Third Quarter 2016
Investment Review

THE METROPOLITAN WATER DISTRICT *of* SOUTHERN CALIFORNIA

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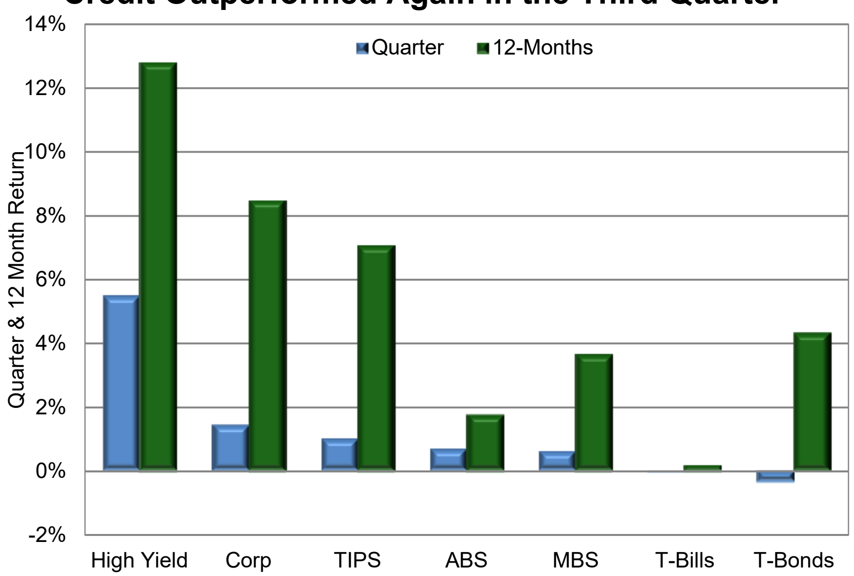
MARKET SNAPSHOT
SEPTEMBER 30, 2016

Index	Qtr	One Year	Three Year	Five Year
S&P 500	3.9%	15.4%	11.2%	16.4%
Dow Jones Industrial	2.8%	15.5%	9.2%	13.7%
Wilshire 5000	4.5%	14.8%	10.1%	16.1%
MSCI EAFE Index	6.4%	6.5%	0.5%	7.4%
Barclays Aggregate	0.5%	5.2%	4.0%	3.1%
BofA ML G/C 1-5 Yr A+	**-0.1%**	**1.8%**	**1.6%**	**1.5%**
BofA ML 3 Month T-Bill	**0.1%**	**0.3%**	**0.1%**	**0.1%**

Credit Outperformed Again in the Third Quarter



Source: Merrill Lynch

- US stock markets continued to rebound with the acknowledgement that the Fed will go slow and support the economic expansion. Earnings growth has been better than expected, but valuations (especially small and mid-cap) expanded as the markets moved higher than earnings.
- The yield-oriented sectors (like utilities and tele-comm) declined by about 6% in the quarter, since valuations were just too stretched. The small and mid-cap stocks outperformed with investors embracing the risk-on environment. The five year results jumped as declines in 3Q11 fell off the avg.
- The international markets also shook off the British decision to leave the EU (Brexit) to post higher returns; even the UK was able to offset a 7% decline in the pound to post a positive return.
- The best international returns came from the emerging markets, as countries like China and Brazil rebounded from low valuations. The Japanese yen softened a bit due to continuing low growth, after a 25% move higher in 2016.
- 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, the valuations will be eventually corrected.
- Low inflation and low growth continue to push commodity prices lower. Earlier in the year the stock market benefitted from higher energy prices, which have leveled off; high inventories remain a problem.
- The fixed income markets were driven in the quarter by a rebound in credit, after capital gains driven by the decline in yields earlier in the year.

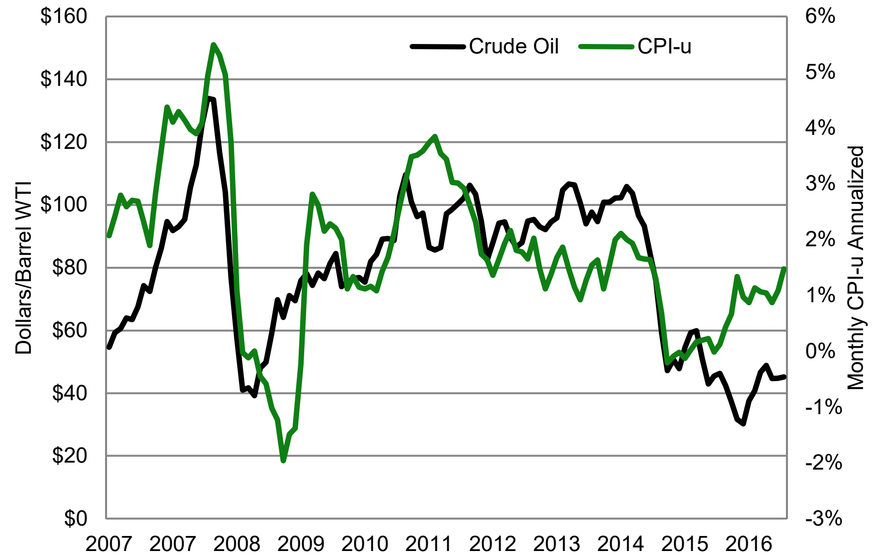
Economic Growth is Improving, But Trend Line is Low

- US economic growth hit a two year high of +2.9% in the third quarter. But the headline improvement does little to change the trajectory of relatively weak results over the last ten years; US GDP has failed to grow more than 3% since 2005. Consumer spending (+2.1% in 3Q) and business investment (+1.2% in 3Q) have both been weak.

- Global growth in 2016 is also expected to slip to the lowest rate since 2009. Most estimates place growth at about 3%, but this includes the emerging markets that have historically driven higher growth. The EM trend began to decline in 2015 as the fall in commodity prices and macroeconomic imbalances led to an outflow of foreign capital.

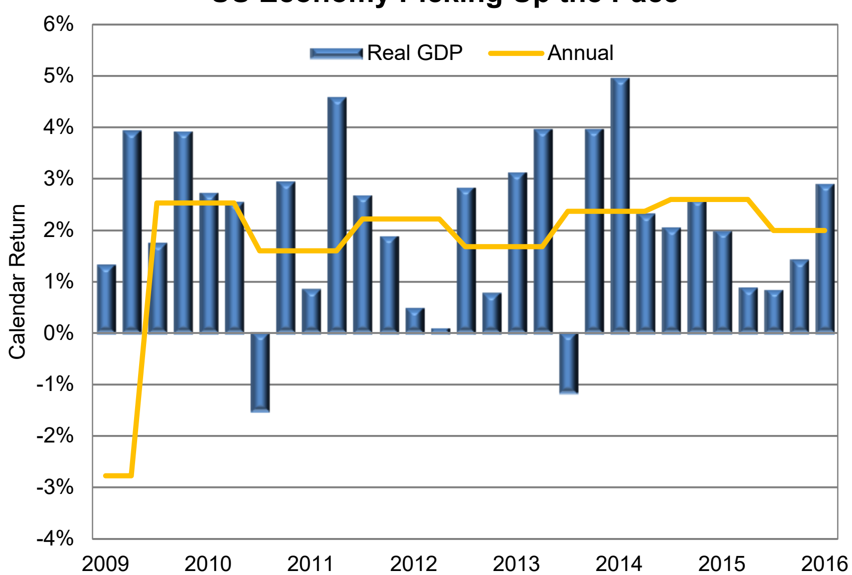
- The global developed economies have managed to fare a bit better by resorting to expansionary monetary policies; but despite the initial successes, they too are now struggling to maintain growth momentum. The rate of growth is not expected to change due to: 1) low population growth, 2) debt added in the previous decade, and 3) globalization that dispersed high margin manufacturing jobs.

Inflation and Oil Have Bounced Off the Bottom



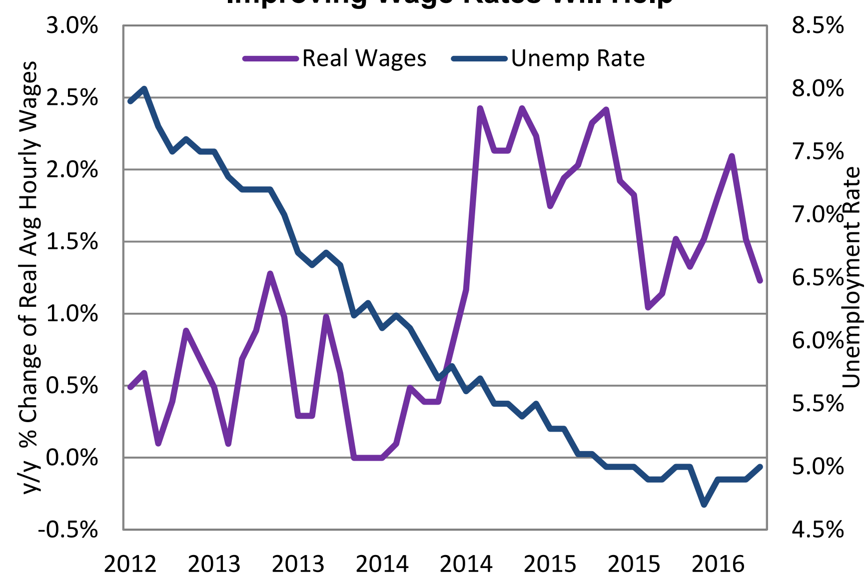
Source: Bureau of Labor Statistics

US Economy Picking Up the Pace



Source: US Bureau of Economic Analysis

Improving Wage Rates Will Help

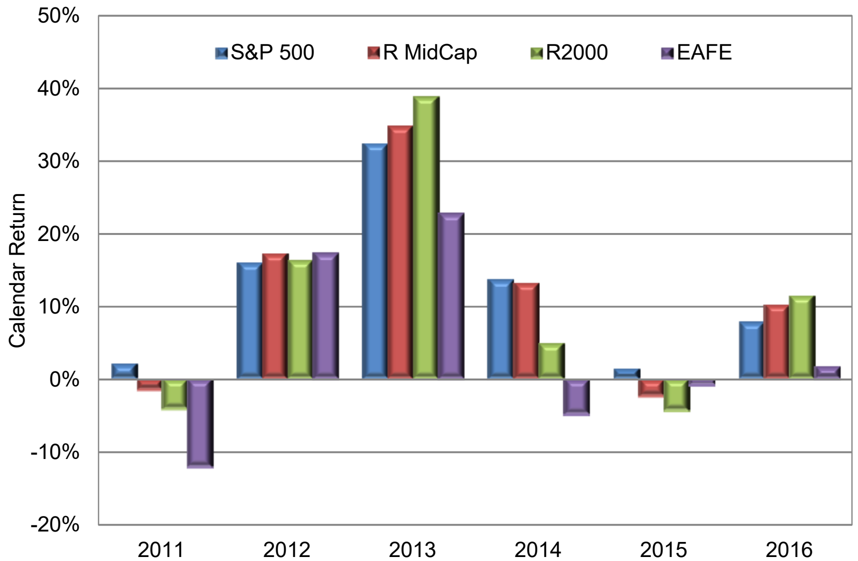


Source: Bureau of Labor Statistics

US Stock Performance at Risk

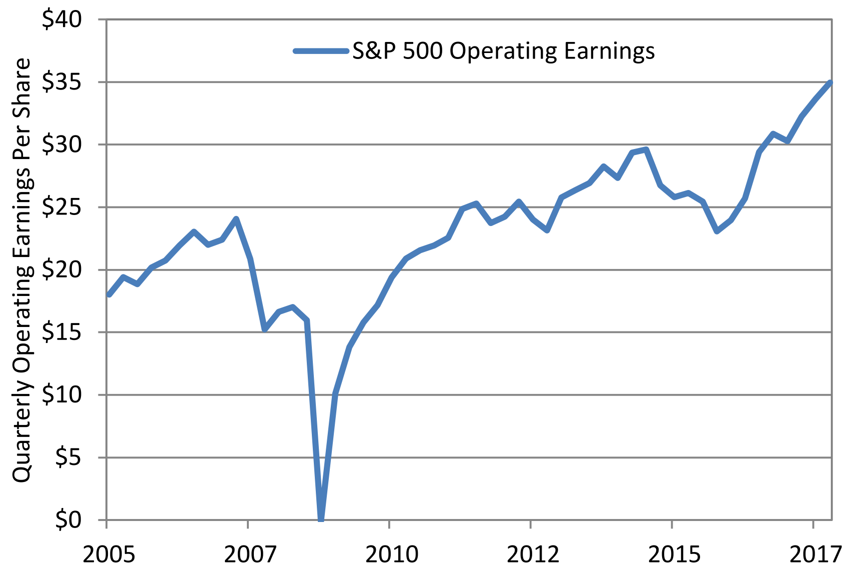
- US stock prices advanced in the third quarter, but most of the gain was reversed in October. The flat performance in the last few months has been a victory given 1) softer economic data, 2) weak earnings growth, and 3) valuation concerns; still stocks look better than bonds.
- Investor sentiment (individuals and institutions) continues to slip and cash continues to flow out of equity funds, especially actively-managed funds. The yield sectors of utilities, telecommunications and consumer staples declined 3% to 6% in the quarter, due to stretched valuations.
- The strength of the technology and financial (cyclical) sectors is an indication that investors are willing to take on more risk. But the next Fed rate increase looms in December, and previous Fed moves that reduced support resulted in relatively steep stock declines.
- Small and mid-cap stocks led the US market higher, and growth-oriented stocks outperformed value across all capitalizations. Earnings growth in 3Q is expected to be 15%, but growth was expected to be 8% in 2Q and ended the second quarter with a -1.7% decline.

International Markets Turn and Outperform the US



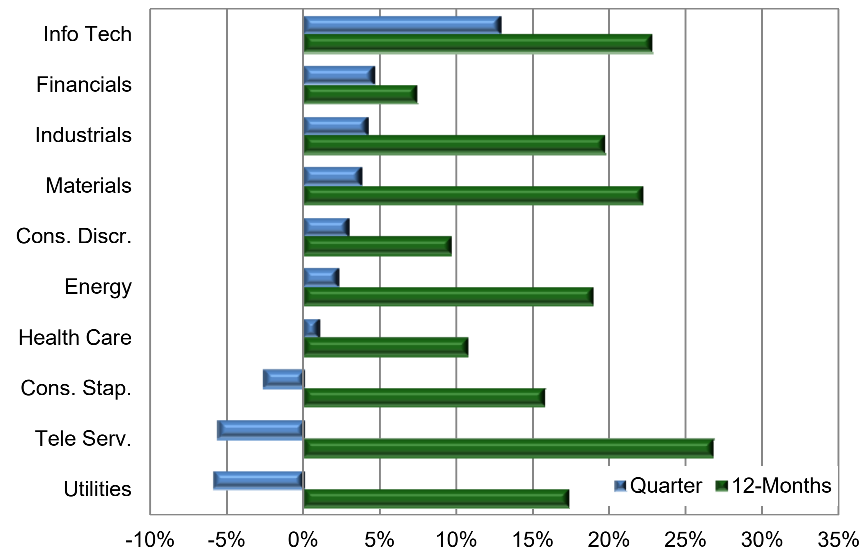
Source: Standard & Poor's, Russell, MSCI

Earnings Expected to Grow in 2017



Source: Standard & Poor's

Yield Sectors Decline as Valuations Correct

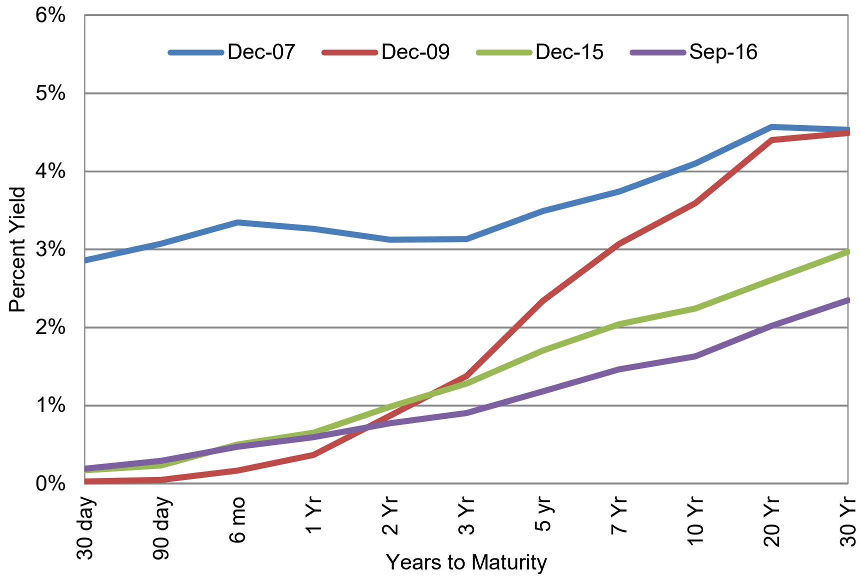


Source: Standard & Poor's

Strong Rebound in Credit

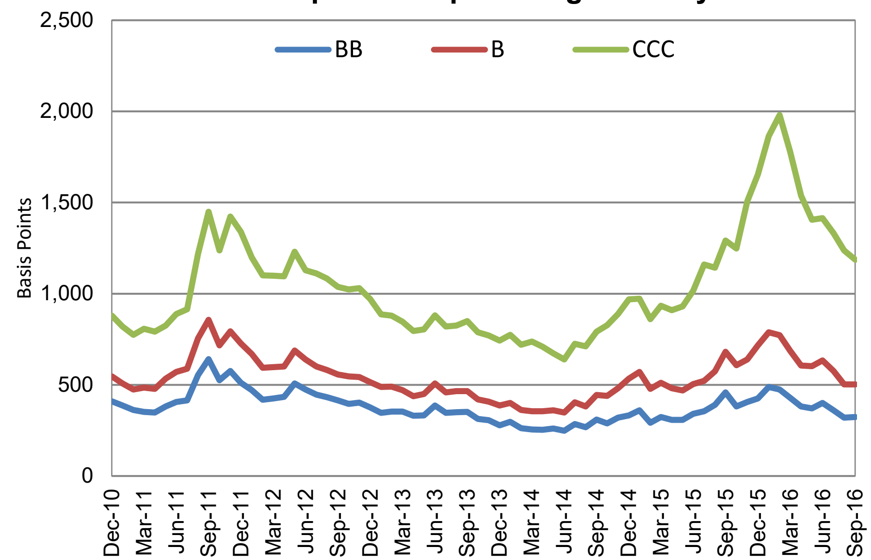
- Treasury yields increased modestly during the quarter and the yield curve flattened; yields rose more in shorter maturities. The return of a risk-on environment led to strong gains in high yield corporate bonds, as spreads tightened by 120 bps. Mortgage securities outperformed duration equivalent treasury bonds.
- Investors will now focus on the next move by the Fed in December. The last four moves by the Fed to reduce bond purchases or raise interest rates have led to big declines in stocks and corporate bonds.
- Global bonds, as measured by the JPM GBI-ex US index, performed in line with the US market. But the emerging markets debt (EMD) produced returns of about 4%, with spreads falling by 50 bps. Venezuela and South Africa were standout performers with gains of more than 28% and 10%, respectively.
- The sparkling returns in EMD are characteristic after "the turn," when investors focus economic data showing improvement, even though the environment is negative.

Interest Rates Rise in the Quarter



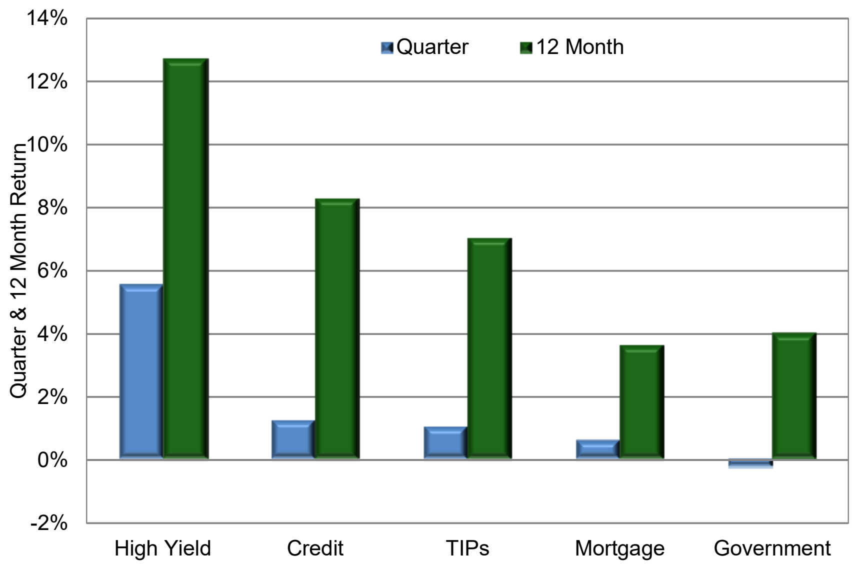
Source: Federal Reserve

Credit Spreads Improve Significantly



Source: Merrill Lynch

High Yield Bonds Lead the Rebound



Source: Barclays

PORTFOLIO SUMMARY
SEPTEMBER 30, 2016

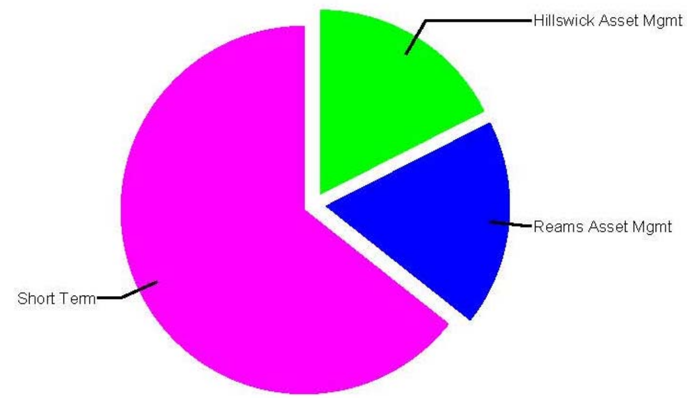
	Assets	Weight
Managed Accounts		
Hillswick Asset Mgmt	$170,860,917	18%
Reams Asset Mgmt	$176,544,521	18%
Total External Managed	$347,405,438	36%
Short-Term Account	$627,449,093	64%
Grand Total	$974,854,531	100%

- The value of the Total Fund decreased by $ 460.6 million in the third quarter, due to net cash outflow of $ 461.4 million offset by an investment gain of $0.8 million.
- Net investment gain/loss for the quarter were:

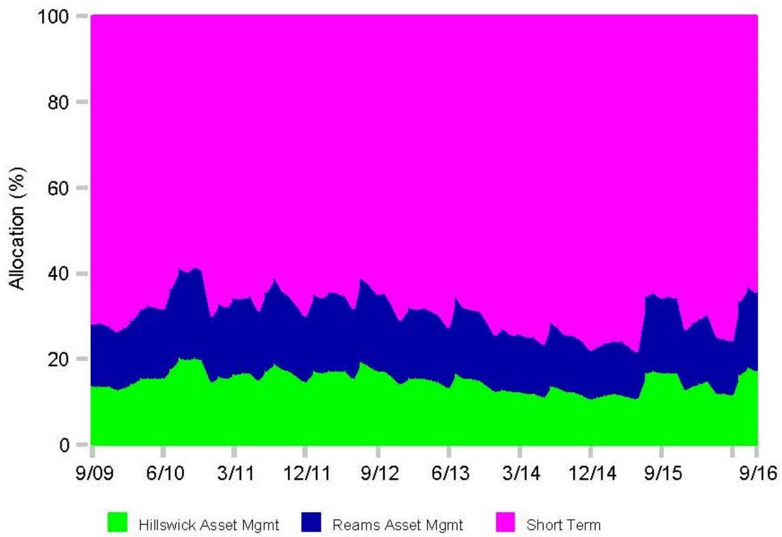
Hillswick	-$0.1 million
Reams	-$0.1 million
Short-Term	$1.1 million
Total	$0.9 million

Note: Totals may differ slightly due to rounding.

CURRENT ALLOCATION



HISTORICAL ALLOCATION



PERFORMANCE SUMMARY - TOTAL RETURN

SEPTEMBER 30, 2016

Manager	QTR	Fiscal YTD	1 Year	3 Yrs	5 Yrs
Total Fund	0.1%	0.1%	0.9%	1.1%	0.9%
Benchmark[1]	0.1%	0.1%	0.7%	0.5%	0.5%
Hillswick Asset Mgmt	-0.1%	-0.1%	2.1%	2.2%	1.6%
BofA ML G/C 1-5 yr. A	-0.1%	-0.1%	1.8%	1.6%	1.5%
Reams Asset Mgmt	0.0%	0.0%	1.7%	1.7%	1.9%
BofA ML G/C 1-5 yr. A	-0.1%	-0.1%	1.8%	1.6%	1.5%
Total External Managers	-0.1%	-0.1%	1.9%	1.9%	1.7%
BofA ML G/C 1-5 yr. A	-0.1%	-0.1%	1.8%	1.6%	1.5%
Short-Term Account	0.2%	0.2%	0.6%	0.8%	0.5%
BofA ML 90-day T-Bill	0.1%	0.1%	0.3%	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 primarily to excess returns in the internally-managed Short-Term Account. The increase in short rates has helped short-term returns in 2016, but the increase in intermediate yields has resulted in declines in the managed accounts.

- Ten-year treasury yields fell to new lows early in the third quarter, after the shock of the Brexit vote. But then investors looked beyond this event to the inevitable Fed rate increases and yields drifted higher; the treasury index declined by 28 bps.

- Hillswick performed in line with the benchmark in the quarter but still outperformed in the last 12 months even without credit exposure. However, an underweight to credit was a drag to performance during a credit rebound. Hillswick continues to manage the duration of the portfolio to capture capital gains.

- Hillswick believes that credit spreads as well as option-adjusted spread on MBS are not attractive enough yet. Therefore, they will remain patient in awaiting a buying opportunity in corporate bonds and mortgages.

- Reams outperformed the benchmark for the quarter. An overweight to mortgages and a shorter duration position helped performance. Reams believes that the bond market is late in the credit cycle, so they will continue to conservatively position the portfolio and seek to add value through 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 8.

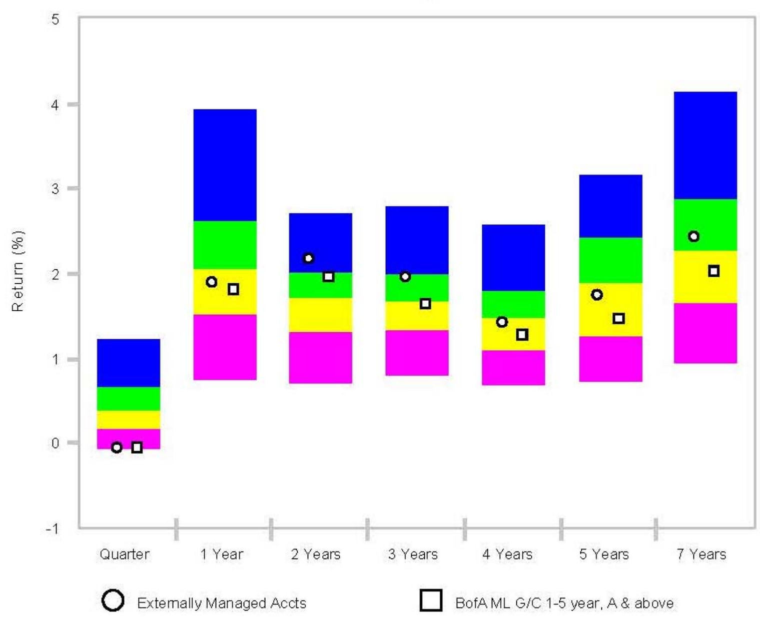
CONSOLIDATED BALANCE SHEET and CASH FLOW SUMMARY FOR THE FISCAL YEAR

JULY 1, 2016 TO SEPTEMBER 30, 2016

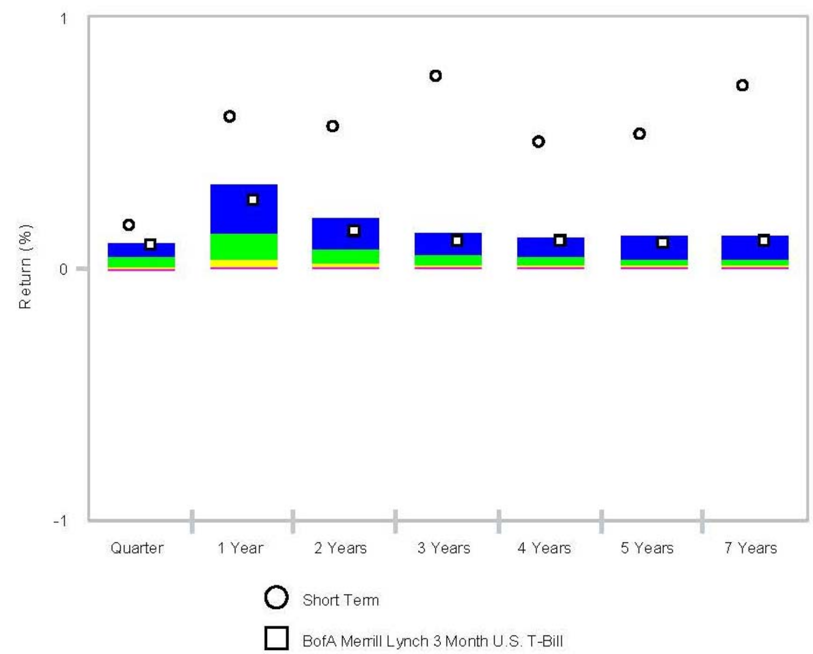
Manager	Beginning Balance	Net Cash Flows	Income	Gain/(Loss)	Ending Balance
Total Fund	**$1,435,462,976**	**($461,432,135)**	**$3,313,849**	**($2,490,159)**	**$974,854,531**
Externally Managed					
Hillswick Asset Mgmt	$171,009,214	$0	$853,821	($1,002,119)	$170,860,917
Reams Asset Mgmt	$176,624,830	$0	$815,093	($895,402)	$176,544,521
Total Externally Managed	$347,634,044	$0	$1,668,914	($1,897,521)	$347,405,438
Short-Term Account	$1,087,828,932	($461,432,135)	$1,644,935	($592,638)	$627,449,093

Note: Totals may differ slightly due to rounding.

TOTAL EXTERNAL MGRS VS. PEER GROUP

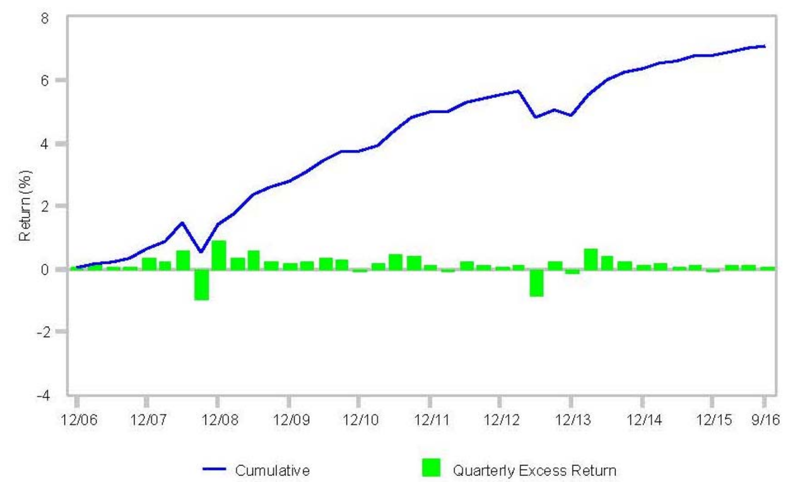


SHORT-TERM VS. PEER GROUP



TOTAL EXTERNAL MGRS VALUE ADDED

SHORT-TERM VALUE ADDED



MANAGER SCORECARD

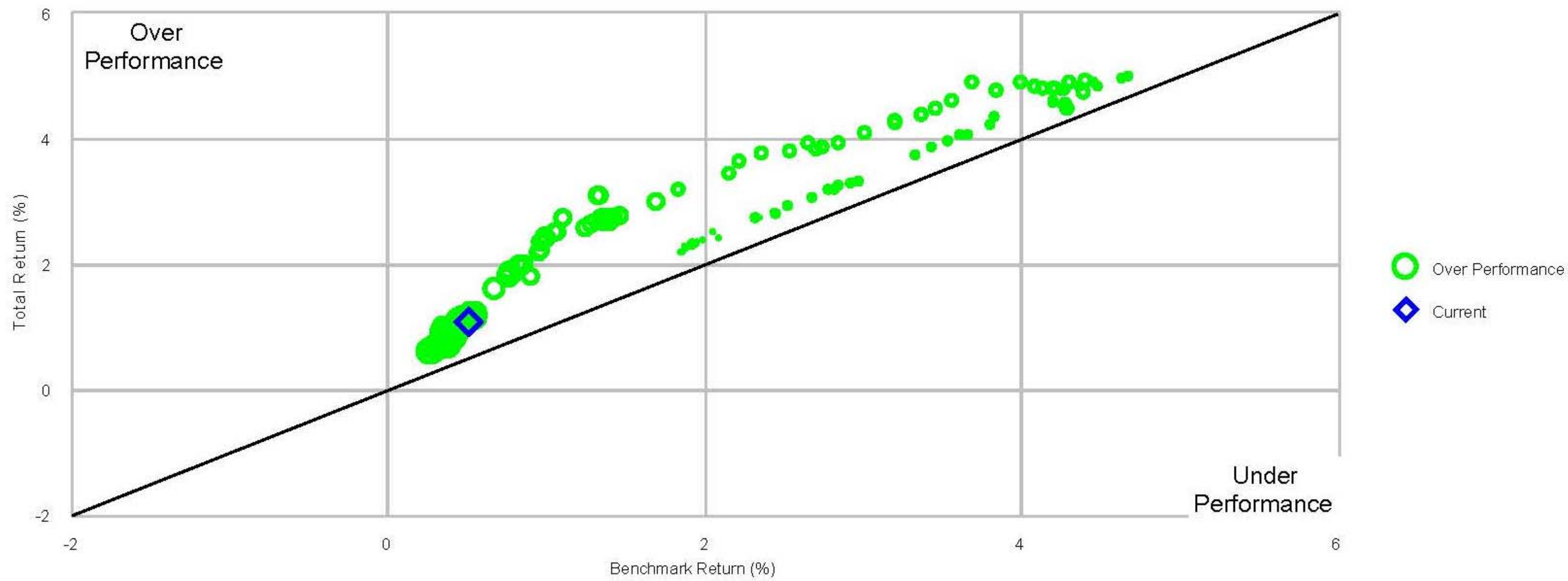
SINCE INCEPTION OF MANAGER

Manager	Return	Index Return	Std Dev	Alpha	Beta	Batting Average	Incept
Total Fund	2.57	1.91	1.03	0.55	1.06	73.99	5/02
Hillswick Asset Mgmt.	3.64	3.23	2.41	0.07	1.11	54.34	5/02
Reams Asset Mgmt.	3.79	3.23	2.65	1.02	0.86	56.07	5/02
Short-Term Account	1.92	1.35	0.67	0.78	0.84	78.03	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	OK	Exceed	Exceed	Positive	High
Reams Asset Mgmt	OK	Under	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.