OFFICES OF THE COUNTY EXECUTIVE

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County Executive

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May 28, 2014

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, 2014. 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. There were approximately 5,200 active members and 5,635 retirees participating in the ERS as of March 31, 2014.

Performance Results

The total return achieved by the ERS assets for the quarter was a return of 3.44%, 16 basis points ahead of the 3.28% return recorded by the policy benchmark. For the one year period ending March 31, 2014 the ERS' gross return (before fees) was a gain of 11.18%, 264 basis points ahead of the 8.54% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the third quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates due to the ERS having a lower weighting to public equities than its peers. However, our annualized performance of 10.23% for the three-year period and 15.32% for the five-year period ranked in the top decile and the top quarter of the universe, respectively. The asset allocation at March 31, 2014 was: Domestic Equities 18.3%, International Equities 16.7%, Global Equities 4.0%, Fixed Income 23.7%, Inflation Linked Bonds 9.6%, Commodities 5.6%, Private Equity 6.8%, Private Real Assets 4.8%, REITS 5.4%, Opportunistic 3.3%, and Cash 1.8%. We estimate that the funded status of the ERS was 82.9% as of March 31, 2014, a 4.1% increase from the June 30, 2013 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 June 30, 2014 valuation.

Major Initiatives

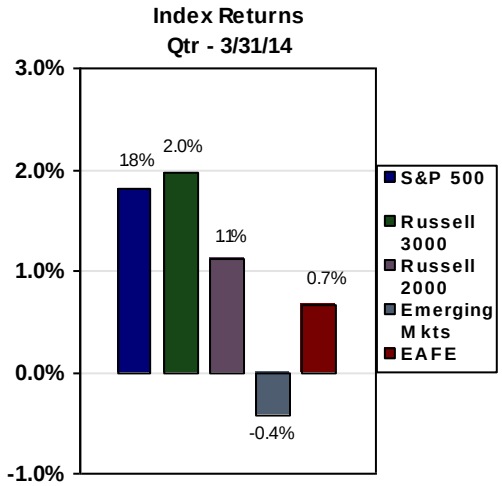
During the quarter, the Board approved the recommended 2014 commitment pace for both private equity and private real assets. Within the private equity sector, the Board made a commitment of $9,000,000 to the Franklin Park Venture 2014 Series. In addition, the Board made commitments of $10,000,000 to each Castlelake Fund III and Levine Leichtman Capital Partners Fund V, both within the private debt sector. Staff continues to review opportunities within the private real assets, private equity and opportunistic allocations.

Capital Markets and Economic Conditions

Economic data released during the first quarter showed some signs of weakness. From the housing market to manufacturing to jobs, there were signs that the economic recovery may be slowing. The Fed remained a key focus for investors as Janet Yellen took the reins of the central bank from Ben Bernanke. The Federal Open Market Committee, following its most recent meetings, stayed the course on tapering

its quantitative easing program despite the softer economic data. Real GDP growth slowed during the fourth quarter of 2013 but was still solid at an annual rate of 2.6%, down from 4.1% during Q3. Inflation continues to remain low and below the Fed's target of a consistent 2% annual rate. Growth in consumer prices slowed to begin 2014 with the Consumer Price Index (CPI) up 0.1% in each of the first two months. The CPI rose by just 1.1% for the year ending February 28, allowing the Fed the ability to keep the current Federal Funds Rate near historic lows. Jobs growth has slowed during the past three months ending February. Total nonfarm jobs added averaged 129,000 during that period after averaging 205,000 during the previous six months. The unemployment rate fell from 7.0% in November to 6.7% in February, a level last seen in late-2008. The Institute for Supply Management (ISM) announced national factory activity rose to 53.2 in February, up from January's read of 51.3, which was the weakest reading since May 2013. Home prices stalled for the first time in a year as the S&P Case-Schiller 20-city Home Price Index was down for three straight months, with a total decline of 0.2% ending January, 2014.

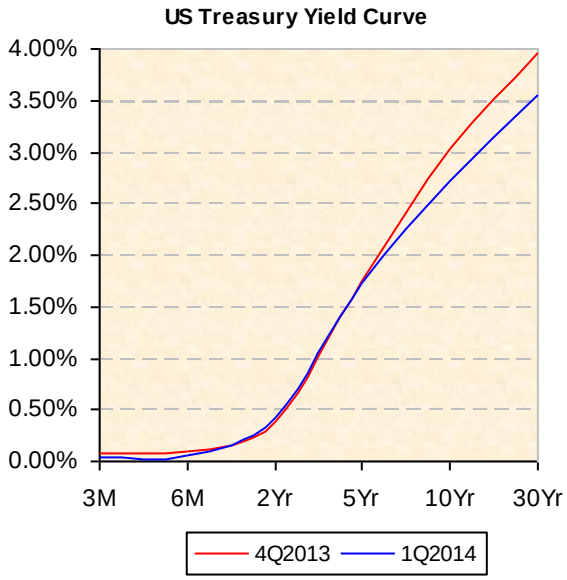
Public Equity Markets: U.S. equities experienced highs and lows during the quarter, with a loss during January followed by a strong February and moderate gain in March ending the quarter posting the seventh consecutive quarterly gain. Larger capitalization stocks (as represented by the S&P 500 Index) underperformed their smaller counterparts. Nine of the ten sectors of the S&P 500 Index were up with Health Care and Utilities the best performers while Consumer Discretionary declined 2.80%. Our combined domestic equity performance was a gain of 1.47%, underperforming the 1.97% gain recorded by the Russell 3000 benchmark.



International markets dealt with concerns over economic and political uncertainty. European stocks rallied on stronger economic growth, with the MSCI Europe Index returning 2.1%. However, the Asia-Pacific region declined. Emerging markets trailed their developed counterparts as the crisis in Ukraine and ongoing questions over China's growth trajectory impacted the markets. During the quarter, developed markets, as measured by the MSCI EAFE Index, posted a 66 bps return with the markets of Denmark, Ireland, and Italy the best performers while Japan was the largest detractor. Emerging Markets declined 0.43% with Russia posting double digit declines. Our combined international equity was 0.78% for the quarter, outperforming the 0.51% gain recorded by the MSCI ACWI ex-US Index.

The global equity performance was a gain of 2.95%, outperforming the 1.08% return of the MSCI ACWI benchmark.

Fixed Income: Global economic uncertainty, geopolitical events, and severe weather that hit much of the U.S., resulting in significantly depressed economic activity, resulted in investors seeking the safety of U.S. Treasuries causing yields in maturities past five years to fall. The outcome of the first Federal Open Market Committee (FOMC) meeting under the leadership of Janet Yellen, in March, revealed an inclination to follow a slightly more rapid path towards normalized monetary policy going forward resulting in a rise in short term rates. 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 35 bps to 230 bps. For the quarter, the 2-year Treasury yield ended at 0.42%, up 4 bps, while the 10-year Treasury yield declined by 31 bps to 2.72%. Credit yield spreads tightened over the quarter resulting in investment-grade and high-yield corporate bonds outperforming Treasuries. For the quarter, the Merrill



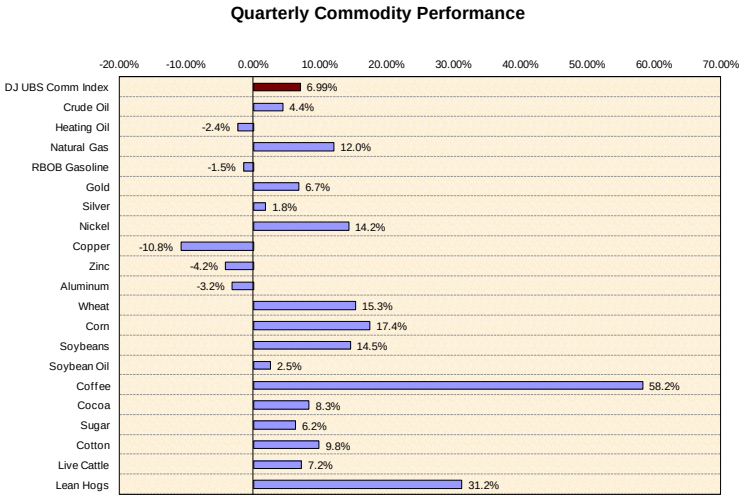
High Yield Index returned 2.99%, the Barclays Aggregate returned 1.84%, and the Barclays Long Govt/Credit Index was the best performer, returning 6.55%. Our combined fixed income performance for the quarter was a gain of 5.33%, outperforming the custom benchmark's 4.89% return. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 6.24% for the quarter, outperforming the 4.97% return recorded by the benchmark.

Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 1.07% in the first quarter. Relative Value and Event Driven were the best performing strategies. The HFRI Relative Value Index gained 2.40% for the quarter with performance led by Corporate Credit, Convertible Arbitrage, and Asset Backed Strategies. The HFRI Event Driven Index gained 1.78% for the quarter, led by a continuation of the M&A, IPO and shareholder activist trends that dominated 2013. The HFRI Equity Hedge Index posted a gain of 1.35%. Macro strategies were the only area of hedge fund performance to post a decline for the quarter as they continue to struggle due to strong price gyrations and changing market sentiment through the quarter. The HFRI Macro index declined 0.5% in the quarter. Generally, these strategies have grappled with central bank-driven price action, which has made it difficult to anticipate market direction and identify clear investment themes. Fund-of-Funds returns, as measured by the HFRI Fund-of-Funds Index, returned 0.24% in the quarter. Our opportunistic portfolio returned 1.42%, net of management fees, for the quarter, outperforming the benchmark by 105bps.

Private Equity: The first quarter of 2014 saw 185 private equity funds reach a final close and raise an aggregate $98 billion, a 14% increase in the amount of capital raised during the same period in 2013; however this represents the lowest number of funds to close in any quarter since Q3 2009. Private equity dry powder continues to grow, as more capital is raised by private equity fund managers, with $1.1 trillion available to fund managers as of March 2014, representing a 2.9% increase from December 2013. During the quarter, our private equity managers called a combined $6.0 million and paid distributions of $10.9 million. Our current allocation to private equity is 6.8%, with a market value of $237 million. From its 2003 inception through September 30, 2013, the private equity program has generated a net internal rate of return of 7.4% versus a 10.7% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 basis points).

Private Real Assets: Commercial real estate transaction activity in the U.S. decreased 26% quarter over quarter, although these levels remained 15% above the first quarter of 2013. Globally, major markets witnessed a substantial increase in property transactions with cities such as London and Tokyo experiencing a 41% and 37% increase in annual deal volumes, respectively. This trend was also evident in the U.S. as cities such as New York, Los Angeles and Washington, DC all experienced over a 20% increase in year over year transaction levels. Within the energy markets, U.S. natural gas prices have continued to increase due to a cold winter across the country. The global mining markets transaction levels were at their lowest point since 2009, largely due to declines in commodity prices as a result of concerns around a slowdown in emerging market growth. During the quarter, our managers called a total of $6.7 million and paid distributions of $13.3 million. Our current allocation to private real assets is 4.8%, with a market value of $167.8 million. From its 2006 inception through September 30, 2013, the private real assets program has generated a net internal rate of return of 0.4% versus a 6.9% gain for the long-term benchmark CPI plus 500 basis points.

Commodities: The Dow Jones-UBS Commodity Index returned 6.99% during the quarter due to record setting cold weather in the U.S., the ongoing drought in the Western U.S. and the geopolitical issues in Ukraine. Natural gas inventory levels fell to their lowest level in over a decade on heavy heating demand. Coffee prices appreciated dramatically after falling to a multi-year low in the fourth quarter of 2013. Dry weather in Brazil drove the sharp rally in prices. Coffee rallied 58.2% in the three-month period. Industrial Metal prices declined with Copper suffering the



largest loss on fears of China's slowing economy. Nickel was the sole base metal to appreciate during the quarter. Precious metals rallied with Gold prices advancing 6.7% in the quarter, supported by safe haven purchases resulting from geopolitical instability in the Ukraine as well as U.S. Dollar weakness on concerns over U.S. macroeconomic data. During the quarter, our commodities portfolio returned 5.07%, 192 bps behind the DJ UBS Commodities Index.

REITs: Real estate stocks turned in positive results during the first quarter in the face of geopolitical tensions and investor concerns about eventual monetary policy tightening. Interest rates declined which provided a boost to equities offering yields, including REITs. Returns were positive across most property types, with self-storage delivering the strongest performance and apartments rebounding from weakness in 2013. By contrast, lodging and diversified REITs were somewhat lackluster. Global REITs, as measured by the FTSE EPRA/NAREIT Developed Index, returned 3.83% for the quarter, while our global REIT portfolio returned 4.12%, outperforming 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, 2014 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 3/31/2014	Fiscal YTD
Employer Contributions	$ 35.8	$ 107.9
Member Contributions	6.4	20.0
Net Investment Income	110.7	366.3
	$ 152.9	$ 494.2

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 3/31/2014	Fiscal YTD
Benefits	$ 55.4	$ 170.2
Refunds	1.3	3.6
Administrative Expenses	0.5	1.7
	$ 57.2	$ 175.5

Outlook

U.S. economic conditions should continue to improve modestly. However, the question remains if the weak economic data in the first quarter was merely an anomaly due to severe weather or a sign of true underlying economic weakness. Economic analysis suggests it is likely a combination of both, with some sectors of the economy seeing a fundamental slowdown while others are only experiencing a temporary shift in demand. GDP is expected to grow between 2.0% and 2.5% for the full year with anticipated improvement in housing, less restrictive fiscal policies, and energy production to power the recovery for the foreseeable future. The number of jobs is growing and the unemployment rate can continue to drop, but the labor participation rate is still low, and, more importantly, wage growth is sluggish.

Market volatility could increase if geopolitical events, such as the Ukraine, escalate. Inflation does appear to be bottoming in the United States, but that's not the case everywhere. In some areas of the world, notably Europe and Japan, deflation has actually been the greater risk.

Emerging markets can be characterized by modest cyclical recovery and below-trend growth. While domestic demand remains strong, export orders from developed markets have declined and do not support the prospect of a significant reacceleration of exports. China, in particular, is still a question mark on the growth front. Data indicated the country's manufacturing sector was slowing considerably and that growth would be well below levels achieved in the recent past.

Sources: Bloomberg, Northern Trust, MSCI, S&P, Pyramis Global Advisors, 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 PLAN NET POSITION
March 31, 2014

Assets		
Equity in pooled cash and investments	$	964,290
Investments:		
Northern Trust		3,488,029,083
Aetna		1,092,690
Fidelity - Elected Officials Plan		410,426
Fidelity - DRSP/DROP		7,686,365
Total investments		3,497,218,564
Contributions receivable		11,056,094
Total assets		3,509,238,948
Liabilities		
Benefits payable and other liabilities		6,290,901
Net position restricted for pensions	**$**	**3,502,948,047**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET POSITION
March 31, 2014

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 35,822,095	$ 107,943,640
Member	6,365,559	19,993,183
Total contributions	42,187,654	127,936,823
Investment income	115,851,355	380,269,350
Less investment expenses	5,138,368	13,959,389
Net investment income	110,712,987	366,309,961
Total additions	152,900,641	494,246,784
Deductions		
Retiree benefits	41,027,632	127,472,785
Disability benefits	12,198,590	36,295,947
Survivor benefits	2,159,701	6,417,764
Refunds	1,294,747	3,605,965
Administrative expenses	553,279	1,751,487
Total deductions	57,233,949	175,543,948
Net increase (decrease)	**95,666,692**	**318,702,836**
Net position restricted for pensions		
Beginning of period	**3,407,281,355**	**3,184,245,211**
End of period	**$ 3,502,948,047**	**$ 3,502,948,047**