OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

September 9, 2010

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 June 30, 2010. 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 5,800 active members and 5,600 retirees participating in the ERS as of June 30, 2010.

Performance Results

The total return achieved by the ERS assets for the quarter was a loss of 3.50%, 52 basis points ahead of the 4.02% loss recorded by the policy benchmark. For the one year period ending June 30, 2010 the ERS' gross return (before fees) was a gain of 14.45%, 94 basis points ahead of the 13.51% gain recorded by the policy benchmark. The one-year return, after fees, places the ERS' performance in the top 50% of a universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was a loss of 2.30%, after fees, ranking in the top 20% of the universe. The asset allocation at June 30, 2010 was: Domestic Equities 25.5%, International Equities 18.7%, Fixed Income 26.8%, Inflation Linked Bonds 10.2%, Commodities 4.9%, Private Equity 6.8%, Real Estate 3.2%, Opportunistic 3.1%, and Cash 0.8%. We estimate that the funded status of the ERS was 77.8% as of June 30, 2010, a slight decrease from the March 31, 2010 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.

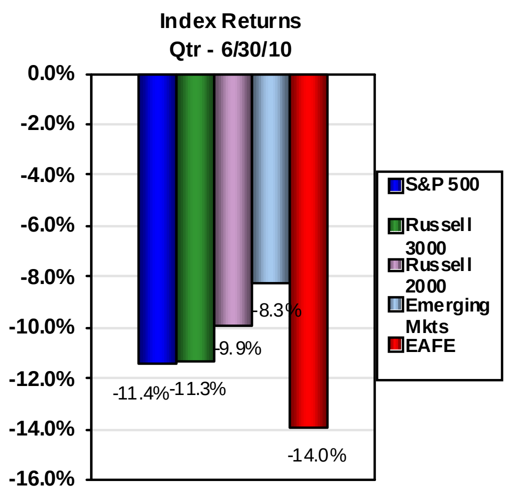
Major Initiatives

During the quarter, the Board completed its investment consultant search resulting in Wilshire Associates being selected. Within the private equity sector, the Board approved an investment of $10,000,000 in Mason Wells Buyout Fund III, L.P and in the private real assets sector a $15,000,000 investment in Hampshire Partners Fund VIII, LP. In addition, the Board amended the Service Provider Procurement Policy to add the definition of an emerging manager.

Capital Markets and Economic Conditions

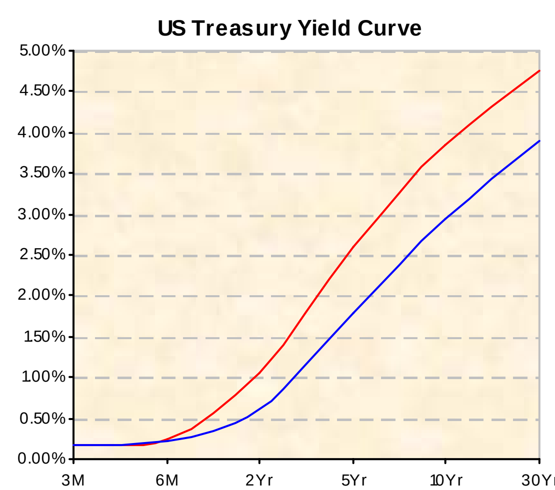
Real GDP rose 2.4% during the second quarter on an annualized basis with positive contributions from private inventory investment, exports, personal consumption expenditures, and residential and non-residential fixed investment. Durable goods purchases were up strongly for the second quarter; however, imports substantially outpaced export growth, leading to a 25% decrease in net exports relative to the first quarter. The U.S. manufacturing sector, as measured by the Institute of Supply Management's (ISM) composite, expanded for the twelfth consecutive month in June. These statistics are indicative of moderate economic growth and the potential for business expansion and higher employment in the future. The pace of growth is slower than previous economic recoveries, which brings the sustainability of this growth into question. Positive readings on GDP and manufacturing during the first quarter conflict with near-zero growth in personal incomes during the quarter. Personal consumption expenditures continue to show weak growth, reflecting low earnings growth and an increased savings rate. Both domestically and internationally, capital markets weakened due to the concern of a potential double dip recession.

Public Equity Markets: The U.S. equity markets fell in the second quarter on worries that the European debt crisis, and signs of slowing in Asia, could send the U.S. economy back into recession. Reports showing that the housing market is slumping again, consumer confidence is falling, and that job growth remains anemic, also added to worries about the strength of the U.S. recovery. The S&P 500 declined -11.43% this quarter, breaking a four quarter winning streak and is down more than 15% from the highs of late April. All three major indexes are at 6-month lows. As shown in the chart to the left, smaller capitalization companies (Russell 2000 Index) fared better than their larger counterparts (S&P 500 Index). The last two months there has been an increase in the level of volatility, as measured by the CBOE Volatility Index (VIX), not seen since the financial market crisis in 2008. All sectors of the S&P 500 posted negative returns this quarter with all but Consumer Staples, Telecom and Utilities posting double digit declines. Our combined domestic equity performance was a decline of 11.92%, underperforming the 11.32% loss recorded by the Russell 3000 benchmark.



Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were down 13.97% in the second quarter. European equities were impacted by sovereign debt worries, particularly Greece whose credit rating was cut four grades to below investment grade by Moody's. Emerging markets declined 8.37% last quarter with the Shanghai Composite Index declining 26% to its lowest level in 14 months on concerns that China's economy may be slowing due to central bank policy tightening and the European debt crisis. Our combined international equity performance was a decline of 9.93% for the quarter, 252 basis points ahead of the benchmark's loss of 12.45%.

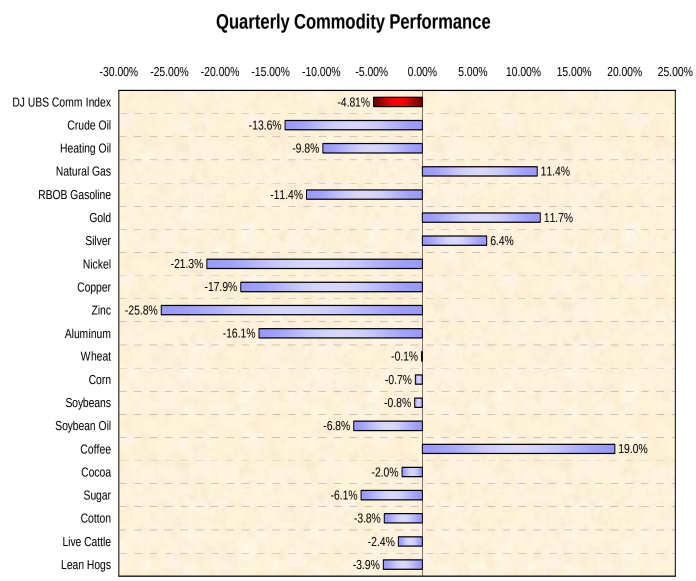
Fixed Income: Treasury yields fell sharply during the quarter in a sequel to the flight-to-quality seen during the heights of the credit crisis. Yields on the 10-year Treasury dropped below 3.0% for the first time since April 2009 to close the quarter at 2.97%. The Federal Reserve reiterated its view that current economic conditions warrant exceptionally low levels for an extended period and voted to maintain its target rate at a 0% - .25% range. The yield curve (shown in the chart to the right) flattened as the 2 year Treasury bond fell 45 bps to 0.61% while the 10 year Treasury bond fell 92 bps to 2.97%. Credit spreads widened over the quarter, especially in the high yield sector, as investors moved away from risky assets into US Treasury bonds. The Merrill Lynch High Yield Master II Index was unchanged for the quarter while Citigroup Broad Investment Grade Index rose 3.66% and the Barclays Long Govt/Credit Index returned 8.56%, primarily from the drop in Treasury yields. Our combined fixed income performance for the quarter was a gain of 3.65%, underperforming the 4.20% gain recorded by the benchmark index. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 4.95% for the quarter, compared to the 2.18% return of the benchmark.



Private Equity: Private equity transaction activity was roughly in line with the past four quarters, though more large deals have occurred than during 2009. The second quarter was the most active period for private equity exits in the past two years, as sales to corporate acquirers, other private equity firms and public stock offerings, all rose. The fundraising environment remains slow and the process of raising capital from investors is taking longer on average. During the quarter, our private equity managers called a combined $3.9 million and paid distributions of $1.8 million. Our current allocation to private equity is 6.8%, with a market value of $165.4 million.

Private Real Assets: Global real estate deal activity increased, albeit at a reduced pace, during the second quarter. The largest impact on the slowdown in deal volume came from the Chinese government, which put new restrictions in place on real estate investment in an attempt to cool a market many believed was overheated. The early indication domestically is that the U.S. followed the global pattern, showing an increase in deal volume. In the wake of sustained high unemployment, commercial property fundamentals – especially for office properties – continue to weaken. Investors remain concerned over the large amount of deteriorating real estate loans on the balance sheets of some commercial banks. During the quarter, our managers called a total of $11.1 million and paid distributions of $0.3 million. Our current allocation to private real assets is 3.2%, with a market value of $76.7 million.

Commodities: The DJ UBS Commodity Index declined 4.81% for the quarter. All major sectors were down with the exception of precious metals and softs. A soaring dollar and doubts about the strength of the economic recovery lowered the demand for raw materials. Industrial metals declined 19% and were the worst performing sector while precious metals recorded a 10.3% gain. The price of gold rose more than 11 percent in the second quarter, as safe-haven demand lifted the metal to its best quarterly performance since the fourth quarter of 2007. On an individual commodity level, Zinc fell sharply, down 25.8%, its worst quarter since the final three months of 2008 on subdued domestic demand and concerns that growth in China will slow, hurting demand for commodities. Coffee, the best performer, rose 19% over concerns that output in Brazil, the world's largest producer, may fall short of forecast expectations. During the quarter, our commodities portfolio declined 5.40%, underperforming the DJ UBS Commodities Index by 59 bps.



Additions

The primary sources of additions for the ERS include contributions from members and employers, investment income and the transfer of RSP account balances to the GRIP. The following table displays the source and amount of additions for the quarter ending June 30, 2010 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 6/30/2010	Fiscal YTD
Employer Contributions	$ 113.9	$ 113.9
Member Contributions	20.4	20.4
GRIP Transfers	30.5	30.5
Net Investment Income	303.4	303.4
	$ 468.2	$ 468.2

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 6/30/2010	Fiscal YTD
Benefits	$ 169.1	$ 169.1
Refunds	1.4	1.4
Administrative Expenses	2.9	2.9
	$ 173.4	$ 173.4

Outlook

Capital markets sold off during the second quarter, as economic statistics began coming in weaker than expectations and European sovereign risk awareness was heightened. The month of May was especially volatile, with a "flash crash" on May 6th that erased nearly 10% from the Dow Jones Industrial Average in a matter of minutes, before recovering and ending the day down just over 3%. Investors were reminded of the extreme volatility that is possible in equity markets and the VIX Index (a measurement of expected stock volatility) increased substantially as investors paid up to protect their portfolios. Capital markets have recovered subsequent to the June 30th quarter end, but the VIX Index remains high relative to the first several months of 2010. In Europe, fears over sovereign debt levels drove a sell off in the Euro and the bonds of the riskiest countries, especially Greece, Spain, and Portugal. European sovereign debt and the Euro have recovered since the end of the second quarter as emergency actions by the European Central Bank and the IMF have calmed investors' nerves.

Outside of the developed international markets, the emerging market economies are beginning to face problems of their own. China has had several quarters of strong growth, but inflationary concerns prompted monetary tightening during the second quarter, as the government tried to reign in property speculation and other risky borrowing. In addition, China announced that it would continue its measured program to increase the value of its currency relative to the U.S. Dollar, a program it had put on hold during the financial crisis in 2008. Monetary tightening steps taken in China and other emerging market countries will be closely watched in the coming quarters as these economies have been the marginal drivers of growth over the past year.

Through the second quarter of 2010, the S&P 500 Index rallied 14.4% for the trailing one year period, a strong advance considering the steep second quarter sell off. Job growth in the United States continues to be slow, implying a long recovery for the economy as a whole. Housing prices have stabilized in recent quarters, and with fixed income yields falling substantially during the second quarter, mortgage rates are lower and housing has become more affordable. Still, the uncertainty that remains in the economy has convinced consumers and businesses to slow their expenditures and increase savings, which is likely to drag on growth going forward. Subsequent to quarter end, as a result of continued economic weakness, the Federal Reserve announced further steps to ensure easy monetary policy, including re-commencing its purchase of U.S. Treasury securities using the proceeds from its existing Treasury and mortgage backed securities portfolio.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
June 30, 2010

Assets		
Equity in pooled cash and investments	$	1,397,773
Investments:		
Northern Trust		2,418,196,872
Aetna		14,364,256
Fidelity - Elected Officals Plan		631,597
Fidelity - DRSP		4,038,739
Total investments		2,437,231,464
Contributions receivable		8,839,544
Total assets		2,447,468,781
Liabilities		
Benefits payable and other liabilities		6,591,153
Net assets held in trust for pension benefits	**$**	**2,440,877,628**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
June 30, 2010

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 113,947,668	$ 113,947,668
GRIP Transfers	$ 30,500,217	$ 30,500,217
Member	20,426,081	20,426,081
Total contributions	164,873,966	164,873,966
Investment income	319,135,563	319,135,563
Less investment expenses	15,752,831	15,752,831
Net investment income	303,382,732	303,382,732
Total additions	468,256,698	468,256,698
Deductions		
Retiree benefits	122,861,083	122,861,083
Disability benefits	38,607,638	38,607,638
Survivor benefits	7,620,034	7,620,034
Refunds	1,414,893	1,414,893
Administrative expenses	2,874,617	2,874,617
Total deductions	173,378,265	173,378,265
Net increase (decrease)	**294,878,433**	**294,878,433**
Net asset held in trust for pension benefits		
Beginning of period	**2,145,999,195**	**2,145,999,195**
End of period	**$ 2,440,877,628**	**$ 2,440,877,628**