OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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Chief Administrative Officer

March 4, 2016

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 December 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 5,541 ERS and GRIP active members and 6,380 retirees participating in the ERS as of June 30, 2015.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 1.09%, 49 basis points behind the 1.58% gain recorded by the policy benchmark. For the one-year period ending December 31, 2015 the ERS' gross return (before fees) was a loss of 0.71%, 122 basis points ahead of the 1.93% loss recorded by the policy benchmark. The one-year gross return places the ERS' performance in the fourth quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 6.42% for the three-year period and 7.71% for the five-year period ranked at the fourth and second quartile of the universes, respectively. The asset allocation at December 31, 2015 was: Domestic Equities 19.6%, International Equities 15.9%, Global Equities 3.5%, Fixed Income 23.9%, Inflation Linked Bonds 10.6%, Commodities 2.5%, Private Equity 6.9%, Private Real Assets 5.5%, Private Debt 0.4%, REITS 5.7%, Opportunistic 3.6%, MLPs 0.7%, and Cash 1.1%. We estimate that the funded status of the ERS was 90% as of December 31, 2015. 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.

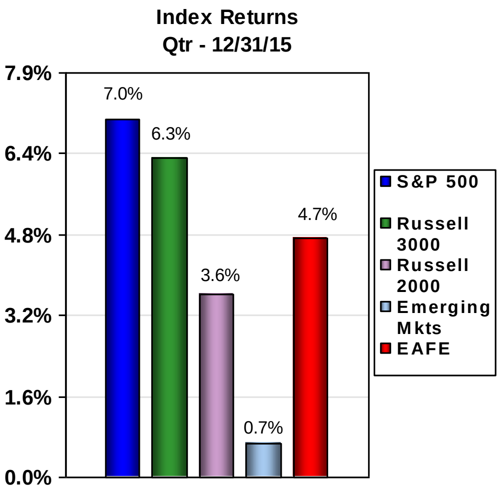
Major Initiatives

During the quarter, the following commitments were made: $17 million to JFL Equity Investors IV, LP, a special situations private equity fund, and $10 million to Scopia PX LLC, an equity long/short hedge fund.

Capital Markets and Economic Conditions

Economic data showed that the GDP increased at a 0.7% annual rate in the fourth quarter, a decline of approximately 130bps from the economy's third quarter expansion of 2.0%. This reading puts 2015 GDP at 2.4%, which was the same level of growth experienced in 2014. The slowing rate of economic growth can be attributed to a decrease in business capital investment, a cooling of consumer spending, and a decrease in net exports due to the strength of the dollar. Despite a slowdown in consumer spending in Q4, household finances remain in solid shape with debt service ratios hovering near all-time lows and household net worth increasing to all-time highs. The residential real estate sector of the economy continues to improve with home prices and new housing starts increasing to levels not seen since before the global financial crisis. The economy added over 800,000 jobs during the fourth quarter and saw the unemployment rate fall to 5.0%, its lowest level since 2008. Inflation continues to be muted as CPI posted a modest 0.7% growth rate during the quarter due to declining energy prices. Core CPI, which excludes food and energy, has seen a modest uptick to 2.1% due primarily to increases in the costs of rent, medical care, and education.

Public Equity Markets: U.S. stocks advanced during the quarter despite the steep decline of the markets in December. Strong economic reports related to employment growth and housing indicated that the U.S. economy continued to move forward with economic growth. Larger cap stocks outperformed smaller cap stocks, while value lagged growth. All the ten sectors of the S&P 500 Index advanced with Materials, Healthcare, and IT performing the best. Energy was the weakest sector posting a 0.20% return. Our combined domestic equity performance was a gain of 7.10%, outperforming the 6.27% gain recorded by the Russell 3000 benchmark.

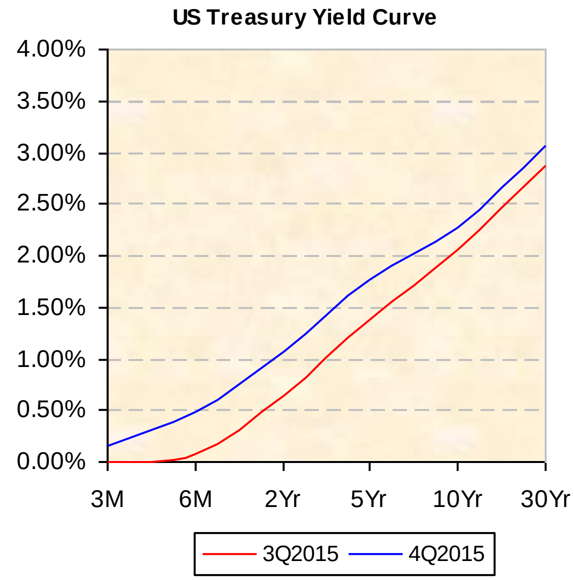


Within the international markets, investors welcomed the economic recovery in Europe and the European Central Bank's accommodative monetary policy during the quarter. Emerging markets were impacted by the economic slowdown in China, the ongoing weakness in commodity prices, and the strong U.S. dollar. The majority of the emerging markets were down during the quarter with commodity price sensitive regions such as Russia, Brazil, and the Middle East markets declining the most. During the quarter, developed markets, as measured by the MSCI EAFE Index, were up 4.71, while Emerging Markets posted a 0.66% return. Our combined international equity performance was a gain of 4.95% for the quarter, outperforming the 3.31% gain recorded by the MSCI ACWI ex-US Index. Global equities recorded a gain of 2.36%, underperforming the 5.03% gain of the MSCI ACWI benchmark.

Private Equity: Buyout funds raised $107 billion in 2015, which was in line with the prior year's fund raising. Buyout investment activity slowed in 2015, as the $41 billion invested during the year represents a 25% decline versus last year. Pricing multiples continued to expand from 9.3x in 2014 to 9.9x presently, while leverage multiples have dropped slightly from their peak in 2014. Within venture capital, investment activity was in line with last year while invested capital increased to $56 billion, which was 19% higher than 2014. Exit activity (primarily through IPOs and M&A transactions) in U.S. buyout and venture markets slowed versus the very active 2014. During the quarter, our private equity managers called a combined $15.9 million and paid distributions of $16.4 million. Our current allocation to private equity is 6.9%, with a market value of $238.4 million. From its 2003 inception through June 30, 2015, the private equity program has generated a net internal rate of return of 9.1% versus a 12.0% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps). The direct private equity program generated a 15.8% return versus the 18.8% for the benchmark since inception (2009).

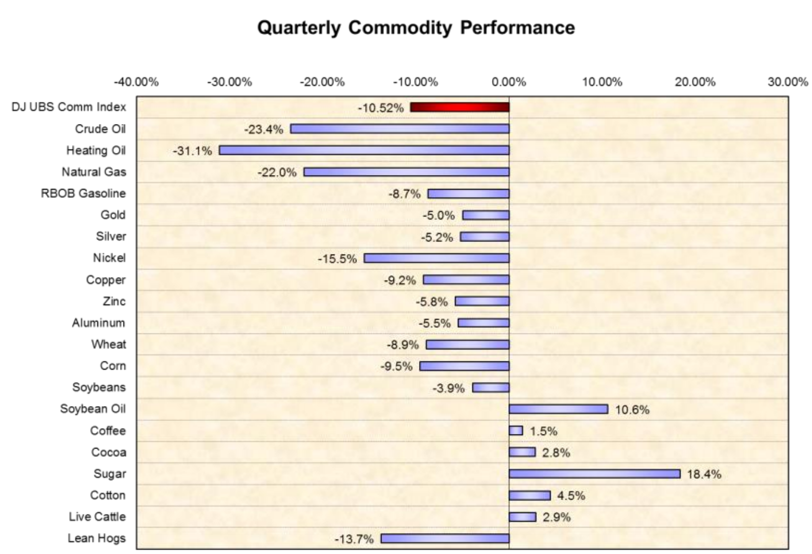
Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 0.72% in the fourth quarter. High beta strategies performed strongly augmented by positive equity performance earlier in the quarter. The HFRI All Equity Hedge Index was up by 2.27%. The HFRI Distressed was the worst performing index, which declined 3.58% during the quarter primarily due to a decline in credit, primarily from the energy related sector. The opportunistic portfolio lost 2.85% in the fourth quarter, underperforming the HFRI Fund of Funds Index by 351 basis points.

Fixed Income: U.S. Treasury yields rose across the board during the quarter, as the Fed voted to increase the Federal Funds Rate by 25 bps for the first time since 2006 during their December FOMC meeting. The Fed expects that further interest rate hikes will be gradual in nature and highly dependent on whether future economic data points continue to support an environment of modest monetary tightening. The yield on the 30-year bond increased 20 bps during the quarter, and ended the period at 3.07%. 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, tightened by 21 bps to 121 bps. For the quarter, the 2-year Treasury yield ended at 1.06%, up by 42 bps from the prior period, while the 10-year Treasury yield moved up by 21 bps to 2.27%. For the quarter, the Merrill High Yield Index declined by 2.16%, the Barclays Aggregate was down 0.57%, and the Barclays Long Govt/Credit Index fell by 0.94% as the long end of the yield curve rose slightly. The fixed income performance for the quarter was a loss of 1.44% slightly underperforming the custom benchmark's loss of 1.39%. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, returned a negative 1.48% for the quarter, underperforming the benchmark's 0.28% gain.



Private Real Assets: U.S. real estate values continued to rise during Q4'2015 increasing by approximately 3% during the quarter according to the NCREIF Property Index. The increase in valuations was led by the retail sector which rose by 3.5% although all underlying sub-sectors (office, multi-family, hospitality, retail and industrial) were positive during the quarter. In the energy markets, U.S. oil prices decreased by over 15% during Q4'15 from approximately $45 to $37/barrel as market participants continue to be concerned about the oversupplied nature of the global oil markets. As a result, the oil directed rig count in the U.S. fell to approximately 535 as of 12/31/15, its lowest level since the middle of 2010 and 65% below the peak level witnessed in 2014. During the quarter, our private real assets managers called a combined $24.3 million and paid distributions of $13.9 million. Our current allocation to private real assets is 5.5%, with a market value of $192.2 million. From its 2006 inception through March 31, 2015, the private real assets program has generated a net internal rate of return of 3.7% versus a 6.6% gain for the long-term benchmark CPI plus 500 bps.

Public Real Assets: Commodities saw continued volatility throughout the fourth quarter, with the Bloomberg Commodity Index down 10.5%, led by the energy sector. Crude oil prices experienced sharp declines following OPEC's decision in early December to maintain production levels in light of the oversupplied market – Saudi Arabia and Iraq are producing 1 million barrels per day more than what they were producing a year ago. Natural gas and heating oil prices also experienced significant declines due to a historically warm start to the winter heating season. The agriculture and livestock sector held up better than the broad commodity index over the fourth quarter with several individual commodities posting positive returns. Industrial metals fell across the board on concerns that China's economic slowdown may be deepening and global demand for industrial metals



worsening. Continued US dollar strength and US economic stability weighed on precious metal prices, yet they outperformed the broad commodity index for the quarter.

Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index advanced 4.19% for the quarter as real estate fundamentals have remained strong and insulated from the steep commodity price declines. US REITs gained over 7% for the quarter and was the top performing country, while the strength of the US dollar continued to be a drag on international real estate equity returns in US dollar terms.

Master Limited Partnerships (MLPs), as measured by the Alerian MLP Total Return Index, declined 2.76% during the quarter as selling pressure in the asset class continues to drive the cost of equity capital higher which makes it more challenging for MLPs to fund their capital growth projects. Further, the severe oil and natural gas price declines are creating a high degree of uncertainty regarding the prospects for the US energy sector.

For the quarter, the public real asset portfolio declined 1.78%, underperforming the custom benchmark decline by 45 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 December 31, 2015 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 12/31/2015	Fiscal YTD
Employer Contributions	$ 34.9	$ 70.1
Member Contributions	5.9	12.0
Net Investment Gain/(Loss)	32.9	(133.3)
	$ 73.7	$ (51.2)

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 12/31/2015	Fiscal YTD
Benefits	$ 58.0	$ 116.0
Refunds	1.8	3.6
Administrative Expenses	0.7	1.5
	$ 60.5	$ 121.1

Outlook

After years of speculation, the Federal Reserve finally announced the first interest rate hike in December, which represents the first increase in the Federal Funds Rate since 2006. Many investors believed that the Fed would postpone a rate hike until 2016 given weak global growth, a strong dollar, and tepid inflation. The market now seems to be focused on the pace of Fed tightening with consensus view that the Fed will proceed slowly and gradually back to more normalized levels. Fed president Janet Yellen has stated that the Fed will need to see stronger evidence of upward wage and price pressures before recommending another rate increase. In addition to the Fed's December tightening announcement, the European Central Bank announced a further cut to its benchmark rate, meaning that the Fed and ECB now have divergent monetary policies.

The rate of global growth declined slightly in 2015, due primarily to a continued softening in China, the impact of the precipitous drop in energy prices on commodity producing countries, and the inability of the United States and European Union to see growth materially increase. While a significant portion of global growth has been generated by the U.S. in recent years, there is an opportunity for Europe and emerging markets to start to shoulder some of the burden given these regions weaker currencies and more accommodative monetary policies. Overall, the economic impact of low oil prices has been mixed but it is likely that the effects will be felt much more intensely in 2016 as market participants adjust to the likelihood of a "lower for longer" energy price outlook. Given that the five largest economies in the world are net energy importers, this should have a positive impact on global growth and corporate performance.

The domestic economy is likely to continue to grow at a moderate pace into next year as the positive backdrop for the consumer should outweigh the headwinds on the manufacturing front. Given that consumer spending makes up approximately two-thirds of U.S. economic activity, improvements to the labor market, gains in the housing market, and benefits from lower energy costs should more than offset any weakness in the manufacturing and energy sectors.

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, U.S. Bureau of Labor Statistics.

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

Assets		
Equity in pooled cash and investments	$	374,269
Investments:		
Northern Trust		3,479,167,543
Aetna		1,000,774
Fidelity - Elected Officials Plan		488,733
Fidelity - DRSP		3,932,223
Fidelity - DROP		342,219
Total investments		3,484,931,492
Contributions receivable		8,627,171
Capital assets		900,043
Less depreciation		(450,021)
Net capital assets		450,022
Total assets		3,494,382,954
Liabilities		
Benefits payable and other liabilities		5,069,194
Net position restricted for pensions	**$**	**3,489,313,760**

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

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 34,947,648	$ 70,133,892
Member	5,854,957	11,972,446
Total contributions	40,802,605	82,106,338
Investment income/loss	37,202,553	(124,825,458)
Less investment expenses	4,340,414	8,452,815
Net investment income/loss	32,862,139	(133,278,273)
Total additions/deletions	73,664,744	(51,171,935)
Deductions		
Retiree benefits	43,178,974	86,398,041
Disability benefits	12,557,438	25,098,216
Survivor benefits	2,245,301	4,524,774
Refunds	1,776,838	3,631,613
Administrative expenses	750,265	1,522,905
Total deductions	60,508,816	121,175,549
Net increase/decrease	**13,155,928**	**(172,347,484)**
Net position restricted for pensions		
Beginning of period	**3,476,157,832**	**3,661,661,244**
End of period	**$ 3,489,313,760**	**$ 3,489,313,760**