



OFFICES OF THE COUNTY EXECUTIVE

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County Executive

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February 15, 2007

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended December 31, 2006. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were an estimated 5,300 active members and 4,800 retirees participating in the ERS as of December 31, 2006.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 6.10%, 46 basis points ahead of the 5.64% gain recorded by the policy benchmark. For the one year period ending December 31, the ERS' gross return (before fees) was 13.77%, 39 basis points ahead of the 13.38% return of the policy benchmark and 5.77% above the 8% actuarial assumed return. The one-year return places the ERS' performance in the top 34% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 11.10%, before fees, ranking in the top 28% of the universe. The asset allocation at December 31, 2006 was: Domestic Equities 46.1%, International Equities 20.0%, Fixed Income 21.6%, Inflation Linked Bonds 8.8%, Alternative Investments 2.8%, Real Estate 0.5% and Cash 0.2%.

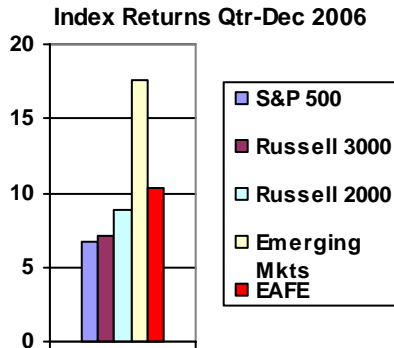
Major Initiatives

During the quarter, the Board expanded its investments in the alternatives sector by hiring two direct private fund-of-funds managers and increased their allocation with another current fund-of-funds manager. The Board now has \$220 million committed to the sector and will be looking to make additional investments in the coming year.

Other actions by the Board included: approval of the FY 2007 estimated and FY 2008 requested budgets, issuance of the Board's FY 2006 annual report, and approval to commence a search for third-party transition managers.

Capital Markets and Economic Conditions

The fourth quarter started and ended economically in broadly the same position, although there was volatility along the way. The Fed maintained their watchful stance and the FOMC left rates at 5.25% throughout the period. During the quarter there was growing anticipation of monetary policy easing, as the yield curve priced in at least two 25bps rate cuts during 2007 - this was based on weak economic data, particularly in housing. However, there was a complete turn-around in December – consumer spending continued unabated, residential real estate gave the impression of starting to stabilize, unemployment rates were at a cyclical low and suddenly the prospects of an early interest rate cut were gone.

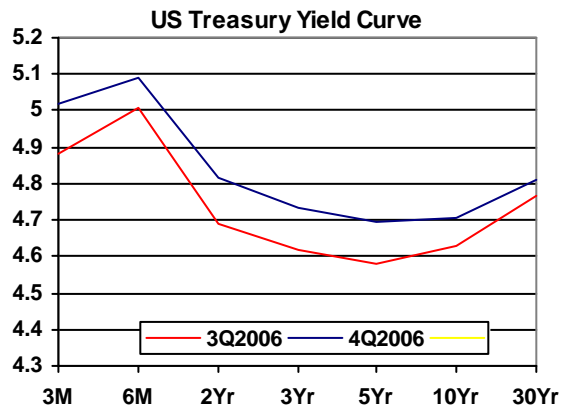


U.S. equity markets continued to rally during the fourth quarter on falling energy prices and record M&A activity. As shown in the chart to the left, the smaller capitalization firms (as represented by the Russell 2000 Index) outperformed large capitalization companies (as represented by the S&P 500 Index). The top performing sectors of the S&P 500 during the quarter were Energy, Materials, and Consumer Discretionary all up around 10%, with all other sectors posting positive returns. Our combined domestic equity performance was a gain of 7.28%, 16 basis points ahead of the Russell 3000 benchmark index return, driven by the strong performance of our small cap managers. For the one year period ending

December 31, our combined domestic equity performance was 15.66%, 6 basis points behind the 15.72% return achieved by the benchmark.

Within the international markets, emerging markets were up 17.60% in US dollar terms for the quarter. The weakening of U.S. dollar had a bolstering effect on most markets when converting the local return to U.S. dollars. The markets of China (+35.9%), Argentina (+33.7%), and Hungary (+32.0%) ranked among the top performing countries while Jordan and Pakistan posted negative returns. Developed international markets, as measured by the MSCI EAFE Index, were up 10.35% for the quarter. All markets posted positive returns with Norway, Singapore, and New Zealand each returning over 20%. Our combined international equity performance was a gain of 11.34% for the quarter, 18 basis points ahead of the benchmark index's return of 11.16%.

US 10-year Treasuries yields were virtually the same at the start and end of the fourth quarter, ending the year at 4.70%. However, there were large shifts in the interim and 10-year Treasuries bottomed out at the beginning of December at 4.54%, before the improved economic outlook caused yields to widen out again. Elsewhere around the globe, interest rate tightening is still taking place, with the European Central Bank raising rates in Europe twice during the quarter and the prospect of another rate rise in Japan early in 2007. Credit defaults have remained low from a long term average perspective and the expectation is that the current financial conditions and the macro outlook will continue to support this. The ERS combined fixed income return for the quarter was a gain of 2.16% compared to the gain of 1.93% recorded by the benchmark index, led by our High Yield managers who outperformed their respective index by around 1%. ERS investments in inflation-linked bonds gained 0.04% for the quarter, 55 basis points ahead of the benchmark's negative return of .51%.



Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending December 31, 2006 and fiscal year-to-date.

**Employees' Retirement System
Contributions and Investment Income (millions)**

	Qtr 12/31/2006	Fiscal YTD
Employer Contributions	\$ 27.3	\$ 54.2
Member Contributions	4.2	8.3
Net Investment Income	142.2	231.6
	\$ 173.7	\$ 294.1

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

**Employees' Retirement System
Deductions by Type (millions)**

	Qtr 12/31/2006	Fiscal YTD
Benefits	\$ 34.0	\$ 67.9
Refunds	0.1	0.2
Administrative Expenses	0.6	1.1
	\$ 34.7	\$ 69.2

Outlook

2006 was a strong year for equity market returns – domestic equities returned 16% and international equity returns were well over 20% for the calendar year. Economic growth seems to have moderated slightly, although consumer spending remains strong and unemployment is low heading into 2007.

The market is currently pricing in an interest rate cut - however, the expectation of Fed rate cuts is based on the assumption that the US economy will deteriorate and this is not yet certain. Inflation has been the watch word for some time, but energy prices have retreated substantially from their 2006 highs and any rate changes will carefully take into account the state of the labor market and economic growth.

Bond issuance remains strong and therefore access to credit is relatively easy and corporate profits are at record levels. Stable monetary policy has led to a low volatility environment for bonds and this, when combined with a supportive economy and contained inflation, means that individual security ideas are likely to be the driving force for bond portfolio returns.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**

December 31, 2006

Equity in pooled cash and investments	\$ <u>123,903</u>
Investments:	
Northern Trust	2,516,189,671
Aetna	11,494,639
Fidelity - Elected Officials Plan	<u>958,261</u>
Total Investments	<u>2,528,642,571</u>
Contributions Receivable	<u>7,253,759</u>
Total Assets	<u>2,536,020,233</u>
Liabilities	
Benefits payable and other liabilities	<u>3,498,289</u>
Net assets held in trust for pension benefits	<u><u>\$ 2,532,521,944</u></u>

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**

December 31, 2006

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 27,340,834	\$ 54,237,889
Member	<u>4,167,055</u>	<u>8,254,041</u>
Total Contributions	<u>31,507,889</u>	<u>62,491,930</u>
Investment Income	145,055,306	236,616,674
Less Investment Expenses	<u>2,814,373</u>	<u>5,019,559</u>
Net Investment Income	<u>142,240,933</u>	<u>231,597,115</u>
Total Additions	<u>173,748,822</u>	<u>294,089,045</u>
Deductions		
Retiree benefits	24,597,952	49,069,086
Disability benefits	7,958,721	15,863,334
Survivor benefits	1,481,792	2,943,917
Refunds	85,764	252,117
Administrative expenses	<u>619,918</u>	<u>1,118,209</u>
Total deductions	<u>34,744,147</u>	<u>69,246,663</u>
Net increase	<u>139,004,675</u>	<u>224,842,382</u>
Net asset held in trust for pension benefits		
Beginning of period	<u>2,393,517,269</u>	<u>2,307,679,562</u>
End of period	<u>\$ 2,532,521,944</u>	<u>\$ 2,532,521,944</u>