OFFICES OF THE COUNTY EXECUTIVE

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County Executive

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September 18, 2020

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, 2020. 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 6,204 ERS and GRIP active members and 6,369 retirees participating in the ERS as of June 30, 2020.

Performance Results

The total return achieved by the ERS' assets for the quarter was a gain of 10.06%, 83 basis points behind the 10.89% gain recorded by the policy benchmark. For the one-year period ending June 30, 2020 the ERS' gross return (before fees) was a gain of 3.82%, 29 basis points behind the 4.11% gain recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top decile of the universe of comparable pension funds constructed by the Board's consultant, NEPC. Our annualized performance of 7.17% and 7.06% for the three and five-year periods, respectively, ranked in the top decile, or better than 90% of our public fund peers. The asset allocation on June 30, 2020 was: Domestic Equities 14.2%, International Equities 11.7%, Global Equities 2.9%, Fixed Income 20.9%, Inflation Linked Bonds 13.3%, Public Real Assets 11.5%, Private Equity 10.7%, Private Real Assets 5.9%, Private Debt 2.3%, Opportunistic 5.0%, and Cash 1.6%. We estimate that the funded status of the ERS was 98.4% as of June 30, 2020. 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.

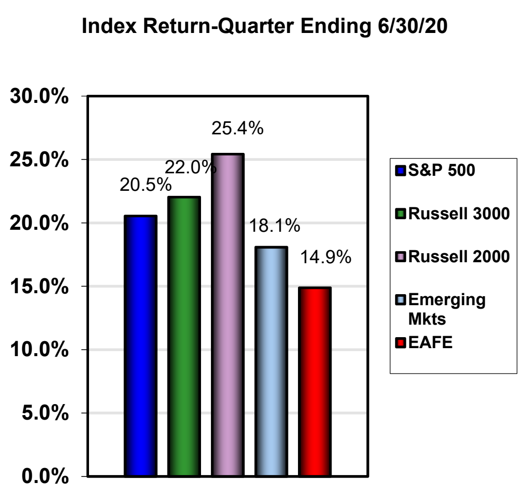
Major Initiatives

During the quarter, the following commitments were made: Private Real Estate - $25 million to Longpoint Realty Fund II; Private Equity - $24 million to Franklin Park Venture Capital Fund XIII, $24 million to Franklin Park International Fund X, $23 million to Princeton Equity Partners I, and $23 million to JFL Equity Investors V; Private Debt - $17 million to GCG investors V.

Capital Markets and Economic Conditions

Economic data reflected that GDP contracted at an annualized rate of 32.9% in the second quarter of 2020, the single largest quarterly plunge in activity ever recorded in the U.S. Sharp declines in personal consumption, inventories, investment, and spending in response to the spread of COVID-19 all combined to bring down GDP. Consumer expenditures, which accounts for a majority of total GDP, plummeted 34.1% during the period. Federal and state spending, as well as the U.S. Federal Reserve's commitment to an ultra-low policy rate regime for the foreseeable future, helped to offset some of the losses, and as a result the drop in GDP was less severe than the consensus 34.7% economists had predicted. Imports continued to outpace exports, but the slowdown in global trade during the second quarter provided a tailwind for GDP growth as exports fell less in nominal terms than imports, leading to a reduction in the size of the trade deficit. The U.S. labor market experienced a historic shock in Q2 as the economy lost 20.8 million jobs and unemployment jumped from 4.4% in March to 14.7% in April, before recovering partially to 11.1% in June. Inflation decreased from 1.5% in March to 0.1% in May, before ending the quarter slightly higher at 0.6%. CPI fell 0.8% in April, the largest monthly decline since December 2008. The decrease was driven primarily by the 20.6% decline in the gasoline index. However, the CPI trend reversed in June, increasing 0.6%, buoyed by a sharp rebound in the same index. The housing market continued its decline in April, but an increase in housing starts, construction permits, new home sales, and existing home sales improved numbers in May and June.

Public Equity Markets: U.S. equity markets bounced back significantly during the quarter despite weakening economic conditions. Much of the positive optimism was driven by the impact of government programs and trial data for COVID-19 vaccines, combined with the phased openings of states across the country. The S&P 500 rallied as high as 25% before finishing up 20.5%. Smaller cap stocks fared better than larger cap stocks with growth outperforming value by a wide margin across all market caps. An increase in risk sentiment saw investors shifting away from the low volatility names that provided downside protection during the Q1 sell-off. Among the S&P 500 sectors, consumer discretionary, information technology, and energy were the best performers while utilities and consumer staples lagged. Our combined domestic equity performance was a gain of 25.05%, outperforming the 22.03% gain of the Russell 3000 Index.



International developed markets also had a strong quarter but trailed their domestic counterparts. Value stocks underperformed growth with smaller companies outperforming larger counterparts. Markets were bolstered by Governments and Central Banks which launched immense monetary and fiscal stimulus packages in response to the economic consequences of COVID-19. Australia, New Zealand, and Germany were the top performing developed markets during the quarter. Emerging markets outpaced the international developed markets. All emerging markets saw positive returns for the quarter with Argentina, South Africa, and the Czech Republic leading the returns. Meanwhile the larger EM countries such as Brazil, India, Russia, and China posted strong double-digit returns. Our combined international equity performance was a gain of 18.11%, outperforming the 16.96% return recorded by the benchmark. Our global equity allocation recorded a gain of 25.50%, outperforming the 19.22% gain of the MSCI ACWI Index.

Private Equity: During the second quarter, a total of 278 private equity funds reached a final close, securing $121 billion in commitments, below the $148 billion raised in the prior quarter. Total capital raised also was down relative to Q2 of 2019, demonstrating the impact that COVID-19 had on the fundraising market. The trend towards larger funds being raised continued in the quarter as the average fund raised $469 million, which is the fourth highest quarter on record. North America continued to dominate the fundraising landscape, representing 51% of the number of funds raised and 52% of the total assets raised during the first quarter.

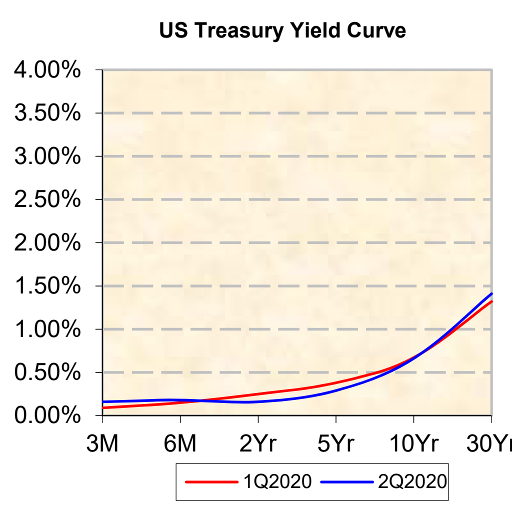
Within the buyout space, the number of completed deals decreased precipitously, with only 944 deals being consummated, a 31% drop relative to last quarter. Aggregate deal value in Q2 also dropped sharply to $59.6 billion, which represents a 44% drop relative last quarter. Additionally, these drops look even more pronounced relative to Q2 2019, a frothy environment, as the number of deals, aggregate deal value, and average deal size decreased 41%, 49%%, and 33%, respectively. Market participants cite the global concern over the economic impacts of COVID-19 and the limitations on travel as the primary drivers of the weak deal environment. Buyout multiples recovered somewhat in Q2 in line with recovering public markets, with the median EV/EBITDA increasing from 9.0x to 10.2x. Healthcare and technology were the most popular acquisition targets, representing 30% of aggregate deal value during the quarter as these sectors are considered pandemic-resistant. Exit activity in Q2 was down significantly relative to Q1 as the number of exits decreased from 441 to 283, the aggregate exit value decreased from $68.8 billion to $63.5 billion and the average exit value decreased from $573.7 million to $389.6 million.

Relative to Q1, venture activity posted a slight recovery with the number of deals increasing 6% to 3,855, aggregate deal value increased 10% to $70.7 billion, and average deal size increased 2% to $26.7 million. Exit activity was mixed in Q2 as the number of exits increased 17% to 368, the aggregate exit value decrease 4% to $40.9 billion, and the average exit size decreased 32% to $237.9 million.

During the quarter, our private equity managers called a combined $19.3 million and paid distributions of $18.6 million. Our current allocation to private equity is 10.7%, with a market value of $454.1 million. From its 2003 inception through March 31, 2020, the total private equity program (including fund-of-funds) has generated a net internal rate of return of 11.6% versus an 11.3% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps). The direct private equity program, which began in 2009, has generated a 21.1% return versus 11.6% for the benchmark.

Hedge Funds: For the quarter, hedge funds advanced 7.9% based on the Composite Index. On a sub-strategy basis, the Event-Driven Index advanced 10.3%, the Relative Value Index gained 6.3%, the Macro Index gained 1.0%, and the Equity Hedge Index gained 13.1%. The System's diversifying hedge fund portfolio recorded a gain of 3.5% versus a gain of 5.6% for the Conservative Index. The diversifying underperformance is primarily attributable to manager selection within the event driven and multi-strategy sectors. The System's directional hedge fund portfolio recorded a gain of 9.9% compared to the 11.0% return for the Strategic Index. The directional underperformance is primarily attributable to the System's underweight to equity long/short and event driven strategies and manager selection within the event driven sector.

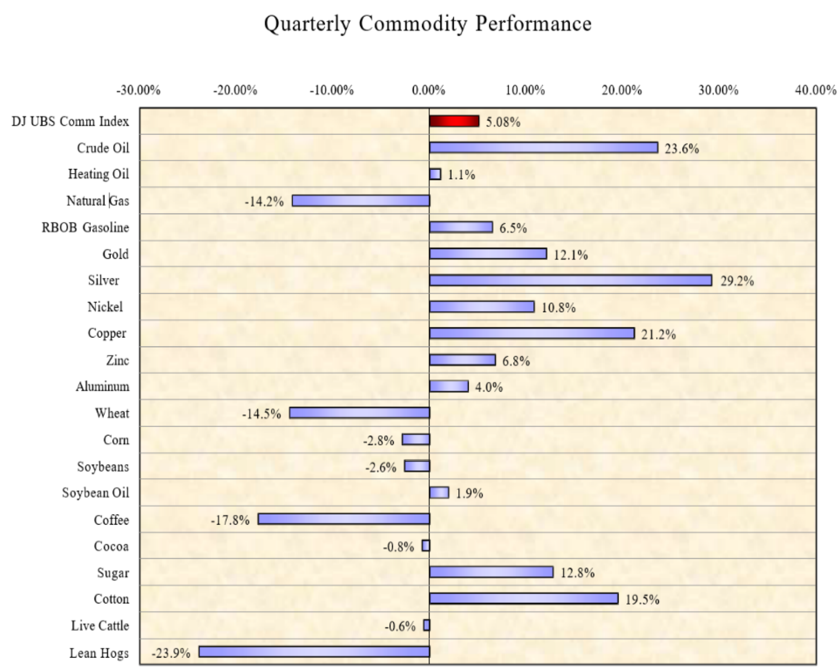
Fixed Income: The yield curve steepened slightly as shorter maturity bond yields moved lower while the 30-year Treasury yields moved higher. The yield on the 30-year bond advanced by 9 bps during the quarter and ended the period at 1.4%. The spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, steepened by 8 bps to 50 bps, as yields on the 2-year maturities fell. For the quarter, the 2-year Treasury yield ended lower by 9 bps to 0.2%, while the 10-year Treasury yield was around flat at 0.7%. The high yield portfolio's performance for the quarter was a gain of 10.7%, outperforming the Merrill Lynch High Yield II Constrained Index by 113 bps. The long duration portfolio's return for the quarter was a gain of 6.8%, outperforming the Barclays Long Govt/Credit Index by 57 bps. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, recorded a gain of 12.5%, outperforming the custom benchmark by 148 bps.



Private Debt: Private debt fundraising rallied in Q2 following reduced activity in the first quarter. Capital raised was slightly higher than in Q1, with 49 funds closing for an aggregate of $34 billion, which was slightly lower than the $55 billion in Q2 2019. The majority of private debt funds closed in Q2 were focused on opportunities in North America. Although direct lending funds were the dominant strategy in terms of the number of funds closed, special situation funds raised the most capital. Five special situation funds that were closed raised $12 billion in aggregate capital while 20 direct lending funds closed to raise $9 billion. Overall, the number of private debt funds in market has grown to a new record high (486 vehicles seeking $239 billion in aggregated capital) over the last five years with the aggregate capital targeted doubling since January 2015. The largest funds that aim to secure more than $1 billion account for 65% of total capital targeted due to investor undertake a flight to safety to larger, more established managers in this uncertain market. Direct lending strategies hold $314 billion as of December 2019, of which $95 billion is dry powder. Meanwhile, distressed debt AUM reached $216 billion, up from $198 billion in December 2018, with dry powder falling by $6.9 billion on Q1 2020, indicating that fund managers are deploying capital within the strategy. During the quarter, our private debt managers called a combined $11 million and paid distributions of $1.6 million. Our current allocation to private debt is 2.4%, with a market value of $100.3 million. From 2013 through March 31, 2020, the private debt program generated a net internal rate of return of 7.6% versus a 3.7% return for the dollar-weighted public market equivalent benchmark (ICE BofA Merrill Lynch High Yield Master II Constrained + 300 bps).

Private Real Assets: Despite a decline in the number of private real estate funds that closed in Q2 2020 vs. Q1 2020, aggregate capital raised increased from $28 to $39 billion. Even in a highly uncertain and volatile macro environment, over two-thirds of all private real estate funds that closed during the first half of the year met or exceeded their initial fundraising target. Investors in this space also appear to be more willing to move away from core real estate, as opportunistic funds accounted for $22 billion of the total capital raised during the quarter. In the natural resources sector, fundraising during the quarter slowed considerably from Q1 2020 due to sharply reduced demand for commodities such as raw materials and oil, as economies around the world were shut down. Just 15 funds closed an aggregate of $8.5 billion during the quarter – both record lows for the sector. Like the prior quarter, fundraising was highly concentrated, as Blackstone Global Energy & Power Infrastructure Fund III, was responsible for raising 60% of the Q2 2020 capital. During the quarter, our private real asset managers called a combined $8.4 million and paid distributions of $2.4 million. Our current allocation to private real assets is 5.9%, with a market value of $252.2 million. From its 2006 inception through December 31, 2019, the total private real assets program (including fund-of-funds) has generated a net internal rate of return of 5.5% versus a 6.8% gain for the long-term benchmark CPI plus 500 bps. From 2008, when we began investing in direct funds, the private real assets program has generated a 9.5% return versus 6.8% for the benchmark.

Public Real Assets: Following one of the worst performing quarters in history, the Bloomberg Commodity Index returned 5.1% for the quarter due to an improving demand outlook across most the commodity sectors and more favorable supply dynamics. Energy, industrial metals, and precious metals posted gains for the quarter while the agriculture and livestock sectors struggled. After the price of crude briefly traded in negative territory in April, the commodity rebounded later in the quarter due to improving demand and historic production cuts across the globe. Industrial metals delivered strong gains due to supply disruptions and a brighter demand outlook, particularly for copper. Precious metals also delivered double-digit gains in the quarter led by a nearly 30% return in silver and another strong quarter from gold. Despite solid returns from cotton and sugar, the agriculture and livestock sector posted losses due to weakness in wheat, coffee, and lean hogs.



Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index increased by 10.1% in Q1 as risk appetite improved, global economic activity strengthened, and economic data surprised to the upside. A continued concern about rent collection, sustained levels of social distancing and remote work, and uncertainty around fiscal aid meant that REITs underperformed global equities. From a regional perspective, North America led the index due to better-than-expected retail sales and employment reports. Europe lagged their North American counterparts due to further uncertainty over Brexit and weakness in the office sector, which is a large component of the REIT space in Switzerland, France, Austria, and Norway. The retail sector rebounded globally, particularly within the U.S. and Australia. Office REITs continued to struggle as market participants seek to assess the level of permanence of the trend towards remote work. Logistics REITs continued their climb as e-commerce demand showed no signs of abating in Q2.

Listed infrastructure increased by 11.6% for the quarter as measured by the Dow Jones Brookfield Global Infrastructure Index. Returns were quite bifurcated during the quarter as the sectors heavily impacted by COVID-19 demand destruction rebounded following a horrible first quarter, with energy infrastructure, toll roads, and airports posting returns above 20%. Despite a strong earnings season, utilities were the notable laggard in Q2 primarily due to technical factors, particularly the market's shift away from defensive sectors into cyclical ones. There was limited regional dispersion in Q2 as Europe, Asia, and the Americas each returned between 10 and 12%.

For the quarter, the public real asset portfolio returned 9.9%, outperforming the custom benchmark gain of 9.0% by 91 bps due to outperformance across our commodities and global REIT managers. Our global listed infrastructure manager underperformed for the quarter.

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 June 30, 2020 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	6/30/2020	YTD
Employer Contributions	$ 21.5	$ 87.2
Member Contributions	7.6	30.8
Net Investment Income	436.6	168.7
	$ 465.7	$ 286.7

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 6/30/2020	Fiscal YTD
Benefits	$ 64.9	$ 262.0
Refunds	0.8	9.4
Administrative Expenses	0.7	3.1
	$ 66.4	$ 274.5

Outlook

During the second quarter of 2020, the global economy experienced one of the largest contractions in GDP in recorded history. In response to this, governments implemented aggressive fiscal and monetary policies which helped ease some of these economic hardships. The U.S. Federal Reserve continued to provide fiscal support to the economy by maintaining the Federal Funds rate between 0% - 0.25% and continuing with its program of quantitative easing. Combined, these policies are designed to combat the sharp decline in demand as a result of the COVID-19 outbreak while providing liquidity into the market to ensure its normal functioning. Thus far, fiscal support through the CARES Act and other packages have amounted to roughly 12% of U.S. GDP. Policymakers in Brussels achieved unanimous approval on a €750 billion stimulus package to help support an economic recovery within the European Union. Meanwhile, Japan has provided some of the most aggressive stimulus packages in the world, with spending representing approximately 42% of GDP. The IMF now expects 2020 global GDP to fall -4.9%, followed by a +5.4% recovery in 2021.

Moving forward into Q3, discussions around the economic outlook are likely to revolve around several different topics including, but not limited to, the ability and willingness of governments to provide further accommodation, the level of future unemployment, the financial health of the consumer and their willingness to consume, the level of inflation, and the risk of a second wave of COVID-19 infections.

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

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF FIDUCIARY NET POSITION

June 30, 2020

Assets		
Equity in pooled cash and investments	$	2,492,344
Investments:		
Northern Trust		4,320,962,325
Aetna		699,417
Fidelity - Elected Officials Plan		456,016
Fidelity - DRSP/DROP		10,909,823
Total investments		4,333,027,581
Contributions receivable		7,963,530
Total assets		4,343,483,455
Liabilities		
Benefits payable and other liabilities		14,682,446
Net position restricted for pensions	**$**	**4,328,801,009**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION

For the Quarter Ended June 30, 2020

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 21,486,234	$ 87,191,530
Member	7,629,259	30,781,032
Total contributions	29,115,493	117,972,562
Investment Income	443,166,872	189,352,019
Less investment expenses	6,556,882	20,677,235
Net investment Income	436,609,990	168,674,784
Total income	465,725,483	286,647,346
Deductions		
Retiree benefits	48,784,269	197,278,602
Disability benefits	13,528,145	54,100,956
Survivor benefits	2,588,041	10,625,975
Refunds	834,264	9,417,879
Administrative expenses	725,231	3,059,212
Total deductions	66,459,950	274,482,624
Net Income	**399,265,533**	**12,164,722**
Net position restricted for pensions		
Beginning of period	**3,929,535,476**	**4,316,636,287**
End of period	**$ 4,328,801,009**	**$ 4,328,801,009**