STANISLAUS COUNTY

EMPLOYEES' RETIREMENT ASSOCIATION

INVESTMENT PERFORMANCE ANALYSIS

SEPTEMBER 30, 2006

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ECONOMIC REVIEW

- The trade deficit (import/export of goods & services) for June was $64.8 billion, rose to $68.0 billion in July, and peaked at $69.9 billion for August. In the third quarter, the dollar once again turned in a mixed performance against major currencies. The dollar rose against the Japanese Yen; it began the quarter at 114.73 and ended at 118.01 for an increase of 3.1%. Against the Euro, the dollar started at 1.2785 and rose to a quarter-ending value of 1.2686 for an increase of 0.8%. The dollar fell against the British pound beginning the quarter at 1.8469 falling to 1.8718, a 1.3% decline.

- Third quarter GDP (advance report) will be released on 27 October 2006. The second quarter GDP (final) was 2.6% on an annualized basis. Similar to the second quarter, the third quarter experienced an increase in every month for the CPI (CPI-U). The CPI for July and August increased by 0.3% and 0.2% respectively. Prices were still increasing but going up at a slower rate. For July, the increase was due to a 2.9% increase in energy costs and a 0.2% increase in the food index. August showed a moderation in energy costs only increasing by 0.3% and the food index up by 0.4%. The third quarter unemployment rate moved downward. For July, August, and September, the rate was 4.8%, 4.7%, and 4.6% respectively. It remains to be seen whether this historically low rate is the natural rate of unemployment which prevents an acceleration of inflation.

EQUITY MARKETS REVIEW

- Most indices were in positive territory for the third quarter with the Russell 1000 Value leading the pack with a 6.2% return, followed by the S&P with a 5.7% return and the DJIA following closely behind with a return of 5.3%. The only negative returns were the S&P MidCap -1.1% and the Russell 2000 Growth -1.7%. Seven of the ten economic sectors had positive returns with Communications reporting the highest return of 10.5% followed closely by Health Care with a 10.2% return. The three sectors with negative returns were Energy, Materials, and Industrials with returns of -1.5%, -1.2%, and -0.2% respectively. From a yearly perspective, Communications came in first place with a 22.6% return followed by Financials with a 20.7% return and third place went to Materials with a 17.5% return. All sectors showed positive returns from a year-on-year perspective.

- Among large capitalization stocks, value outperformed growth during the quarter, with the Russell 1000 Value (R1000V) adding 6.2% versus the Russell 1000 Growth (R1000G) adding 3.4%. Among smaller capitalization stocks, value outperformed growth, with the R2000V adding 2.6% vs. the R2000G, which decreased 1.7%. Small stocks have underperformed large stocks for the trailing 12-month period, with the Russell 2000 returning 9.9% and the Russell 1000 returning 10.2%.
- The MSCI EAFE returned 4.0% and 19.6% for the quarter and year, respectively (U.S. $ terms).

FIXED INCOME MARKETS REVIEW

- The Federal Reserve's long-awaited pause in rate increases finally occurred in the third quarter. Both Federal Open Market Committee (FOMC) meetings in August and September kept rates on hold. The current yield curve sits below last quarter's yield curve and above the yield curve dated 30 September 2006. For the third quarter, there is a slight inversion of the curve: the three-month rate is 11 basis points higher than the thirty-year rate.

- During the third quarter, the major bond indices showed positive returns. The Lehman Aggregate Bond Index (LAB) posted a 3.8% gain, while the Citigroup World Government Bond (CWGB) Index increased 1.4%. The Lehman Mortgage Backed (LBMB) Index ended the quarter 3.6% higher. High yield corporates, as measured by the Citigroup High Yield (CHY) Index, gained 4.2%. For the trailing 12 months, the LAB was up 3.7%, the CWGB up 2.2%, LBMB up 4.2% and the CHY up 7.6%.

REAL ESTATE MARKETS REVIEW

- For the one year period ending 6/30/06, the NAREIT index was up 19.1%; for three years, 26.1%; for five years, 19.4%; and for ten years, 15.1%. For the one year period, th NCREIF index was up 18.7%; for three years, 15.8%; for five years, 12%; and for ten years, 12.4%.

- There are signs that these returns will not continue. *The Wall Street Journal* reported contract-cancellation rates for builders were about 40%, which is about twice as many as last year. As deposits typically are from 1% to 5% of the total price, people who give their deposits are forfeiting tens of thousands of dollars.

- The composite fund returned 3.8% in the third quarter of 2006 and ranked in the 46th percentile among other public funds greater than $100 million (3.7% median). The fund trailed its policy index (4.0%) during this time period. Longer term, the three and five-year returns of 11.8% and 10.0%, were slightly under and above median among total public plans (11.9% and 9.0%, respectively).

- Third quarter results were enhanced by the following factors:

  1. The Bank of NY S&P 500 Index Fund matched the S&P 500 Index return of 5.7% and was ahead of the median large cap core manager return of 5.5%.

  2. Mazama (4.8%) beat its benchmark and ranked at the 2nd percentile of the small and mid cap growth manager universe (-0.5% median). The Russell 2500 Growth Index returned -1.2%. It carried strong stock selection from its Info Tech (Parametric Technology, T&HQ, Activision) and Industrials (Herman Miller) sectors.

  3. MFS was terminated mid-August, with proceeds split between new managers Delaware and Loomis Sayles. The combined Large Cap Growth quarterly return, including the Transition Account, was ahead of the Russell 1000 Growth Index (4.4% vs. 3.9%).

  4. LSV (5.1%) beat the MSCI ACWI -ex US (4.0%) and ranked 28th among international equity managers. LSV's overweight Swiss position and value bias helped results.