

City of Milwaukee Employees' Retirement System Executive Summary



September 30, 2011

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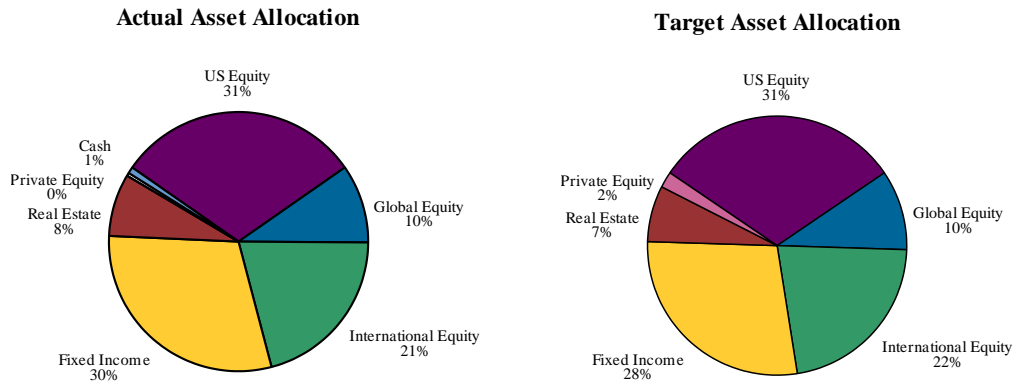
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Change in the CMERS Market Value During the Third Quarter

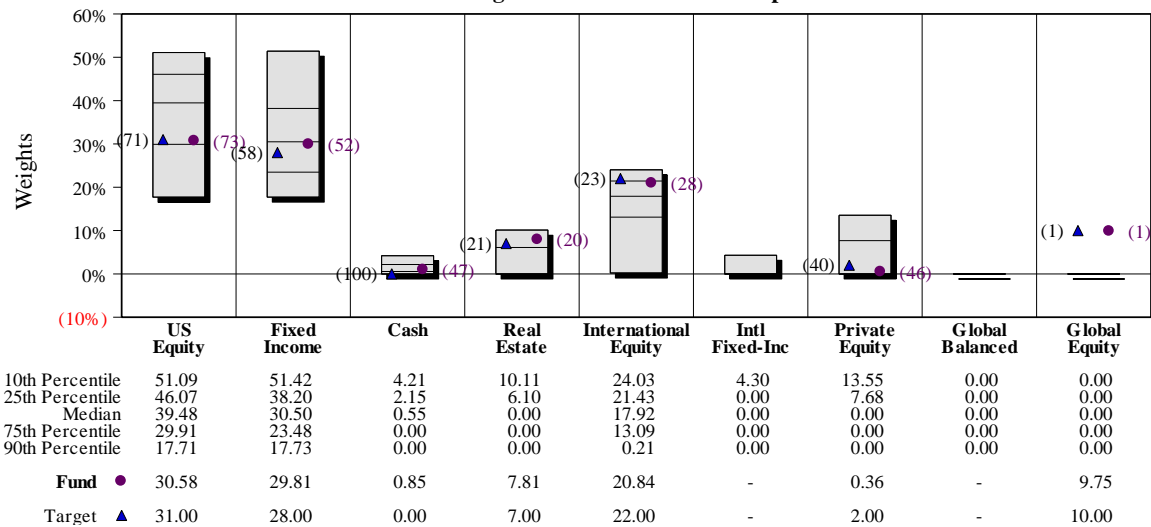
Beginning-of-Quarter Market Value:	\$4,402,562,377
Net Decrease in Market Value:	<u>(\$568,922,919)</u>
End-of-Quarter Market Value:	\$3,833,639,458

Asset Allocation of CMERS Assets at September 30, 2011



Asset Class	\$000s Actual	Percent Actual	Percent Target	Percent Difference	\$000s Difference
US Equity	1,172,420	30.6%	31.0%	(0.4%)	(16,008)
Global Equity	373,786	9.8%	10.0%	(0.2%)	(9,578)
International Equity	798,995	20.8%	22.0%	(1.2%)	(44,405)
Fixed Income	1,142,782	29.8%	28.0%	1.8%	69,363
Real Estate	299,468	7.8%	7.0%	0.8%	31,114
Private Equity	13,730	0.4%	2.0%	(1.6%)	(62,943)
Cash	32,458	0.8%	0.0%	0.8%	32,458
Total	3,833,639	100.0%	100.0%		

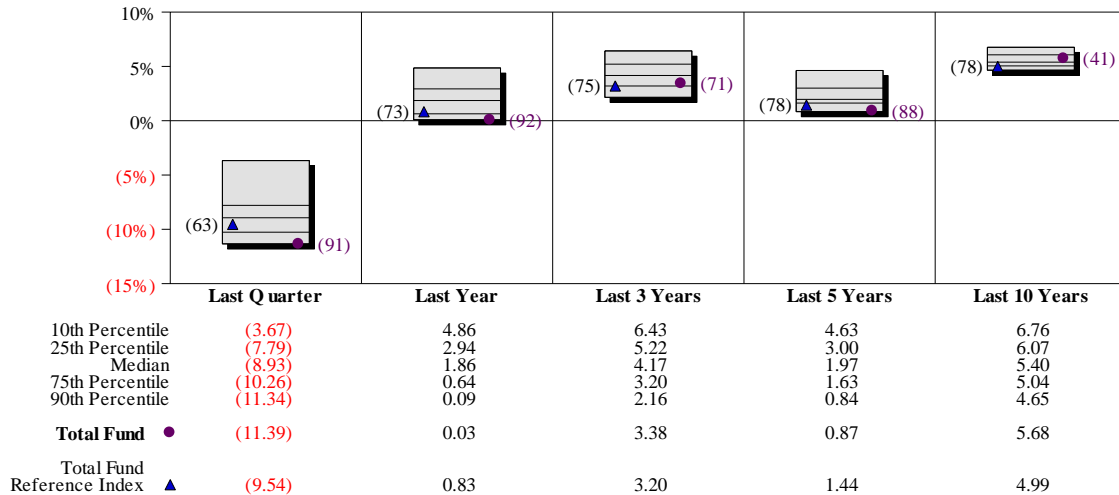
Asset Class Weights vs CAI Public Fund Sponsor Database



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Total Fund Performance

Performance vs CAI Public Fund Sponsor Database (Gross)



Policy Target consists of 31% Russell 3000, 28% Barclays Capital Aggregate, 22% MSCI EAFE (net), 10% MSCI World (net) and 7% NCREIF Property (One Quarter in Arrears) and 2% Russell 3000 (On a Quarter lag) + 3%.

Relative Attribution Effects for Quarter ended September 30, 2011

Asset Class	Effective Actual Weight	Effective Target Weight	Actual Return	Target Return	Manager Effect	Asset Allocation	Total Relative Return
Domestic Equity	32%	33%	(18.04%)	(15.28%)	(0.90%)	0.03%	(0.87%)
Fixed Income	27%	28%	0.53%	3.82%	(0.90%)	(0.08%)	(0.98%)
Real Estate	6%	7%	6.24%	3.94%	0.15%	(0.09%)	0.05%
International Equity	22%	22%	(18.23%)	(19.01%)	0.17%	(0.02%)	0.15%
Private Equity	0%	0%	1.87%	1.87%	0.00%	0.03%	0.03%
Global Equity	11%	10%	(19.31%)	(16.61%)	(0.28%)	(0.04%)	(0.32%)
Cash	1%	0%	2.25%	2.25%	0.00%	0.08%	0.08%
Total			(11.39%)	(9.54%)	(1.77%)	(0.09%)	(1.85%)

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Notes and Observations

- Total Fund trailed the policy benchmark by 185 basis points this quarter, ranking in the 91st percentile of peers.
- Performance this quarter was hindered by relative underperformance of the domestic equity and fixed income managers. Real estate and international equity composite performance versus their benchmarks made a positive contribution.

Investment Manager Performance Overview

- The **Blackrock Russell 1000 Alpha Tilts** portfolio beat the return of the Russell 1000 Index by 39 basis points in the quarter. For five- and seven-year periods ended September 30, 2011, the portfolio trailed the benchmark and ranked in the fourth quartile of Callan's Large Cap Core Style Group.
- **Turner Investment Partners** underperformed the benchmark by 267 basis points in the quarter. Performance was hindered by stock selection primarily in the information technology and consumer discretionary sectors. Over the five-year period ended September 30, 2011, the fund trailed the return of the Russell 1000 Growth Index by 384 basis points and ranked at the 98th percentile of Callan's Large Cap Growth Style Group.
- **AllianceBernstein Large Cap Value Equity** trailed the benchmark by 373 basis points for the quarter, and over the five-year period underperformed the blended benchmark by 3.37% and ranked at the 99th percentile of Callan's Large Cap Value Style Group. Performance for the quarter was hindered by poor security selection overall; however, an overweight to health care helped performance.
- The **Earnest Partners Mid Cap Portfolio** trailed the return of the Russell Mid Cap Index by 64 basis points and ranked at the 49th percentile of Callan's Mid Cap Core Style Group in the quarter. Sector allocation in consumer staples and industrials detracted from performance, as did security selection in information technology. Security selection in energy and industrials contributed positively to performance. Over the long-term periods, the fund exceeds the benchmark and ranks within the second quartile of peers.
- **Dimensional Fund Advisors' Small Cap Value Equity** underperformed the return of the Russell 2000 Value Index by 190 basis points in the quarter and ranked at the 85th percentile of Callan's Small Cap Value Style Group. DFA struggled this quarter as high quality, small value stocks were out of favor. For the five-years ended September 30, 2011, the portfolio outperformed the benchmark return by 158 basis points and ranked at the 65th percentile of the style group.

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- For the quarter, the **Allianz Small Cap Growth** portfolio missed the benchmark by 512 basis points and ranked at the 96th percentile of the Callan Small Cap Growth Style Group. Sector allocation was a drag on performance with an overweight to energy and underweight to consumer staples. Security selection in information technology and health care were significant detractors from performance.
- The **Grantham Mayo Van Otterloo** portfolio underperformed the MSCI World Index in the quarter by 285 basis points and ranked at the 67th percentile of Callan's Global Equity Style Group. An overweight to Germany detracted from performance while an overweight to Japan was positive. Overweights to consumer discretionary and energy also detracted. The portfolio has underperformed over the last year and ranked at the 67th percentile of the style group.
- The **T. Rowe Price** global equity portfolio underperformed the MSCI World Index by 254 basis points and ranked at the 62nd percentile of the Callan Global Equity Style Group for the quarter. The portfolio was overweight information technology stocks which was additive this quarter. While performance last quarter was helped by an overweight to the United States, this quarter it had a negative effect on the portfolio.
- **Brandes Investment Partners** beat its benchmark by 78 basis points and ranked at the 26th percentile of the Callan Non-U.S. Equity Style Group. Performance was hindered by country selection while security selection was additive. Longer term performance has ranked consistently in the third quartile outperforming the MSCI EAFE Index over the five-, seven-, and ten-year periods.
- The **William Blair** portfolio beat its benchmark by 153 basis points relative to the benchmark for the quarter, and ranked at the 29th percentile relative to peers. Country and security selection were slightly negative during the quarter, while currency selection accounted for all of the positive performance performance. Over the five- and seven-year periods the portfolio has outperformed and ranked in the 26th and 20th percentiles, respectively, relative to the Callan Non-U.S. Equity Style group.
- The **Dimensional Fund Advisors** international small cap portfolio lagged the blended benchmark by 298 basis points in the quarter and ranked at the 77th percentile of the Callan International Small Cap Style Group. The portfolio's allocation and selection among the smallest capitalization and lowest book-to-market ratio stocks took away from returns. For five-years ended September 30, 2011, the fund outperformed the index by 416 basis points, and ranked at the 55th percentile of the style group.
- The **BlackRock** Intermediate Aggregate portfolio performed in-line with its benchmark in the third quarter and ranked at the 37th percentile of its peer group. The portfolio has slightly outperformed the Barclays Capital Intermediate Aggregate benchmark for the last ten quarters and ranks at the 8th percentile so far this year versus peers. Long term performance shows the portfolio falling in the third quartile over all time periods while still exceeding its benchmark return.

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- The **Reams Asset Management** core plus portfolio returned 2.22% in the quarter trailing the benchmark by 160 basis points and ranking at the 40th percentile of its universe. The Barclays Aggregate ranked at the 1st percentile this quarter. The portfolio maintained a slightly shorter duration than the benchmark and added RMBS throughout the quarter by reducing Treasury exposure. This overweight to RMBS and US credit hurt performance. Long term performance remains strong with three-, five-, and seven-year returns ranking in the first quartile of Callan's Core Bond Plus Style group.
- **Loomis Sayles** returned -2.80% in the quarter lagging the Barclays Aggregate benchmark by 6.62%. The portfolio, which ranked at the 100th percentile of peers, was overweight BBB-rated and below investment grade bonds which was detrimental to performance. With an average portfolio quality of BBB+, portfolio holdings which provided the most upside in the second quarter were a hindrance this quarter. Despite this tough quarter Loomis still ranks at the top quartile for the long term trailing time periods.
- **Wellington's** Global Bond portfolio returned 3.03% in the third quarter exceeding the benchmark by 65 basis points and ranking at the 16th percentile of the Callan Global Fixed Income Database.

Investment Manager Organizational Developments

MacKay Shields Hires AllianceBernstein Vet as New Chief Executive Officer

9/21/2011 – MacKay Shields announced the appointment of Jeffrey Phlegar as the firm's new Chief Executive Officer. Phlegar replaces Lucille Protas, who has been Acting Chief Executive Officer since former CEO Osbert Hood departed the firm in March 2010.

Phlegar joins MacKay Shields from AllianceBernstein, where he was most recently President of the firm's Special Situations Group. Over his 18 year career with AllianceBernstein, Phlegar was at one point co-Head of Fixed Income and was responsible for both client relationship management and product development on a global basis. Phlegar will join MacKay Shields in the Fall of 2011.

Protas remains as MacKay Shields' Chief Operating Officer.

DFA announces new Head of Research

9/30/2011 – Dimensional Fund Advisors Inc. (DFA) announced today that Gerard O'Reilly will assume the role of Head of Research, effective immediately. O'Reilly replaces Eduardo Repetto who will continue to serve as the firm's co-CEO and co-CIO. Repetto was named co-CEO in January 2010. Since joining DFA in 2004, O'Reilly has been instrumental in the design of "investment products and more efficient methods for portfolio management and reporting".

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T. Rowe Price Africa & Middle East Fund Update

10/11/2011 – T. Rowe Price announced the appointment of Oliver Bell as Lead Portfolio Manager of its Africa & Middle East funds. Bell, who joined the firm from Pictet Asset Management, succeeds Chris Alderson, President - International Equity, who has been managing the funds on an interim basis since July 2011 when previous Portfolio Manager Joseph Rohm left the firm.

T. Rowe Price Announces New Head of Fixed Income Solutions

10/04/2011 – T. Rowe Price (T. Rowe) has hired Peter S. Austin as the new head of the firm's Fixed Income Solutions division. The newly created department will combine the different fixed income portfolio management groups to create client specific liability and volatility solutions. Austin joins T. Rowe after a 26-year career at BNY Mellon Corporation where he was Head of BNY Mellon Pension Services.

T. Rowe Price's Notzon to Retire at Year End

4/05/2011 – T. Rowe Price Associates, Inc. announced the retirement of **Edmund "Ned" Notzon**, effective December 31, 2011. Notzon has been with the firm since 1989 and has served as a portfolio manager in the firm's fixed income and asset allocation divisions and as Chairman of the T. Rowe Price Asset Allocation Committee. Effective May 1, 2011, **Richard Whitney**, Director of Asset Allocation, will succeed Notzon as Chairman of the Asset Allocation Committee. Notzon's portfolio management responsibilities for T. Rowe Price's Balanced, Personal Strategy, and Spectrum funds will be assumed by **Charles Shriver**, effective October 1, 2011. Shriver has been with the firm since 1991 and has worked with Notzon for the last 12 years.

Grantham, Mayer, Van Otterloo Appoints New CEO

6/30/2011 – In a letter from Chairman Arjun Divecha, Grantham, Mayo, Van Otterloo (GMO) announced on September 30, 2011 the appointment of Brad Hilsabeck to CEO and its Board of Directors. Hilsabeck replaces Marc Mayer who will be leaving the firm. Hilsabeck has been with the firm for eight years, most recently as Head of Global Client Relations since 2006 when he became member of the firm's Executive Committee.

GMO Co-Head of Global Fixed Income to Retire

8/05/2011 – Bill Nemerever, Co-Head of Global Fixed Income at Grantham, Mayo, Van Otterloo & Co., and Lead Portfolio Manager for developed fixed income strategies, has announced he will retire at the end of 2011. Nemerever joined the firm in 1993 and has held his leadership position for 18 years. Tom Cooper, who has co-headed the group with Nemerever over the same time span, will assume sole responsibility of the fixed income group after Nemerever's retirement.

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Wellington Announces Impending Departure of Co-Director of Fixed Income

7/11/2011 – Wellington Management Company announced that **Diane Nordin**, Co-Director of Fixed Income, has elected to withdraw from the partnership and depart from the firm at the end of 2011. Nordin joined Wellington in 1991. Jim Valone remains as Co-Director of Fixed Income.

Nordin's role as Co-Director of Fixed Income will be assumed by Steve Klar, who is currently Director of Investment Products & Strategies and Sponsored Products, upon her departure. Adam Puritz, currently Associate Director of Global Equity Portfolio Management, will subsequently assume Klar's role as Director of Investment Products & Strategies.

Allianz CEO to Retire at Year End

9/07/2011 – In an e-mail notification sent September 7, 2011, Allianz Global Investors announced the retirement of CEO Marna Whittington, effective at the end of 2011. Whittington's duties will be assumed by Brian Gaffney who is CEO of Allianz Global Investors Distributors, the retail distribution and marketing arm of AGI Capital and its affiliates. Whittington has been with the firm for 10 years and also served as COO of the firm's global parent.

Whittington's retirement announcement coincides with a global reorganization where Allianz Global Investors will be under the Allianz Asset Management umbrella alongside PIMCO. These changes do not affect the investment teams or processes at the firm which remain under the oversight of CIO Horacio Valeiras.

Investment Manager Compliance

All CMERS investment managers have reported they are in compliance with CMERS investment policy guidelines as of September 30, 2011.

Action Items

- Large Cap Equity structure evaluation

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Exhibit I

	September 30, 2011		June 30, 2011	
	Market Value	Percent	Market Value	Percent
Total Domestic Equity	\$1,172,420,347	30.58%	\$1,438,090,612	32.66%
Northern Trust Global	319,631,901	8.34%	358,020,758	8.13%
BlackRock R1000 Alpha Tilts	153,208,413	4.00%	178,756,864	4.06%
Turner Investment Partners	182,908,124	4.77%	227,258,076	5.16%
AllianceBernstein L.P.	178,354,380	4.65%	222,758,546	5.06%
Earnest Partners LLC	109,299,154	2.85%	135,840,241	3.09%
Dimensional Fund Advisors Inc.	150,843,546	3.93%	207,826,061	4.72%
Allianz Global Investors Capital	78,174,829	2.04%	107,630,067	2.44%
Total Global Equity	\$373,785,848	9.75%	\$463,261,255	10.52%
Grantham Mayo Van Otterloo	190,972,406	4.98%	237,129,214	5.39%
T. Rowe Price	182,813,442	4.77%	226,132,041	5.14%
Total International Equity	\$798,995,310	20.84%	\$987,606,582	22.43%
Brandes Investment Partners	323,911,840	8.45%	390,748,588	8.88%
William Blair & Company	374,207,553	9.76%	467,991,130	10.63%
Dimensional Fund Advisors Inc.	100,875,917	2.63%	128,866,863	2.93%
Total Fixed Income	\$1,142,781,802	29.81%	\$1,209,274,520	27.47%
BlackRock Intermediate Agg	236,855,207	6.18%	258,390,174	5.87%
Reams Asset Management	258,667,233	6.75%	268,700,192	6.10%
Loomis, Sayles & Company, L.P.	413,901,797	10.80%	450,988,385	10.24%
Wellington Management Company	233,357,564	6.09%	231,195,769	5.25%
Total Private Equity	\$13,729,831	0.36%	\$11,107,594	0.25%
Abbott Capital Management 2010	1,648,476	0.04%	890,316	0.02%
Abbott Capital Management 2011	290,935	0.01%	555,191	0.01%
Mesirow Financial	11,790,420	0.31%	9,662,087	0.22%
Total Real Estate	\$299,468,360	7.81%	\$268,799,197	6.11%
Real Estate	299,468,360	7.81%	268,799,197	6.11%
Total Cash	\$32,457,960	0.85%	\$24,422,616	0.55%
Cash	32,457,960	0.85%	24,422,616	0.55%
Total Fund	\$3,833,639,458	100.0%	\$4,402,562,377	100.0%

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Exhibit II

	Last Quarter		Last Year		Last 3 Years		Last 5 Years		Since Inception	
Total Domestic Equity	(18.04%)		(1.21%)		1.04%		(2.30%)		3.04%	
Russell 3000 Index	(15.28%)		0.55%		1.45%		(0.92%)		2.27%	
Northern Trust Global	(13.87%)	25	1.21%	44	1.37%	46	(1.24%)	72	8.76%	89
S&P 500 Index	(13.87%)	25	1.14%	44	1.23%	47	(1.18%)	72	8.77%	88
CAI Large Cap Core Style	(15.21%)	50	0.46%	50	1.10%	50	(0.83%)	50	9.74%	50
BlackRock R1000 Alpha Tilts	(14.29%)	33	2.53%	23	0.69%	63	(2.53%)	97	3.61%	70
Russell 1000 Index	(14.68%)	39	0.91%	48	1.61%	35	(0.91%)	55	3.90%	54
CAI Large Cap Core Style	(15.21%)	50	0.46%	50	1.10%	50	(0.83%)	50	3.96%	50
Turner Investment Partners	(15.80%)	70	1.89%	46	2.62%	59	(2.22%)	98	4.27%	92
Russell 1000 Growth Index	(13.14%)	24	3.78%	28	4.69%	32	1.62%	46	6.32%	51
CAI Lrg Cap Growth Style	(14.74%)	50	1.34%	50	3.51%	50	1.54%	50	6.37%	50
AllianceBernstein L.P.	(19.93%)	95	(6.02%)	91	(2.39%)	82	(6.90%)	99	4.73%	96
Blended Benchmark	(16.20%)	38	(1.89%)	55	(1.52%)	70	(3.53%)	71	5.01%	91
CAI Large Cap Value Style	(17.06%)	50	(1.70%)	50	(0.80%)	50	(2.80%)	50	6.54%	50
Ernest Partners LLC	(19.54%)	49	(0.99%)	48	3.58%	54	1.67%	47	3.59%	45
Russell MidCap Index	(18.90%)	37	(0.88%)	48	3.96%	51	0.56%	67	2.87%	64
CAI Mid Cap Style	(19.61%)	50	(1.13%)	50	4.18%	50	1.53%	50	3.35%	50
Dimensional Fund Advisors Inc.	(23.38%)	85	(3.99%)	53	1.99%	40	(1.50%)	65	10.06%	27
Russell 2000 Value Index	(21.47%)	45	(5.99%)	73	(2.78%)	92	(3.08%)	85	7.04%	93
CAI Small Cap Value Style	(21.52%)	50	(3.72%)	50	1.70%	50	(0.23%)	50	9.58%	50
Allianz Global Investors Capital	(27.37%)	96	(10.56%)	95	-	-	-	-	(8.10%)	95
Russell 2000 Growth Index	(22.25%)	54	(1.12%)	62	2.07%	64	0.96%	57	0.85%	61
CAI Sm Cap Growth Style	(21.95%)	50	2.46%	50	3.25%	50	1.59%	50	2.87%	50
Total Global Equity	(19.31%)		(8.67%)		-		-		(6.47%)	
MSCI The World Index	(16.61%)		(4.35%)		(0.07%)		(2.23%)		(3.33%)	
Grantham Mayo Van Otterloo	(19.46%)	67	(7.54%)	67	-	-	-	-	(5.73%)	73
MSCI The World Index	(16.61%)	24	(4.35%)	38	(0.07%)	61	(2.23%)	64	(3.33%)	48
CAI Global Eq Broad Style	(18.41%)	50	(5.50%)	50	0.79%	50	(1.46%)	50	(3.62%)	50
T. Rowe Price	(19.16%)	62	(9.82%)	81	-	-	-	-	3.48%	73
MSCI AC World	(17.42%)	33	(6.01%)	55	0.59%	53	(1.59%)	51	5.93%	51
CAI Global Eq Broad Style	(18.41%)	50	(5.50%)	50	0.79%	50	(1.46%)	50	5.98%	50

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Total International Equity	(18.23%)		(8.89%)		1.50%		(1.52%)		6.24%	
MSCI EAFE Index	(19.01%)		(9.36%)		(1.13%)		(3.46%)		3.21%	
Brandes Investment Partners	(17.10%)	19	(9.10%)	54	(1.59%)	75	(2.81%)	63	7.09%	9
MSCI EAFE Index	(19.01%)	38	(9.36%)	57	(1.13%)	69	(3.46%)	74	2.34%	93
CAI Non-U.S. Equity Style	(19.68%)	50	(8.82%)	50	(0.09%)	50	(2.16%)	50	4.30%	50
William Blair & Company	(18.24%)	29	(8.97%)	53	3.49%	14	(0.74%)	26	5.70%	28
MSCI ACWI ex-US Index	(19.78%)	52	(10.42%)	68	0.98%	37	(1.12%)	33	5.69%	28
CAI Non-U.S. Equity Style	(19.68%)	50	(8.82%)	50	(0.09%)	50	(2.16%)	50	4.73%	50
Dimensional Fund Advisors Inc.	(21.57%)	77	(7.73%)	76	3.35%	75	(1.08%)	63	(1.75%)	100
Blended Benchmark	(18.59%)	40	(5.76%)	62	3.88%	69	(3.67%)	90	(4.91%)	100
CAI Int'l Small Cap Style	(19.35%)	50	(4.84%)	50	5.72%	50	(0.12%)	50	-	
Total Fixed Income	0.53%		5.27%		11.99%		8.05%		8.73%	
Barclays Capital Aggregate	3.82%		5.26%		7.97%		6.53%		7.40%	
BlackRock Intermediate Agg	2.30%	37	4.38%	8	7.30%	73	6.31%	59	6.16%	1
Barclays Capital Int Aggregate	2.30%	37	4.22%	10	7.12%	79	6.16%	73	6.05%	1
CAI Intermediate F-I Styl	2.09%	50	3.67%	50	7.78%	50	6.42%	50	0.00%	50
Reams Asset Management	2.22%	40	4.40%	79	12.72%	8	8.32%	11	6.82%	1
Barclays Capital Aggregate	3.82%	1	5.26%	43	7.97%	93	6.53%	56	5.94%	1
CAI FI Core Plus Style	2.00%	50	5.09%	50	10.21%	50	6.91%	50	0.00%	50
Loomis, Sayles & Company, L.P.	(2.80%)	100	4.35%	81	13.13%	6	8.09%	14	9.94%	1
Barclays Capital Aggregate	3.82%	1	5.26%	43	7.97%	93	6.53%	56	7.40%	86
CAI FI Core Plus Style	2.00%	50	5.09%	50	10.21%	50	6.91%	50	8.19%	50
Wellington Management Company	3.03%	16	-	-	-	-	-	-	8.07%	1
CG WGBI Index	2.38%	27	4.61%	31	7.71%	71	7.54%	44	6.50%	1
CAI Global Fixed-Inc DB	0.82%	50	3.68%	50	8.79%	50	7.39%	50	8.53%	50
Total Private Equity	1.87%		5.25%		-		-		4.14%	
Abbott Capital Management 2010	(7.79%)		(35.93%)		-		-		(63.07%)	
Abbott Capital Management 2011	(47.60%)		-		-		-		(47.60%)	
Mesirow Financial	5.63%		13.58%		-		-		14.13%	
Russell 3000 (On a Qtr Lag) + 3%	0.72%		36.11%		-		-		17.03%	
Total Real Estate	6.24%		21.10%		(12.22%)		(2.85%)		5.47%	
Real Estate	6.24%	2	21.10%	7	(12.22%)	85	(2.85%)	72	5.47%	68
NCREIF Property (1 Quarter in Arrears)	3.94%	27	16.73%	57	(2.57%)	9	3.44%	7	7.22%	13
Open-End Real Estate	3.45%	50	16.96%	50	(7.06%)	50	(0.84%)	50	-	
Total Fund	(11.39%)		0.03%		3.38%		0.87%		9.40%	
Total Fund Reference Index	(9.54%)		0.83%		3.20%		1.44%		-	

*Note: Numbers adjacent to return number represent the portfolio's rank relative to the corresponding peer group.
1 = Highest Ranking; 100 = Lowest Ranking.*

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Economic Overview and Capital Market Review – Third Quarter 2011

Brief Market Recap

Equities continued the decline that started in early May and finished the quarter either on the verge of, or well into, bear market territory, commonly cited as a 20% retracement from a market peak. The 7% slide experienced by the S&P 500 in the month of September marked the 5th consecutive month of declines for the broad market measure.

Foreign equity markets performed roughly in line on a local currency basis, but significant declines in currencies such as the euro and Brazilian real pushed dollar-denominated results well below domestic returns.

Interest rates continued to fall paving the way for another strong quarter for fixed income indices. Returns were strongest in government sectors while high yield and emerging markets debt saw negative results.

Commodities experienced tremendous volatility during the quarter with livestock producing the best result and industrial metals experiencing a punishing rout.

Market Environment and Events

As the quarter commenced, the US Congress was embroiled in a bitter debate about the debt ceiling. The 11th hour resolution in early August averted a default on government obligations; however, much damage was done to credibility and confidence on both sides of the aisle. In an unanticipated and sharply worded announcement, Standard & Poor's downgraded the credit rating of US Treasury obligations from AAA to AA+ based on concerns surrounding the "effectiveness, stability, and predictability of American policymaking and political institutions." The market impact of the downgrade was rather interesting; while traditional expectations are that a downgrade would negatively impact bond prices, the flight to quality status of US Treasuries overrode the credit rating decline and pushed bond prices higher.

As attention on the US debt ceiling shifted to a focus on the ongoing debt crisis in Greece, global equity markets continued their slide. Greece remains on the brink of default and the country's finance minister announced that there is only enough money to fund the government through mid-November.

Moving from political issues to monetary policy, the beginning of the 3rd quarter marked the end of the Fed's QE2 bond buying program; however, it wasn't long before yet another round of stimulus was rumored. By quarter end, Fed Chairman Ben Bernanke announced the next attempt at spurring economic growth, "Operation Twist." The plan is to move the Fed's balance sheet further out on the yield curve by selling \$400 billion in short term fixed income assets while buying longer dated paper. Additionally, the Fed announced that it would reinvest principal and

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interest payments received on its \$1 trillion holdings in mortgage backed and agency securities in order to maintain the size of its holdings in the sector.

The equity sell-off that began in May accelerated through the 3rd quarter and by the end of September much of the global equity market was at or beyond the brink of a bear market. While the US economy has not yet been declared to be in a recession by the National Bureau of Economic Research ("NBER"), forecasting firms and market participants widely believe a new recession may have already begun. The NBER is typically quite slow in its determination of the beginning and end of business cycles; for example, NBER announced the end of the last recession (June 2009) on September 22, 2010. Federal Reserve Chairman Ben Bernanke has said the economic recovery "is close to faltering" and the central bank is prepared to take further steps to support the economy. Poor job growth and low consumer confidence are among the Fed's chief economic concerns.

Despite the political and economic turmoil that currently dominate the news cycle, corporations continue to perform well. With the 2Q2011 earnings season nearly complete, companies in the S&P 500 posted record profits, eclipsing the peak levels of 2Q2007. Looking forward, forecasts for 2012 S&P earnings are in the \$110 range. Cash balances continue to amass on corporate balance sheets as firms remain reluctant to return capital to shareholders. Cash as a percentage of current assets is approaching 30% and has climbed steadily since the 2008 recession. However, dividends and stock buybacks dropped sharply during the recession and remain well below their 2007 peak. The strong earnings statements and balance sheets coupled with weak stock prices to give strong support to bullish equity valuations. The forward P/E on the S&P 500 has dropped to 10.6x, well below the 20-year average of about 16x. Bearish investors counter the low valuations with observations about the risks that macroeconomic and geopolitical uncertainty place on the sustainability of the currently high profit margins. Margins are well above historical norms and appear unlikely to sustain those levels over the longer term.

Inflation data remain fairly benign. Headline CPI ticked up slightly in August to 3.8% while Core CPI (excluding food and energy) came in at 2%. Similarly, inflation fears overseas, particularly in emerging economies, are taking a backseat to concerns of contagion from the debt crisis in Greece and problems in several other peripheral euro zone countries. Just a few months ago a number of foreign central banks were in the process of increasing interest rates; however, many have slowed or even reversed course. China and South Korea stopped raising rates while Turkey and Brazil have shifted to rate cuts in recent weeks. Both the Turkish and Brazilian currencies suffered notably as a result of the cuts.

American consumers remain defensive due in large part to high unemployment, stagnant wages, and weak housing prices. Unemployment remains stubbornly high at 9.1% and there appears to be little expected change despite another job creation plan from the White House. Further compounding the problem is the decline in the labor force participation rate. Just 64% of the population over 16 years of age is working or actively looking for work. Ironically, should job creation materialize and lure discouraged workers back into the labor force, the unemployment rate could remain elevated in spite of job growth. For those lucky enough to have a job, wages (adjusted for inflation) have been stagnant for a decade, according to a recent study by the US

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Census Bureau. Finally, house prices have remained weak and the outlook remains glum. Despite mortgage rates being at generational lows, many households are unable to refinance to take advantage of those rates due to negative equity, falling conforming loan limits, and stricter lending standards. New buyers are also reluctant to enter the housing market despite the very low cost of ownership. Expectations for further price declines combine with high debt levels to make a house purchase unattractive to young people. With the next generation of homeowners finishing college with an average of nearly \$30,000 in education loans, the time it takes to save the now obligatory 20% down payment is growing and delaying house purchase decisions. These three factors are keeping consumers, who account for 71% of economic activity in the US, focused on balance sheet repair rather than consumption. Effectively, consumers are enacting their own austerity plans and have boosted personal savings rates back to around 5% from a low of below 2% in 2005.

Third Quarter Market Performance

U.S. equity markets fell throughout the quarter as the S&P 500 posted its largest decline since the depths of the credit crisis in the 4th quarter of 2008. The 13.9% drop in the S&P was the 5th worst quarter in 25 years. Only in 4Q87 (black Monday; -22.5%), 3Q01 (9/11 attacks; -14.7%), 3Q02 (bottoming of the internet bubble; -17.3%), and 4Q08 (Lehman bankruptcy, credit bubble; -21.9%) did the S&P suffer more acutely. 3Q90 (1st Gulf War, -13.7%) and 2Q02 (internet bubble; -13.4%) were close behind.

Capitalization and performance were positively correlated as large caps suffered least (Russell Top 50: -10.3%, Top 200: -12.8%, R1000: -14.7%) while results eroded notably through the mid, small and microcaps (Russell Midcap: -18.9%, R2000: -21.9%, Microcap: -22.7%). Growth outperformed value among large cap issues (R1G: -13.1%, R1V: -16.2%) due in part to significant declines in large banks. Among mid and small caps the trend was reversed and value held up slightly better than growth (RMG: -19.3%, RMV: -18.5%, R2G: -22.3%, R2V: -21.5%). High quality issues held up far better than lower quality names and the 10% quarterly return differential between the S&P Quality indices (S&P HQ: -12.3%, S&P LQ: -22.3%) reversed some of the performance advantage that low quality had enjoyed through the market rally since early 2009. Within the GICS classification of the S&P 500, the traditionally defensive Utilities and Consumer Staples sectors were the best performers (+1.5% and -4.2%, respectively) while the economically sensitive Industrials and Materials sectors performed worst (-21.0% and -24.5%, respectively). Financials (-22.8%) also suffered as the European debt crisis rippled throughout the global banking system.

Developed foreign equity markets underperformed their large cap US counterparts while emerging market equities fell further. The relative strength of the US dollar had much to do with the relative results as both developed and emerging equities underperformed only mildly in local terms (EAFE US\$: -19.0%, EAFE Local: -15.7%, EM US\$: -22.5%, EM Local: -14.9%). There was little distinction in results from a capitalization or style perspective as growth, value, and small caps all fell by roughly the same amount (EAFE Growth: -19.0%, Value: -19.0%, Small: -18.6%). Unsurprisingly, Greece's ongoing debt saga continued to weigh on equities and again was the worst performing country in the EAFE Index (MSCI Greece -47%). Japan and New

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Zealand were the best performers among developed countries (MSCI Japan: -6.4%, MSCI New Zealand: -6.5%). Both countries enjoyed a strong currency tailwind that mitigated larger losses when measured in local currency. In the developing world, Hungary is embroiled in a debt crisis of its own and led country decliners (MSCI Hungary: -44%) while Peru held up best (MSCI Peru: -5%). September was also a particularly bad month for the currencies of emerging markets; the Russian ruble fell 14%, the Brazilian real fell 18%, and the South African rand fell 19%.

To round out equity performance, securitized real estate performed in line with large caps and better than mid and small broad equity markets for the quarter. The NAREIT Equity Index fell 14.7% in the quarter.

Concerns of potential contagion from the Greek debt crisis and skepticism regarding the ability of the US Congress to overcome extreme partisanship to effectively run the government led to yet another quarter of declining interest rates in the US. The 10-year Treasury yield fell through the quarter with the debt ceiling debate and the Fed's announcement of "Operation Twist" accelerating the drop in yield. After commencing the quarter at 3.16%, the yield broke through the low set in 2008 (2.07% on 12/18/2008) and fell to a 50-year low of 1.72% on 9/22/2011 with the Twist announcement before inching up slightly to close the quarter at 1.92%. As a result of the drop in rates, the BC Aggregate index (+3.8%) rose and long-dated government-related paper posted the strongest gains. The US dollar strengthened against most world currencies as the flight to quality, perhaps better described as a flight from risk, pressured the euro, the British pound, and many emerging markets currencies. Local currency developed market sovereign debt underperformed hedged indices as the dollar strengthened (Citi Non-US WGBI Hedged: +3.0%, Unhedged: +0.9%). Further down the credit quality spectrum, high yield bonds (BC High Yield CP: -5.9%) suffered along with the equity markets and posted their worst quarter since 4Q2008. Emerging markets debt also struggled due to the flight from risk assets. The US dollar denominated JPM EMBI+ (-1.2%) gave back some of its gains from 1H2011 while the local currency JPM EMLI+ fell nearly 9% as many emerging markets currencies experienced notable declines. Municipal bonds were relatively strong performers (BC Muni Index +2.4%) as supply remained muted and falling yields pushed up prices.

Volatility in commodity markets persisted during the quarter and the energy-heavy S&P GSCI Index narrowly underperformed the more balanced DJ-UBS Index (GSCI: -11.7%, DJUBS: -11.3%). Industrial Metals was the worst performing group losing more than 20% as investors feared weakening demand for building materials in the face of a global slowdown. Early strength in gold kept the precious metals group (GSCI Precious Metals: +4.4%) in positive territory. In August, gold peaked just over \$1900/oz, setting an all-time high before facing a substantial bout of selling during the flight from risk in September that drove the price under \$1600/oz. Silver also suffered in the September selloff. The metal reached an all-time high in late April at near \$50/ounce before dropping into the high \$20s just before the end of the 3rd quarter.

Closing Thoughts

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After peaking in May, US equity markets are flirting with the 20% slide that is often marked as the definition of a bear market. The riskier corners of the equity markets such as small caps and emerging markets have seen more aggressive selling pressure and are well into bear market territory at nearly 30% below their respective peaks.

Despite the equity market declines, corporate profits and margins remain at all-time highs and consequently equity market valuations around the globe appear very attractive. Forward P/E ratios range from 10.6x in the US to as low as 8.8x for broad emerging markets and as low as 4.7x for markets such as Russia. Bullish market participants point to these historically attractive P/Es as reasons to be optimistic while bearish sentiment relies on the troubling macroeconomic and geopolitical environment as arguments against the sustainability of current corporate earnings and margin levels. Government deficits threaten to strain growth and recession-fighting monetary and fiscal policy may well spur inflation. Historically low yields on fixed income instruments leave little cushion to offset any principal erosion resulting from rising interest rates.

Acknowledging these risks, Callan continues to recommend prudent asset allocation and risk assessment based on future capital needs for both plan sponsors and individual investors. Due diligence reviews and an adherence to a well-developed investment policy remain the most prudent long-term course for investors.

Returns Ending September 30, 2011

