OFFICES OF THE COUNTY EXECUTIVE

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County Executive

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May 24, 2015

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 March 31, 2015. 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. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan ("GRIP"). There were approximately 5,600 ERS and GRIP active members and 6,400 retirees participating in the ERS as of March 31, 2015.

Performance Results

The total return achieved by the ERS assets for the quarter was 3.51%, 97 basis points ahead of the 2.54% return recorded by the policy benchmark. For the one year period ending March 31, 2015 the ERS' gross return (before fees) was a gain of 8.40%, 148 basis points ahead of the 6.92% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 10.29% for the three-year period and 10.84% for the five-year period ranked at the median and top decile of the universes, respectively. The asset allocation at March 31, 2015 was: Domestic Equities 19.3%, International Equities 15.5%, Global Equities 3.7%, Fixed Income 24.0%, Inflation Linked Bonds 11.4%, Commodities 3.6%, Private Equity 6.5%, Private Real Assets 5.0%, Private Debt 0.3%, REITS 5.9%, Opportunistic 3.2%, MLPs 0.5%, and Cash 1.1%. We estimate that the funded status of the ERS was 88.0% as of March 31, 2015, a 0.8% increase from the December 31, 2014 level. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

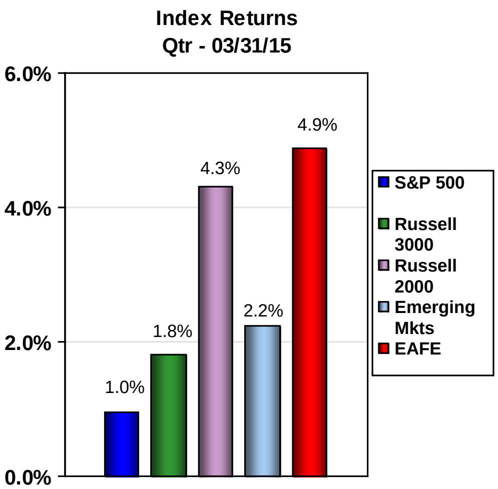
Major Initiatives

During the quarter, the Board hired Chickasaw Capital Management, for a Master Limited Partnership mandate, and made two private real assets fund commitments – $8,000,000 to Homestead Capital I and $8,000,000 to Lyme Timber Fund IV.

Capital Markets and Economic Conditions

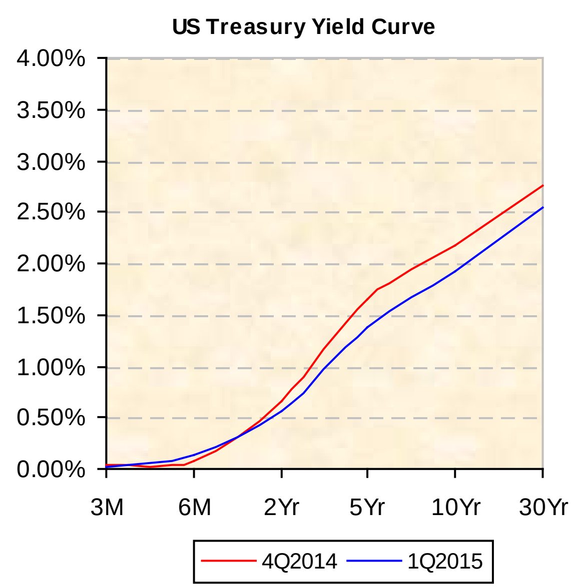
Economic data released during the first quarter showed an unrevised Q4 2014 annual real GDP estimate of a 2.2% increase, confirming that the economy expanded at a healthy pace moving into the New Year. However, advanced estimates released by the Bureau of Economic Analysis revealed that real GDP in Q1 2015 increased at a 0.2% annual rate. The primarily cause of the drop is related to decelerations of personal consumption expenditures, residential & nonresidential fixed investment, and local government spending. Consumer spending saw a significant reduction from the previous quarter as harsher than usual winter conditions likely contributed meaningfully to the slowdown. Energy companies sharply reduced capital expenditures and other types of fixed investments as a result of declining oil prices. March nonfarm payroll numbers were also disappointing, increasing at a pace of 126,000 which was well below recent month figures. Even with March's employment data coming in weaker than expected, the unemployment rate was able to continuing ticking downwards, as it fell from 5.7% to 5.5% during the quarter. The ISM Manufacturing Index also indicated slower expansion in the first quarter suggesting that multinational firms are beginning to see an impact from the challenges associated with a rising U.S. dollar. The Case-Shiller Home Price Index increased 0.95% from December 2014 to February 2015, confirming that home prices are still increasing at a modest pace. Headline CPI reported in March on a year-over-year unadjusted basis showed a decline of 0.1%. Year-over-year Core CPI, which does not include the prices of food and energy, posted a much stronger 1.8%.

Public Equity Markets: U.S. stocks advanced during the quarter with the S&P 500 Index reaching all-time highs in February. The Nasdaq Composite Index performed strongly, briefly exceeding 5,000 for the first time in 15 years. A slight rebound in oil prices and hopes that the Fed will continue to keep interest rates low boosted investor sentiment. Smaller capitalization stocks (as represented by the Russell 2000 Index) continued to outperform their larger counterparts as the latter was impacted by the strong dollar – large cap companies in the S&P 500 receive over one-third of their revenues from overseas. Six of the ten sectors of the S&P 500 Index were up with Healthcare reporting the strongest returns and Utilities the weakest. Our combined domestic equity performance was a gain of 2.00%, outperforming the 1.80% gain recorded by the Russell 3000 benchmark.



International markets rallied during the quarter led by European stocks. Despite Greece's ongoing fiscal issues, the Eurozone began to show signs of economic recovery, and coupled with the European central banks to relax monetary policy, equities advanced strongly. Emerging markets also had a positive start for the year; however, results varied widely. Russia, Hungary, and most of the Asian markets led the way, while Greece and much of Latin America were in negative territory. During the quarter, developed markets, as measured by the MSCI EAFE Index, were up 4.88% with the markets of Denmark and Japan contributing the most. Emerging Markets advanced 2.24% led by Russia, Hungary, and China. Our combined international equity performance was a gain of 5.06% for the quarter, outperforming the 3.49% gain recorded by the MSCI ACWI ex-US Index. Global equities recorded a gain of 0.19%, underperforming the 2.31% return of the MSCI ACWI benchmark.

Fixed Income: U.S. Treasury yields, with the exception of the very front end of the curve, continued to fall during the quarter as fears about a slowing economy persisted in response to news of weaker than expected U.S. economic data. Conversely, short-term U.S. Treasury yields rose slightly ahead of a potential Federal Reserve interest rate hike in Q2 2015. The yield on the 30 year bond fell 22 bps during the quarter, and ended the year at 2.54%. In addition to slowing domestic growth, continued worries about economic conditions and deflation in Europe also increased investor appetite for safe haven U.S. government bonds. With eurozone sovereign debt yields beginning to reach negative territory, foreign investor demand for U.S. Treasuries returning low, albeit positive yields, remains robust. The yield curve flattened (shown in the chart to the right) as the spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, narrowed by 14 bps to 137 bps. For the quarter, the 2-year Treasury yield ended at 0.56%, down 11



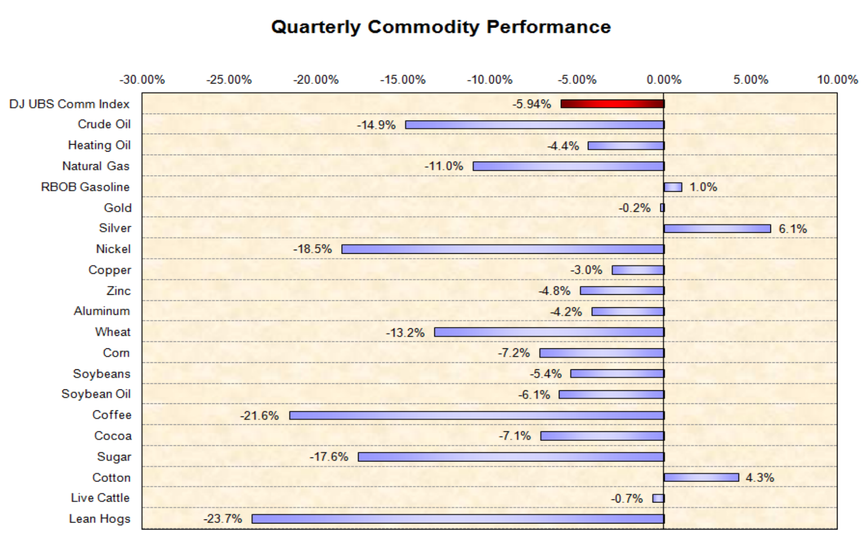
bps, while the 10-year Treasury yield declined by 25 bps to 1.92%. For the quarter, the Merrill High Yield Index rose 2.54%, the Barclays Aggregate returned 1.61%, and the Barclays Long Govt/Credit Index used the declining long-term yields as a tailwind to return 3.36%. The fixed income performance for the quarter was a positive return of 3.22%, and the blended performance outperformed the custom benchmark's gain of 3.02%. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, returned 11.75% for the quarter, outperforming the benchmark's 5.90% return.

Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 2.28% in the first quarter as all major strategies were up. Global Macro gained 3.22%, measured by the HFRI Global Macro Index, as macro managers were able to profit from long USD, short Euro and long European risk assets. Event Driven strategies as measured by the HFRI Event-Driven Index were up 1.83%, buoyed by strong equity and credit markets. Relative Value strategies gained 1.79% due to healing in the credit markets. Within strategies, European long/short equity had a fairly consistent and solid quarter up 4.66%. The HFRI Fund of Funds Index was up 2.52% for the quarter. The opportunistic portfolio advanced 2.98% in the first quarter, outperforming the HFRI Fund of Funds Index by 46 basis points.

Private Equity: Capital raised by U.S. buyout funds during the first quarter saw its fourth consecutive quarterly decline totaling $26 billion, versus $27 billion in Q4 2014. Conversely, venture capital fundraising increased during the quarter from $5.8 billion in Q4 2014 to $7.3 billion in Q1 2015. Exit activity slowed during the first quarter. IPO and M&A exits totaled 162 in Q1 2015, versus 240 in Q4 2014. Purchase prices, particularly for larger transactions, continue to trade at historically high levels above 9x EBITDA. During the quarter, our private equity managers called a combined $13.1 million and paid distributions of $21.7 million. Our current allocation to private equity is 6.5%, with a market value of $239.3 million. From its 2003 inception through September 30, 2014, the private equity program has generated a net internal rate of return of 8.3% versus an 11.9% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps).

Private Real Assets: Commercial real estate transaction values in the U.S. decreased by 1% quarter over quarter although these levels were 45% above Q1'14 volumes. The U.S. real estate market experienced the strongest first quarter from a transaction standpoint ($129B) since Q1 2007. Quarter over quarter capitalization rates declined across all major property types (multi-family, industrial, retail and office) in the United States continuing its downward trend post global financial crisis. In the energy markets, U.S. oil prices declined an additional 9% during Q1'15 from approximately $53 to $47/barrel. Oil prices are likely to stabilize going forward as many upstream oil and gas companies have announced decreased capital expenditure programs due to the lower price environment. During the quarter, our private real assets managers called a combined $1.9 million and paid distributions of $4.8 million. Our current allocation to private real assets is 5.0%, with a market value of $186.2 million. From its 2006 inception through September 30, 2014, the private real assets program has generated a net internal rate of return of 3.4% versus a 6.8% gain for the long-term benchmark CPI plus 500 bps.

Commodities: The Bloomberg Commodity Index fell broadly during the quarter led by declines in the agriculture and energy markets. The U.S. Dollar climbed an additional 9% versus a basket of foreign currencies, continuing its strength from the second half of 2014, and serving to pressure commodity prices lower. Concerns over growth in Europe and Asia also weighed on commodity prices. Crude Oil prices extended their decline from the second half of 2014 with WTI prices falling by more than 10% in the quarter amid lingering concerns about abundant global supplies from sustained OPEC and US production. Natural Gas continued its decline as the relatively mild winter across the US resulted in far lower draws than expected



and allowed inventories to build. Precious Metal prices showed moderate strength as deflation concerns increased demand for gold and silver. Industrial Metal prices declined on lower demand for nickel and surging production of zinc and aluminum out of China. Agriculture prices fell on higher than expected supplies of wheat and corn by the USDA and expectations of increased sugar exports from Brazil. Lean hog prices moved sharply lower as hog producers expanded the breeding herd to take advantage of low grain prices. During the quarter, our commodities portfolio declined 5.15%, 79 bps ahead of the Bloomberg Commodity Index.

REITs: Global listed real estate securities had a strong 1st quarter as the FTSE EPRA/NAREIT Developed Index returned 3.97% for the quarter. Attractive yield spreads and dovish central bank policies drove performance in Europe. US REITs benefitted from an improving economy and favorable supply/demand property fundamentals. Japanese developers led performance in Asian markets. Our global REIT portfolio returned 4.16%, outperforming the benchmark by 19 bps.

Additions

The primary sources of additions for the ERS include contributions from members and employers and investment income. The following table displays the source and amount of additions for the quarter ending March 31, 2015 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 3/31/2015	Fiscal YTD
Employer Contributions	$ 37.4	$ 113.5
Member Contributions	6.6	20.0
Net Investment Income	118.1	96.8
	$ 162.1	$ 230.3

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 3/31/2015	Fiscal YTD
Benefits	$ 57.4	$ 173.5
Refunds	0.7	2.0
Administrative Expenses	0.7	2.2
	$ 58.8	$ 177.7

Outlook

As previously highlighted, following the aftermath of the financial crisis, differences in indebtedness and monetary policies resulted in substantial divergences in growth rates and economic activity across countries. Countries such as the US and UK, which eased aggressively, experienced strong cyclical recoveries, whereas countries that did not pursue aggressive monetary policy, such as continental Europe and Japan, experienced insufficient growth. These divergences are likely to narrow as the US and UK are moving towards tightening policy, whereas Europe and Japan are now easing aggressively.

The US economy has been growing at a healthy rate without the support of quantitative easing as private sector credit growth and labor markets have normalized and are supporting growth. Further boosting growth is the recent fall in oil prices which has helped increase consumer confidence and household spending. Going forward, growth is likely to moderate as the positive effect of lower oil prices is likely to fade and become a headwind due to lower fixed investment and reduced employment in the oil sector. In addition, an appreciating US dollar may hurt the export sector and reduce overall production growth.

Highly anticipated European quantitative easing began during the quarter and pushed the euro down, reduced bond yields to historically low levels, and raised stock prices. These positive forces are supporting growth in Europe by lowering debt costs, increasing employment and improving consumer sentiment and demand. However, the effectiveness of European quantitative easing may be not as impactful as it was in the US given that yields are at low levels and Europe may also need to agree to fiscal and structural reforms to produce sustainable growth.

The Federal Reserve is expected to begin increasing short term rates by the middle of the year; however, the Fed will likely be cautious given that the risks of tightening prematurely outweigh the risks of not tightening soon enough. A global overcapacity remains, high levels of indebtedness in the developed world, and steep commodity price declines, serve to reduce inflationary risk and heighten the risk of raising interest rates too soon. Additionally, the Fed has a greater ability to subdue inflation if it surprises on the upside versus providing additional stimulus to support faltering growth as interest rates and risk premiums are at low levels.

Sources: Bloomberg, Northern Trust, MSCI, S&P, T. Rowe Price, FRM, Wilshire Associates, Bridgewater, JP Morgan, BlackRock, PE Hub, Private Equity Analyst, Pitchbook, Real Capital Analytics, RE Alert, Schroder, Oil & Gas Investor.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF FIDUCIARY NET POSITION
March 31, 2015

Assets		
Equity in pooled cash and investments	$	1,052,778
Investments:		
Northern Trust		3,695,639,131
Aetna		1,036,803
Fidelity - Elected Officials Plan		473,714
Fidelity - DRSP/DROP		3,868,914
Total investments		3,701,018,562
Contributions receivable		11,875,446
Capital assets		900,043
Less depreciation		(225,011)
Net capital assets		675,032
Total assets		3,714,621,818
Liabilities		
Benefits payable and other liabilities		9,225,491
Net position restricted for pensions	**$**	**3,705,396,327**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
March 31, 2015

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 37,419,176	$ 113,527,363
Member	6,557,557	20,029,890
Total contributions	43,976,733	133,557,253
Investment income	125,305,398	113,924,267
Less investment expenses	7,239,599	17,158,006
Net investment income	118,065,799	96,766,261
Total additions	162,042,532	230,323,514
Deductions		
Retiree benefits	42,771,539	129,546,006
Disability benefits	12,419,571	37,269,480
Survivor benefits	2,231,274	6,731,437
Refunds	686,485	2,025,080
Administrative expenses	701,290	2,222,281
Total deductions	58,810,159	177,794,284
Net increase	**103,232,373**	**52,529,230**
Net position restricted for pensions		
Beginning of period	**3,602,163,954**	**3,652,867,097**
End of period	**$ 3,705,396,327**	**$ 3,705,396,327**