Callan
FORTY YEARS


**Third Quarter 2013**

## Self-Inflicted Wounds

**U.S. ECONOMY**

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As spring turned into summer, all eyes were on Washington. The most important issues for many participants in the capital markets remained the state of the economy and the ability of the Fed to manage the taper in a way that allows the economy to remain healthy.

## Forging Ahead

**FUND SPONSOR**

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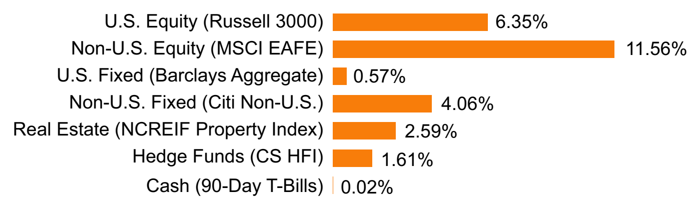
According to the Callan fund sponsor database, all fund types boasted sound gains, rising between 4% and 5%. Endowments and foundations were on top (+5.00%), followed closely by public (+4.84%), corporate (+4.66%), and Taft-Hartley (+4.56%) funds.

## Broad Market Quarterly Returns




Sources: Barclays, Citigroup, Credit Suisse Hedge Index LLC, Merrill Lynch, MSCI, NCREIF, Russell Investment Group, Standard & Poor's

## Bumpy Ride

**U.S. EQUITY**

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The Fed's decision to continue monetary easing resulted in a soft landing for the quarter (**S&P 500 Index**: +5.24%; **Russell 3000 Index**: +6.35%). By capitalization size, smaller was better, and growth beat value in both the small and large cap ranges.

## Tall and Venti

**NON-U.S. EQUITY**

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A late rally brought the **MSCI EAFE Index** (+11.56%) back into positive territory this quarter, though shaky sentiment served up a lighter recovery for emerging markets (**MSCI EM Index**: +5.90%). A slow recovery has yet to truly take off, and investors remain alert going into the end of 2013.

## Congress Bangs its Head on Debt Ceiling

**U.S. FIXED INCOME**

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Concerns over the Fed tapering asset purchases dissipated, with attention shifting to Washington's continued financial gridlock. The **Barclays Aggregate Index** advanced 0.57%, reversing direction from the first half of 2013. The **Barclays Corporate High Yield Index** rose 2.28% as investors returned to credit risk.

## Central Banks Take Center Stage

**NON-U.S. FIXED INCOME**

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The quarter ended solidly, as indicated by the **Citi Non-U.S. World Government Bond Index** (+4.06%). Non-U.S. sovereign debt was boosted primarily by improving global economic data, while unhedged returns benefited from the U.S. dollar depreciating against major currencies.

## Up and Down

**REAL ESTATE**

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Domestic institutional real estate assets, as measured by the **NCREIF Property Index**, advanced 2.59%. Domestic REITs, as measured by the **FTSE NAREIT Equity REITs Index**, fell 3.09% and traded at a 3.67% dividend yield at quarter end.

## Mild Autumn

**PRIVATE EQUITY**

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Private equity activity was flat to moderately down, with both expansion and contraction seen in the various key metrics. Fundraising slowed, investments and exits showed mixed results, and industry returns followed the public market upward.

## Market Bounce Boosts Hedge Funds

**HEDGE FUNDS**

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The **Credit Suisse Hedge Fund Index** (CS HFI) grew 1.61%. Within the CS HFI, Long/Short Equity (+3.48%) was the best-performing strategy, aided by rising equities. The median manager in the Callan Hedge Fund-of-Funds Database climbed 2.03%.

## Hard-Earned, Modest Gains

**DEFINED CONTRIBUTION**

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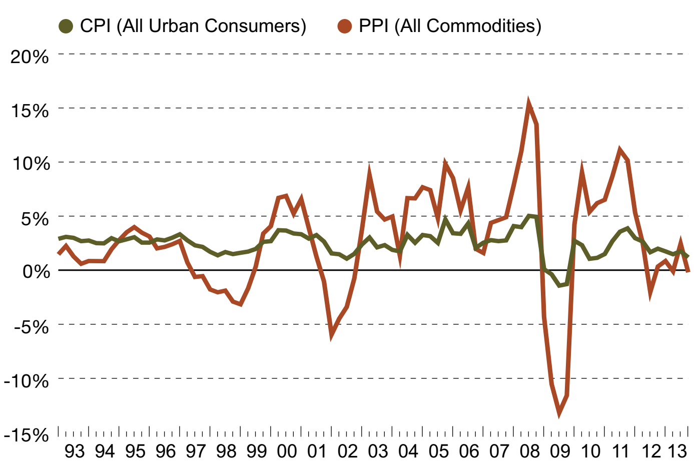
The average DC plan gained 1% in the quarter ended June 30, 2013, according to the Callan DC Index™. DC plan balances increased 1.48% during the second quarter, the fourth consecutive quarter of growth for the DC Index. Turnover came in well below average at 0.43%.

# Self-Inflicted Wounds

**U.S. ECONOMY** | Jay Kloepfer

As spring turned into summer, all eyes were on Washington. The markets attempted to read whether the Fed would slow purchases of debt securities ("The Taper"), and then start withdrawal of liquidity and raise short-term interest rates on a path to "normalization." All along, the Fed telegraphed clearly that its decisions would be driven by economic data, as it had no intention of withdrawing support before it believed the economy was strong enough to handle the moves. In the spring, the bond market had immediately reacted to the mere suggestion of the taper, with prices falling and yields jumping by 120 to 140 basis points. As economic data looked to be softening in the third quarter, the Fed announced "no taper yet" in September, which of course sent the capital markets into a brief tizzy. Then politics trumped economics, with Congress unable to pass a budget and raise the debt ceiling, leading to a two-week government shutdown and the threat that the U.S. would default on its bills and interest and principal payments on debt.

**Inflation Year-Over-Year**




Source: Bureau of Labor Statistics

Congress and the President did come up with a short-term solution to the budget and debt crises. However, note the emphasis on "short-term," as the bill that passed only funds the government until January 15, 2014, and only raises the debt ceiling until February 7. The can was not kicked very far down the road.

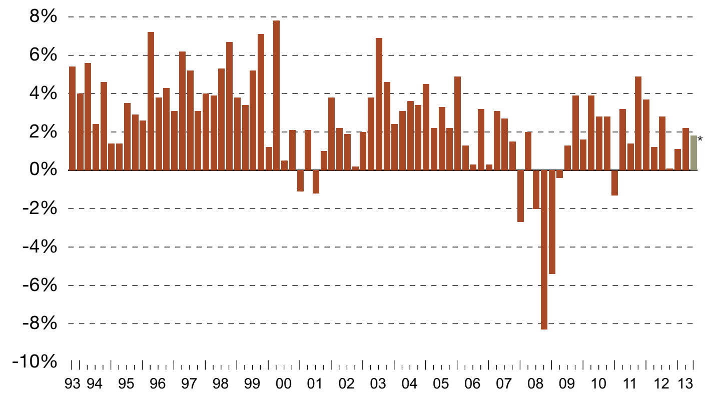
The most important issues for many participants in the capital markets are the state of the economy and the ability of the Fed to manage the taper such that the economy remains healthy. The budget and the debt ceiling are political issues. It is not as if investors are unwilling to lend money to the U.S.; rather, we have a self-imposed limit on how much we wish to borrow. In other words, it's not (yet) a solvency issue, as it was in Latin America during its sovereign debt crises. It's our willingness to borrow and to pay back our lenders. The sideshow created by the inability of our elected officials to execute on their responsibilities only serves to dampen consumer and investor confidence, both here and abroad, thereby weakening prospects for the economy and lessening the likelihood that the Fed will in fact begin the taper later this fall. The wounds are entirely self-inflicted.

The economic impact of the government shutdown is relatively modest, on the order of 0.1% to 0.2% of GDP per week of shutdown, based on previous shutdowns. There is precedence that the federal employees furloughed will receive retroactive pay, further dampening the impact on consumer spending. The impact of default caused by not raising the debt ceiling has the potential to be much larger, ranging from short-term oddities like a downgrade of U.S. debt followed by a potential flight to quality (and a Treasury rally, in all its perverse glory), to bond and cash managers avoiding notes and bonds with maturity dates falling in the months when the next potential debt crisis will hit. The dollar would likely fall, increasing import costs but helping exports.

Longer term, a loss of consumer and investor confidence would increase the possibility that we'd get knocked off our current modest growth path. If growth recedes, so will the Fed's plan to taper asset purchases and then withdraw liquidity from the bond market. QE 4, anyone?

The government shutdown delayed data releases, including GDP, so for this report we must use an estimate for the third quarter. Second-quarter GDP was revised up to 2.2%, but third quarter estimates average around 1.8%, reflecting a reduction of 0.2% to 0.4% for the shutdown. Expectations are now being downgraded for the fourth quarter. The Fed is still optimistic that we will see 2.0-2.3% growth, but consensus is building for growth falling below 2%.

**Quarterly Real GDP Growth*** (20 Years)




Source: Bureau of Economic Analysis
* Average third quarter estimate, offical GDP data was not available at time of publication.

The slowdown in the job market is the primary cause of concern cited by the Fed. As recently as February, the U.S. economy generated almost 350,000 jobs, and the rolling three-month average had climbed to 233,000. Beginning in March, job gains began to moderate, and fell below 150,000 in both July and September. Explanations for the weakening job market include personal tax hikes in January, the sequester in March and the ensuing fiscal drag, and the rise in long-term interest rates in May. Offsetting these factors, however, are the following points: a) the expiration of the payroll tax cut did not hit spending very hard, b) sequestration cuts should not have greatly impacted the private sector, and c) the slowdown in job growth began before taper talk pushed up yields in May. The argument for a reversal in the job market slowdown rests in part on the recovery that appears to be underway in European economies such as France and Germany, and encouraging reports from emerging markets. Stronger growth overseas and the softening of the dollar provide hope for an improvement from exports. While the rise in mortgage interest rates may slow the return of the housing market, momentum from existing strength and pent-up demand may keep the market from deflating.

**Recent Quarterly Indicators**

| **Economic Indicators** (seasonally adjusted) | **3Q13** | **2Q13** | **1Q13** | **4Q12** | **3Q12** | **2Q12** | **1Q12** | **4Q11** |
|---|---|---|---|---|---|---|---|---|
| Employment Cost–Total Compensation Growth | 1.9% | 2.4% | 1.7% | 2.0% | 1.7% | 2.1% | 1.7% | 2.1% |
| Nonfarm Business–Productivity Growth | 1.8% | 2.3% | -1.7% | -1.7% | 3.1% | 1.9% | -0.5% | 1.2% |
| GDP Growth* | *1.8%** | 2.5% | 1.1% | 0.1% | 2.8% | 1.2% | 3.7% | 4.9% |
| Manufacturing Capacity Utilization | 76.0% | 76.0% | 76.3% | 75.7% | 75.5% | 77.5% | 77.6% | 76.1% |
| Consumer Sentiment Index (1966=100) | 81.6 | 81.7 | 76.7 | 79.4 | 75.0 | 76.3 | 75.5 | 64.7 |

*Third quarter GDP growth was not available at the time of publication, this figure represents an average of third quarter estimates.
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Reuters/University of Michigan

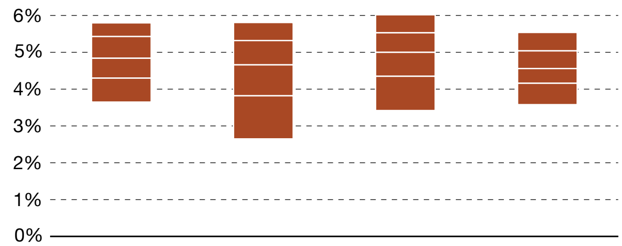
# Forging Ahead

**FUND SPONSOR** | Connie Lee, CFA

Aside from a brief pause in August, the capital markets forged ahead in the third quarter. September was notably strong, as the Fed's decision not to rein in quantitative easing reinvigorated investors. Global equities posted solid gains, with non-U.S. stocks advancing more than domestic (**Russell 3000 Index**: +6.35%, **MSCI ACWI ex-U.S.A. Index**: +10.17%). Meanwhile, fixed income markets remained volatile, but the **Barclays Aggregate Index** managed to eke out 57 basis points. Foreign bonds, like equities, fared better than their domestic counterparts, with the **Citi Non-U.S. World Government Bond Index** climbing 4.06%.

The Callan Fund Sponsor Returns chart—illustrating the range of returns for public, corporate, and Taft-Hartley pension plans, as well as endowments and foundations—depicts solid gains across the board. At the median, all fund types performed within a tight range, rising between 4% and 5%. Endowments/foundations were on top (+5.00%), closely followed by public (+4.84%), corporate (+4.66%), and Taft-Hartley (+4.56%) funds. Returns along the top were also clustered, as illustrated by the narrow span of 10th percentile returns (+5.54% to +6.02%). There was wider dispersion among bottom performers, with returns in the 90th percentile varying from 2.65% to 3.65%.

**Callan Fund Sponsor Quarterly Returns**




| | Public Database | Corporate Database | Endow/Fndn Database | Taft-Hartley Database |
|---|---|---|---|---|
| 10th Percentile | 5.80 | 5.81 | 6.02 | 5.54 |
| 25th Percentile | 5.43 | 5.32 | 5.53 | 5.04 |
| Median | 4.84 | 4.66 | 5.00 | 4.56 |
| 75th Percentile | 4.30 | 3.82 | 4.35 | 4.16 |
| 90th Percentile | 3.65 | 2.65 | 3.42 | 3.58 |

Source: Callan

The table compares the returns of the four types of institutional fund sponsors over longer time periods. With the help of a strong third quarter, all are firmly in positive territory year-to-date, with some fund types, such as public and Taft-Hartley, breaking 10%. Even more impressive is the fact that all fund types have added between 9% and 10% over the three-year period. Trailing five- and ten-year returns remain well intact, with all fund types returning in the range between 6.7%-8.7%.

**Style Median and Index Returns* for Periods ended September 30, 2013**

| Fund Sponsor | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Public Database** | **4.84** | **10.21** | **12.19** | **9.70** | **8.03** | **7.28** |
| **Corporate Database** | **4.66** | **8.47** | **10.34** | **9.67** | **8.69** | **7.39** |
| **Endowments/Foundations Database** | **5.00** | **9.61** | **11.95** | **9.18** | **7.66** | **7.28** |
| **Taft-Hartley Database** | **4.56** | **10.97** | **12.63** | **10.19** | **7.42** | **6.71** |
| **Diversified Manager** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Asset Allocator Style** | **4.64** | **12.92** | **13.56** | **10.29** | **7.64** | **7.48** |
| Domestic Balanced Database | 4.98 | 11.65 | 13.31 | 10.56 | 8.40 | 7.38 |
| Global Balanced Database | 3.99 | 3.95 | 5.20 | 7.41 | 8.37 | 8.44 |
| 60% Russell 3000 + 40% Barclays Agg | 4.04 | 11.65 | 11.91 | 11.46 | 9.21 | 7.13 |
| 60% MSCI World + 40% Barclays Glbl Agg | 6.02 | 9.25 | 10.67 | 8.17 | 7.33 | 6.92 |

*Returns less than one year are not annualized.

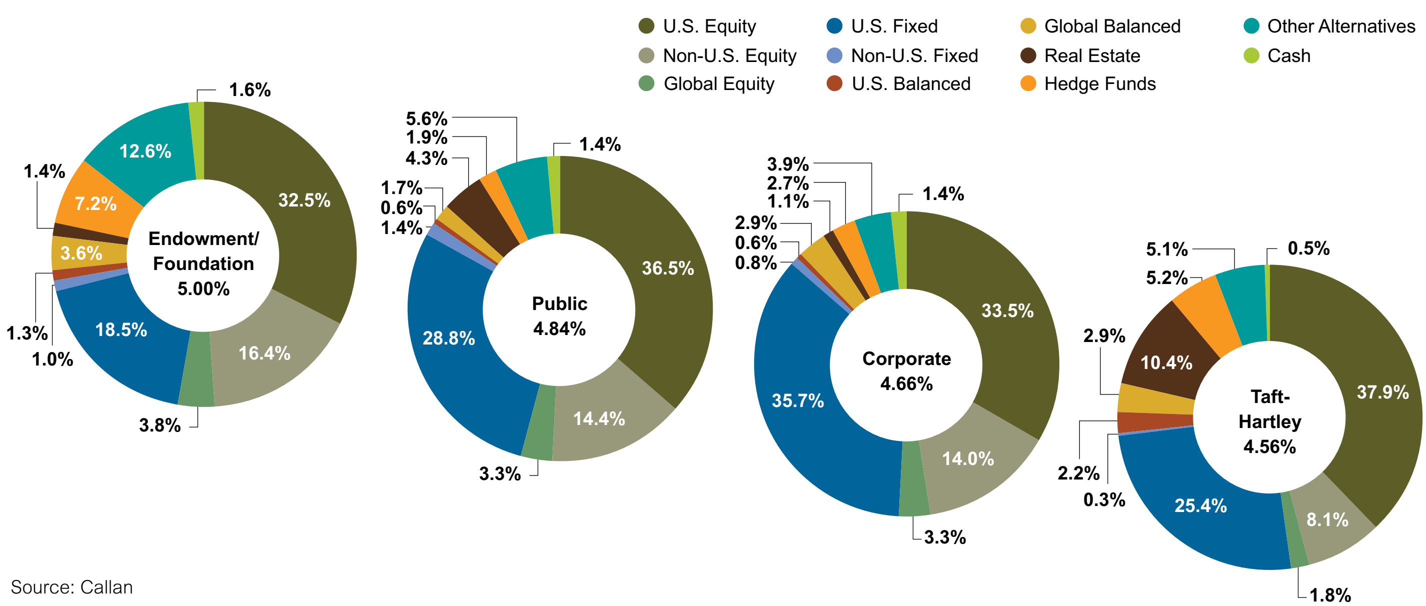
Sources: Callan, Barclays, MSCI Inc., Russell Investment Group

Asset allocation decisions help explain the difference in performance. Year-to-date, global equity markets have rallied sharply, while bond markets have turned in losses. Naturally, fund types with heavier equity allocations—especially of the U.S. variety—have fared the best. For example, Taft-Hartley funds, with an average 38% allocation to U.S. stocks, have increased nearly 11% in the last nine months.

Meanwhile, the scale and duration of fixed income has bifurcated performance within corporate funds, as evidenced by the 3% divide between the best and worst returns. However, the trade-off has paid off for those employing liability-driven investment (LDI) programs. Despite longer-duration bonds weighing on the absolute return of some corporate funds, a meaningful decrease in liabilities associated with rising interest rates has notably improved funded status ratios.

Callan's balanced manager groups generally maintain well-diversified portfolios and attempt to add value by underweighting or overweighting asset classes, as well as through stock selection. As a whole, asset allocators (+4.64%) performed in line with their institutional counterparts for the quarter. Year-to-date, global balanced managers (+3.95%) have noticeably fallen behind given weakness abroad, primarily within emerging markets. At the same time, domestic balanced managers kept up with the blended 60% Russell 3000 and 40% Barclays Aggregate benchmark, surging 11.65%.

**Callan Fund Sponsor Average Asset Allocation**




Source: Callan

# Bumpy Ride

**U.S. EQUITY** | Lauren Mathias, CFA

July's strong performance reversed a gloomy June. However, the marketplace in August reflected concerns about future Fed tapering and geopolitical tensions in Syria. The Fed's decision to continue monetary easing resulted in a generally positive September and, ultimately, a softer landing for the quarter (**S&P 500 Index**: +5.24%).

The unemployment rate declined to 7.3% due to a contracted labor force; the number of jobs added per month was at the year's lowest level. Yet second-quarter GDP was revised up to 2.5% from 1.1%, existing home sales hit the fastest growth rate since the economic downturn, and the median home price was up 14.7% from a year prior.

However, the Federal Reserve's unexpected decision to delay tapering created uncertainty in the marketplace. As policymakers see more signs of an economic recovery, quantitative easing will be scaled back; until then, it appears it will be a bumpy ride.

The **Russell 3000 Index** increased 6.35%. By capitalization size, smaller was better, as mega cap stocks (**Russell Top 50 Mega Cap Index**: +3.51%) trailed large cap (**Russell 1000 Index**: +6.02%), and mid cap stocks (**Russell Midcap Index**: +7.70%) lagged the smallest (**Russell 2000 Index**: +10.21%).

Economically sensitive areas did well, while those affected by interest rates declined. Five sectors posted returns greater than 8%. Chemicals companies within Materials (+9.90%) helped boost the sector's performance, as firms like Dow Chemical Company (+20.32%) benefited from low natural gas liquids costs. Industrials (+9.63%) did well, mostly due to the professional services and aerospace and defense industries.

Internet companies were very strong within Information Technology (+9.05%), particularly Facebook (+101.89%) and LinkedIn (+38.00%). A better employment outlook and an improved housing market encouraged consumers to spend, which added to the Consumer Discretionary (+8.63%) sector's strong performance.

**Economic Sector Exposure** (Russell 3000)

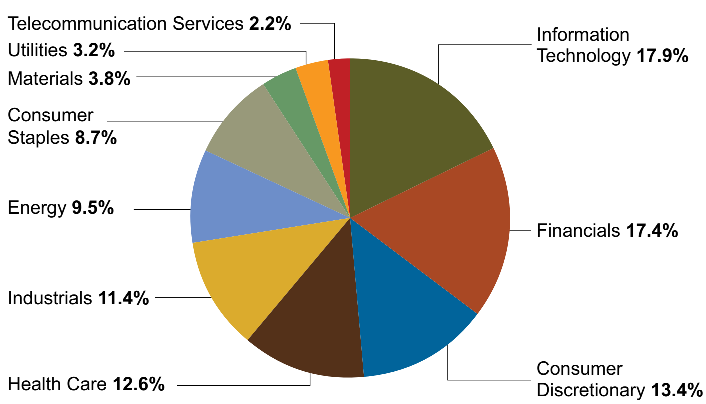
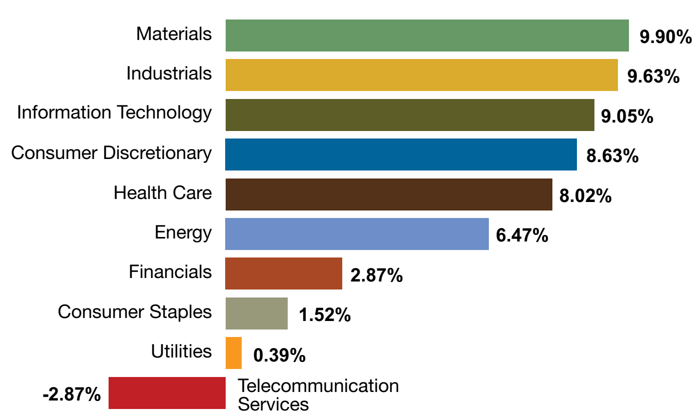



Chart may not sum to 100% due to rounding.
Source: Russell Investment Group

**Economic Sector Quarterly Returns** (Russell 3000)



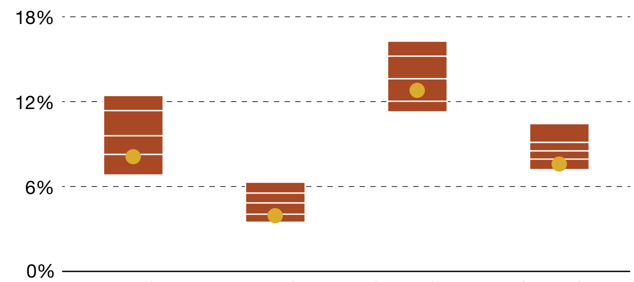
The market's preference for risk was evident within biotechnology (+21.56%) stocks, which helped Health Care (+8.02%) continue its pattern of strong returns. Energy (+6.47%) was supported by U.S. crude oil production growth, which was substantially higher than in 2012.

Financials (+2.87%), Consumer Staples (+1.52%), Utilities (+0.39%), and Telecommunication Services (-2.87%) lagged during the quarter. Telecommunication Services posted the only negative quarterly return; competition among the integrated services group diminished results. Utilities' sensitivity to interest rates forced performance down as Treasury yields climbed.

Within Consumer Staples, cyclicals like food retailers (+16.92%) stood out, while packaged food and meats (+0.50%) trailed. REITs (-2.60%) dampened Financials sector performance, as investors quickly reversed course after strong results through May.

Growth beat value in both the small and large cap ranges. The **Russell 2000 Small Cap Value Index** (+7.59%) trailed its growth counterpart (+12.80%). Larger companies in the **Russell 1000 Value Index** (+3.94%) lagged versus the **Russell 1000 Growth Index** (+8.11%).

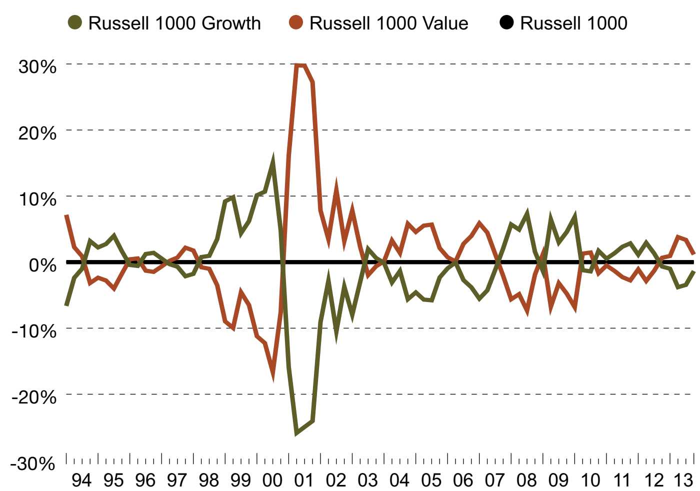
### Callan Style Group Quarterly Returns




| | Large Cap Growth Style | Large Cap Value Style | Small Cap Growth Style | Small Cap Value Style |
|---|---|---|---|---|
| 10th Percentile | 12.44 | 6.31 | 16.28 | 10.45 |
| 25th Percentile | 11.37 | 5.54 | 15.22 | 9.12 |
| Median | 9.59 | 4.84 | 13.62 | 8.52 |
| 75th Percentile | 8.27 | 4.05 | 12.03 | 7.94 |
| 90th Percentile | 6.82 | 3.48 | 11.28 | 7.20 |
| | R1000 Growth | R1000 Value | R2000 Growth | R2000 Value |
| Benchmark ● | 8.11 | 3.94 | 12.80 | 7.59 |

Sources: Callan, Russell Investment Group

### Rolling One-Year Relative Returns (vs. Russell 1000)




Source: Russell Investment Group

### U.S. Equity Index Characteristics as of September 30, 2013

| | S&P 1500 | S&P 500 | S&P 400 | S&P 600 | Rus 3000 | Rus 1000 | Rus Midcap | Rus 2000 |
|---|---|---|---|---|---|---|---|---|
| Cap Range Min ($MM) | 77 | 1,692 | 480 | 77 | 10 | 323 | 323 | 10 |
| Cap Range Max ($B) | 433.13 | 433.13 | 10.31 | 4.99 | 447.50 | 447.50 | 25.79 | 4.79 |
| Number of Issues | 1,500 | 500 | 400 | 600 | 2,965 | 1,003 | 808 | 1,962 |
| % of S&P 1500/Rus 3000 | 100% | 88% | 8% | 4% | 100% | 92% | 28% | 8% |
| Wtd Avg Mkt Cap ($B) | 91.71 | 103.80 | 4.71 | 1.67 | 84.77 | 92.16 | 10.47 | 1.61 |
| Price/Book Ratio | 2.4 | 2.4 | 2.3 | 2.2 | 2.4 | 2.4 | 2.4 | 2.1 |
| P/E Ratio (forecasted) | 14.5 | 14.2 | 17.2 | 18.4 | 14.9 | 14.6 | 16.6 | 19.1 |
| Dividend Yield | 2.0% | 2.1% | 1.5% | 1.2% | 2.0% | 2.0% | 1.6% | 1.3% |
| 5-Yr Earnings (forecasted) | 11.2% | 11.2% | 10.9% | 13.5% | 11.7% | 11.6% | 12.3% | 12.9% |

Sources: Russell Investment Group, Standard & Poor's.

### Style Median and Index Returns* for Periods ended September 30, 2013

| Large Cap Equity | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Large Cap–Core Style** | **6.25** | **21.52** | **21.37** | **16.82** | **10.23** | **8.32** |
| **Large Cap–Growth Style** | **9.59** | **21.91** | **20.88** | **16.65** | **11.31** | **8.46** |
| **Large Cap–Value Style** | **4.84** | **21.73** | **24.08** | **16.74** | **9.63** | **8.67** |
| **Aggressive Growth Style** | **11.82** | **28.82** | **26.71** | **16.38** | **13.11** | **9.75** |
| **Contrarian Style** | **4.93** | **21.71** | **25.40** | **16.37** | **10.48** | **8.85** |
| **Yield-Oriented Style** | **4.56** | **19.73** | **19.40** | **15.78** | **10.03** | **9.18** |
| Russell 3000 | 6.35 | 21.30 | 21.60 | 16.76 | 10.58 | 8.11 |
| Russell 1000 | 6.02 | 20.76 | 20.91 | 16.64 | 10.53 | 7.98 |
| Russell 1000 Growth | 8.11 | 20.87 | 19.27 | 16.94 | 12.07 | 7.82 |
| Russell 1000 Value | 3.94 | 20.47 | 22.30 | 16.25 | 8.86 | 7.99 |
| S&P Composite 1500 | 5.63 | 20.20 | 20.24 | 16.47 | 10.32 | 7.95 |
| S&P 500 | 5.24 | 19.79 | 19.34 | 16.27 | 10.02 | 7.57 |
| NYSE | 6.23 | 16.83 | 20.38 | 15.68 | 9.63 | 9.01 |
| Dow Jones Industrials | 2.12 | 17.64 | 15.59 | 14.94 | 9.93 | 7.74 |

| Mid Cap Equity | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Mid Cap–Core Style** | **8.04** | **24.24** | **28.57** | **18.94** | **13.83** | **11.11** |
| **Mid Cap–Growth Style** | **11.18** | **25.64** | **26.84** | **17.62** | **13.50** | **11.00** |
| **Mid Cap–Value Style** | **6.89** | **23.55** | **28.41** | **17.36** | **12.84** | **11.32** |
| Russell Midcap | 7.70 | 24.34 | 27.91 | 17.53 | 12.97 | 10.78 |
| S&P MidCap 400 | 7.54 | 23.23 | 27.68 | 17.45 | 13.08 | 10.84 |

| Small Cap Equity | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Small Cap–Core Style** | **10.12** | **27.86** | **31.42** | **20.04** | **12.84** | **10.98** |
| **Small Cap–Growth Style** | **13.62** | **33.69** | **33.46** | **21.01** | **14.28** | **10.99** |
| **Small Cap–Value Style** | **8.52** | **26.69** | **30.52** | **19.26** | **12.71** | **11.27** |
| Russell 2000 | 10.21 | 27.69 | 30.06 | 18.29 | 11.15 | 9.64 |
| S&P SmallCap 600 | 10.73 | 28.66 | 31.51 | 20.68 | 12.40 | 11.14 |
| NASDAQ | 11.19 | 26.11 | 22.98 | 18.28 | 13.84 | 8.78 |

| Smid Cap Equity | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Smid Cap–Broad Style** | **10.75** | **27.97** | **30.63** | **19** | **13.41** | **11.16** |
| **Smid Cap–Growth Style** | **12.96** | **30.13** | **31.59** | **19.3** | **14.02** | **11.52** |
| **Smid Cap–Value Style** | **8.52** | **25.43** | **30.34** | **17.70** | **13.25** | **11.16** |
| Russell 2500 | 9.08 | 25.89 | 29.79 | 18.44 | 12.68 | 10.38 |
| S&P 1000 | 8.52 | 24.88 | 28.86 | 17.72 | 12.44 | 10.71 |

| Russell 3000 Sectors | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| Consumer Staples | 8.63 | 30.80 | 34.64 | 24.21 | 19.02 | 9.69 |
| Consumer Discretionary | 1.52 | 17.46 | 15.80 | 16.43 | 11.30 | 10.42 |
| Industrials | 9.63 | 25.72 | 32.44 | 17.94 | 11.21 | 9.57 |
| Energy | 6.47 | 16.72 | 13.73 | 15.32 | 6.56 | 14.03 |
| Materials | 9.90 | 12.50 | 16.46 | 12.68 | 9.53 | 10.97 |
| Information Technology | 9.05 | 16.64 | 11.18 | 14.20 | 12.60 | 7.49 |
| Utilities | 0.39 | 11.43 | 8.77 | 11.45 | 7.88 | 9.94 |
| Financials | 2.87 | 21.23 | 27.11 | 13.53 | 2.60 | 1.37 |
| Telecommunications | -2.87 | 7.60 | 1.63 | 12.51 | 10.85 | 8.77 |
| Health Care | 8.02 | 30.06 | 29.33 | 21.76 | 13.82 | 9.14 |

*Returns less than one year are not annualized.
Sources: Callan, Dow Jones & Company Inc., Russell Investment Group, Standard & Poor's, The NASDAQ Stock Market Inc.

# Tall and Venti

**NON-U.S. EQUITY** | Matt Lai

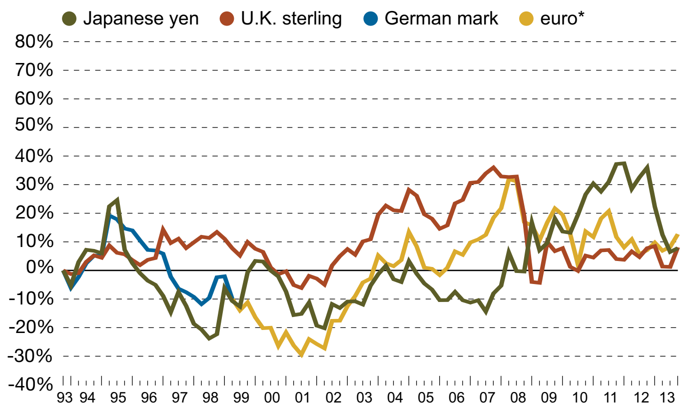
While global markets lumbered through the first two months of the quarter, September signaled prodigious gains and lifted indices well into the black. Optimism slowly returned as Europe surfaced from the recession, and China regained some steam from the first half of 2013. Pockets of unrest persisted, most notably in Syria and emerging markets, but investors warmed to the bigger picture.

International equities boosted the **MSCI ACWI ex-U.S. Index** to a strong 10.17%, aided by the commodities rebound (Energy, Materials, and Industrials all posted returns in the double digits) and the continued dominance of the Telecommunication Services sector (+12.84%). While not as strong, defensive sectors still fared reasonably well, with Consumer Staples setting the low bar at 5.97%.

Zooming in, developed markets charged forward (**MSCI EAFE Index**: +11.56%), securing 16.14% YTD. Similar to American small caps, the **EAFE Small Cap Index** came in strong with 15.52% in the quarter and 22.09% YTD. Once again, the **MSCI EAFE Value Index** (+12.63%) outperformed the **MSCI EAFE Growth Index** (+10.50%). The **MSCI EM Index** (+5.90%) continued to underwhelm against its regional peers.

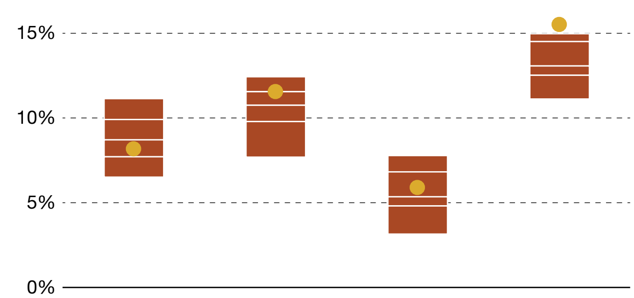
Sturdy gains in July and September welcomed investors to a European holiday (**MSCI Europe Index**: +13.61%). Sectors were universally positive, with notable strides from Telecommunication Services (+21.65%) and Consumer Discretionary (+18.55%). Unemployment figures came down to 12% in July and held steady in August. The ECB held its benchmark interest rate at 0.50%. Greece, which will be downgraded to emerging market status in November, bid farewell with a continent-leading 33.63%. Continuing Norwegian woes led them to a last place finish in Europe (+9.15%), though early September elections revived optimism with the nation's first Conservative prime minister since 1990. Both the euro and the pound sterling gained on the U.S. dollar.

**Major Currencies' Cumulative Returns** (vs. U.S. Dollar)




*euro returns from 1Q99
Source: MSCI

**Callan Style Group Quarterly Returns**




| | Global Eq Style | Non-U.S. Eq Style | Emg Mkts Style | Small Cap Style |
|---|---|---|---|---|
| 10th Percentile | 11.09 | 12.38 | 7.73 | 14.92 |
| 25th Percentile | 9.86 | 11.50 | 6.77 | 14.46 |
| Median | 8.66 | 10.70 | 5.30 | 13.02 |
| 75th Percentile | 7.66 | 9.74 | 4.76 | 12.47 |
| 90th Percentile | 6.46 | 7.64 | 3.10 | 11.07 |
| | **MSCI World** | **MSCI EAFE** | **MSCI Emg Mkts** | **MSCI Small Cap** |
| Benchmark ● | 8.18 | 11.56 | 5.90 | 15.52 |

Sources: Callan, MSCI

Volatility in the **MSCI Pacific Index** marred the first two months, but developed Pacific nations rode a global surge in September to end at 7.99%. Unlike earlier this year, Japan provided a headwind to the Index (+6.66%). Japanese defensive sectors fell hardest, with Utilities sitting at 0.60%, joined by Consumer Staples (+1.17%) and Health Care (+1.19%). The GDP of Singapore (the region's worst at +4.65%) contracted 1.0% quarter-over-quarter. Rebounding commodities data and improving news from China benefited the region's leaders, Australia (+11.94%) and New Zealand (+17.21%). While Australia lowered its benchmark interest rate to another record 2.50% in August, elections in early September saw the Liberal-National Party take Parliament, ending six years of Labor Party rule.

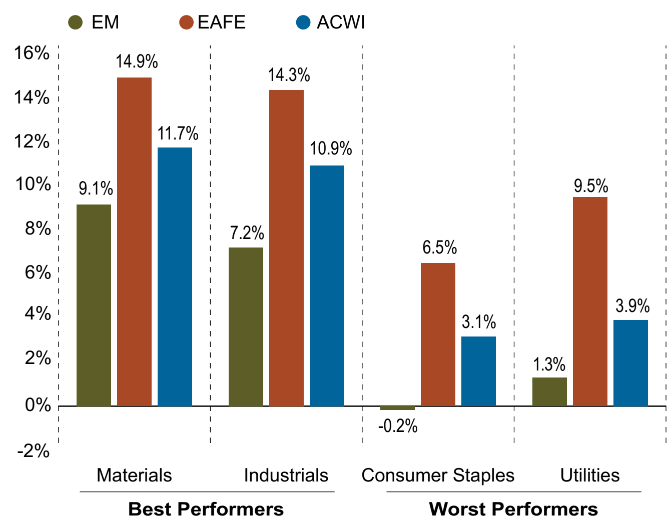
Recovery efforts were more mixed in emerging markets (**MSCI EM**: +5.90%); the YTD tally finished at a paltry -4.05%. China (+12.25%) bolstered the Index, spearheaded by a rocketing Information Technology sector (+31.62%) and strong data from Chinese retail and industrial companies. Wariness remained though, and the IMF cut its 2013 growth forecast to 7.60% from 7.75%, casting doubt on sustained growth in China. Beleaguered Indonesia (-23.93%) was hit hardest by the EM sell-off, and the World Bank has lowered the archipelago's growth forecast to 5.60% for the year. **EM Latin America** (+4.14%) also suffered, though the **MSCI Frontier Markets Index** appeared unfazed at 6.34%.

### Quarterly Return Attribution for EAFE (U.S. Dollar)

| Country | Total | Local | Currency | Wtg |
|---|---|---|---|---|
| Australia | 11.94% | 9.58% | 2.15% | 7.98% |
| Austria | 18.91% | 14.19% | 4.14% | 0.29% |
| Belgium | 13.60% | 9.09% | 4.14% | 1.16% |
| Denmark | 13.69% | 9.16% | 4.14% | 1.12% |
| Finland | 26.59% | 21.56% | 4.14% | 0.88% |
| France | 15.43% | 10.84% | 4.14% | 9.81% |
| Germany | 12.71% | 8.23% | 4.14% | 8.71% |
| Greece | 33.63% | 33.61% | 4.14% | 0.04% |
| Hong Kong | 8.89% | 8.88% | 0.02% | 2.95% |
| Ireland | 16.84% | 12.20% | 4.14% | 0.33% |
| Israel | 2.52% | -1.02% | 3.24% | 0.44% |
| Italy | 19.63% | 14.88% | 4.14% | 2.13% |
| Japan | 6.66% | 5.36% | 1.23% | 21.61% |
| Netherlands | 14.79% | 10.23% | 4.14% | 2.65% |
| New Zealand | 17.21% | 8.68% | 7.85% | 0.12% |
| Norway | 9.15% | 7.50% | 1.53% | 0.80% |
| Portugal | 10.71% | 6.31% | 4.14% | 0.18% |
| Singapore | 4.65% | 3.55% | 1.08% | 1.55% |
| Spain | 25.65% | 20.66% | 4.14% | 3.18% |
| Sweden | 15.19% | 9.62% | 5.08% | 3.25% |
| Switzerland | 9.47% | 4.62% | 4.63% | 9.05% |
| U.K. | 12.04% | 4.94% | 6.77% | 21.74% |

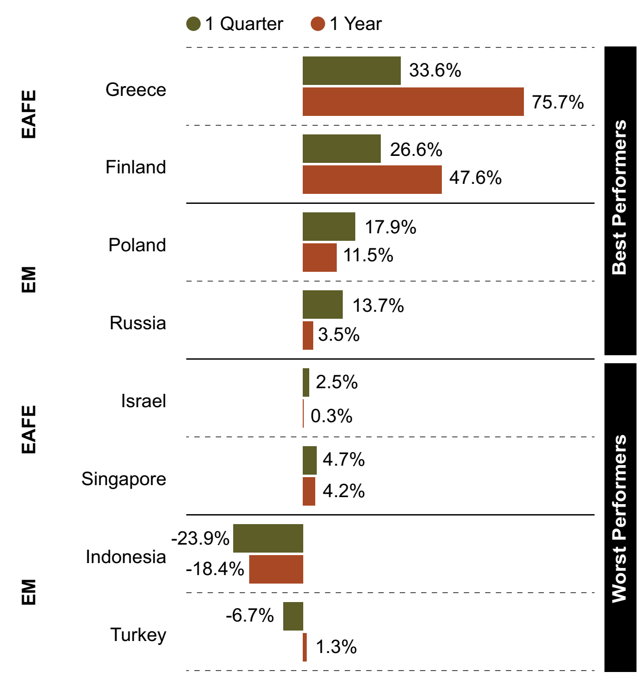
Sources: Russell Investment Group, Standard & Poor's.

### Strong and Struggling Sectors



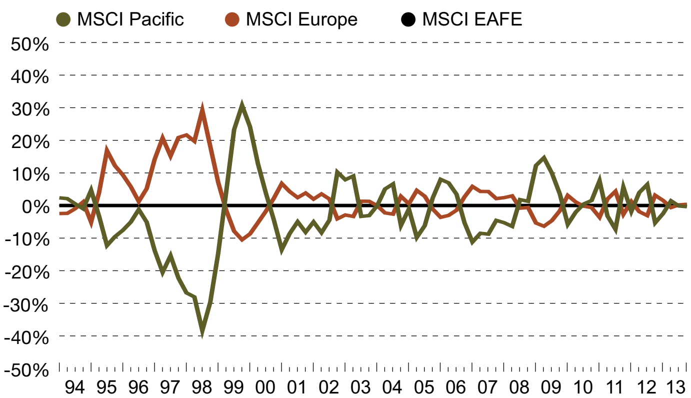

Source: MSCI

### Country Performance Snapshot



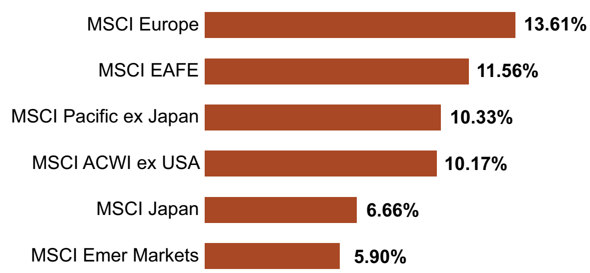

Source: MSCI

**Rolling One-year Relative Returns** (vs. MSCI EAFE U.S. Dollar)




Source: MSCI

**Regional Quarterly Performance** (U.S. Dollar)




Source: MSCI

**Style Median and Index Returns* for Periods ended September 30, 2013**

| Non-U.S. Equity | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Non-U.S. Style** | **10.70** | **15.56** | **22.69** | **9.34** | **7.61** | **9.14** |
| MSCI EAFE | 11.56 | 16.14 | 23.77 | 8.47 | 6.35 | 8.01 |
| MSCI EAFE (local) | 7.50 | 19.34 | 28.31 | 9.11 | 5.54 | 6.27 |
| MSCI EAFE Growth | 10.50 | 16.54 | 23.27 | 8.88 | 6.79 | 8.00 |
| MSCI EAFE Value | 12.63 | 15.71 | 24.27 | 7.99 | 5.86 | 7.94 |
| MSCI ACWI ex USA | 10.17 | 10.47 | 16.98 | 6.43 | 6.74 | 9.24 |
| **Global Equity** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Global Style** | **8.66** | **18.35** | **22.30** | **12.50** | **8.95** | **8.91** |
| MSCI World | 8.18 | 17.29 | 20.21 | 11.82 | 7.84 | 7.58 |
| MSCI World (local) | 6.40 | 18.85 | 22.34 | 12.07 | 7.36 | 6.66 |
| MSCI ACWI | 8.02 | 14.92 | 18.37 | 10.81 | 8.30 | 8.41 |
| **Regional Equity** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| MSCI Europe | 13.61 | 16.09 | 24.23 | 8.73 | 6.03 | 8.47 |
| MSCI Europe (local) | 8.12 | 14.72 | 20.62 | 8.07 | 6.37 | 7.06 |
| MSCI Japan | 6.66 | 24.31 | 31.50 | 8.91 | 5.16 | 4.84 |
| MSCI Japan (local) | 5.36 | 41.08 | 65.85 | 14.91 | 3.51 | 3.49 |
| MSCI Pacific ex Japan | 10.33 | 5.20 | 11.57 | 7.37 | 11.60 | 12.62 |
| MSCI Pacific ex Japan (local) | 8.62 | 12.77 | 19.67 | 7.74 | 8.68 | 9.75 |
| **Emerging/Frontier Markets** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Emerging Markets Style** | **5.30** | **-3.23** | **3.04** | **-0.31** | **6.68** | **12.90** |
| MSCI Emerging Markets | 5.90 | -4.05 | 1.33 | 0.00 | 7.56 | 13.16 |
| MSCI Emerging Markets (local) | 5.76 | 0.78 | 6.19 | 3.08 | 8.52 | 12.85 |
| MSCI Frontier Markets | 6.30 | 18.15 | 21.75 | 4.12 | -2.88 | 7.24 |
| **International Small Cap Equity** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Small Cap Style** | **13.02** | **22.11** | **29.42** | **13.64** | **12.35** | **12.12** |
| MSCI EAFE Small Cap | 15.52 | 22.09 | 29.43 | 11.25 | 11.43 | 10.29 |
| MSCI ACWI ex USA Small Cap | 12.38 | 14.43 | 20.04 | 7.27 | 11.38 | 11.13 |

*Returns less than one year are not annualized.
Sources: Callan, MSCI

# Congress Bangs its Head on the Debt Ceiling

**U.S. FIXED INCOME** | Steven Center, CFA

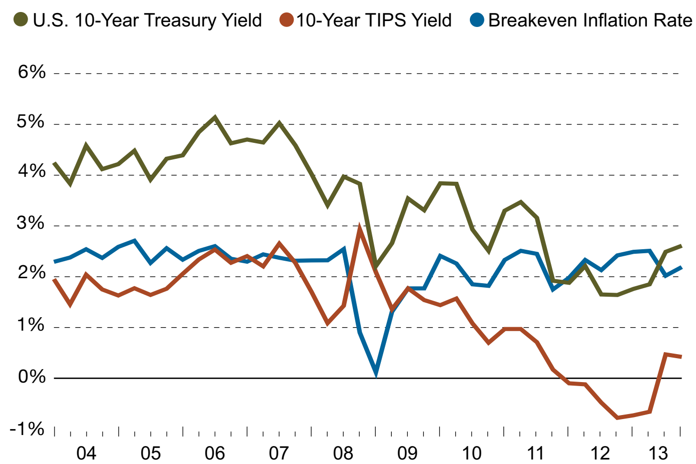
After the Fed gave the market a good fright regarding the potential tapering of asset purchases, it reversed course in September due to tepid GDP growth and other economic concerns. The House and Senate also failed to meet a September 30 deadline to fund government operations, resulting in a partial shutdown. Treasury yields moved only slightly, but investors returned to spread sectors as a source of yield. The **Barclays Aggregate Index** climbed 0.57%, its first positive quarter in 2013.

The Fed lowered its GDP growth forecast to 2.0–2.3% for 2013, fueling the argument that near-term tapering of asset purchases is off the table. The Fed also continued its policy of low interest rates, keeping the federal funds and discount rates at 0.00%–0.25% and 0.75%, respectively.

The yield curve steepened slightly during the quarter, with the spread between 2-year and 30-year Treasuries widening 23 basis points (bps) to 337 bps. The majority of the movement occurred at the long end of the curve, with 10- and 30-year yields rising 12 and 19 bps, respectively. The short end of the curve remained fairly static, with the six-month yield dipping 6 bps and the two-year yield falling 4 bps. The breakeven rate (the difference between nominal and real yields) on the 10-year Treasury increased 17 bps to 2.19% during the quarter.

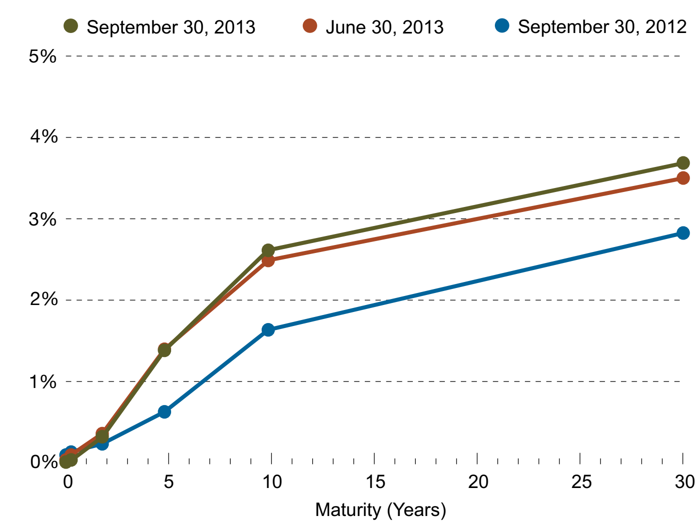
Amid concerns over a potential government shutdown, along with relatively positive corporate earnings reports, the fixed income market was buoyed by strong returns from

### Historical 10-Year Yields



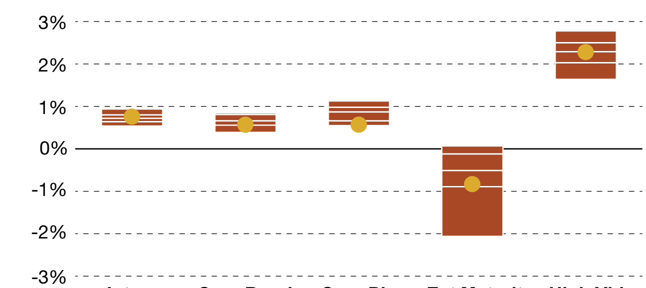

Source: Bloomberg

### U.S. Treasury Yield Curves




Source: Bloomberg

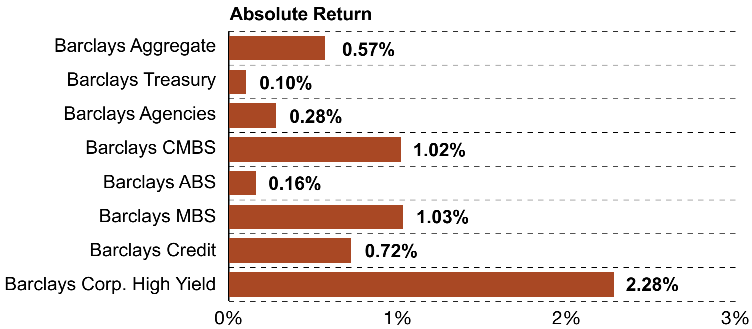
### Callan Style Group Quarterly Returns

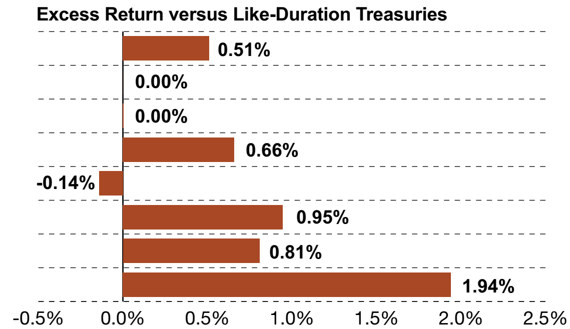



| | Interm Style | Core Bond Style | Core Plus Style | Ext Maturity Style | High Yld Style |
|---|---|---|---|---|---|
| 10th Percentile | 0.94 | 0.85 | 1.13 | 0.07 | 2.78 |
| 25th Percentile | 0.80 | 0.81 | 0.98 | -0.12 | 2.50 |
| Median | 0.72 | 0.66 | 0.87 | -0.51 | 2.29 |
| 75th Percentile | 0.64 | 0.56 | 0.66 | -0.89 | 2.03 |
| 90th Percentile | 0.54 | 0.39 | 0.55 | -2.06 | 1.64 |
| | **Barclays Intm Agg** | **Barclays Agg** | **Barclays Agg** | **Barclays G/C Long** | **Barclays High Yld** |
| Benchmark | 0.76 | 0.57 | 0.57 | -0.83 | 2.28 |

Sources: Barclays, Callan

## Fixed Income Index Quarterly Returns



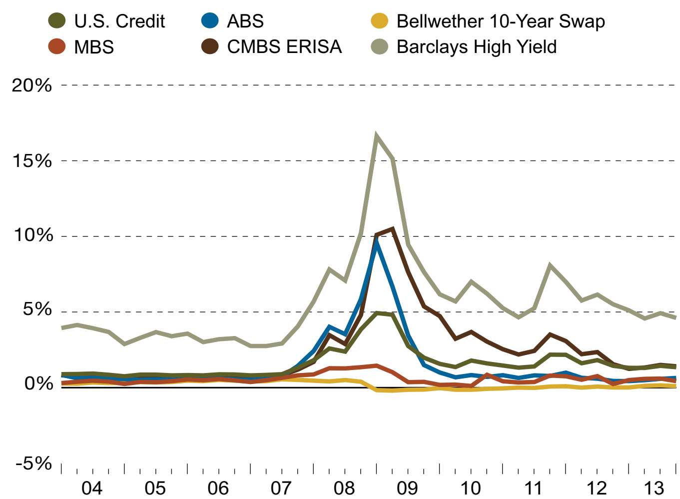




Source: Barclays

non-Treasuries. Only asset-backed securities lagged like-duration Treasuries during the quarter (-0.14%), with all other sectors notching positive relative performance. Mortgage-backed securities and commercial mortgage-backed securities posted excess relative returns of 0.95% and 0.66%, respectively. Investment-grade corporate credit also performed well, evidenced by Verizon's record-breaking $49 billion new issue. Financials climbed 1.40%, Industrials advanced 0.69%, and Utilities gained 0.60%.

The high yield corporate sector performed well during the quarter, with the **Barclays Corporate High Yield Index** increasing 2.28%. New issue activity slowed slightly from the first half of the year, with 172 issues totaling approximately $91 billion coming to market during the quarter.

## Effective Yield Over Treasuries




Source: Barclays

## U.S. Fixed Income Index Characteristics as of September 30, 2013

| Barclays Indices | Yield to Worst | Mod Adj Duration | Avg Maturity | % of Barclays G/C | % of Barclays Agg |
|---|---|---|---|---|---|
| Barclays Aggregate | 2.34 | 5.52 | 7.50 | 0.00% | 100.00% |
| Barclays Govt/Credit | 2.04 | 5.65 | 7.66 | 100.00% | 68.34% |
| Intermediate | 1.48 | 3.87 | 4.19 | 82.51% | 56.39% |
| Long-Term | 4.64 | 14.04 | 24.05 | 17.49% | 11.95% |
| Barclays Govt | 1.24 | 4.93 | 5.99 | 59.32% | 40.54% |
| Barclays Credit | 3.19 | 6.70 | 10.10 | 40.68% | 27.80% |
| Barclays Mortgage | 3.07 | 5.40 | 7.44 | - | 29.45% |
| Barclays Asset-Backed | 1.26 | 2.60 | 2.89 | - | 0.44% |
| Barclays Comm Mortgage | 2.24 | 3.19 | 3.56 | - | 1.73% |
| Barclays Corp High Yield | 6.23 | 4.26 | 6.64 | - | - |

Source: Barclays

## U.S. FIXED INCOME (Continued)

### Style Median and Index Returns* for Periods ended September 30, 2013

| Broad Fixed Income | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Core Bond Style** | **0.66** | **-1.67** | **-1.12** | **3.58** | **6.45** | **5.11** |
| **Core Bond Plus Style** | **0.87** | **-1.27** | **-0.32** | **4.58** | **7.95** | **5.71** |
| Barclays Aggregate | 0.57 | -1.89 | -1.68 | 2.86 | 5.41 | 4.59 |
| Barclays Govt/Credit | 0.36 | -2.32 | -1.96 | 2.89 | 5.71 | 4.52 |
| Barclays Govt | 0.12 | -1.92 | -1.98 | 2.13 | 4.00 | 4.17 |
| Barclays Credit | 0.72 | -2.91 | -1.90 | 4.13 | 8.54 | 5.19 |
| Citi Broad Investment Grade | 0.57 | -1.89 | -1.67 | 2.85 | 5.41 | 4.72 |
| **Long-Term** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Extended Maturity Style** | **-0.51** | **-7.72** | **-6.55** | **5.48** | **10.51** | **6.91** |
| Barclays Gov/Credit Long | -0.83 | -8.74 | -8.33 | 4.71 | 9.07 | 6.33 |
| Barclays Gov Long | -2.12 | -9.79 | -10.43 | 3.64 | 6.50 | 6.14 |
| Barclays Credit Long | -0.03 | -8.04 | -6.89 | 5.36 | 11.17 | 6.35 |
| **Intermediate-Term** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Intermediate Style** | **0.72** | **-0.72** | **-0.25** | **2.84** | **5.75** | **4.65** |
| Barclays Intermediate Aggregate | 0.76 | -0.88 | -0.71 | 2.58 | 4.95 | 4.36 |
| Barclays Gov/Credit Intermediate | 0.62 | -0.84 | -0.50 | 2.42 | 4.95 | 4.10 |
| Barclays Gov Intermediate | 0.40 | -0.83 | -0.80 | 1.75 | 3.52 | 3.76 |
| Barclays Credit Intermediate | 1.01 | -0.85 | 0.09 | 3.71 | 7.70 | 4.84 |
| **Short-Term** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Defensive Style** | **0.45** | **0.36** | **0.53** | **1.39** | **2.91** | **3.14** |
| **Active Duration Style** | **0.66** | **-0.96** | **-0.54** | **2.88** | **5.54** | **4.74** |
| Money Market Funds (net of fees) | 0.00 | 0.01 | 0.01 | 0.01 | 0.11 | 1.53 |
| ML Treasury 1–3-Year | 0.29 | 0.30 | 0.37 | 0.71 | 1.62 | 2.58 |
| 90-Day Treasury Bills | 0.02 | 0.06 | 0.10 | 0.10 | 0.17 | 1.70 |
| **High Yield** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **High Yield Style** | **2.29** | **3.91** | **7.25** | **9.32** | **12.34** | **8.77** |
| Barclays Corporate High Yield | 2.28 | 3.73 | 7.14 | 9.19 | 13.53 | 8.86 |
| ML High Yield Master | 2.28 | 3.77 | 7.03 | 8.83 | 13.22 | 8.63 |
| **Mortgage/Asset-Backed** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Mortgages Style** | 0.97 | -0.80 | -0.54 | 3.29 | 5.31 | 4.98 |
| Barclays MBS | 1.03 | -1.00 | -1.20 | 2.65 | 4.66 | 4.75 |
| Barclays ABS | 0.16 | -0.59 | -0.38 | 2.20 | 5.91 | 3.49 |
| Barclays CMBS | 1.02 | -0.30 | 0.91 | 5.36 | 9.17 | 5.27 |
| **Municipal** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| Barclays Muni | -0.19 | -2.87 | -2.21 | 3.24 | 5.98 | 4.40 |
| Barclays Muni 1–10-Year | 0.72 | -0.63 | -0.34 | 2.79 | 4.75 | 3.86 |
| Barclays Muni 3-Year | 0.78 | 0.73 | 0.71 | 1.77 | 3.26 | 2.95 |

*Returns of less than one year are not annualized.

Sources: Barclays, Callan, Citigroup, Merrill Lynch

# Central Banks Take Center Stage

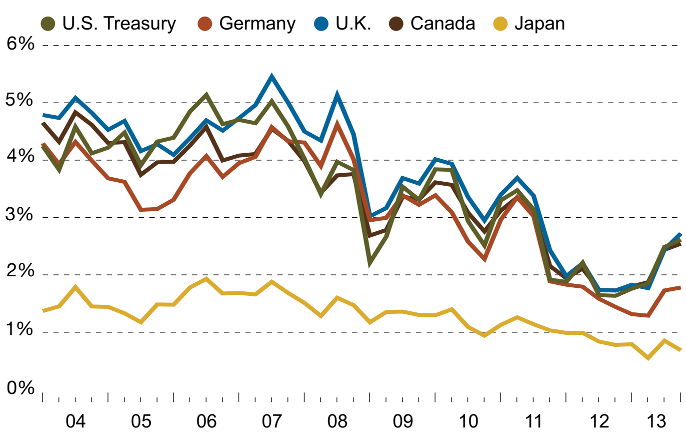
**NON-U.S. FIXED INCOME** | Kyle Fekete

The **Citi Non-U.S. World Government Bond Index** (+4.06%) solidly finished out the third quarter. Non-U.S. sovereign debt was boosted primarily by improving global economic data and news that the Federal Reserve would not yet curtail quantitative easing. Unhedged returns benefited from the U.S. dollar depreciating against major currencies, as indicated by the laggard **Citi Non-U.S. World Government Bond Index-Local** (+1.00%).

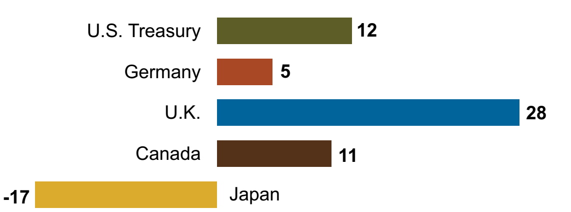
Government debt from peripheral eurozone countries outperformed, as Spain (+3.50%) and Italy (+1.40%) experienced gains from their 10-year notes, reflecting improving market sentiment in the face of deep political infighting. Europe's flagship economy, Germany, was flat for the quarter and confronted a steepening yield curve. In August, the eurozone climbed out of its worst recession on record as second-quarter GDP grew 0.3%, or 1.2% on an annualized basis. Nevertheless, the ECB remained vigilant and maintained its loose monetary policy, as the eurozone continued to battle a high (+12.0%) unemployment rate.

The Bank of Japan was persistent with its debt-buying program, lowering yields on Japanese government bonds across the curve. Concerns about the Japanese two-stage consumption tax increase (set to take effect in April 2014) dissipated as investors were handed an encouraging second-quarter GDP revision and promising business spending and manufacturing data.

**10-Year Global Government Bond Yields**




**Change in 10-Year Yields from 2Q13 to 3Q13 (bps)**




Source: Bloomberg

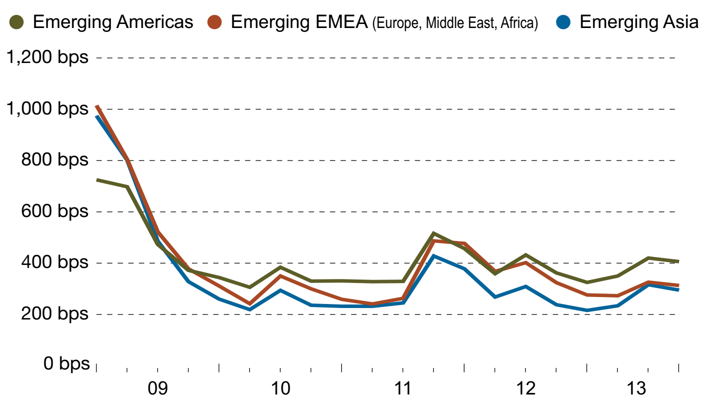
**Quarterly Return Attribution for Non-U.S. Gov't Indices**
(U.S. Dollar)

| Country | Total | Local | Currency | Wtg |
|---|---|---|---|---|
| Australia | 2.83% | 0.66% | 2.15% | 1.59% |
| Austria | 4.49% | 0.33% | 4.14% | 1.84% |
| Belgium | 4.77% | 0.61% | 4.14% | 2.80% |
| Canada | 2.51% | -0.12% | 2.63% | 2.62% |
| Denmark | 3.25% | -0.87% | 4.15% | 0.89% |
| Finland | 4.36% | 0.21% | 4.14% | 0.67% |
| France | 4.67% | 0.51% | 4.14% | 10.51% |
| Germany | 4.14% | 0.00% | 4.14% | 9.22% |
| Ireland | 6.08% | 1.86% | 4.14% | 0.84% |
| Italy | 5.60% | 1.40% | 4.14% | 9.98% |
| Japan | 2.61% | 1.37% | 1.23% | 38.20% |
| Malaysia | -2.84% | 0.24% | -3.07% | 0.51% |
| Mexico | 0.02% | 1.08% | -1.05% | 1.07% |
| Netherlands | 4.09% | -0.05% | 4.14% | 2.87% |
| Norway | 0.72% | -0.80% | 1.53% | 0.34% |
| Poland | 7.15% | 0.40% | 6.72% | 0.83% |
| Singapore | 1.75% | 0.66% | 1.08% | 0.39% |
| South Africa | 0.58% | 1.96% | -1.36% | 0.52% |
| Spain | 7.76% | 3.48% | 4.14% | 5.43% |
| Sweden | 4.48% | -0.58% | 5.08% | 0.57% |
| Switzerland | 4.87% | 0.23% | 4.63% | 0.39% |
| U.K. | 7.28% | 0.48% | 6.77% | 7.89% |

Portugal was removed in 1Q12. South Africa was added in 4Q12.
Source: Citigroup

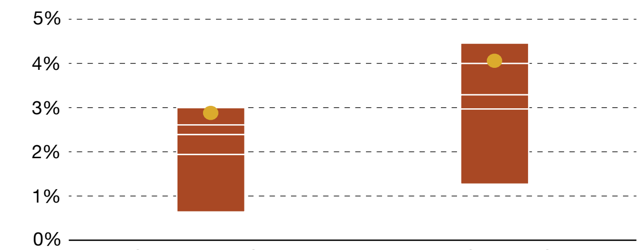
For the first two months of the quarter, emerging market bonds experienced outflows as investors moved their assets to developed economies in pursuit of higher interest rates. However, the **J.P. Morgan GBI Emerging Market Composite Index** (+0.23%) rallied late in the quarter as investors' risk appetite returned following the Fed's surprise announcement. Emerging market inflows also benefited from data showing that the Chinese economy was performing better than expected as efforts to stabilize future growth took effect. Egyptian (+15.6%) and Argentinean (+15.0%) sovereign debts led those of nearly every country. India's wide current account deficit and high inflation led its central bank to raise the benchmark rate in September for the first time in two years. Overall, India fell 1.8% for the quarter. The heaviest drags on performance came from Ukraine (-5.4%) and Paraguay (-4.0%).

### Emerging Spreads Over Developed (By Region)




Source: Barclays

### Callan Style Group Quarterly Returns




| | Global Fixed Style | Non-U.S. Fixed Style |
|---|---|---|
| 10th Percentile | 3.00 | 4.46 |
| 25th Percentile | 2.61 | 4.00 |
| Median | 2.39 | 3.29 |
| 75th Percentile | 1.94 | 2.97 |
| 90th Percentile | 0.64 | 1.27 |
| | **Citi World Govt Unhedged** | **Citi Non-U.S. World Govt Unhedged** |
| Benchmark | 2.88 | 4.06 |

Sources: Callan, Citigroup

### Style Median and Index Returns* for Periods ended September 30, 2013

| Global Fixed | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Global Style** | **2.39** | **-3.14** | **-3.48** | **2.13** | **5.60** | **5.55** |
| Citi World Govt | 2.88 | -2.94 | -4.60 | 1.02 | 4.25 | 4.79 |
| Citi World Govt (Local) | 0.73 | 0.07 | 0.88 | 2.61 | 4.08 | 3.61 |
| Barclays Global Aggregate | 2.80 | -2.17 | -2.64 | 2.09 | 5.07 | 4.92 |
| **Non-U.S. Fixed** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Non-U.S. Style** | **3.29** | **-3.86** | **-4.91** | **1.27** | **5.37** | **5.66** |
| Citi Non-U.S. World Govt | 4.06 | -3.37 | -5.65 | 0.55 | 4.27 | 4.91 |
| Citi Non-U.S. World Govt (Local) | 1.00 | 0.92 | 2.09 | 2.92 | 4.18 | 3.49 |
| **European Fixed** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| Citi Euro Govt Bond | 5.12 | 3.77 | 9.54 | 3.44 | 4.49 | 5.91 |
| Citi Euro Govt Bond (Local) | 2.88 | 3.01 | 6.10 | 4.39 | 5.67 | 4.53 |
| **Emerging Markets Fixed** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| JPM Emerging Mkts Bond Plus | 0.51 | -8.89 | -5.94 | 4.69 | 9.51 | 8.74 |
| JPM Emerging Local Mkts Plus | 0.46 | -1.89 | -0.78 | 0.12 | 1.91 | 6.12 |
| JPM GBI EM Global Composite | 0.23 | -6.95 | -3.81 | 1.82 | 6.14 | 9.12 |

*Returns less than one year are not annualized.
Sources: Callan, Citigroup, JPMorgan Chase & Co.

# Up and Down

**REAL ESTATE** | Jay Nayak

Relatively liquid equity and debt markets made capital available for public and private real estate across all property types and risk profiles during the third quarter. Private real estate and international real estate stocks generated positive returns, while domestic real estate stocks were negatively impacted by the Congressional debate preceding the government shutdown.

U.S. institutional real estate, as measured by the **NCREIF Property Index**, advanced 2.59%. Income contributed 1.37%, while capital return added 1.22%. Industrial (+3.14%) led, while Hotels (+2.11%) continued to lag all other major property sectors. The South led the regional subindices by advancing 3.04%, while the East (+2.09%) lagged.

On a leveraged basis, NCREIF advanced 3.70% and reflected an overall leverage level of 46.22%. On a preliminary basis, NCREIF recorded 190 asset trades representing $7.09 billion of transactional volume. The overall transactional capitalization rate for the quarter was 5.58%, increasingly converging with an overall Index appraisal capitalization rate of 5.20%.

**NCREIF Overall Capitalization Rates**

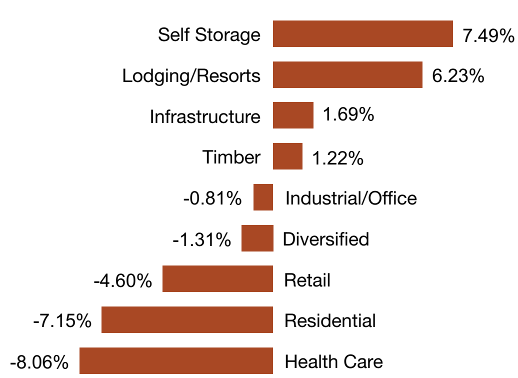
| Sector | 3Q13 | 2Q13 | 1Q13 |
|---|---|---|---|
| Apartment | 4.86% | 5.05% | 5.03% |
| Industrial | 5.70% | 5.73% | 5.82% |
| Office | 4.97% | 5.31% | 5.10% |
| Retail | 5.65% | 5.64% | 5.67% |

Rates based on unleveraged, value-weighted, appraisal capitalization data.
Source: NCREIF

Global listed real estate, as measured by the **FTSE EPRA/NAREIT Developed REIT Index**, advanced 2.44%. Domestic REITs, as measured by the **FTSE NAREIT Equity REITs Index**, fell 3.09% and traded at a 3.67% dividend yield at quarter end. Self Storage (+7.49%) led sector performance, supported by relatively short-duration leases and fairly attractive margins.

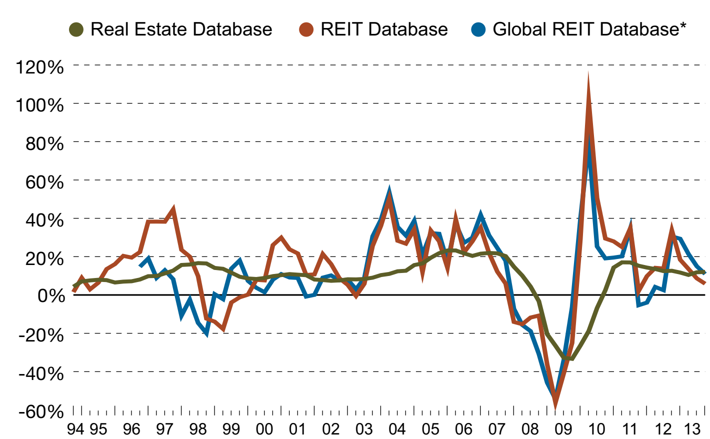
The Residential sector declined 7.15% as concerns of oversupply widened; in the years following the global financial crisis, incremental real estate development activity was largely concentrated on apartments. The Retail sector declined 4.60% on tempered expectations of holiday sales.

**NAREIT All Equity Sector Quarterly Performance**




*Timber replaced Specialty in 4Q10. Infrastructure was added in 1Q12.
Source: NAREIT

**Rolling One-Year Returns**

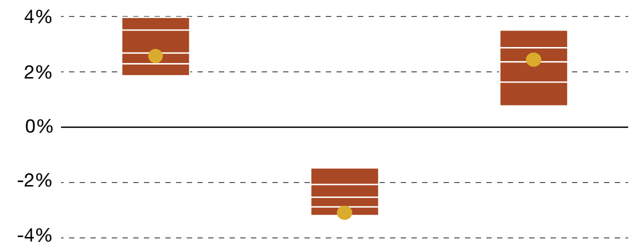



*Global REIT returns from 3Q96
Source: Callan

European stocks gained 10.09% per the **FTSE EPRA/NAREIT Developed Europe Index (USD)**, led by real estate stocks in the United Kingdom; alternatively, continental stocks broadly lagged. Stock performance in the Asia/Pacific region (**FTSE EPRA/NAREIT Developed Asia Index (USD)**: +7.30%) was driven by developers in Japan and China.

Domestic REITs executed 45 offerings, raising $15.1 billion. Four primary offerings raised $1.2 billion and 21 secondary offerings raised $5.0 billion. Additionally, domestic REITs raised $8.8 billion of unsecured debt. Domestic commercial mortgage-backed securities (CMBS) issuance totaled $16.7 billion. Year-to-date CMBS issuance reached $60.5 billion, exceeding the $48.4 billion issuance total seen in 2012.

### Callan Style Group Quarterly Returns




| | Real Estate Database | REIT Database | Global REIT Database |
|---|---|---|---|
| 10th Percentile | 3.97 | -1.47 | 3.51 |
| 25th Percentile | 3.51 | -2.07 | 2.87 |
| Median | 2.68 | -2.53 | 2.36 |
| 75th Percentile | 2.29 | -2.88 | 1.63 |
| 90th Percentile | 1.86 | -3.19 | 0.77 |
| | **NCREIF Property** | **FTSE NAREIT Equity** | **EPRA/NAREIT Developed** |
| Benchmark ● | 2.59 | -3.09 | 2.44 |

Sources: Callan, NAREIT, NCREIF, The FTSE Group

### NCREIF All Equity Sector Quarterly Performance

**Quarterly Returns by Property Type**


**Quarterly Returns by Region**


Source: NCREIF

### Style Median and Index Returns* for Periods ended September 30, 2013

| Private Real Estate | Quarter | 2 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Real Estate Database (net of fees)** | **2.68** | **8.78** | **11.78** | **13.11** | **-0.36** | **5.76** |
| NCREIF Property** | 2.59 | 8.24 | 10.99 | 12.67 | 3.35 | 8.66 |
| **Public Real Estate** | **Quarter** | **2 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **REIT Database** | **-2.53** | **2.92** | **5.67** | **12.91** | **6.88** | **10.66** |
| FTSE NAREIT Equity | -3.09 | 3.20 | 5.87 | 12.34 | 5.75 | 9.54 |
| **Global Real Estate** | **Quarter** | **2 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| **Global REIT Database** | **2.36** | **4.47** | **10.40** | **10.91** | **8.12** | **11.34** |
| FTSE EPRA/NAREIT Developed | 2.44 | 4.90 | 10.95 | 10.50 | 7.43 | 10.06 |

*Returns less than one year are not annualized.
**Represents data available as of publication date.
All REIT returns are reported gross in USD.
Sources: Callan, NAREIT, NCREIF, The FTSE Group

# Mild Autumn

**PRIVATE EQUITY** | Gary Robertson

In fundraising, *Private Equity Analyst* reports that new third-quarter commitments totaled $55.2 billion with 126 new partnerships formed. This represents a moderate slowdown from the surprisingly strong prior quarter, which saw $70.3 billion and 175 new partnerships formed. The year-to-date commitment total is 23% ahead of the same period last year, which produced $128.6 billion of new commitments and 319 new funds.

According to *Buyouts* newsletter, the investment pace by funds into companies in the third quarter totaled 362 transactions with announced dollar volume of $23.6 billion. The transaction count matched the second quarter's 362 deals, but the announced transaction value decreased 42% from $41.1 billion. The $27 billion purchase of H.J. Heinz had inflated the second-quarter dollar volume, so without Heinz the third quarter would have been an increase. There were five deals with announced values of $1 billion or more that closed in the third quarter; the largest was $6.5 billion.

According to the National Venture Capital Association, new investments in venture capital companies totaled $7.7 billion in 1,005 rounds of financing. The dollar volume and number of rounds both increased compared to the second quarter's $7.0 billion and 956 rounds.

**Funds Closed 1/1/13 to 9/30/13**

| Strategy | No. of Funds | Amt ($MM) | Percent |
|---|---|---|---|
| Venture Capital | 146 | 15,972 | 10% |
| Buyouts | 158 | 96,834 | 61% |
| Subordinated Debt | 29 | 13,162 | 8% |
| Distressed Debt | 16 | 16,473 | 10% |
| Secondary and Other | 25 | 9,099 | 6% |
| Fund-of-funds | 48 | 6,840 | 4% |
| **Totals** | **422** | **158,380** | **100%** |

Source: Private Equity Analyst

Regarding exits, *Buyouts* reported 113 private M&A exits of buyout-backed companies, with 23 deals disclosing values totaling $20.4 billion. *Buyouts* also reported 7 buyout-backed IPOs, a decrease from the 16 IPOs in the second quarter.

Venture-backed M&A exits in the third quarter totaled 107 transactions, with 31 investments disclosing total dollar volume of $4.9 billion. This represented an increase from the second quarter, which had 92 transactions with 19 investments disclosing total dollar volume of $3.4 billion. There were 26 VC-backed IPOs in the third quarter, with a combined float of $2.7 billion. For comparison, the second quarter had 28 VC-backed IPOs and total issuance of $2.4 billion. Please see our upcoming issue of *Private Markets Trends* for more in-depth coverage.

**Private Equity Performance Database (%)** (Pooled Horizon IRRs Through March 31, 2013*)

| Strategy | 3 Months | Year | 3 Years | 5 Years | 10 Years | 20 Years |
|---|---|---|---|---|---|---|
| All Venture | 2.7 | 5.0 | 4.3 | 0.6 | 4.7 | 16.0 |
| All Buyouts | 5.8 | 15.4 | 11.1 | 3.9 | 11.2 | 10.4 |
| Mezzanine | -2.5 | -3.6 | 5.9 | 2.5 | 6.8 | 7.5 |
| **All Private Equity** | **4.9** | **12.7** | **9.6** | **3.7** | **9.7** | **11.3** |
| S&P 500 | 10.6 | 14.0 | 12.7 | 5.8 | 8.5 | 8.5 |

Private equity returns are net of fees.
Source: Thomson ONE
* Latest quarterly data available.

# Market Bounce Boosts Hedge Funds

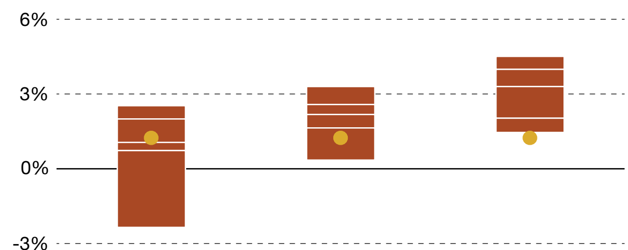
**HEDGE FUNDS** | Jim McKee

Markets rebounded in the third quarter as Europe's slipping economy seemed to stabilize and the Federal Reserve removed short-term fears of reduced liquidity. With the Fed's punch bowl back on the table, the **S&P 500 Index** jumped 5.24% and other developed markets, as measured by the **MSCI EAFE Index**, celebrated an 11.56% pop.

Representing a paper portfolio of hedge fund interests without implementation costs, the **Credit Suisse Hedge Fund Index** (CS HFI) grew 1.61%. As a live hedge fund portfolio proxy, net of all fees, the median manager in the **Callan Hedge Fund-of-Funds Database** climbed 2.03%.

Within the CS HFI, *Long/Short Equity* (+3.48%) was the best-performing strategy, aided by rising equities. The strong stock market also supported *Event-Driven Multi-Strategy* (+3.29%), given its long biased equity exposure from special situations and activist efforts. While the risk on/risk off dynamics were in play during the third quarter, fundamentals still rewarded discrete stock pickers, as the average *Equity Market Neutral* manager edged ahead 1.17%.

### Callan Style Group Quarterly Returns




| | Absolute Return FoF Style | Core Diversified FoF Style | Long/Short Eq FoF Style |
|---|---|---|---|
| 10th Percentile | 2.53 | 3.30 | 4.51 |
| 25th Percentile | 2.00 | 2.58 | 3.99 |
| Median | 1.06 | 2.18 | 3.30 |
| 75th Percentile | 0.73 | 1.64 | 2.03 |
| 90th Percentile | -2.35 | 0.35 | 1.46 |
| T-Bills + 5% ● | 1.24 | 1.24 | 1.24 |

Sources: Callan, Merrill Lynch

Within Callan's Hedge Fund-of-Funds Database, market exposures modestly affected performance. With the tailwind of rising stock prices, the median *Callan Long/Short Equity FoF* (+3.30%) outpaced the *Callan Absolute Return FoF* (+1.06%). Diversified across non-directional and directional styles, the *Core Diversified FoF* gained 2.18%. Please see our upcoming issue of *Hedge Fund Monitor* for more in-depth coverage.

### Style Median and Index Returns* for Periods ended September 30, 2013

| Diversified Hedge Fund Strategies | Quarter | 3 Quarters | Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| **Hedge Fund-of-Funds Database** | **2.03** | **7.45** | **9.26** | **4.92** | **4.67** | **5.08** |
| CS Hedge Fund Index | 1.61 | 5.35 | 7.41 | 5.00 | 5.49 | 6.40 |
| CS Investable Blue Chip Index | 0.95 | 2.22 | 3.73 | 3.02 | 3.96 | 3.33 |
| **Credit Suisse Subindices** | **Quarter** | **3 Quarters** | **Year** | **3 Years** | **5 Years** | **10 Years** |
| Equity Market Neutral | 1.17 | 3.93 | 4.79 | 3.12 | -7.88 | -0.58 |
| Convertible Arb | 0.87 | 4.72 | 6.66 | 5.62 | 9.65 | 4.69 |
| Fixed Income Arb | 1.10 | 2.47 | 4.56 | 6.87 | 6.57 | 4.15 |
| Multi-Strategy | 2.68 | 6.62 | 9.54 | 7.90 | 7.52 | 6.70 |
| Distressed | 2.21 | 10.36 | 13.92 | 7.25 | 6.59 | 7.84 |
| Risk Arb | 1.82 | 3.82 | 5.68 | 2.15 | 4.13 | 4.67 |
| Event Driven Multi | 3.29 | 10.11 | 13.66 | 4.57 | 6.31 | 7.78 |
| Long-Short Equity | 3.48 | 10.73 | 13.07 | 5.58 | 6.05 | 7.04 |
| Short Bias | -10.92 | -21.92 | -24.60 | -16.99 | -16.17 | -8.79 |
| Global Macro | 0.17 | 1.51 | 2.78 | 5.45 | 6.85 | 8.24 |
| Managed Futures | -3.95 | -7.39 | -10.22 | -3.17 | 0.03 | 3.30 |

*Returns less than one year are not annualized.
Sources: Callan, Credit Suisse Hedge Index LLC

# Hard-Earned, Modest Gains

**DEFINED CONTRIBUTION** | James O'Connor

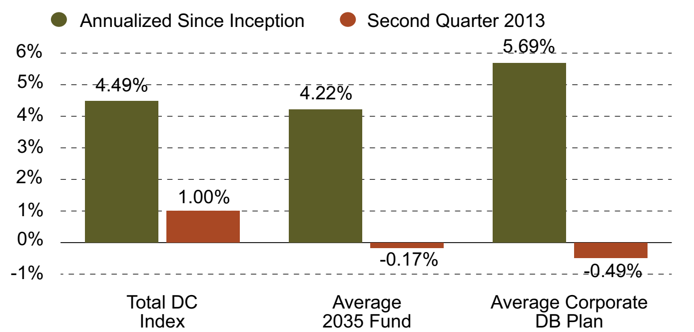
The average DC plan scored a hard-earned, although modest, gain of 1% in the quarter ended June 30, 2013,* according to the Callan DC Index™. Since the Index's inception in January 2006, the average corporate DB plan has outperformed DC plans by 1.20% annually, and target date funds have slightly underperformed both DB and DC plans.

DC plans increased a respectable 1.48% during the second quarter. Participant contributions (net flows) added 0.48% while market appreciation (return growth) contributed the remaining 1%. This represents the fourth consecutive quarter of growth for the DC Index. Since the Index's 2006 inception, annual growth in balances (+7.47%) has been predominantly driven by investment returns (+4.49%), with inflows accounting for the remainder (+2.98%).

Activity was modest in the second quarter; turnover came in at 0.43%, well below the historical average of 0.70%. When money did move, it followed investment performance, as it typically does. This is especially evident in domestic fixed income, which experienced outflows equating to 41% of total DC flows. Stable value, in contrast, experienced modest inflows. Target date funds proved to be a major exception to the performance-chasing rule, as they once again took in the lion's share of inflows (74%), despite weak performance. In fact, second-quarter inflows are among the highest since the Index's inception—exceeded only by flows during the first quarter of 2012 (77%). Target date funds are well on their way to becoming the single-largest holding in the typical DC plan, with the target date allocation now standing at 19.4% within the DC Index. Only domestic large cap equity allocations are higher, at 23.2%.

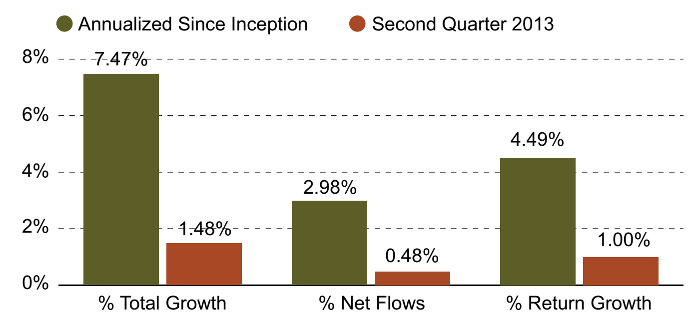
*The Callan DC Index™ tracks the cash flows and performance of 70+ plans, representing more than 800,000 DC participants and over $80 billion in assets. The Index is updated quarterly and is available to clients at http://www.callan.com/research/dcindex/. Read the quarterly DC Observer newsletter for additional commentary and data.*

### Investment Performance*




Source: Callan DC Index

### Growth Sources*




Source: Callan DC Index

### Net Cash Flow Analysis (Second Quarter 2013)*
(Top Two and Bottom Two Asset Gatherers)

| Asset Class | Flows as % of Total Net Flows |
|---|---|
| Target Date Funds | 74.40% |
| Domestic Small/Mid Cap | 6.78% |
| Company Stock | -33.68% |
| Domestic Fixed | -41.30% |
| **Total Turnover[1]** | **0.43%** |

1 Total Index "turnover" measures the percentage of total invested assets (transfers only, excluding contributions and withdrawals) that moved between asset classes.

Source: Callan DC Index

*Notes: DC Index inception date is January 2006. DB plan performance is gross of fees. Data provided here is the most recent available at time of publication.

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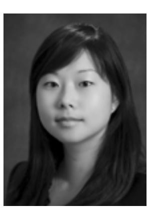

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The *Capital Market Review* is a quarterly macroeconomic indicator newsletter that provides thoughtful insights on the economy and recent performance in the equity, fixed income, alternatives, international, real estate, and other capital markets.

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Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are uniquely backed by proprietary research, exclusive data, ongoing education and decision support. Today, Callan advises on more than $1.8 trillion in total assets, which makes us among the largest independently owned investment consulting firms in the U.S. We use a client-focused consulting model to serve public and private pension plan sponsors, endowments, foundations, operating funds, smaller investment consulting firms, investment managers, and financial intermediaries. For more information, please visit www.callan.com.

**About the Callan Investments Institute**

The Callan Investments Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys, and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

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