Second Quarter 2016
Investment Review

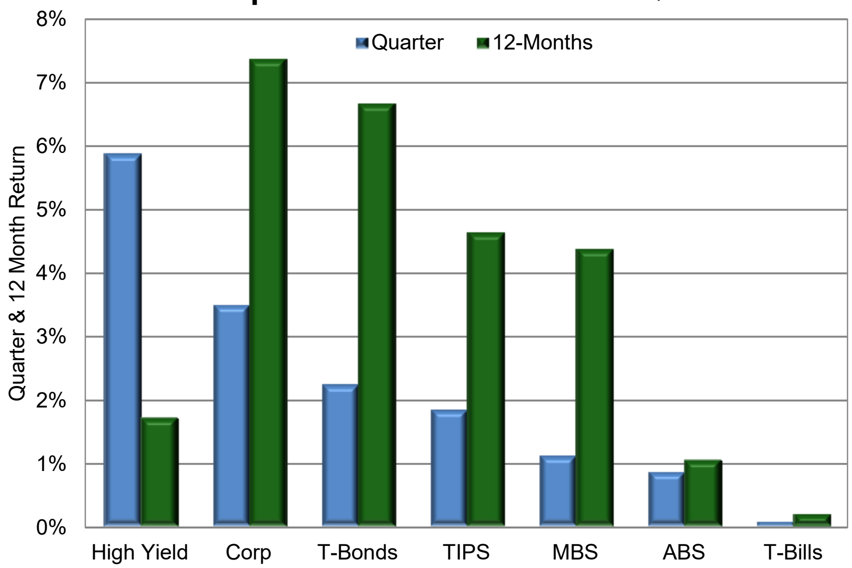
THE METROPOLITAN WATER DISTRICT
of SOUTHERN CALIFORNIA

Prepared by: **Meketa Investment Group**
CHICAGO, IL 60661
(312) 474-0900

MARKET SNAPSHOT
JUNE 30, 2016

Index	Qtr	One Year	Three Year	Five Year
S&P 500	2.5%	4.0%	11.7%	12.1%
Dow Jones Industrial	2.1%	4.5%	9.0%	10.4%
Wilshire 5000	2.8%	1.6%	10.7%	11.4%
MSCI EAFE Index	-1.5%	-10.2%	2.1%	1.7%
Barclays Aggregate	2.2%	6.0%	4.1%	3.8%
BofA ML G/C 1-5 Yr A+	**0.9%**	**2.6%**	**1.9%**	**1.7%**
BofA ML 3 Month T-Bill	**0.1%**	**0.1%**	**0.1%**	**0.1%**

Credit Outperformed in the Second Quarter



Source: Merrill Lynch

- Global stock markets have more than recovered from the steep decline in 1Q16 and the shock of the Brexit vote in late June. Investors are questioning the sustainability of this rally since little has changed from earlier in the year.
- The big difference in 2Q16 is acknowledgement that the Fed will go slow and continue to support the economic expansion, but low rates have concentrated US stock market performance in the high dividend sectors, driving telecom stocks up 25% and utilities up 33% in the last year.
- In the US, small cap beat large cap, and value beat growth with a snapback in the beaten down value sectors, like energy with an 11% gain in 2Q16.
- The big news in the international markets was the unexpected decision of the UK to leave the EU; this not only put a cloud over growth in the UK, but also raised doubts about the future of the EU.
- In another example of “bad news is good news” for the markets, the EAFE and EM indexes have rallied significantly after the close of the quarter. In addition, the widely expected strength in the US dollar has not materialized as a threat to int’l stocks.
- Commercial real estate continues to amaze with a combination of good income and capital gains, but valuations in the core markets are at an all-time high. Just like the yield sectors of the global stock market, this will not end well.
- Commodities were generally helped by a 20% rebound in energy and precious metals.
- Global bond yields continued to fall with the US 10-year and 30-year treasuries briefly touching all time lows. Lower yields and higher stock prices also helped the credit markets to rebound.

Central Banks Push for Growth

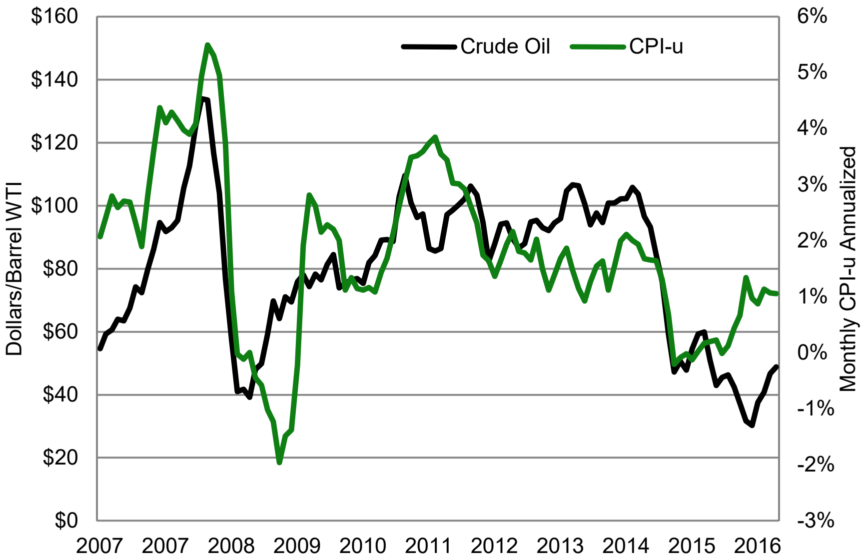
- US economic growth has averaged just 2.1% per year since 2009, with real GDP growth at just 0.8% in 1Q16 and 1.2% (estimated) in 2Q16. Low growth has prompted the Fed to delay their plan for more normal interest rates, but higher yields are likely by the end of the year.

- The rate of global growth is not expected to change soon, since it was caused by three factors that will be slow to change: 1) low population growth in developed countries, 2) debt added in the previous decade, and 3) globalization that dispersed high margin manufacturing jobs.

- However, the US is beginning to see more robust job creation, with the average work week and the average hourly wage growing a bit faster than expected, which bodes well for US consumer spending.

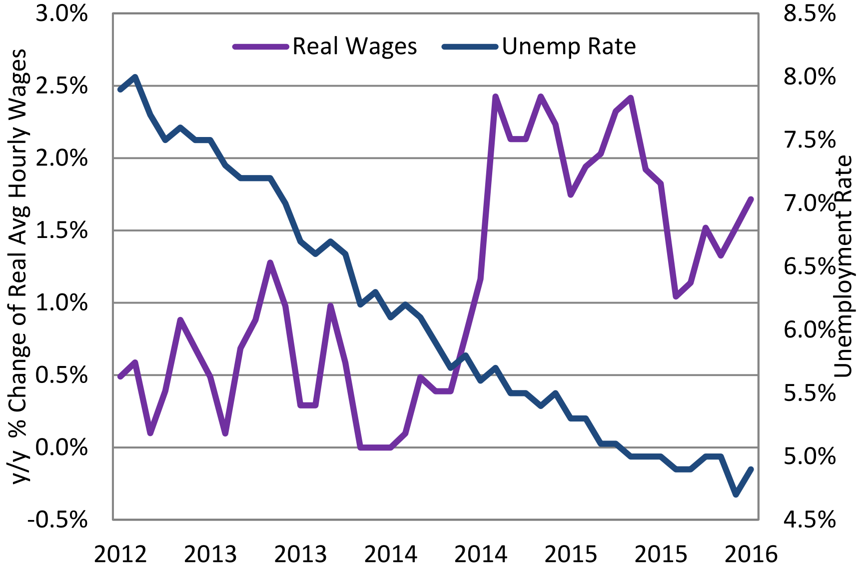
- The rest of the world looks weaker. Europe was shocked on June 23 by the UK voting, in a referendum known as Brexit, to leave the European Union. The Bank of England reduced their growth outlook and in August cut short rates to 0.25%, the lowest in their history.

Oil Prices Have Bounced Off the Bottom



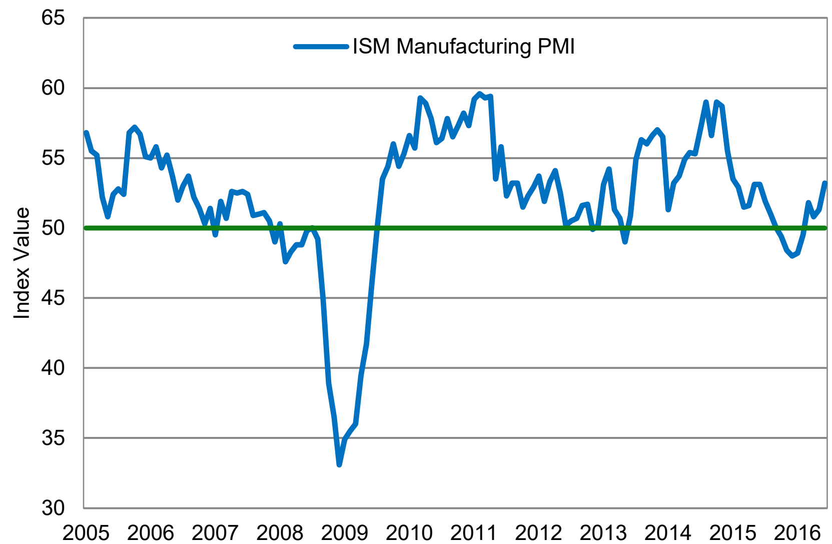
Source: Bureau of Labor Statistics

Improving Wage Rates Will Help Consumers



Source: Bureau of Labor Statistics

Manufacturing is Rebounding in the US



Source: ISM

US Stock Performance Concentrated in High Yield Sectors

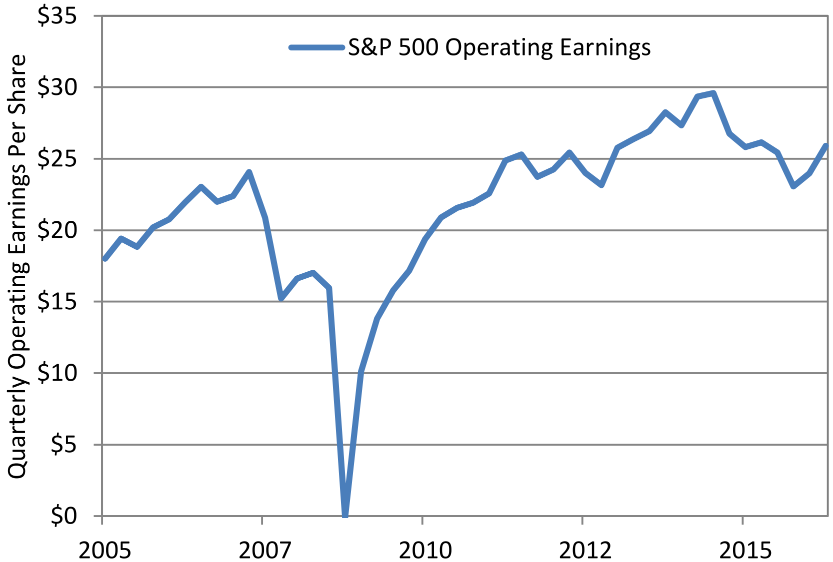
- Reported profits shrank in aggregate in the second quarter, marking the fourth straight quarter of slumping earnings. But there are few reasons for optimism: 1) operating earnings are improving and reported earnings have beaten expectations, 2) jobs data is better, and 3) corporate executives see growth improving in the second half of 2016.

- Revenue growth is also coming in ahead of analysts' expectations, led by autos and technology, while sales growth is above earnings growth in eight of the ten S&P sectors.

- The problem is that growth is concentrated in technology and health care, and performance is concentrated in the high yield sectors of the market. The 25% gain in telecom stocks and the 33% gain in utilities in the last 12 months will not be sustainable.

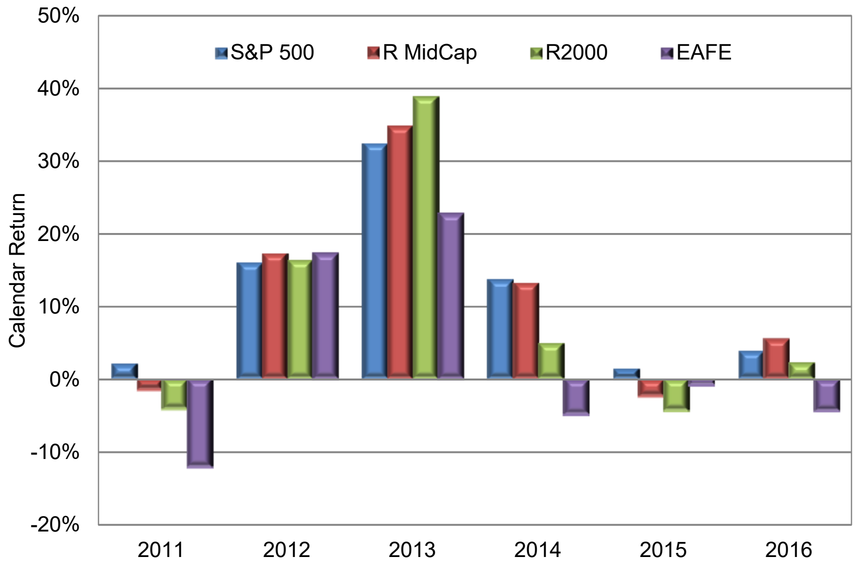
- The US stock market is selling (on a PE basis) about 24 times reported earnings and 18 times future operating earnings; both numbers are well above average, and investors have repeatedly shown the inability to handle Fed pull backs in 2011, 2013, and 1Q-2016.

Some Improvement in Operating Earnings



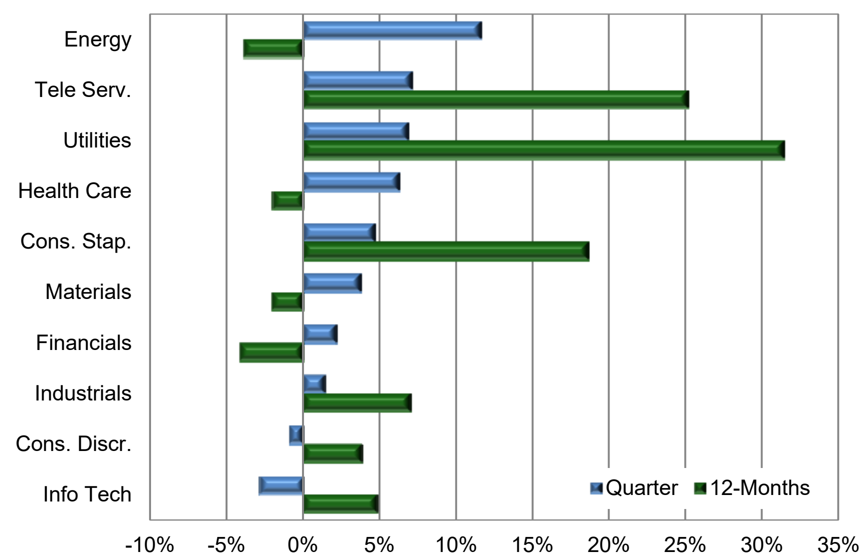
Source: Standard & Poor's

Low Returns Continue Across Equity Markets



Source: Standard & Poor's, Russell, MSCI

Investors Seek Yield in Utilities and Telecom



Source: Standard & Poor's

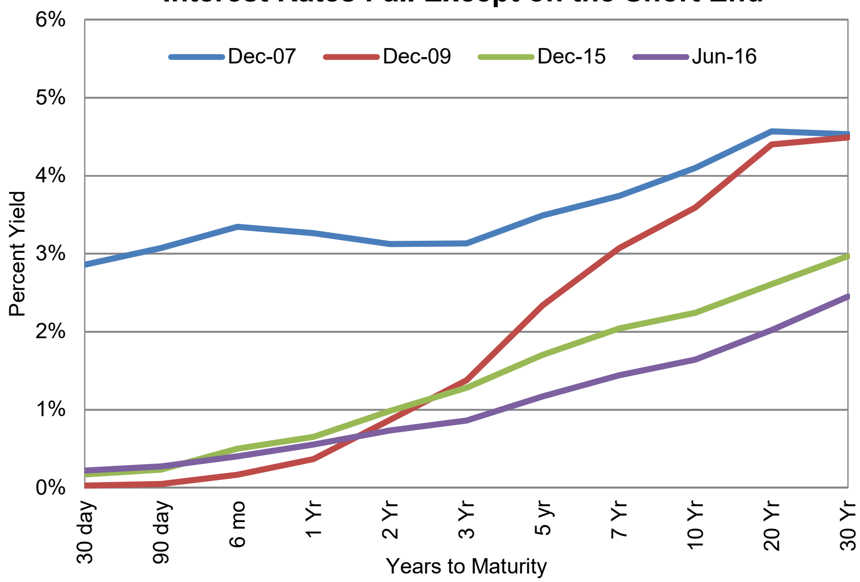
Yields Fall and Duration Drives Performance

- Few investors expected global bond yields to be hitting new lows in July 2016, especially new lows in US government bonds. But the growth scare in January and February combined with the instability highlighted by the Brexit vote caused US, German, Japanese, and British 10-year debt to fall to all-time lows in June and early July.

- In 2Q16 U.S. treasuries returned 2.1%, as the yield on the 10-year note fell to 1.47% from 1.77% at the end of March; long treasuries performed even better, with a 6.4% gain in the quarter. Mortgages returned 1.1% in 2Q16, outperforming duration-matched treasuries by 3 bps, and high yield corporate bonds delivered 411 bps of excess returns.

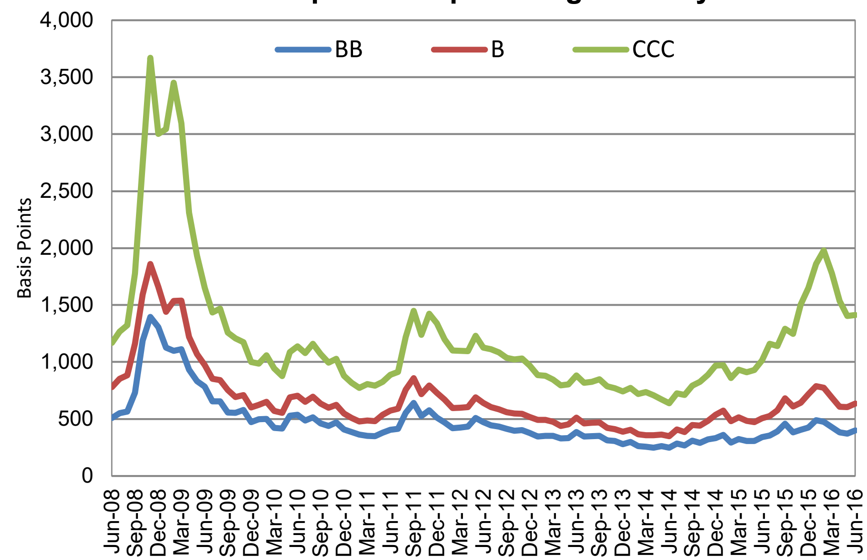
- Global bond prices, as measured by the JPM GBI-ex US are up 14% in 2016, as bond yields have fallen across the globe and bond prices have reached new highs. In times of uncertainty investors flock to US treasuries, but with less pressure from outside forces, US bond yields are poised to gradually reconnect with economic growth and inflation.

Interest Rates Fall Except on the Short End



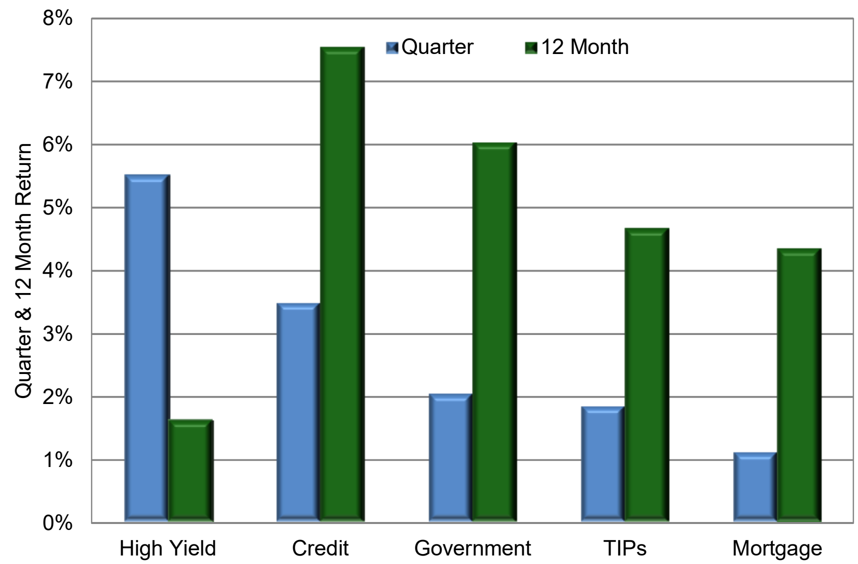
Source: Federal Reserve

Credit Spreads Improve Significantly



Source: Merrill Lynch

Corporate Bonds Leads the Rebound



Source: Barclays

PORTFOLIO SUMMARY
JUNE 30, 2016

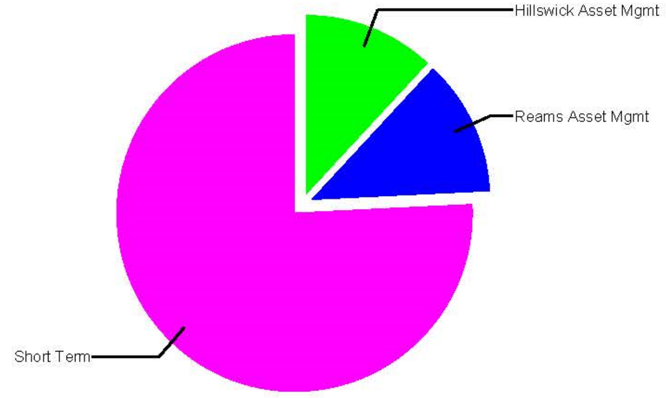
	Assets	Weight
Managed Accounts		
Hillswick Asset Mgmt	$171,009,214	12%
Reams Asset Mgmt	$176,624,830	12%
Total External Managed	$347,634,044	24%
Short-Term Account	$1,087,828,932	76%
Grand Total	$1,435,462,976	100%

- The value of the Total Fund increased by $ 316.6million in the second quarter, due to net cash inflow of $ 311.7million plus an investment gain of $4.9 million.
- Net investment gain/loss for the quarter were:

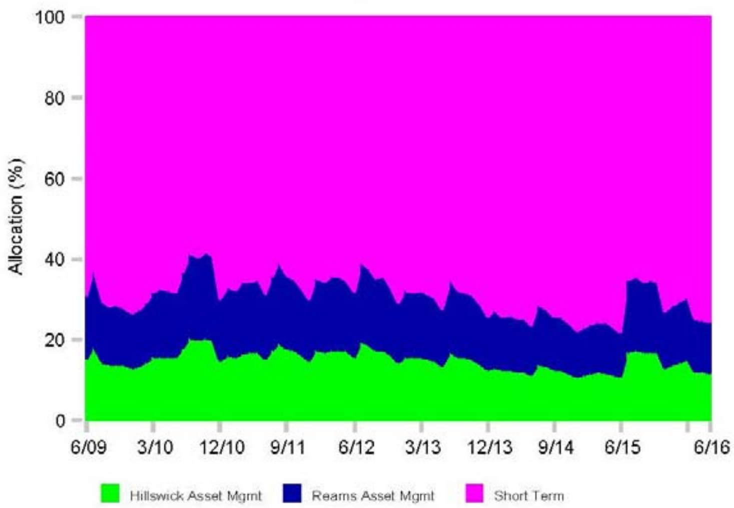
Hillswick	$1.7 million
Reams	$1.6 million
Short-Term	$1.7 million
Total	$5.0 million

Note: Totals may differ slightly due to rounding.

CURRENT ALLOCATION



HISTORICAL ALLOCATION



PERFORMANCE SUMMARY - TOTAL RETURN

JUNE 30, 2016

Manager	QTR	Fiscal YTD	1 Year	3 Yrs	5 Yrs
Total Fund	0.4%	1.2%	1.2%	1.2%	1.1%
Benchmark[1]	0.3%	0.8%	0.8%	0.5%	0.5%
Hillswick Asset Mgmt	1.0%	3.0%	3.0%	2.2%	2.3%
BofA ML G/C 1-5 yr. A	0.9%	2.6%	2.6%	1.9%	1.7%
Reams Asset Mgmt	0.9%	2.3%	2.3%	2.0%	2.1%
BofA ML G/C 1-5 yr. A	0.9%	2.6%	2.6%	1.9%	1.7%
Total External Managers	0.9%	2.7%	2.7%	2.1%	2.2%
BofA ML G/C 1-5 yr. A	0.9%	2.6%	2.6%	1.9%	1.7%
Short-Term Account	0.2%	0.6%	0.6%	0.8%	0.6%
BofA ML 90-day T-Bill	0.1%	0.1%	0.1%	0.1%	0.1%

[1] The benchmark for the Total Fund is based on the average asset allocation between the Externally Managed and Short-term Accounts, incorporating the BofA Merrill Lynch Government/Corporate 1-5 yr A & above and the BofA Merrill Lynch 3 Month T-Bill.

- The Total Fund exceeded the benchmark in the last 12 months due to excess returns in the internally-managed Short Term Account. The increase in short rates has helped short-term returns in 2016, and the decline in intermediate rates has produced capital gains in the managed accounts.

- Ten-year treasury yields ranged between 1.7% to 1.9% during the second quarter until the Brexit vote, which triggered a flight to quality and caused a decline by nearly 30 bps. Credit was the strongest sector in the second quarter.

- Hillswick outperformed for the quarter even without credit exposure. The portfolio once again benefitted from the duration and yield curve positions. They continue to manage the duration of the portfolio to capture capital gains.

- Hillswicks believes that global deflationary forces and increasing political uncertainly will cause more pain ahead. Therefore, they remain conservative and patient in awaiting a buying opportunity in corporate bonds.

- Reams performed in line with the benchmark. Credit helped performance, especially the rebound in their energy holdings. Mortgages added to performance, but a shorter duration was a drag on returns. Reams believes that the bond market is late in the credit cycle, so they still seek to add value through conservative security selection in both corporate and mortgage bonds.

- The staff-managed Short-Term Account continued strong performance from this yield strategy as shown in the peer group comparison on page 5.

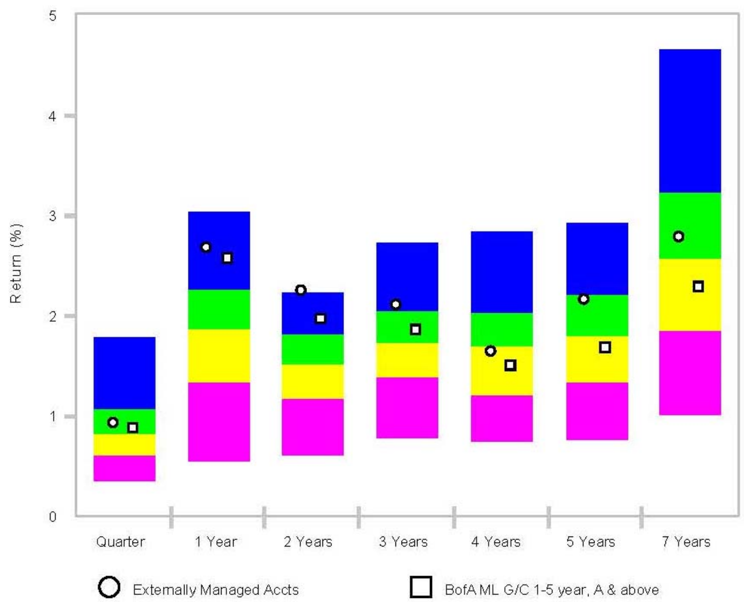
CONSOLIDATED BALANCE SHEET and CASH FLOW SUMMARY FOR THE FISCAL YEAR

JULY 1, 2015 TO JUNE 30, 2016

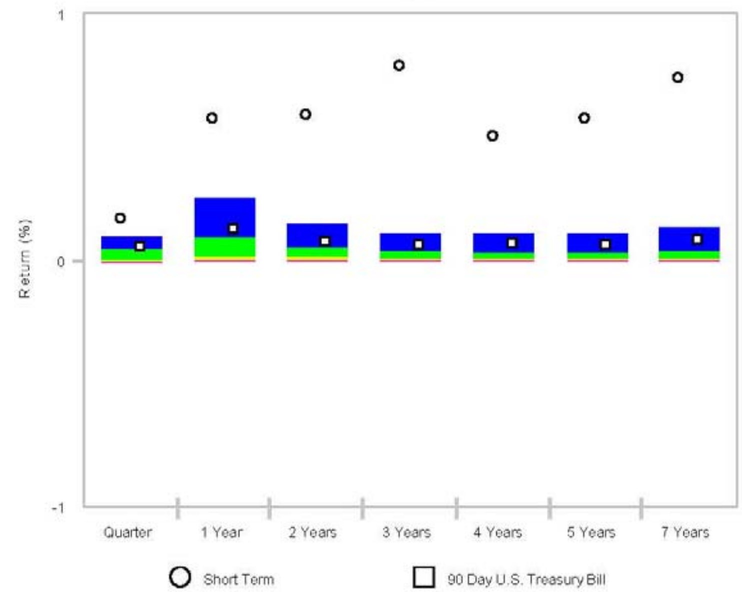
Manager	Beginning Balance	Net Cash Flows	Income	Gain/(Loss)	Ending Balance
Total Fund	**$1,544,474,095**	**($122,701,882)**	**$13,857,913**	**($167,151)**	**$1,435,462,976**
Externally Managed					
Hillswick Asset Mgmt	$165,968,580	$0	$3,417,577	$1,623,057	$171,009,214
Reams Asset Mgmt	$172,581,353	$0	$3,076,482	$966,996	$176,624,830
Total Externally Managed	$338,549,932	$0	$6,494,059	$2,590,053	$347,634,044
Short-Term Account	$1,205,924,163	**($122,701,882)**	$7,363,854	($2,757,204)	$1,087,828,932

Note: Totals may differ slightly due to rounding.

TOTAL EXTERNAL MGRS VS. PEER GROUP



SHORT-TERM VS. PEER GROUP



TOTAL EXTERNAL MGRS VALUE ADDED

SHORT-TERM VALUE ADDED

MANAGER SCORECARD

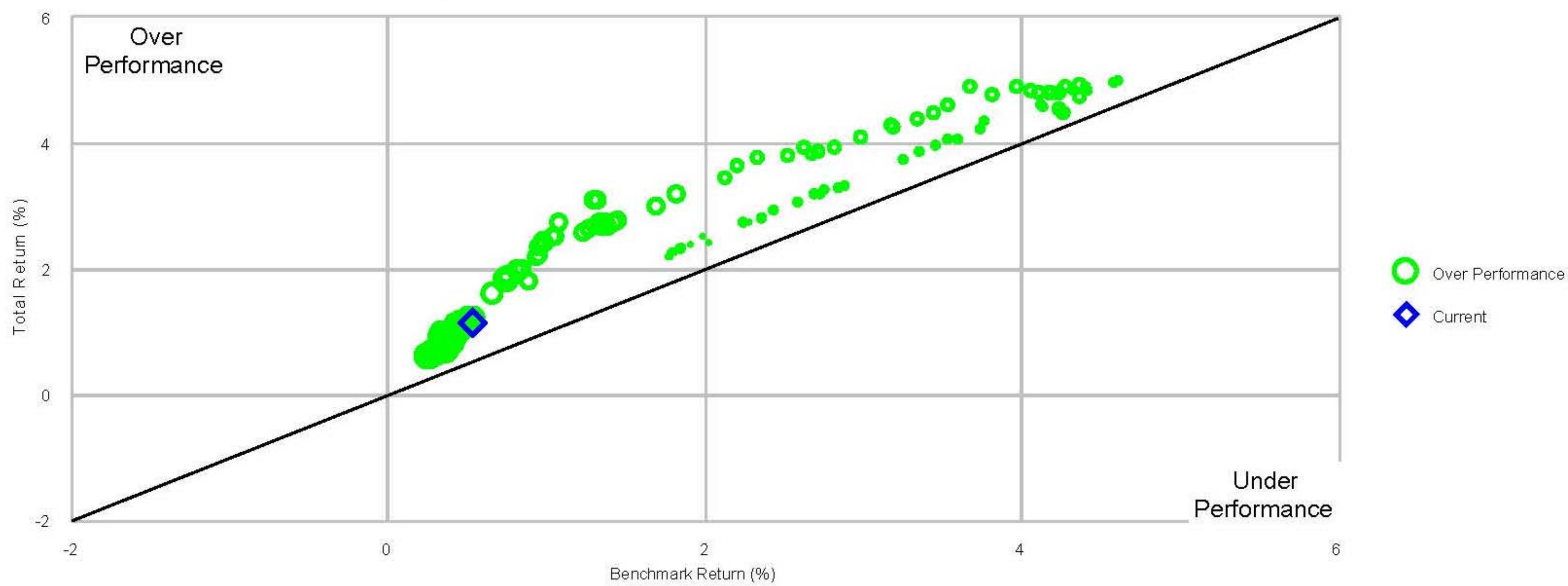
SINCE INCEPTION OF MANAGER

Manager	Return	Index Return	Std Dev	Alpha	Beta	Batting Average	Incept
Total Fund	2.61	1.91	1.04	0.59	1.06	74.71	5/02
Hillswick Asset Mgmt.	3.71	3.29	2.42	0.07	1.11	54.12	5/02
Reams Asset Mgmt.	3.86	3.29	2.67	1.04	0.86	55.88	5/02
Short-Term Account	1.94	1.32	0.68	0.82	0.85	79.41	5/02

INVESTMENTS PORTFOLIOS VS. POLICY BENCHMARKS

Manager	1 Year Benchmark	1 Year Univ Med	3 Year Benchmark	3 Year Univ Med	Alpha	Beta <1.10
Total Fund	Exceed	NA	Exceed	NA	Positive	OK
Hillswick Asset Mgmt	Exceed	Exceed	Exceed	Exceed	Positive	High
Reams Asset Mgmt	Under	Exceed	OK	Exceed	Positive	Low
Short-Term Account	Exceed	Exceed	Exceed	Exceed	Positive	Low

3-YEAR ROLLING VALUE ADDED FOR TOTAL FUND
(FROM INCEPTION)



Each green circle above the line represents a 3-year period above the benchmark, larger circles = more recent periods

Alpha

Alpha is a measure of the value added (or the excess return of a portfolio versus the benchmark - adjusted for risk) for an actively managed portfolio. It is generally interpreted as a measure of a manager's skill as the result of security selection and asset allocation - the higher the number the better.

Batting Average

Batting Average is a measure of how often the manager has beaten the benchmark. A batting average of 600 indicates that the manager has beaten the portfolio benchmark (or comparable market index) six out of every ten quarters, or 60% of the time.

Beta

Beta is a measure of a manager's risk vs the benchmark. A beta of 1.0 indicates that a portfolio has roughly the same volatility as the benchmark. A beta greater than 1.0 indicates that the portfolio is more volatile or sensitive to changes in the market.

Duration

Duration is a measure of the sensitivity in the price of a bond to changes in interest rates, so it is a measure of risk in a fixed income portfolio. As a rule of thumb, a fixed income portfolio with a duration of 5 (years) will decline 5% in value for every 1% upward movement in comparable interest rates.

Standard Deviation

Standard deviation is a measure of the dispersion of a portfolio's return around its expected return. A higher standard deviation indicates greater dispersion and, therefore, lower predictability of future returns.