

# City of Milwaukee Employees' Retirement System

## Executive Summary



**December 31, 2011**

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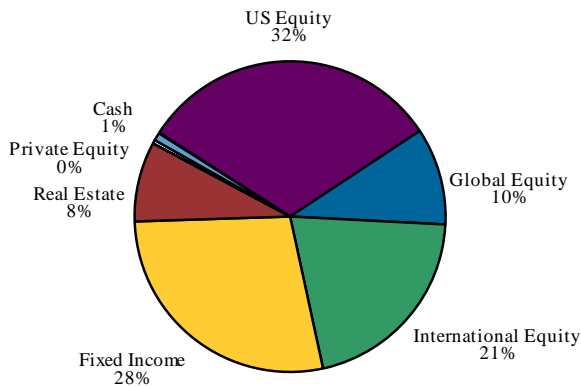
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**Change in the CMERS Market Value During the Fourth Quarter**

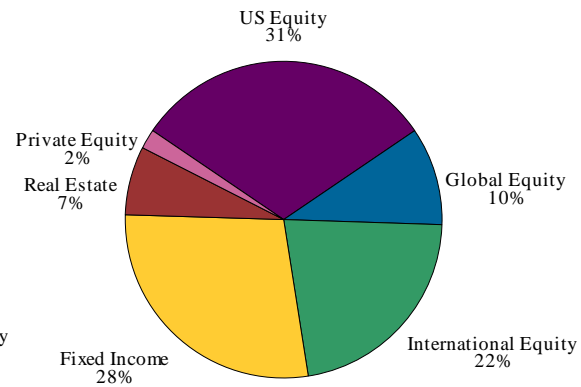
Beginning-of-Quarter Market Value:	\$3,833,639,458
Net Increase in Market Value:	<u>\$143,046.839</u>
End-of-Quarter Market Value:	\$3,976,686,297

**Asset Allocation of CMERS Assets at December 31, 2011**

**Actual Asset Allocation**

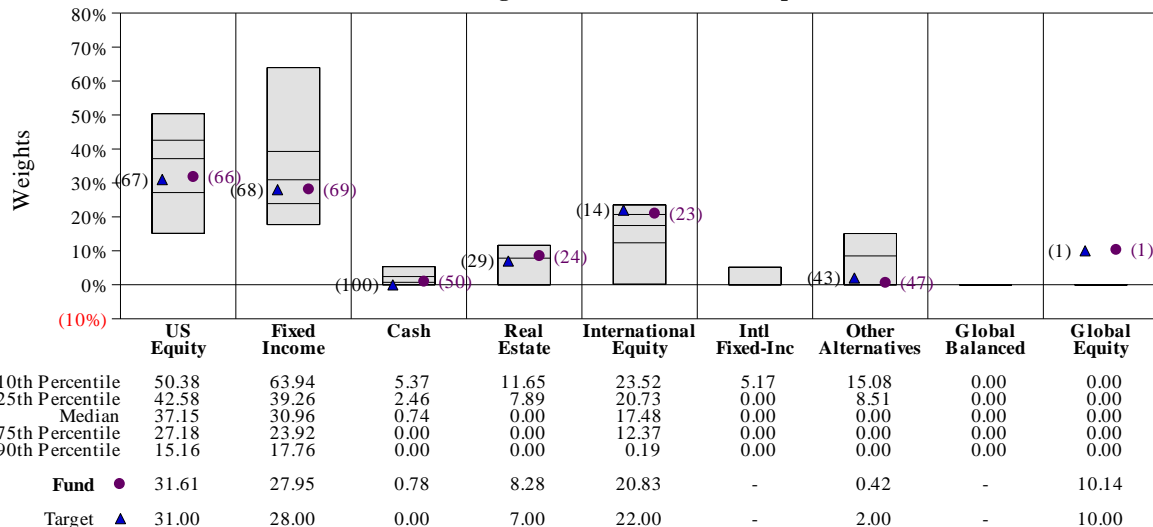


**Target Asset Allocation**



Asset Class	\$000s Actual	Percent Actual	Percent Target	Percent Difference	\$000s Difference
US Equity	1,256,985	31.6%	31.0%	0.6%	24,213
Global Equity	403,425	10.1%	10.0%	0.1%	5,756
International Equity	828,148	20.8%	22.0%	(1.2%)	(46,723)
Fixed Income	1,111,433	27.9%	28.0%	(0.1%)	(2,040)
Real Estate	329,120	8.3%	7.0%	1.3%	50,752
Private Equity	16,558	0.4%	2.0%	(1.6%)	(62,976)
Cash	31,018	0.8%	0.0%	0.8%	31,018
<b>Total</b>	<b>3,976,686</b>	<b>100.0%</b>	<b>100.0%</b>		

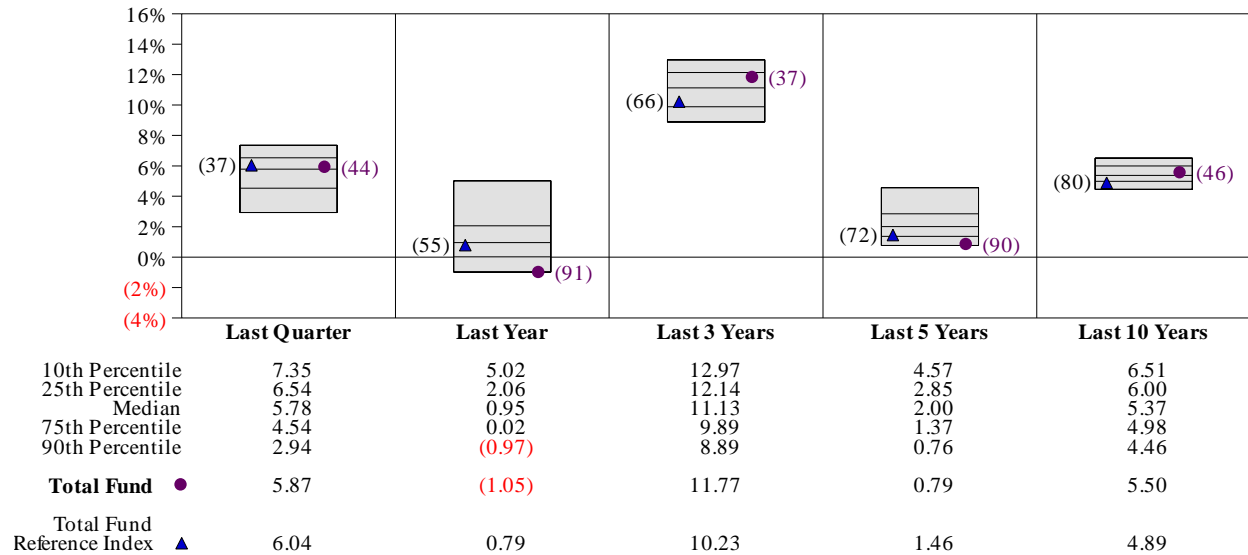
**Asset Class Weights vs CAI Public Fund Sponsor Database**



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**Total Fund Performance**

**Performance vs CAI Public Fund Sponsor Database (Gross)**



*Policy Target consists of 33% Russell 3000, 28% Barclays Capital Aggregate, 22% MSCI EAFE (net), 10% MSCI World (net) and 7% NCREIF Property (One Quarter in Arrears).*

**Relative Attribution Effects for Quarter ended December 31, 2011**

Asset Class	Effective Actual Weight	Effective Target Weight	Actual Return	Target Return	Manager Effect	Asset Allocation	Total Relative Return
Domestic Equity	31%	33%	11.75%	12.12%	(0.11%)	(0.13%)	(0.24%)
Fixed Income	29%	28%	2.02%	1.12%	0.26%	(0.05%)	0.21%
Real Estate	8%	7%	1.15%	3.30%	(0.18%)	(0.03%)	(0.21%)
International Equity	21%	22%	3.70%	3.33%	0.08%	0.04%	0.11%
Private Equity	0%	0%	(3.91%)	(3.91%)	0.00%	(0.04%)	(0.04%)
Global Equity	10%	10%	7.93%	7.59%	0.03%	(0.00%)	0.03%
Cash	1%	0%	1.43%	1.43%	0.00%	(0.03%)	(0.03%)
<b>Total</b>			<b>5.87%</b>	<b>6.04%</b>	<b>+ 0.08%</b>	<b>+ (0.25%)</b>	<b>(0.17%)</b>

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**Notes and Observations**

- Total Fund trailed the policy benchmark by 17 basis points this quarter, ranking in the 44<sup>th</sup> percentile of peers.
- Performance this quarter was hindered by the underweighting of domestic equity managers. Real estate and domestic equity composite performance versus their benchmarks also made a negative contribution.

**Investment Manager Performance Overview**

- The **Blackrock Russell 1000 Alpha Tilts** portfolio beat the return of the Russell 1000 index by 117 basis points in the quarter. For five- and seven-year periods ended December 31, 2011, the portfolio trailed the benchmark and ranked in the fourth quartile of Callan's Large Cap Core Style group.
- The Fund's two large cap equity managers, **Turner Investment Partners** and **AllianceBernstein Large Cap Value Equity** assets will be temporally managed by Northern Trust Global Investments (NTGI) pending the outcome of a search.
- The **Earnest Partners Mid Cap Portfolio** outpaced the return of the Russell Mid Cap index by 206 basis points and ranked at the 24<sup>th</sup> percentile of Callan's Mid Cap Core Style group in the quarter. Sector allocation in consumer staples and industrials positively contributed to performance, as did security selection in consumer discretionary and information technology. Security selection in industrial and energy, specifically natural gas explorers and producers, was detrimental. Over the long-term periods, including inception, the fund exceeds the benchmark and ranks above its peer group median.
- **Dimensional Fund Advisors' Small Cap Value Equity** performed in-line with the return of the Russell 2000 Value index during the quarter and ranked at the 51<sup>st</sup> percentile of Callan's Small Cap Value Style group. For the five-years ended December 31, 2011, the portfolio outperformed the benchmark return by 135 basis points and ranked at the 71<sup>st</sup> percentile of the style group.
- For the second consecutive quarter, the **Allianz Small Cap Growth** portfolio missed the benchmark by over 3%, trailing in the fourth quarter by 313 basis points and ranked at the 70<sup>th</sup> percentile of the Callan Small Cap Growth Style group. Security selection was the primary drag on performance with energy holdings detracting nearly 3% during the quarter. Furthermore, security selection within cyclical sectors, such as materials and consumer discretionary, negatively contributed to performance.
- The **Grantham Mayo Van Otterloo** portfolio outperformed the MSCI World index in the quarter by 58 basis points and ranked at the 26<sup>th</sup> percentile of Callan's Global Equity Style

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group. An overweight to Germany and the United Kingdom positively contributed to performance. Conversely, GMO's exposure to non-benchmark countries, specifically emerging markets hurt performance during the fourth quarter. The portfolio has underperformed over the last year and ranked at the 52<sup>nd</sup> percentile of the style group.

- The **T. Rowe Price** global equity portfolio performed in-line with the MSCI World index and ranked at the 45<sup>th</sup> percentile of the Callan Global Equity Style group for the quarter. The portfolio was overweight information technology stocks which hurt performance this quarter. An overweight to the United States and United Kingdom, as well as allocation to non-benchmark countries, namely Brazil and China, boded well for the portfolio.
- **Brandes Investment Partners** performed in-line with the benchmark and ranked at the 73<sup>rd</sup> percentile of the Callan Non-U.S. Equity Style group. Performance was hindered by currency and security selection, while country selection was additive, netting benchmark-like returns for the quarter. 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 81 basis points relative to the benchmark for the quarter, and ranked at the 38<sup>th</sup> percentile relative to peers. Country selection was positive during the quarter, while currency selection was slightly negative, and security selection was flat. Over the five- and seven-year periods the portfolio has outperformed the MSCI ACWI ex-US index and ranked in the 33<sup>rd</sup> and 23<sup>rd</sup> percentiles, respectively, relative to the Callan Non-U.S. Equity Style group.
- The **Dimensional Fund Advisors** international small cap portfolio outperformed the blended benchmark by 211 basis points in the quarter and ranked at the 44<sup>th</sup> percentile of the Callan International Small Cap Style group. The portfolio's allocation and selection among the smallest capitalization and lowest price-to-book ratio were additive for the quarter. Since inception, the portfolio has outperformed the benchmark by over 3.5% but has ranked below its peer group median.
- The **BlackRock** Intermediate Aggregate portfolio performed in-line with its benchmark in the fourth quarter and ranked at the 69<sup>th</sup> percentile of its peer group. The portfolio has slightly outperformed the Barclays Capital Intermediate Aggregate benchmark over all trailing time periods and falling in the third quartile over those same time periods, with the exception of the trailing one year where the portfolio ranked at the 35<sup>th</sup> percentile of the Callan Intermediate Fixed Income group.
- The **Reams Asset Management** core plus portfolio returned 2.24% in the quarter doubling the benchmark and ranking at the 18<sup>th</sup> percentile of its universe. The Barclays Aggregate reversed its ranking from a quarter ago and fell to the 94<sup>th</sup> percentile in the fourth quarter. The portfolio continues to maintain a slightly shorter duration than the benchmark and added RMBS throughout the quarter by reducing Treasury exposure. This overweight to RMBS and US credit was additive to performance. Long term performance remains strong with three-, five-, and ten-year rankings near the first quartile and returns above its benchmark.

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- **Loomis Sayles** returned 3.46% in the quarter outperforming the Barclays Aggregate benchmark by 2.34%. The portfolio, which ranked at the 1<sup>st</sup> percentile of peers, was overweight BBB-rated and below investment grade bonds which was positive for performance. With an average portfolio quality of BBB+, the lower medium grade securities provided the most upside in the fourth quarter. Loomis continues to rank at the top quartile for the long term trailing time periods.
- **Wellington's** Global Bond portfolio returned 0.32% in the fourth quarter exceeding the benchmark by 44 basis points and ranking at the 67<sup>th</sup> percentile of the Callan Global Fixed Income Database.

### Investment Manager Organizational Developments

#### 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.

### Investment Manager Compliance

All CMERS investment managers have reported they are in compliance with CMERS investment policy guidelines as of December 31, 2011.

### Action Items

- Large Cap Equity structure evaluation

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**Exhibit I**

	<b>December 31, 2011</b>		<b>September 30, 2011</b>	
	<b>Market Value</b>	<b>Percent</b>	<b>Market Value</b>	<b>Percent</b>
<b>Total Domestic Equity</b>	<b>\$1,256,985,388</b>	<b>31.61%</b>	<b>\$1,172,420,347</b>	<b>30.58%</b>
Northern Trust Global	721,934,561	18.15%	319,631,901	8.34%
BlackRock R1000 Alpha Tilts	163,042,707	4.10%	153,208,413	4.00%
Turner Investment Partners	175,150	0.00%	182,908,124	4.77%
AllianceBernstein L.P.	140,362	0.00%	178,354,380	4.65%
Earnest Partners LLC	123,011,697	3.09%	109,299,154	2.85%
Dimensional Fund Advisors Inc.	164,331,184	4.13%	150,843,546	3.93%
Allianz Global Investors Capital	84,349,726	2.12%	78,174,829	2.04%
<b>Total Global Equity</b>	<b>\$403,425,026</b>	<b>10.14%</b>	<b>\$373,785,848</b>	<b>9.75%</b>
Grantham Mayo Van Otterloo	206,581,276	5.19%	190,972,406	4.98%
T. Rowe Price	196,843,750	4.95%	182,813,442	4.77%
<b>Total International Equity</b>	<b>\$828,147,663</b>	<b>20.83%</b>	<b>\$798,995,310</b>	<b>20.84%</b>
Brandes Investment Partners	334,533,908	8.41%	323,911,840	8.45%
William Blair & Company	391,361,341	9.84%	374,207,553	9.76%
Dimensional Fund Advisors Inc.	102,252,413	2.57%	100,875,917	2.63%
<b>Total Fixed Income</b>	<b>\$1,111,432,595</b>	<b>27.95%</b>	<b>\$1,142,781,802</b>	<b>29.81%</b>
BlackRock Intermediate Agg	239,048,287	6.01%	236,855,207	6.18%
Reams Asset Management	246,183,193	6.19%	258,667,233	6.75%
Loomis, Sayles & Company, L.P.	407,015,211	10.24%	413,901,797	10.80%
Wellington Management Company	219,185,904	5.51%	233,357,564	6.09%
<b>Total Private Equity</b>	<b>\$16,557,527</b>	<b>0.42%</b>	<b>\$13,729,831</b>	<b>0.36%</b>
Abbott Capital Management 2010	2,240,026	0.06%	1,648,476	0.04%
Abbott Capital Management 2011	695,386	0.02%	290,935	0.01%
Mesirow Financial	13,622,115	0.34%	11,790,420	0.31%
<b>Total Real Estate</b>	<b>\$329,119,738</b>	<b>8.28%</b>	<b>\$299,468,360</b>	<b>7.81%</b>
Real Estate	329,119,738	8.28%	299,468,360	7.81%
<b>Total Cash</b>	<b>\$31,018,360</b>	<b>0.78%</b>	<b>\$32,457,960</b>	<b>0.85%</b>
Cash	31,018,360	0.78%	32,457,960	0.85%
<b>Total Fund</b>	<b>\$3,976,686,297</b>	<b>100.0%</b>	<b>\$3,833,639,458</b>	<b>100.0%</b>

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**Exhibit II**

	<b>Last Quarter</b>	<b>Last Year</b>	<b>Last 3 Years</b>	<b>Last 5 Years</b>	<b>Since Inception</b>
<b>Total Domestic Equity</b>	<b>11.75%</b>	<b>(2.48%)</b>	<b>15.18%</b>	<b>(1.40%)</b>	<b>3.84%</b>
Russell 3000 Index	12.12%	1.03%	14.88%	(0.01%)	3.10%
Northern Trust Global	11.85% 42	2.20% 39	14.37% 41	(0.31%) 73	9.18% 88
S&P 500 Index	11.82% 43	2.11% 40	14.11% 50	(0.25%) 72	9.19% 88
CAI Large Cap Core Style	11.71% 50	1.42% 50	14.15% 50	0.31% 50	10.15% 50
BlackRock R1000 Alpha Tilts	13.01% 11	4.37% 27	14.09% 51	(1.32%) 94	4.86% 61
Russell 1000 Index	11.84% 42	1.50% 49	14.81% 33	(0.02%) 65	5.03% 54
CAI Large Cap Core Style	11.71% 50	1.42% 50	14.15% 50	0.31% 50	5.07% 50
Ernest Partners LLC	14.37% 24	(0.31%) 33	22.00% 22	3.53% 35	5.61% 40
Russell MidCap Index	12.31% 51	(1.55%) 46	20.17% 36	1.41% 67	4.61% 64
CAI Mid Cap Style	12.51% 50	(1.92%) 50	18.92% 50	2.36% 50	5.11% 50
Dimensional Fund Advisors Inc.	15.92% 51	(6.75%) 78	19.73% 35	(0.52%) 71	10.97% 26
Russell 2000 Value Index	15.97% 51	(5.50%) 64	12.36% 99	(1.87%) 88	7.98% 97
CAI Small Cap Value Style	16.01% 50	(3.82%) 50	18.22% 50	1.42% 50	10.60% 50
Allianz Global Investors Capital	11.86% 70	(10.31%) 90	-	-	(0.83%) 96
Russell 2000 Growth Index	14.99% 37	(2.91%) 60	19.00% 63	2.09% 57	9.10% 56
CAI Sm Cap Growth Style	13.93% 50	(1.80%) 50	20.78% 50	2.33% 50	9.61% 50
<b>Total Global Equity</b>	<b>7.93%</b>	<b>(8.95%)</b>	<b>-</b>	<b>-</b>	<b>(1.36%)</b>
MSCI The World Index	7.59%	(5.54%)	11.13%	(2.37%)	1.28%
Grantham Mayo Van Otterloo	8.17% 26	(7.55%) 52	-	-	(0.56%) 66
MSCI The World Index	7.59% 52	(5.54%) 38	11.13% 60	(2.37%) 61	1.28% 49
CAI Global Eq Broad Style	7.60% 50	(7.00%) 50	11.93% 50	(1.95%) 50	1.22% 50
T. Rowe Price	7.67% 45	(10.37%) 78	-	-	8.09% 71
MSCI AC World	7.18% 62	(7.35%) 52	12.01% 48	(1.93%) 50	9.88% 57
CAI Global Eq Broad Style	7.60% 50	(7.00%) 50	11.93% 50	(1.95%) 50	10.46% 50

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	<b>Last Quarter</b>		<b>Last Year</b>		<b>Last 3 Years</b>		<b>Last 5 Years</b>		<b>Since Inception</b>	
<b>Total International Equity</b>	<b>3.70%</b>		<b>(11.84%)</b>		<b>11.04%</b>		<b>(2.94%)</b>		<b>6.39%</b>	
MSCIEAFE Index	3.33%		(12.14%)		7.65%		(4.72%)		3.38%	
Brandes Investment Partners	3.28%	73	(10.13%)	32	5.97%	89	(4.13%)	68	7.20%	9
MSCIEAFE Index	3.33%	72	(12.14%)	57	7.65%	71	(4.72%)	74	2.55%	94
CAI Non-U.S. Equity Style	4.07%	50	(11.40%)	50	8.83%	50	(3.36%)	50	4.57%	50
William Blair & Company	4.65%	37	(11.78%)	53	15.22%	6	(2.06%)	33	6.11%	29
MSCI ACWI ex-US Index	3.77%	58	(13.33%)	68	11.20%	29	(2.48%)	37	6.00%	30
CAI Non-U.S. Equity Style	4.07%	50	(11.40%)	50	8.83%	50	(3.36%)	50	5.05%	50
Dimensional Fund Advisors Inc.	1.55%	44	(16.88%)	82	11.56%	82	(3.30%)	65	(1.41%)	100
Blended Benchmark	(0.56%)	89	(15.94%)	73	12.87%	78	(5.85%)	91	(4.79%)	100
CAI Int'l Small Cap Style	1.43%	50	(13.73%)	50	15.58%	50	(2.27%)	50	-	-
<b>Total Fixed Income</b>	<b>2.02%</b>		<b>7.36%</b>		<b>13.94%</b>		<b>8.05%</b>		<b>8.73%</b>	
Barclays Capital Aggregate	1.12%		7.84%		6.77%		6.50%		7.37%	
BlackRock Intermediate Agg	0.93%	69	6.11%	35	6.37%	71	6.24%	63	6.11%	1
Barclays Capital Int Aggregate	0.91%	76	5.97%	45	6.19%	73	6.09%	74	6.00%	1
CAI Intermediate F-I Styl	1.05%	50	5.79%	50	6.97%	50	6.44%	50	0.00%	50
Reams Asset Management	2.24%	18	7.57%	52	15.25%	8	8.51%	10	6.87%	1
Barclays Capital Aggregate	1.12%	94	7.84%	39	6.77%	100	6.50%	61	5.91%	1
CAI FI Core Plus Style	1.79%	50	7.63%	50	10.89%	50	6.92%	50	0.00%	50
Loomis, Sayles & Company, L.P.	3.46%	1	6.95%	71	17.32%	1	8.21%	15	9.99%	1
Barclays Capital Aggregate	1.12%	94	7.84%	39	6.77%	100	6.50%	61	7.37%	89
CAI FI Core Plus Style	1.79%	50	7.63%	50	10.89%	50	6.92%	50	8.21%	50
Wellington Management Company	0.32%	67	-	-	-	-	-	-	8.42%	1
CG WGBI Index	(0.12%)	84	6.35%	40	4.68%	96	7.13%	53	6.37%	1
CAI Global Fixed-Inc DB	1.04%	50	5.59%	50	8.32%	50	7.17%	50	8.62%	50
<b>Total Private Equity</b>	<b>(3.91%)</b>		<b>(3.21%)</b>		<b>-</b>		<b>-</b>		<b>0.73%</b>	
Abbott Capital Management 2010	(4.66%)		(38.92%)		-		-		(57.77%)	
Abbott Capital Management 2011	(17.65%)		-		-		-		(56.85%)	
Mesirow Financial	(2.98%)		5.05%		-		-		9.41%	
Russell 3000 (On a Qtr Lag) + 3%	(14.53%)		3.61%		-		-		2.67%	
<b>Total Real Estate</b>	<b>1.15%</b>		<b>18.46%</b>		<b>(9.88%)</b>		<b>(3.51%)</b>		<b>5.46%</b>	
Real Estate	1.15%	95	18.46%	15	(9.88%)	95	(3.51%)	89	5.46%	63
NCREIF Property (1 Quarter in Arrears)	3.30%	22	16.10%	27	(1.45%)	41	3.40%	8	7.28%	11
Open-End Real Estate	2.63%	50	15.21%	50	(1.92%)	50	(0.55%)	50	7.36%	50
<b>Total Fund</b>	<b>5.87%</b>		<b>(1.05%)</b>		<b>11.77%</b>		<b>0.79%</b>		<b>9.52%</b>	
Total Fund Reference Index	6.04%		0.79%		10.23%		1.46%		-	

*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 – Fourth Quarter 2011**

**Brief Market Recap**

After nearly dipping into bear market territory by the end of the 3<sup>rd</sup> quarter, most global equity markets rallied in the 4<sup>th</sup> quarter. After a substantial rise in October, US stock indices muddled through November and December to finish with double digit gains across the board for the quarter. Foreign stock indices also rose in October but suffered somewhat in November and December before closing the quarter in positive territory. The minor exception was MSCI EAFE Small Cap which declined fractionally.

Interest rates were volatile but closed the quarter slightly below where they started. Returns on most fixed income indices were positive for the quarter due to the yield component and narrowing credit spreads. Returns were strongest in long dated issues and spread sectors such as high yield and emerging markets debt.

Commodities continued to experience significant volatility with energy, specifically oil, posting the strongest gains while precious metals led declines.

**Market Environment and Events**

2011 was a year of significant global events. Political upheaval in the Middle East; a terrible earthquake and tsunami in Japan; a debt crisis that threatens the world's largest economic union; US political gridlock that seems to drown out most reasonable voices; S&P downgrades on the sovereign debt of nine developed countries and warnings on five others. Additionally, the blowup of investment bank MF Global, blamed on 40-1 leverage utilizing client capital invested in European sovereign debt, resulted in the 7<sup>th</sup> largest bankruptcy in US history. With that as a backdrop, the US stock market went exactly nowhere. The S&P 500 closed 2010 at 1,257.64, traded in a 296 point range through the year, and closed 2011 at 1,257.60. The index fell just four one hundredths of a point; quite a round trip and the smallest annual price change since 1947. Once dividends are included in the total return calculation the index finished in the black, up 2.1% for the year.

2011 may be remembered as the year of the sovereign debt downgrade. Of the 24 countries dubbed "developed" by MSCI, nine were downgraded during 2011 and five others were put on CreditWatch negative. In spite of these ratings actions, government bonds generally performed well in 2011 with returns in the mid to high single digits.

The US political environment also presented challenges to the financial markets. While the debt ceiling debate was resolved in August, the "Super Committee," a major part of the resolution, utterly failed to achieve any of its goals by its late November deadline. Just what that failure implies is hard to say as the mandated spending cuts do not go into effect until 2013. Between then and now we have a presidential election and a reshaped Congress that will significantly impact the strength of the efforts to reduce the US budget deficit.

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The euro zone's future is threatened as Europe continues to be a quagmire with the debt crisis that began with Greece spreading to the rest of the GIIPS countries (Greece, Ireland, Italy, Portugal, Spain). While there has been a great deal of sword-rattling and brinksmanship, Europe's dilemma may come down to the rich countries' (Germany) willingness to backstop the debts of those countries with seemingly insurmountable debt loads. Should diplomacy fail to save the currency union, the question becomes what the disintegration of the euro zone might look like. On the surface it seems that everyone would lose; strong countries would see their newly re-established currencies skyrocket and kill exports (forecasts have been floated that a new German mark would immediately appreciate by as much as 30%) while weak countries would hemorrhage the capital needed to restart growth.

US Federal Reserve policy has kept rates in the range of 0-25 bps for nearly three years. The Fed has committed to ZIRP (zero interest rate policy) at least until mid-2013 and has recently announced it will provide forecasts on its intentions for 12 months. These quarterly forecasts are a first in Fed policy. With ZIRP having an obvious lower bound, nominal rates cannot drop below zero, the Fed has also instituted a purchase program on longer dated Treasuries in an attempt to bring down longer term rates and further flatten the yield curve. "Operation Twist," as it has been dubbed in the press, appears to have been successful as 10- and 30-year rates have fallen to historic lows.

Despite the political and economic turmoil that currently dominates the news, corporations continue to perform well. The 3Q2011 earnings season posted record profits, eclipsing the peak levels of the previous quarter. However, recently a number of analysts have cut 2012 forecasts on the S&P 500 from about \$110 to \$100-105. The forward P/E on the S&P 500 rose to 11.8x during the quarter but remains well below the 20-year average of about 16x. Bullish investors cite those favorable valuations, strong dividend yields, and the very low yields available in bond markets as reasons to favor stocks. Bearish investors counter the low valuations with observations that slower growth is unlikely to support any P/E expansion and concerns 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 unsustainable over the longer term. Additionally, 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 approaches 30% after climbing steadily since the 2008 recession. Dividends and stock buybacks dropped sharply during the recession and remain well below their 2007 peak.

Inflation data remain fairly benign. Headline CPI dropped slightly in November to an annualized rate of 3.4% while Core CPI (excluding food and energy) rose to 2.2%. With 10-year Treasury rates again below 2%, investors are suffering negative real yields for the safety of US Government obligations.

While American consumers remain defensive due in large part to high unemployment, stagnant wages, and weak housing prices, the holiday shopping season was reportedly reasonably strong on the back of major discounting by retailers. Unemployment has dropped below 9% (8.5% at year-end) and initial jobless claims are at a 3-1/2 year low; however, it appears that declining labor force participation has as much to do with the falling unemployment rate as does actual job

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creation. 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 spike 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 Census Bureau. Finally, while house prices have remained weak there has been some positive data of late. November housing starts came in well ahead of forecasts and homebuilder optimism is at a 1½ year high. Additionally, housing affordability is at a generational high. At current average house prices and mortgage rates, it takes just 10.3% of the average monthly income to cover the mortgage payment. The range in the 1990s and 2000s was between 15-20% and peaked above 35% in the 1980s when mortgage rates spiked to the high teens.

#### **Fourth Quarter Market Performance**

US equities finished the 4<sup>th</sup> quarter of 2011 with double digit returns across style and capitalization. Markets rallied sharply in October due in large part to the rout experienced in the latter half of the 3<sup>rd</sup> quarter. November and December were largely flat; albeit with a nearly 10% range trough to peak. The S&P 500 posted its largest quarterly gain since the 3<sup>rd</sup> quarter of 2009 with an 11.8% rise. On a price only basis, the S&P index finished the 2011 year almost exactly where it began in January (2011 close 1,257.60; 2010 close 1,257.64). The total return of 2.1% for 2011 was therefore entirely generated by dividend yield.

For the 4<sup>th</sup> quarter capitalization was inversely related to returns as small and mid caps performed best (Russell Midcap: +12.3%, R2000: +15.5%) while large caps trailed the broad market (Russell Top 50: +11.5%, Top 200: +11.7%, R1000: +11.9%, R3000: +12.1%). Growth trailed value most dramatically within large caps (R1G: +10.6%, R1V: +13.1%) and while value reigned across capitalization its premium was more muted in small and mid caps (RMG: +11.2%, RMV: +13.4%, R2G: +15.0%, R2V: +16.0%). High quality issues trailed lower quality names slightly in the 4<sup>th</sup> quarter (S&P HQ: +12.1%, S&P LQ: +13.1%) but retained a massive lead of more than 13% over the full year. Within the GICS classification of the S&P 500, cyclical and economically sensitive sectors such as Energy, Industrials, and Materials were the best performers (+18.2%, +16.5% and +15.4%, respectively) while Telecom, Utility, and Technology sectors saw the smallest gains (+7.9%, +8.3% and +8.7%, respectively).

Foreign equity markets underperformed their large cap US counterparts with emerging market equities outpacing developed markets. Contrasted to the previous quarter, the strength of the US dollar had a much smaller impact on the relative results in the 4<sup>th</sup> quarter as developed and emerging equities underperformed sharply in both local and US dollar terms (EAFE US\$: +3.3%, EAFE Local: +4.1%, EM US\$: +4.5%, EM Local: +4.9%). Converse to domestic results, growth outperformed value in developed foreign markets (EAFE Growth: +3.9%, EAFE Value: +2.7%) due in large part to concerns surrounding European banks. Also in contrast to domestic results, developed small caps suffered dramatically and finished the quarter with the dubious distinction of posting the only negative quarterly result among the equity classes followed in this letter's attached index review (EAFE Small:-0.6%). Unsurprisingly, Greece's ongoing debt saga continued to weigh on equities and again was the worst performing country in

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the EAFE index (MSCI Greece: -28%). After a 3<sup>rd</sup> quarter rout touched off by a sovereign debt downgrade in July, Ireland was the best performer among developed countries (MSCI Ireland: +22%). In the developing world, Turkey's stock market suffered from euro zone recession fears as Europe represents roughly 50% of Turkey's exports (MSCI Turkey: -16%) while Peru held up best among emerging countries for the 2<sup>nd</sup> consecutive quarter (MSCI Peru: +13%).

To round out equity performance, securitized real estate performed in-line with small caps and better than mid and large broad equity markets for the quarter. The NAREIT Equity index rose 15.2% in the quarter and the hotels & lodging sector led the way with a nearly 30% appreciation while strip malls and manufactured homes trailed.

The 10-year Treasury yield bounced around notably during the 4<sup>th</sup> quarter, only to end up just slightly below where it began. Much news was made about the Fed's latest open market action Operation Twist, the euro zone debt-turned-political crisis, the complete failure of the US Congress' Super Committee to accomplish anything related to deficit reduction, and Ben Bernanke's announcement after year-end that the Fed would provide guidance as to its interest rate target looking forward at least a year. At this point, the Fed has no expectations to deviate from its ZIRP until at least mid-2013.

The BC Aggregate index (+1.1%) rose with long-dated paper and spread sectors enjoying the strongest gains. The US dollar strengthened slightly against most world currencies with the Canadian and Australian dollars being the most notable exceptions. Local currency developed market sovereign debt underperformed hedged indices as the dollar strengthened (Citi Non-US WGBI Hedged: +0.6%, Unhedged: -0.5%). The "risk-on" trade drove spread sectors higher and High Yield and Emerging Markets bond indices led (BC High Yield CP: +6.4%, JPM EMBI+: +5.3%). Municipal bonds were relatively strong performers (BC Muni 1-10 yr.: +1.8%) as new issuance dropped sharply through 2011. Muni issuance through November was running at about 40% below 2010 and will likely close at the lowest level in a decade.

Volatility in commodity markets persisted during the quarter and the energy-heavy S&P GSCI rose sharply as oil prices rallied 25% and topped \$100/barrel by the end of the quarter. Natural gas followed the opposite trajectory and fell from \$4 to \$3/mmBtu. The S&P GSCI handily outperformed the DJ-UBS index due to higher energy and lower agriculture and metals exposure (GSCI: +9.0%, DJUBS: +0.3%). The Energy group performed best while Precious Metals were weak due to falling prices for both gold and silver (GSCI Energy: +13%, GSCI Precious Metals: -4%).

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### **Closing Thoughts**

After peaking in May, broad US equity markets flirted with bear market territory by the end of September and riskier corners of the equity markets such as small caps and emerging markets declined nearly 30% below their respective peaks. October's relief rally salvaged positive results for US Large Caps in 2011; however, small caps, mid caps, and foreign equities finished the year firmly in the red.

Despite the equity market volatility, corporate profits and margins remain at all-time highs and consequently equity market valuations around the globe appear reasonably attractive. Forward P/E ratios range from 11.8x in the US to as low as 9.4x for broad emerging markets and as low as 5x for markets such as Russia. Bullish market participants point to these historically attractive P/Es as reasons to be optimistic; however, many analysts are cutting targets for earnings growth rates and consequently opening the door for bearish sentiment when looking at the P/E-to-growth ("PEG ratio") which on the S&P 500 stood at 1.0x at the end of 2010 and has risen to 1.5x presently. 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 remains the most prudent long-term course for investors.

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**Returns Ending December 31, 2011**

