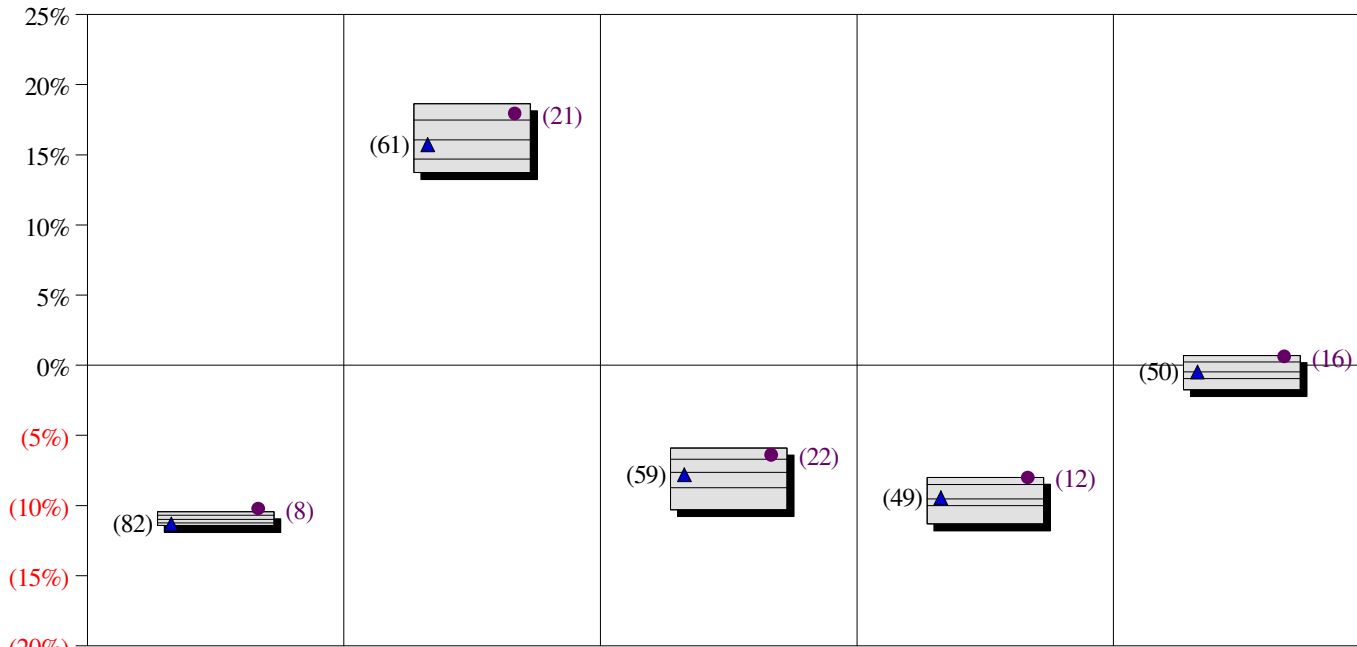
## ***Current MCERA US Equity Structure Observations***

- **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)

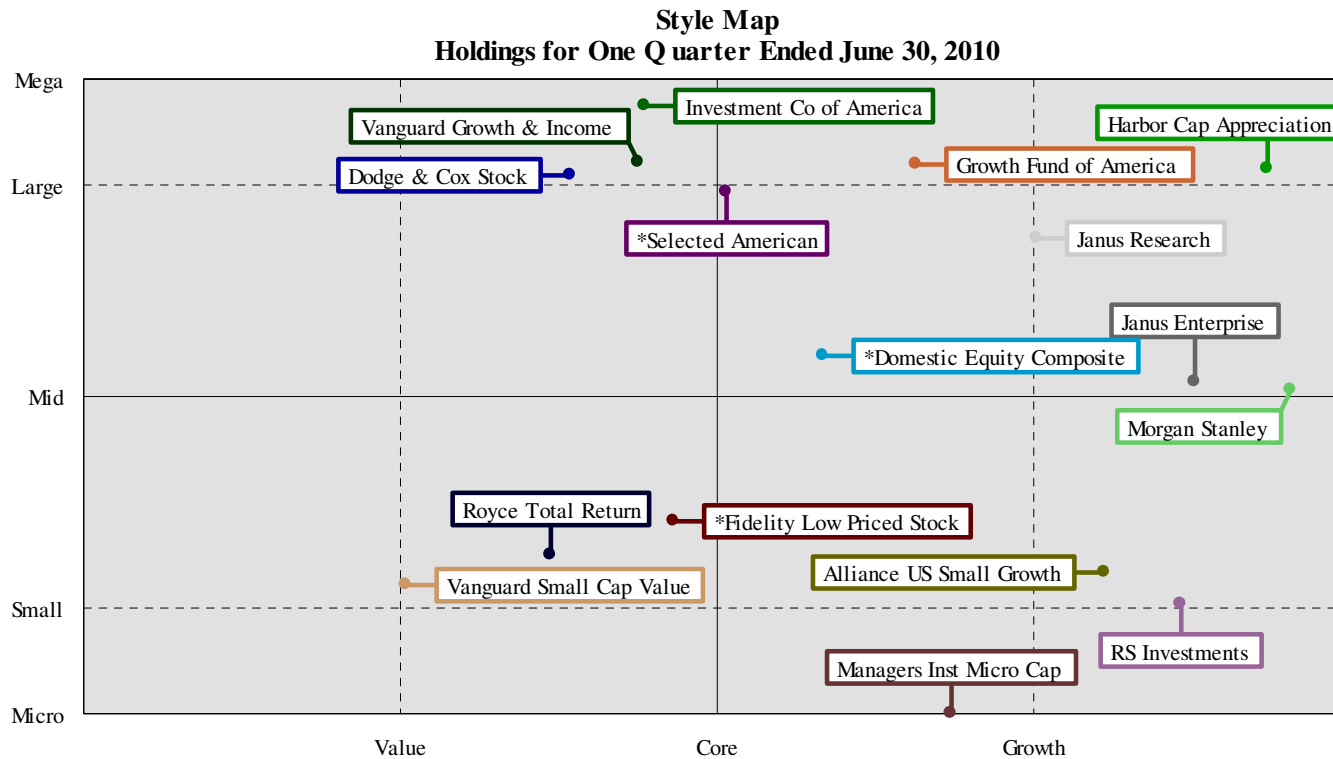


	Last Quarter	Last Year	Last 2 Years	Last 3 Years	Last 5 Years
10th Percentile	(10.45)	18.64	(5.92)	(8.00)	0.67
25th Percentile	(10.69)	17.47	(6.70)	(8.51)	0.23
Median	(10.99)	16.07	(7.64)	(9.54)	(0.47)
75th Percentile	(11.23)	14.68	(8.75)	(10.02)	(0.95)
90th Percentile	(11.43)	13.73	(10.30)	(11.32)	(1.75)

<b>Domestic Equity Composite</b> ●	(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

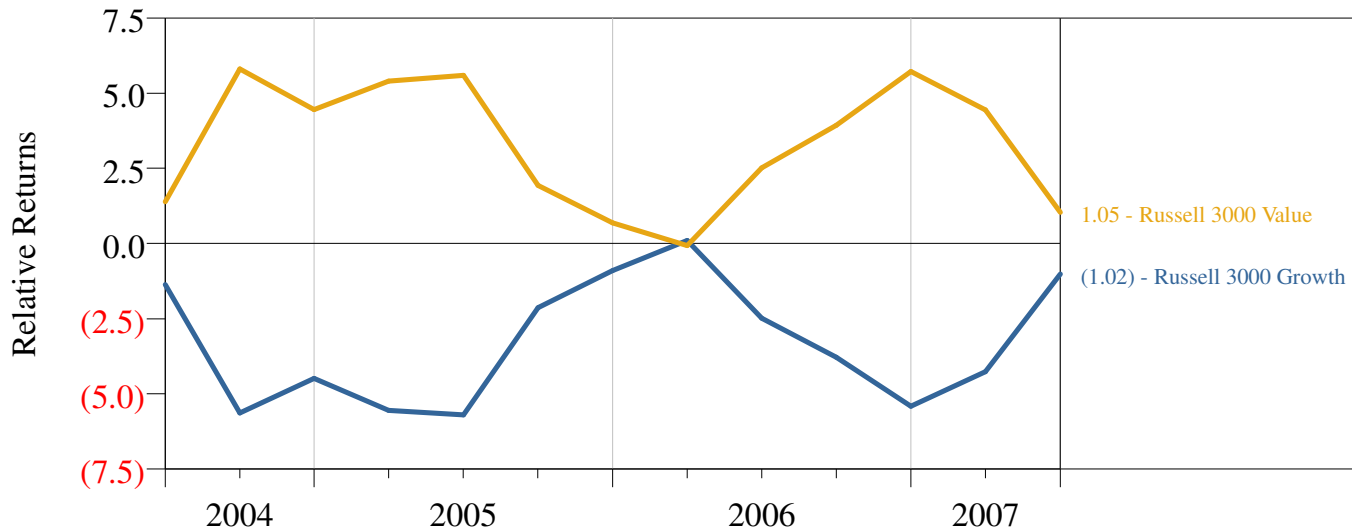


- **Growth has outperformed value over the last 3 years so the MCERA growth bias helped performance.**



## ***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.**



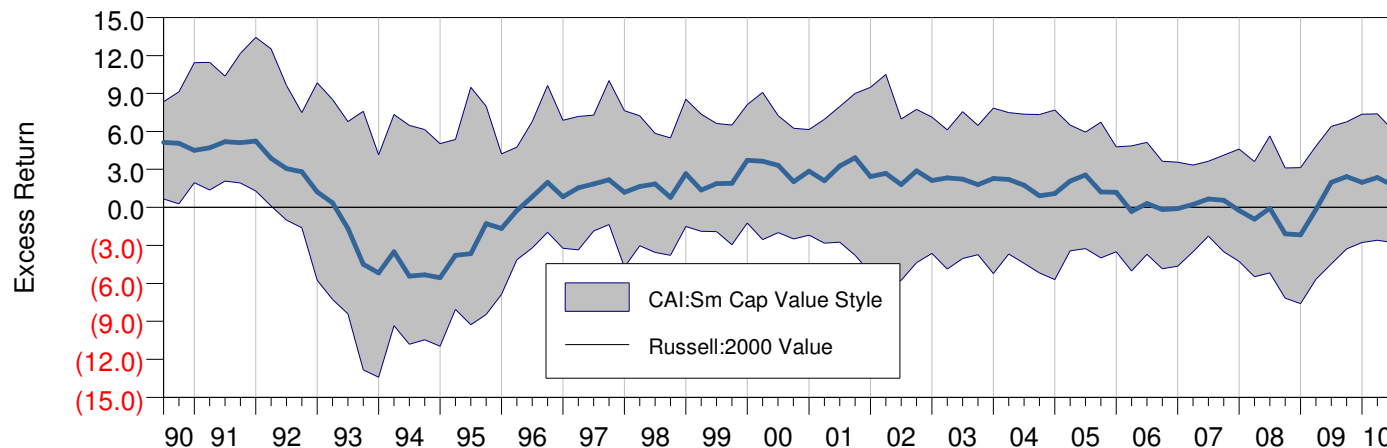
## Small Cap Active Management Frequently Outperforms the Benchmark

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%**

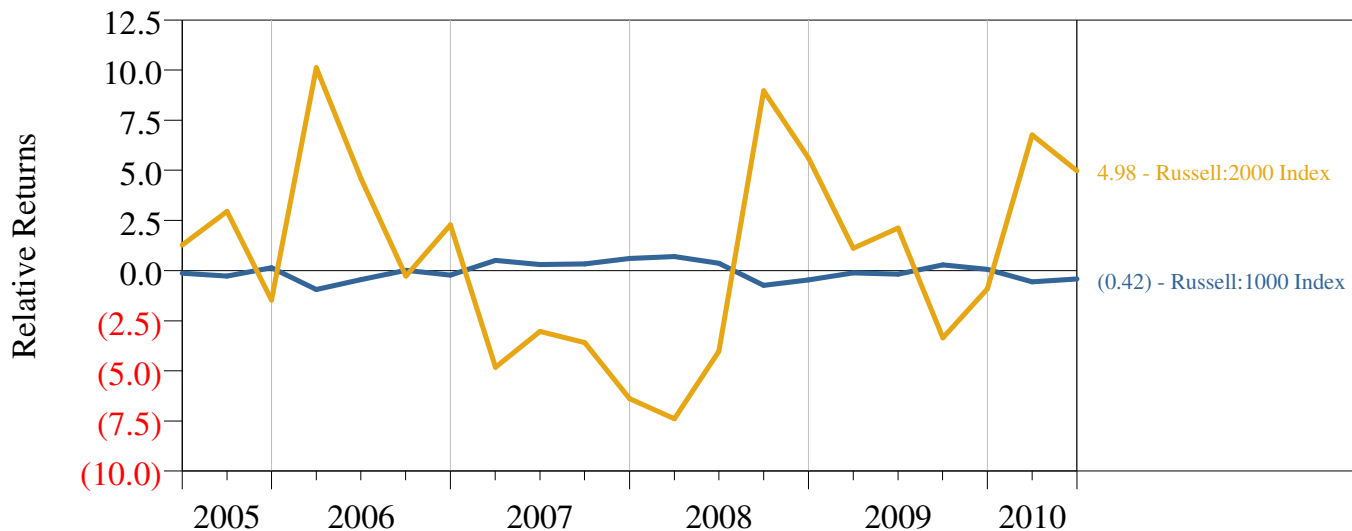
Rolling 12 Quarter Excess Return Relative To Russell:2000 Value for 20 Years Ended June 30, 2010





## ***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
<b>Large Cap</b>			
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%
<b>Small &amp; Mid Cap</b>			
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%
<b>Total</b>	<b>100.0%</b>	<b>104.63</b>	

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***

- 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

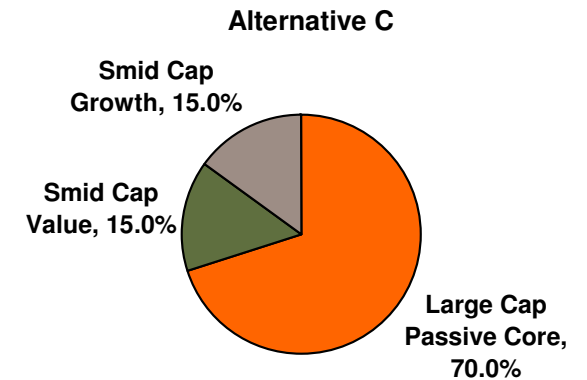
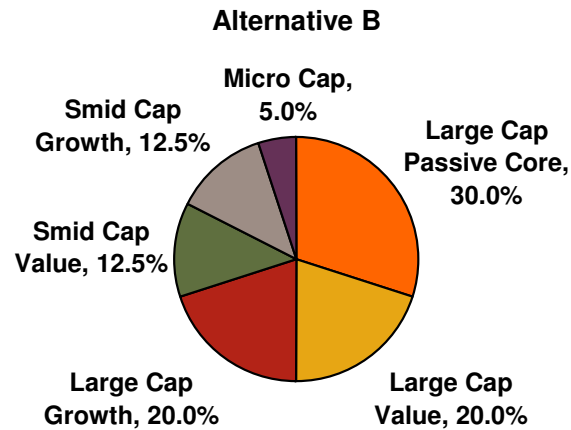
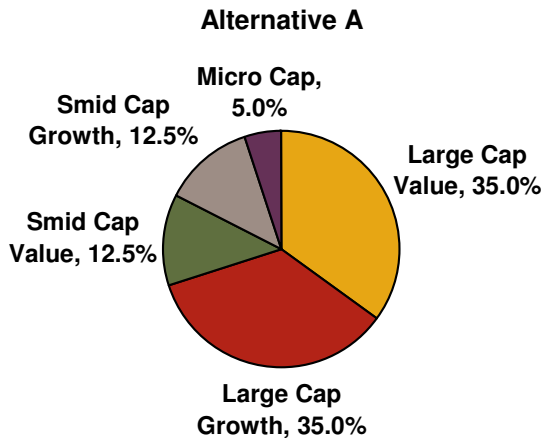
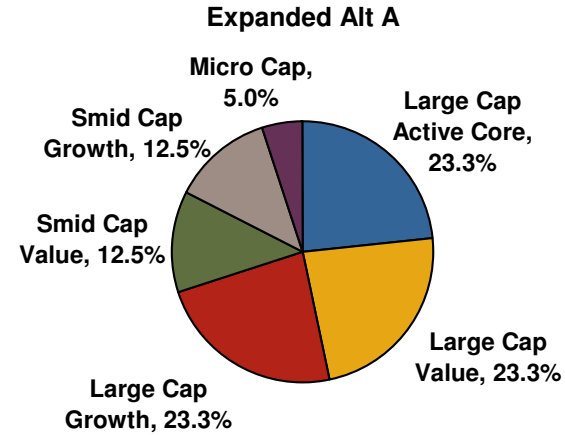
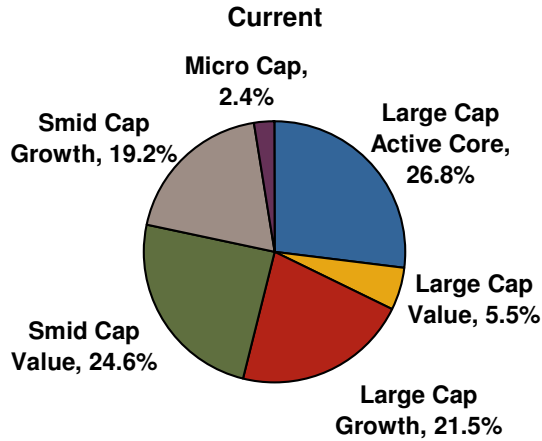


## Current and Alternative Structures

Style	Current	Alternative A	Expanded Alt A	Alternative B	Alternative C
<b>Large Cap</b>					
Passive Core	0.0%	0.0%	0.0%	30.0%	70.0%
New Manager	0.0%	0.0%	0.0%	30.0%	70.0%
Active Core	26.8%	0.0%	23.3%	0.0%	0.0%
Selected American	9.2%	0.0%	7.8%	0.0%	0.0%
Investment Company of America	9.2%	0.0%	7.8%	0.0%	0.0%
Vanguard Growth & Income	8.5%	0.0%	7.8%	0.0%	0.0%
Value	5.5%	35.0%	23.3%	20.0%	0.0%
Dodge & Cox	5.5%	17.5%	11.7%	10.0%	0.0%
New Manager	0.0%	17.5%	11.7%	10.0%	0.0%
Growth	21.5%	35.0%	23.3%	20.0%	0.0%
Growth Fund of America	6.4%	17.5%	7.8%	10.0%	0.0%
Harbor Capital Appreciation	8.0%	17.5%	7.8%	10.0%	0.0%
Janus Research	7.1%	0.0%	7.8%	0.0%	0.0%
<b>Small &amp; Mid Cap</b>					
Mid Cap Value	14.0%	7.5%	7.5%	7.5%	7.5%
Fidelity Low-Priced Stock	7.1%	0.0%	3.8%	0.0%	0.0%
Royce Total Return	7.0%	7.5%	3.8%	7.5%	7.5%
Small Cap Value	10.5%	5.0%	5.0%	5.0%	7.5%
Vanguard Small Cap	10.5%	0.0%	5.0%	0.0%	0.0%
New Active Manager	0.0%	5.0%	0.0%	5.0%	7.5%
Mid Cap Growth	14.0%	7.5%	7.5%	7.5%	7.5%
Morgan Stanley	7.2%	7.5%	3.8%	7.5%	7.5%
Janus Enterprise	6.8%	0.0%	3.8%	0.0%	0.0%
Small Cap Growth	5.2%	5.0%	5.0%	5.0%	7.5%
Alliance	2.8%	5.0%	2.5%	5.0%	7.5%
RS Emerging	2.4%	0.0%	2.5%	0.0%	0.0%
Micro Cap	2.4%	5.0%	5.0%	5.0%	0.0%
Managers Institutional Micro Cap	2.4%	5.0%	5.0%	5.0%	0.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Total Number of Funds	15	9	16	10	5



## Current and Alternative Structures





## ***Appendix***



## ***Hypothetical Historical Returns***

Returns  
for Periods Ended September 30, 2010

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years
MCERA Current	12.36	13.37	(4.31)	2.66	2.36
MCERA Alt A	11.84	10.87	(5.60)	1.64	2.33
MCERA Expanded Alt A	11.74	11.24	(5.79)	1.67	1.70
MCERA Alt B	11.94	11.63	(5.58)	1.71	1.75
MCERA Alt C	12.16	12.83	(5.56)	1.80	1.11
Russell 3000 Index	11.53	10.96	(6.59)	0.92	0.09



## Hypothetical Historical Returns

		Returns for Calendar Years 10 1/2 Years Ended September 30, 2010								
	3 Qtrs. 2010	2009	2008	2007	2006	2005	2004	2003	2002	2001
MCERA Current	7.35	36.13	(38.41)	8.54	13.25	9.11	15.92	35.04	(21.36)	(8.20)
MCERA Alt A	5.04	34.76	(38.90)	7.45	12.58	10.42	14.65	34.68	(21.68)	(5.36)
MCERA Expanded Alt A	5.34	33.48	(38.85)	7.68	13.81	8.58	14.35	33.73	(21.64)	(7.89)
MCERA Alt B	5.76	32.89	(38.33)	7.18	13.65	8.54	13.91	33.97	(22.05)	(7.00)
MCERA Alt C	6.79	30.87	(37.71)	6.57	15.06	6.49	13.20	32.47	(21.99)	(9.36)
Russell 3000 Index	4.78	28.34	(37.31)	5.14	15.72	6.12	11.95	31.06	(21.54)	(11.46)