



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

March 21, 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 December 31, 2013. 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 5,420 active members and 5,695 retirees participating in the ERS as of December 31, 2013.

Performance Results

The total return achieved by the ERS assets for the quarter was a return of 3.73%, 39 basis points ahead of the 3.34% return recorded by the policy benchmark. For the one year period ending December 31, 2013 the ERS' gross return (before fees) was a gain of 11.92%, 287 basis points ahead of the 9.05% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the bottom 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. Our annualized performance of 10.43% for the three-year period ranked just below the top quartile and 13.34% for the five-year period ranked in the top quartile of the universe. The asset allocation at December 31, 2013 was: Domestic Equities 19.8%, International Equities 17.0%, Global Equities 4.0%, Fixed Income 23.1%, Inflation Linked Bonds 9.3%, Commodities 5.5%, Private Equity 6.9%, Private Real Assets 5.1%, REITS 4.0%, Opportunistic 3.3%, and Cash 2.0%. We estimate that the funded status of the ERS was 82.2% as of December 31, 2013, a 3.4% 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

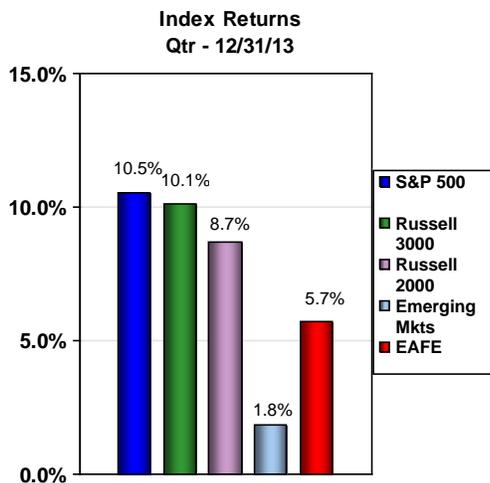
During the quarter, the Board made a commitment of \$10,000,000 in Odyssey Investment Partners Fund V and \$8,000,000 in Atlas Capital Resources Fund II, both within the private equity sector. In addition, Staff conducted meetings with several investment managers, including emerging managers, to discuss their market outlook, investment process and various strategies. Staff continues to review opportunities within the private real assets, private equity and opportunistic allocations.

Capital Markets and Economic Conditions

The U.S. economy continued to show promising signs of moving towards normalization, as GDP expanded at a 4.1% real annualized rate during the third quarter of 2013, as opposed to a more modest real annualized increase of 2.5% reported in June. The increase in GDP was driven primarily by higher business spending and larger personal consumer consumption, partially offset by a continued tightening

in the Federal government’s budget. Employers added just 74,000 jobs in December, well below the 197,000 average that economists expected. Even considering the disappointing December jobs data, the unemployment rate continued its fall to 6.7%; however, the labor force participation rate is the lowest it has been in more than three decades as millions of Americans continue to willingly leave the labor market. Inflation still remains relatively low and below the Fed’s target of maintaining a consistent 2% annual rate. The Consumer Price Index (CPI) rose by just 1.5% during the 2013 calendar year, allowing the Fed the ability to keep the current Federal Funds Rate near historic lows. The S&P/Case-Shiller U.S. National Home Price Index rose 3.2% during the third quarter, as the housing recovery continues to move forward. The proportion of homes in foreclosure is declining as consumers are becoming more financially stable, however, new home construction remains well below its peak prior to the financial crisis and interest rates are expected to normalize in the long run which could put downward pressure on existing housing sales.

Public Equity Markets: U.S. equities continued to rally during the quarter on the strong global economic outlook and the Fed’s measured reduction of monetary stimulus, which bolstered investor confidence. The S&P 500 Index had its best year since 1997. Larger capitalization stocks (as represented by the

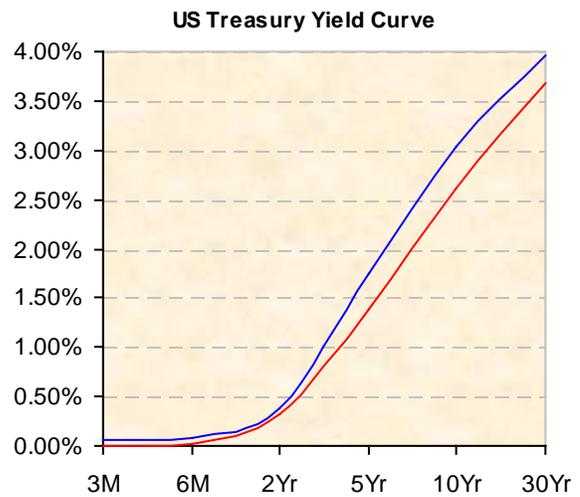


S&P 500 Index) outperformed their smaller counterparts. All of the ten sectors of the S&P 500 Index were up with Industrials and IT performing the best. Our combined domestic equity performance was a gain of 9.71%, underperforming the 10.10% gain recorded by the Russell 3000 benchmark.

International markets continued to advance on stronger economic data and accommodative monetary policy from central banks around the globe. European stocks rallied, with the Stoxx Europe 600 Index posting its biggest annual gain since 2009. Within the Asia-Pacific region, Hong Kong and Japan performed well, while Australia and New Zealand lagged. Emerging markets trailed their developed counterparts with currency moves impacting performance during the quarter. India benefited from the appreciation of the rupee and Brazil declined due to the weakness in the real. During the quarter, developed markets, as measured by

the MSCI EAFE Index, posted a 5.71% return led by the markets of Germany, Finland, and Spain. Emerging Markets advanced 1.83%, with Egypt, India, and Greece posting double digit returns. Our combined international equity was up 5.50% for the quarter, outperforming the 4.77% gain recorded by the MSCI ACWI ex-US Index.

Fixed Income: Treasuries started the quarter off positively as a Government shutdown threatened to slow the pace of the recovery, reducing worries about an early end to quantitative easing and higher interest rates. However, yields moved higher after a budget deal was approved by Congress and the Fed announcement, in mid-December, to begin tapering its monthly bond buying by \$10 billion in January. Federal Reserve Chairman Bernanke eased investor fears by stressing that short term rates would remain low for an extended period and that the pace of tapering would be data driven and flexible. The yield curve steepened (shown in the chart to the right) as the spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, widened by 36 bps to 265 bps. For the quarter, the 2-year Treasury yield ended at 0.38%, up 6 bps, while the 10-year Treasury yield increased by 42 bps to 3.03%, the highest level since July 2011 and 125 bps higher than at the start of the year. Investors, seeking higher yields moved into corporate bonds resulting in credit spread tightening. For the quarter, the Merrill High Yield Index returned 3.49%, the Barclays Aggregate declined 14 bps and the Barclays



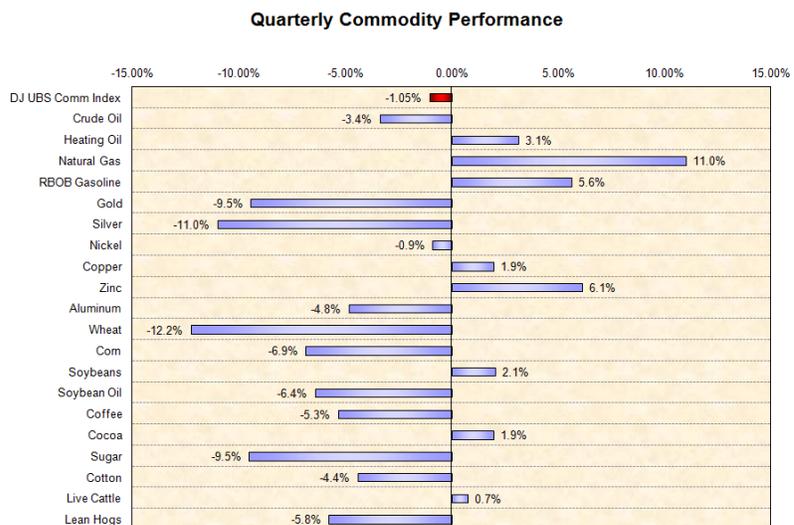
Long Govt/Credit Index declined 10 bps. Our combined fixed income performance for the quarter was a gain of 1.83%, outperforming the custom benchmark's 1.15% return. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, declined 2.35% for the quarter, outperforming the 3.00% decline recorded by the benchmark.

Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 3.7% in the fourth quarter and returned 9.3% for the year. Equity Hedge and Event Driven were the best performing strategies. The HFRI Equity Hedge Index gained 5.0% in quarter. Performance was led by long biased equity hedge fund strategies that benefitted from the equity markets rally during the quarter. The HFRI Event Driven Index returned 3.8% for the quarter and 12.5% for the year driven by increased M&A (merger & acquisition) activity and corporate restructurings. The HFRI Macro Index returned 1.98% in the quarter and but posted a 27 bps decline in 2013, the third consecutive year of declines. Macro managers struggled with central bank driven monetary and fiscal policies and sharp reversals in certain currencies and commodities. Fund-of-Hedge Funds returns, as measured by the HFRI Fund-of-Funds Index, returned 3.53% in the quarter and 8.79% for the year. Our opportunistic portfolio returned 3.38%, net of management fees, in the fourth quarter, underperforming the HFRI Fund-of-Funds benchmark by 15 bps. For the year, the portfolio returned 10.82%, outperforming the benchmark by 203bps.

Private Equity: The number of new platform deals purchased by private equity firms declined in 2013 compared to the prior year with private equity companies choosing to make add-on acquisitions onto existing platform companies. Strong PE fundraising, a favorable borrowing environment, and difficult deal sourcing have contributed to surging valuations for new platform deals. Initial Public Offerings (IPOs) have become an increasingly popular private equity exit strategy this past year, placing 2013 as the best year for IPOs since 2006. During the quarter, our private equity managers called a combined \$5.8 million and paid distributions of \$18.3 million. Our current allocation to private equity is 6.9%, with a market value of \$235.5 million. From its 2003 inception through June 30, 2013, the private equity program has generated a net internal rate of return of 6.8% versus a 10.0% 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. continues to be strong, increasing 24% quarter-over-quarter and up 19% compared to 2012 levels. The office and multi-family sectors continue to command the lowest capitalization rates across the U.S. as investors focused on properties in major markets and the homeownership rate remains well below the 2006 peak levels. In the energy markets, the U.S. continues to increase its production of both oil and natural gas, up 40% and 15%, respectively, since 2008, largely due to the onshore drilling programs of industry participants. During the quarter, our managers called a total of \$2.2 million and paid distributions of \$15.8 million. Our current allocation to private real assets is 5.1%, with a market value of \$171.9 million. From its 2006 inception through June 30, 2013, the private real assets program has been flat (0.00%) versus a 6.9% gain for the long-term benchmark CPI plus 500 basis points. The underperformance versus the benchmark is partially attributable to the young age of the portfolio, with an average maturity of less than four years.

Commodities: The Dow Jones-UBS Commodity Index declined 1.05% during the quarter due to all but the energy and metals sectors posting losses. The energy sector rallied by a boost of natural gas demand on cold weather expectations, along with higher gasoline/heating oil prices due to stronger than expected demand and declining inventory levels. Precious metals fell as the improving global economy cut demand for wealth protection. Furthermore, the announcement of tapering easy monetary policy starting in 2014 eased inflation concerns also



QUARTERLY REPORT

impacting demand. Results in agriculture and livestock were weak due to other robust harvests in the U.S. (corn), India (wheat), and Brazil (sugar) boosting oversupply. During the quarter, our commodities portfolio declined 1.99%, 94bps behind the DJ UBS Commodities Index.

REITs: During the fourth quarter, property news was characterized by stable to positive earnings releases from listed property companies, improving property fundamentals, and an active transactions market. However, news of the Federal Reserve's tapering drove up interest rates during the quarter and put pressure on global real estate security prices. Global REITs, as measured by the FTSE EPRA/NAREIT Developed Index, declined 66 bps for the quarter, while our global REIT portfolio returned 44 bps, 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 December 31, 2013 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr 12/31/2013	Fiscal YTD
Employer Contributions	\$ 36.5	\$ 72.1
Member Contributions	7.2	13.6
Net Investment Income	117.4	255.6
	<u>\$ 161.1</u>	<u>\$ 341.3</u>

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 12/31/2013	Fiscal YTD
Benefits	\$ 56.8	\$ 114.8
Refunds	2.1	2.3
Administrative Expenses	0.7	1.2
	<u>\$ 59.6</u>	<u>\$ 118.3</u>

Outlook

The U.S. economy continues to show promising signs of moving towards normalization in the post-financial crisis era. Inflation remains relatively tame in the face of the Federal Reserve's aggressive monetary policies, and GDP growth is expected to maintain its pace of modest acceleration as we move into the New Year. Business spending is expected to pick up as firms take advantage of strong balance sheets to obtain attractive financing to fund capital expenditures. Household consumption, one of the largest drivers of GDP, is also showing signs of improvement as consumers continue to contribute to the pace of recovery in terms of spending. Housing prices finished out the year strongly, although growth is likely to slow to a more realistic pace rather than continuing to accelerate due in part to the expected rising of interest rates.

Due to a stabilizing U.S. economy, the Federal Reserve formally announced plans to begin tapering quantitative easing (QE) at their most recent FROMC meeting in December. According to the Fed, there

will be a \$10 billion reduction in monthly asset purchases set to commence in January 2014. While no commitment to additional tapering beyond January was released, many economists believe that the Fed is now on a scheduled taper unless economic conditions significantly suggest otherwise. This suggests that QE could now be over before the end of 2014. Although QE may be in its infant stages of winding down, Fed statements imply that the Federal Funds Target rate will likely remain held close to zero even after unemployment declines past its target rate. Janet Yellen, the new Fed chair, took over responsibilities on February 1, 2014, and it is widely expected that Ms. Yellen will continue former chairman Ben Bernanke's policies to support economic expansion.

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**

December 31, 2013

Assets

Equity in pooled cash and investments	\$ 689,959
Investments:	
Northern Trust	3,394,153,331
Aetna	1,118,510
Fidelity - Elected Officials Plan	394,508
Fidelity - DRSP/DROP	8,588,109
	<u>3,404,254,458</u>
Total investments	<u>3,404,254,458</u>
Contributions receivable	<u>8,142,645</u>
Total assets	<u>3,413,087,062</u>

Liabilities

Benefits payable and other liabilities	<u>5,805,707</u>
Net position restricted for pensions	<u>\$ 3,407,281,355</u>

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET POSITION
 December 31, 2013

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 36,565,803	\$ 72,121,545
Member	<u>7,180,182</u>	<u>13,627,624</u>
Total contributions	<u>43,745,985</u>	<u>85,749,169</u>
Investment income	121,764,425	264,417,995
Less investment expenses	<u>4,391,392</u>	<u>8,821,021</u>
Net investment income	<u>117,373,033</u>	<u>255,596,974</u>
Total additions	<u>161,119,018</u>	<u>341,346,143</u>
Deductions		
Retiree benefits	42,604,424	86,445,153
Disability benefits	12,133,239	24,097,357
Survivor benefits	2,117,903	4,258,063
Refunds	2,100,499	2,311,218
Administrative expenses	<u>691,120</u>	<u>1,198,208</u>
Total deductions	<u>59,647,185</u>	<u>118,309,999</u>
Net increase (decrease)	<u>101,471,833</u>	<u>223,036,144</u>
Net position restricted for pensions		
Beginning of period	<u>3,305,809,522</u>	<u>3,184,245,211</u>
End of period	<u>\$ 3,407,281,355</u>	<u>\$ 3,407,281,355</u>