OFFICES OF THE COUNTY EXECUTIVE

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May 28, 2017

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, 2017. 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 5,500 ERS and GRIP active members and 6,520 retirees participating in the ERS as of March 31, 2017.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 4.05%, 48 basis points ahead of the 3.57% gain recorded by the policy benchmark. For the one-year period ending March 31, 2017 the ERS' gross return (before fees) was a gain of 12.33%, 178 basis points ahead of the 10.55% gain 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 6.02% for the three-year period and 8.12% for the five-year period ranked near the second quartile of the universe for both time periods. The annualized return for the ten-year period was 6.56%, and ranks in the first quartile of Wilshire's Large Public Funds Universe. The asset allocation at March 31, 2017 was: Domestic Equities 19.1%, International Equities 15.4%, Global Equities 3.1%, Fixed Income 22.6%, Inflation Linked Bonds 12.2%, Public Real Assets 9.8%, Private Equity 7.0%, Private Real Assets 5.0%, Private Debt 0.8, Opportunistic 3.5%, and Cash 1.5%. We estimate that the funded status of the ERS was 95.0% as of March 31, 2017. 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.

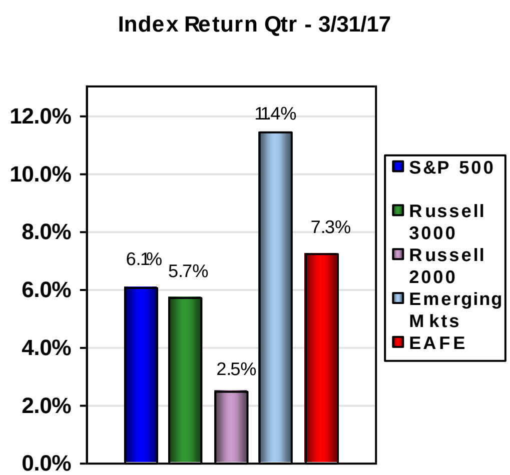
Major Initiatives

During the quarter, the following commitments were made: $60 million to WCM, a public global equities manager, $10 million to Greyrock CG IV, a private debt fund, $19 million to LBA IV, a private real assets fund, and $10 million to Kimmeridge Mineral Fund, a private real assets fund.

Capital Markets and Economic Conditions

Economic data reflected that the GDP increased at a 0.7% annual rate in the first quarter of 2017, a significant decrease of 140 bps from the economy's fourth quarter expansion of 2.1%. The GDP reading was well below the 1.1% consensus estimate of economists. This GDP increase represents the slowest increase in three years and was driven by weak auto sales and consumer spending. Consumer spending, which comprises the largest share of Gross Domestic Product, rose 0.3%, which is the worst performance since 2009. One of the contributors to the weak consumer spending number was the drop in home-heating bills due to a warmer than expected winter. Inventories were another weak area as the reading subtracted 0.93% from growth, following a significant gain of 1.01% in Q4 2016. Fixed nonresidential investment was one of the few bright spots for the economy as this sector contributed 1.12% to growth, led by a record increase in mining and energy exploration. Household finances remain on solid footing with the household debt service ratio remaining at an all-time low of 10% and household net worth increasing to a record level of $95.6 trillion. The residential real estate sector of the economy showed some weakness as new housing starts dropped by 65,000 houses during the quarter. The economy added 527,000 jobs during the first quarter, which was an increase from Q4's 443,000 gain. Given the strong jobs numbers, the unemployment rate decreased from 4.7% to 4.5% during the quarter, even as labor force participation increased. Inflation continues to show signs of positive pressure as CPI posted a 2.4% growth rate year-over-year due primarily to a recovery in energy prices. Core CPI, which excludes food and energy, decreased from 2.2% to 2.0% during the quarter.

Public Equity Markets: U.S. equities produced strong gains during the quarter advancing to all-time highs as the market was supported by positive economic reports as well as expectations that the new administration would cut taxes and regulations on corporations. Employment data, manufacturing activity, and consumer confidence all pointed to a stronger economy. Growth significantly outperformed value across all market capitalization ranges, particularly in the large cap space. U.S. markets were led by the Technology, Health Care, and Consumer Discretionary sectors while Energy and Telecom finished in negative territory. Technology moved higher following strong earnings reports from bellwether companies such as Apple, Facebook, Netflix, and Amazon. Energy was the worst performing asset class as crude oil sold off 7% and natural gas sold off 14%. Following three months of significant underperformance, large cap stocks outperformed small cap stocks in the quarter. Our combined domestic equity performance was a gain of 6.71%, outperforming the 5.74% gain recorded by the Russell 3000 benchmark. Manager selection was positive but our overweight to small cap negatively impacted performance.

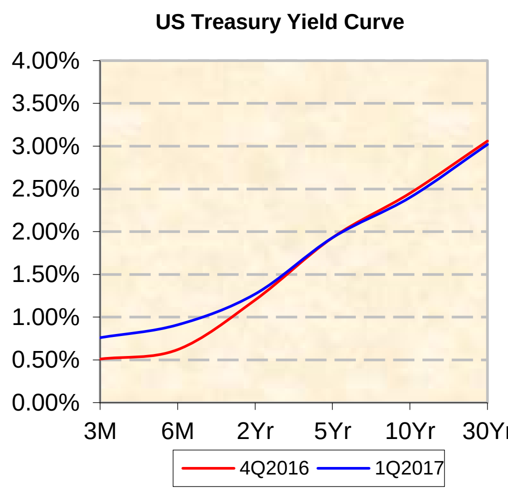


After trailing domestic equities in Q4, both international developed and emerging markets outperformed in Q1. The U.S. Dollar Index, which dropped by 2% during the quarter was a boon to equity markets outside the United States. Despite Japan underperforming for the quarter, Asian markets delivered robust gains as Australia, Singapore, Hong Kong, and South Korea posted double digit quarterly gains. European markets experienced broad based gains during the quarter as economic activity seemed to be picking up across the region. Much like their U.S. counterparts, the top performing sectors were Technology and Health Care while the worst performing sectors were Energy and Telecom. Emerging Market equities posted large gains in the quarter as U.S. Dollar weakness provided a tailwind to performance. Additionally, improving measures of global economic growth and a lack of follow-through of the Trump administration in pursuing protectionist trade policies boosted returns. The only major emerging market to post a loss in Q1 was Russia, which sold off primarily due to weakness in the energy sector. Indian stocks were the strongest performer at +17% as the market gained further confidence in the economic reform agenda of Prime Mister Modi. Our combined international equity performance was a gain of 7.62%, underperforming the 7.96% gain recorded by the benchmark index. Our global equity manager posted a return of 8.24%, outperforming the 6.91% gain of the MSCI ACWI benchmark, primarily due to the manager's overweight to Asia and underweight to the United States.

Private Equity: Buyout funds raised $44 billion during the first quarter of 2017, nearly 1/3 of the total level in 2016. Buyout invested capital during the quarter trailed that of 1Q 2016 while the number of deals remained at similar levels versus a year ago. Purchase price multiples declined to 9.1x EBITDA versus 9.7x in 2016. Leverage multiples slightly increased to 5.5x after declining during the last two years. U.S. venture invested capital during 1Q 2017 remained at similar levels versus a year ago; however, there was a 12% decline in the number of deals. U.S. venture fundraising had a slow start ($6 billion) in 1Q 2017 after a robust ($41 billion) 2016 which exceeded the post-crisis peak. During the quarter, our private equity managers called a combined $11.6 million and paid distributions of $11.8 million. Our current allocation to private equity is 7.03%, with a market value of $269.2 million. From its 2003 inception through September 30, 2016, the private equity program has generated a net internal rate of return of 9.2% versus a 11.6% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps). The direct private equity program generated a 16.7% return versus 15.8% for the benchmark since inception (2009).

Opportunistic: Hedge funds, as measured by the HFRI Fund Weighted Composite Index, gained 3.15% in the first quarter. On a sub-strategy basis, the HFRI Event-Driven Index rose 4.06%, the HFRI Relative Value Index gained 3.11%, and the HFRI Macro Index was up 1.35%. The opportunistic portfolio returned 1.49% in the first quarter, lagging the 2.85% gain of the HFRI Fund of Funds Index primarily due to underperformance from the portfolio's global macro managers.

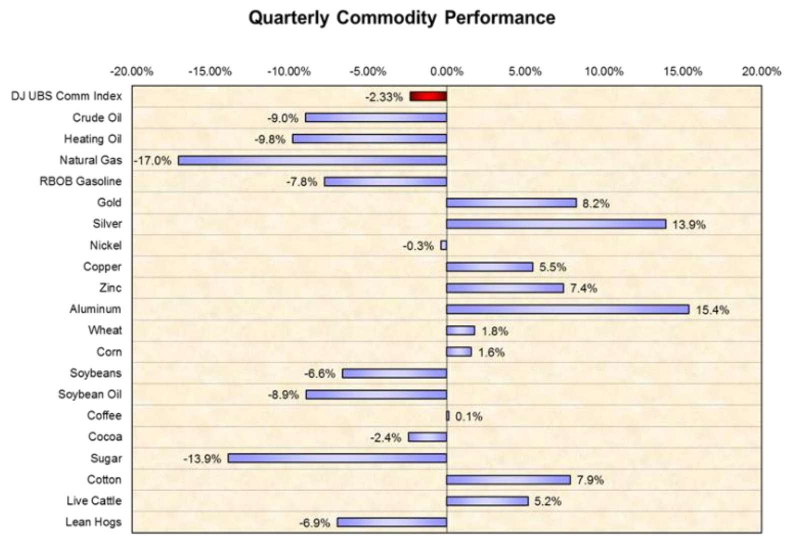
Fixed Income: U.S. Treasury yields increased across the short-end of the curve during the quarter, as the Fed raised the key-rate by another 25 bps due to improving global economic health. This move was highly anticipated, and had a marginal effect on the mid to longer ends of the curve which remained relatively unchanged from the previous quarter. Based on guidance given by the Fed, investors are expecting up to two more interest rate increases this calendar year. The yield on the 30-year bond decreased by 4 bps during the quarter, and ended the period at 3.02%. The yield curve flattened in Q1 (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 12 bps to 113 bps. For the quarter, the 2-year Treasury yield ended at 1.27 %, up by 7 bps from the prior period, while the 10-year Treasury yield moved down by 5 bps to 2.40%. For the quarter, the Merrill Lynch High Yield II Constrained Index rose by 2.71%, the Barclays Aggregate was up 0.82%, and the Barclays Long Govt/Credit Index recorded a gain of 1.58%. The fixed income performance for the quarter was a gain of 2.06%, in-line with the custom benchmark's gain of 2.07%. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, returned 1.58% for the quarter, outperforming the benchmark's 0.65% gain.



Private Debt: Private debt funds had an active first quarter, as 21 vehicles held final closes on approximately $21 billion in new investor commitments - this level of fundraising activity is double the $11 billion which was raised in the first quarter 2016. Direct lending funds had their strongest quarterly raise of all time, and accounted for $13 billion of the new commitments. Nearly two-thirds of the private debt funds which closed in the first quarter exceeded their target size. Looking ahead, future private debt fundraising prospects look strong, as nearly 300 funds are in market seeing to raise an additional $112 billion in investor capital. During the quarter, our private debt managers called a combined $3.4 million and paid distributions of $1.3 million. Our current allocation to private debt is 0.78%, with a market value of $30.0 million. From inception through September 30, 2016, the private debt program generated a net internal rate of return of 14.0% versus a 8.2% return for the dollar-weighted public market equivalent benchmark (BofA Merrill Lynch High Yield Master II Constrained + 300 bps).

Private Real Assets: U.S. real estate returns have continued to slow down as the real estate cycle matures. The NCREIF Property Index (NPI), a measure of private commercial real estate properties in the U.S., gained 1.6% in the first quarter 2017, down from 1.7% last quarter and 2.2% in the same quarter a year ago. The 1.6% total return consisted of a 1.2% income return and a 0.4% appreciation – the income return has been relatively stable while the appreciation return has experienced a downward trend since 2015. The Industrial sector maintained its lead for quarterly (2.8%) and yearly (12.2%) total returns as the sector benefits from the trend toward faster delivery and the expansion of ecommerce. Overall property fundamentals remain resilient as occupancy hovers around 93.0% and net operating income (NOI) advanced 5.8% for the trailing year. Within the upstream oil and gas sector, deal volumes declined slightly from Q42016; however, volumes are still at a high level with most transactions in low cost basins (i.e. Permian, Scoop/Stack, Niobrara). During the quarter, our private real assets managers called a combined $7.5 million and paid distributions of $9.8 million. Our current allocation to private real assets is 5.0%, with a market value of $192.1 million. From its 2006 inception through September 30, 2016, the private real assets program has generated a net internal rate of return of 4.9% versus a 6.6% gain for the long-term benchmark CPI plus 500 bps. Underperformance is primarily due to real estate commitments prior to the financial crisis of 2008 and a private oil and gas fund in 2010.

Public Real Assets: The Bloomberg Commodity Index fell 2.3% as weakness in the energy markets offset gains in industrial and precious metals. Crude oil prices declined below $50 per barrel in March on record U.S. oil inventories as domestic crude oil production increased 400,000 barrels per day in the quarter. Natural gas declined 17% as a warm winter depressed heating demand. Industrial metals advanced due to US dollar weakness and expectations for greater infrastructure spending. Agriculture exhibited mixed performance with small gains in wheat and corn offset by losses in soybeans and sugar. Lastly, precious metals benefited from a weaker US dollar and inflation concerns.



Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index advanced 2.1% led by strong gains for real estate developers in Hong Kong and Singapore. In Hong Kong, new residential development projects are selling out in record time and at record highs. In contrast, Japanese real estate securities lagged as JREITs were hurt by rising interest rates and overall Japanese macro concerns. European markets rebounded on continued property market strength. U.S. REITs advanced marginally with high dispersion across property types. Mall operators declined as they are challenged by the impact of the internet and changing retail trends. Conversely, Data Centers and Single Family Rentals, two relatively new sectors advanced on strong demand.

Master Limited Partnerships (MLPs), as measured by the Alerian MLP Total Return Index, advanced 4.0% for the quarter due to increasing US crude oil production and strong petrochemical demand for Natural Gas Liquids (NGLs).

For the quarter, the public real asset portfolio advanced 1.05%, outperforming the custom benchmark by 6 bps due to a structural underweight to energy relative to the benchmark.

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, 2017 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 3/31/2017	Fiscal YTD
Employer Contributions	$ 24.4	$ 74.8
Member Contributions	6.0	18.0
Net Investment Gain	205.5	287.4
	$ 235.9	$ 380.2

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 3/31/2017		Fiscal YTD	
Benefits	$	58.6	$	175.4
Refunds		2.5		5.1
Administrative Expenses		0.7		2.2
	$	61.8	$	182.7

Outlook

The Federal Reserve increased the federal funds rate to 0.75% from 0.50% at their March meeting. This increase represents the second increase in three months and the third increase since the global financial crisis. The Fed hinted that there would be two more rate hikes in 2017, with the next one likely to occur during the June FOMC meeting. The Fed's inflation expectations remained just shy of the 2.0% target as they anticipate a slight uptick in 2017 from 1.8% to 1.9%. The expectation is that inflation will reach their target in 2018. The market's inflation expectations remained unchanged during the quarter as evidenced by only a 2bps increase in the 10-year break-even inflation rate during Q1.

In March, the Bank of England kept its benchmark interest rate unchanged at 0.25%, which keeps the rate at its lowest level in the BOE's 323-year history. The BOE was split in their decision as several members voted to immediately increase rates following an uptick in inflation to a level above the BOE's 2.0% target. Additionally, the BOE slightly decreased their GDP growth forecast due to an expectation that wage and consumer spending growth will face near-term headwinds. The European Central Bank kept its benchmark interest rate at 0% and indicated that they will continue their aggressive asset purchasing program until at least the end of 2017. The ECB recently tapered their asset purchasing program, decreasing monthly bond purchases to €60 billion from the previous level of €80 billion. Mario Draghi, the President of the ECB, noted that the European economy is improving and that the risk of deflation has been decreased. The ECB is projecting inflation increasing to 1.6% by 2018 and growth increasing from 1.7% to 1.8% this year.

The domestic economy is likely to continue to grow at a steady pace throughout 2017, growing within a range of 2% to 3% as employment and wage growth continue to improve.

Sources: Bloomberg, Northern Trust, MSCI, S&P, T. Rowe Price, FRM, Wilshire Associates, Bridgewater, JP Morgan, BlackRock, Eagle, Gryphon, PE Hub, Private Equity Analyst, Pitchbook, Real Capital Analytics, RE Alert, Schroder, Oil & Gas Investor, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, PwC Deals, NCREIF.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF FIDUCIARY NET POSITION
March 31, 2017

Assets		
Equity in pooled cash and investments	$	538,438
Investments:		
Northern Trust		3,834,047,192
Aetna		487,270
Fidelity - Elected Officials Plan		583,985
Fidelity - DRSP/DROP		7,346,689
Total investments		3,842,465,136
Contributions receivable		4,398,171
Capital assets		900,043
Less depreciation		600,029
Net capital assets		300,014
Total assets		3,847,701,759
Liabilities		
Benefits payable and other liabilities		8,529,524
Net position restricted for pensions	**$**	**3,839,172,235**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
March 31, 2017

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 24,372,706	$ 74,835,046
Member	5,972,331	17,936,507
Total contributions	30,345,037	92,771,553
Investment income	209,839,850	300,018,937
Less investment expenses	4,360,504	12,600,882
Net investment income	205,479,346	287,418,055
Total additions	235,824,383	380,189,608
Deductions		
Retiree benefits	43,548,472	130,466,571
Disability benefits	12,625,820	37,941,006
Survivor benefits	2,395,468	6,949,734
Refunds	2,484,253	5,107,303
Administrative expenses	714,840	2,155,373
Total deductions	61,768,853	182,619,986
Net increase	**174,055,530**	**197,569,622**
Net position restricted for pensions		
Beginning of period	**3,665,116,705**	**3,641,602,613**
End of period	**$ 3,839,172,235**	**$ 3,839,172,235**