OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
*County Executive*

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*Chief Administrative Officer*

September 20, 2018

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, 2018. 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 5,900 ERS and GRIP active members and 6,800 retirees participating in the ERS as of June 30, 2018..

***Performance Results***

The total return achieved by the ERS' assets for the quarter was a gain of 1.88%, 36 basis points ahead of the 1.52% gain recorded by the policy benchmark. For the one-year period ending June 30, 2018 the ERS' gross return (before fees) was a gain of 9.07%, 213 basis points ahead of the 6.94% gain recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top third of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 7.61% for the three-year period and 8.57% for the five-year period ranked in the second quartile. The annualized return for the ten-year period was 7.53% and ranks in the top decile of Wilshire's Large Public Funds Universe. The asset allocation on June 30, 2018 was: Domestic Equities 18.4%, International Equities 14.3%, Global Equities 3.2%, Fixed Income 21.8%, Inflation Linked Bonds 12.2%, Public Real Assets 11.1%, Private Equity 8.3%, Private Real Assets 4.7%, Private Debt 1.3%, Opportunistic 3.1%, and Cash 1.6%. We estimate that the funded status of the ERS was 96.0% as of June 30, 2018. 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.

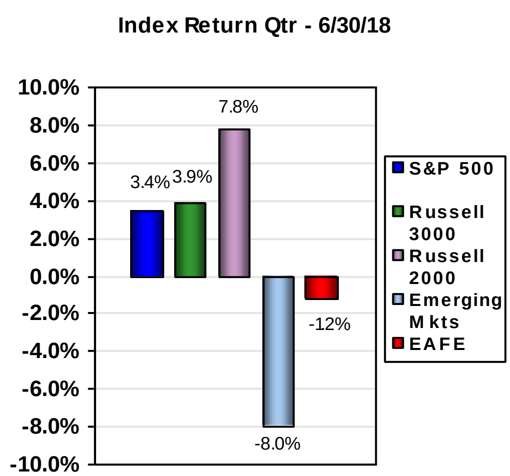
***Major Initiatives***

During the quarter, the following commitments were made: $10 million to Franklin Park Venture Fund Series 2018, LP, a private equity fund-of-funds, $10 million to Franklin Park International Fund, 2018 LP, a private equity fund-of-funds, $15 million to Center Rock Capital Partners I, LP, a private equity fund, $15 million to WNG Aircraft Opportunities Fund II, LP, a private debt fund, $19 million to Gryphon Partners V, LP, a private equity fund, and $18 million to FCP Realty Fund IV, LP, a private real estate fund.

***Capital Markets and Economic Conditions***

Economic data reflected that the GDP increased at an annualized rate of 4.1% in the second quarter of 2018, matching market expectations. This figure represents the highest level of GDP growth since the third quarter of 2014. GDP growth was broad based as consumer, business, and government spending all registered robust gains and exports rose in part due to soybean farmers rushing to beat the tariff deadline. Business investment grew 7.3% year-over-year, which many analysts believe is an effect of last year's corporate tax cut. The economy added 681,000 jobs during the quarter, an increase from Q1's 635,000 gain. The U.S. unemployment rate decreased to 4.0%, which is the lowest quarter-end reading since Q4 2000. Q2 inflation was in line with expectations as the CPI increased 2.9% year-over-year driven by increased fuel and healthcare costs. The last time inflation was above this level was December of 2011, when it reached 3.0%. The housing market experienced a blip in Q2 as new housing starts dropped 12% and permits declined for three straight months. The decline in new housing starts is primarily due to the labor shortage in the construction sector.

**Public Equity Markets:** Following a down market in Q1, the domestic equity market resumed its upward trajectory as markets were buoyed by strong economic and earnings data. Markets largely shrugged off U.S.-China trade fears as GDP, consumer confidence, retail sales, and unemployment reports indicated a rosy economic backdrop. As has been the case for much of this bull market, growth stocks outperformed value stocks and small cap stocks outperformed large cap stocks. While the S&P 500 delivered strong gains during Q2, dispersion was high as the financials, telecom, consumer staples and industrials sectors posted losses. The telecom and consumer staples struggled as interest rates continued to rise. The financial sector posted losses as investors expressed concern over the flattening yield curve, which compresses net interest margins. Finally, industrials underperformed primarily due to concerns about an escalation of tariff concerns with China. The top performing sectors for the quarter were energy, consumer discretionary, and technology. Energy stocks experienced double digit gains as equity prices finally started to catch up to the sharp rise in crude oil prices. Our combined domestic equity performance was a gain of 5.69%, outperforming the 3.89% gain of the Russell 3000 Index. The outperformance was driven by strong active management across the portfolio and an overweight to small cap.




Following two consecutive quarters of strong outperformance relative to developed markets, emerging markets sold off significantly in Q2 due to a sharp rally in the U.S. dollar and escalating trade tensions with the United States. Within developed markets, Europe outperformed Asia as the U.K. performed well in the absence of an interest rate hike. Japanese equities continued to rally in local currency terms but posted losses for the quarter in dollar terms given the dollar strength. Much like in the U.S. markets, the energy sector was the standout performer, posting double digit gains due to price increases across the energy sector. The other positive returning sectors in the index were technology, healthcare, materials, and consumer staples. Financials were the worst performing sector as political uncertainty surrounding Italian elections injected renewed fear into the European banking system. Emerging market equities struggled in Q2 as the four largest markets, Brazil, Russia, India, and China all experienced selloffs. The Brazilian equity market experienced sharp losses, dropping 26% due to further political uncertainty as none of the moderate candidates for the October's elections gained momentum in the polls. Corporate earnings in emerging markets continued to be strong but they generally unperformed analyst expectations. Our combined international equity performance was a loss of 2.80%, slightly underperforming the 2.61% loss recorded by the benchmark. Our global equity allocation recorded a gain of 1.04%, outperforming the 0.53% gain of the MSCI ACWI Index.

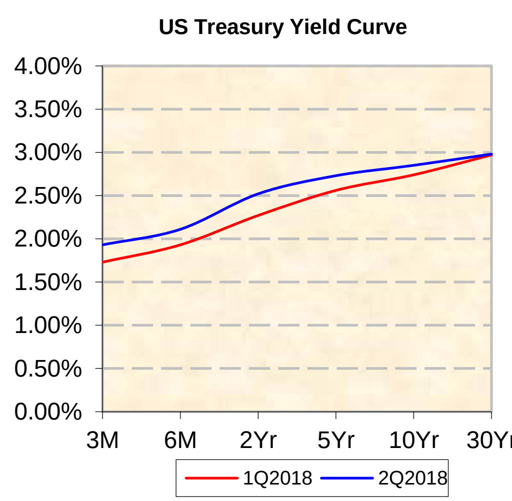
**Private Equity:** Fundraising continued to slow down in Q2 as 230 PE funds reached a final close, securing $85 billion in commitments; this represents the lowest amount of capital raised in the second quarter of any year since 2012. Capital continues to remain concentrated among the largest managers as the ten largest vehicles closed accounted for 40% of the capital secured by all GPs. Although fewer funds have reached a final close in 2018, of the 476 funds that have closed in the first half of 2018, 79% achieved their target size, the largest proportion for the past five years. More North American funds closed in Q2 2018 than in Q2 2017, but the capital raised accounted for just over half the amount compared to the prior year. The number of Asia-focused funds in the market has increased significantly over the past year, up from 380 to 985, a 159% increase. Globally both the number and aggregate value of deals declined from the previous quarter, however, aggregate deal value increased 12% relative to Q2 2017. North American deal value increased 3% compared to the prior quarter and accounted for three of the five largest buyout deals, led by KKR's acquisition of Envision Healthcare Corporation ($9.9 billion). Exit activity increased 14% relative to Q1 2018, consisting of 471 PE exits for an aggregate $103 billion and the high exit value levels seen since Q3 2015. Dry powder levels remain elevated, reaching a record $1.07 trillion, a 7% increase from Q2 2017.

Venture capital fundraising accounted for 26% of all private equity raised in Q2 2018, doubling its 13% proportion form Q2 2017. 3,648 venture capital financing were announced globally during the quarter, up 6% from Q1 2018 and 26% in Q2 2017. Venture deals saw a 50% increase in aggregate deal value over the past year, jumping from $49 billion in Q2 2017 to $73 billion in Q2 2018, the highest quarterly figure since 2007. North American venture capital deals accounted for 37% of all deals globally in Q2 2018, followed by China, which represent 31%.

During the quarter, our private equity managers called a combined $32.2 million and paid distributions of $31.7 million. Our current allocation to private equity is 8.26%, with a market value of $339.1 million. From its 2003 inception through December 31, 2017, the total private equity program (including fund-of-funds) has generated a net internal rate of return of 10.1% versus a 12.6% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps). The direct private equity program, which began in 2009, generated a 19.2% return versus 17.9% for the benchmark.

**Opportunistic:** Hedge funds, as measured by the HFRI Fund of Funds Composite Index, gained 0.57% in the second quarter. On a sub-strategy basis, the HFRI Event-Driven Index rose 0.91%, the HFRI Relative Value Index gained 1.06%, the HFRI Equity Hedge Index advanced 1.17%, and the HFRI Macro Index was down 0.45%. During the second quarter, the System's Diversifying hedge fund portfolio returned 1.20% versus a 1.09% return for the HFRI Fund of Funds Conservative Index, and the System's Directional hedge fund portfolio returned 0.77%, outperforming the 0.03% loss returned by the HFRI Fund of Funds Strategic Index.

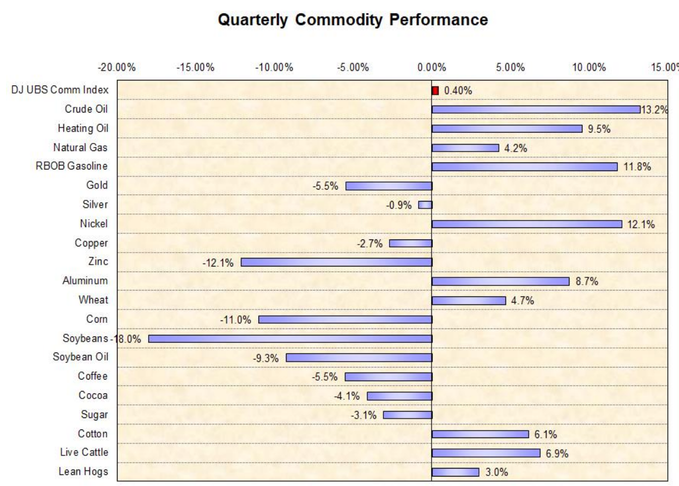
**Fixed Income:** The yield curve continued to flatten during the quarter as short-term bond yields increased more than long-term yields. A flattening yield curve may be viewed as foreshadowing for an economic slowdown, as an inverted yield curve (where short-term rates rise above long-term rates), usually precedes a recessionary environment. The yield on the 30-year bond increased by 1 bp during the quarter and ended the period at 2.98%. The spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, tightened by 14 bps to 33 bps, the tightest level since prior to the 2008 global financial crisis. For the quarter, the 2-year Treasury yield ended at 2.52%, up 25 bps from the prior period, while the 10-year Treasury yield rose by 11 bps to 2.85%. The high yield portfolio's performance for the quarter was a gain of 0.94%, underperforming the Merrill Lynch High Yield II Constrained Index by 6 bps. The long duration portfolio's return for the quarter was a loss of 1.27%, outperforming the Barclays Long Govt/Credit Index by 18 bps. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, recorded a gain of 2.23%, outperforming the custom benchmark's gain of 1.72%.




**Private Debt:** Private debt fundraising in the second quarter increased $5.8 billion from the first quarter of 2018, as 22 funds reached a final close, securing a total of $25 billion in aggregate capital commitments. North American funds contributed the largest share of the capital raising, with 11 funds closing on $16 billion. Ten direct lending funds secured $7.8 billion, while five distressed funds closed on $14 billion of new capital. The second quarter was a slow fundraising period for mezzanine funds, as only two reached final closes for a total of $300 million. During the quarter, our private debt managers called a combined $5.8 million and paid distributions of $2.2 million. Our current allocation to private debt is 1.27%, with a market value of $52.2 million. From 2013 through March 31, 2018, the private debt program generated a net internal rate of return of 10.3% versus a 10.9% return for the dollar-weighted public market equivalent benchmark (BofA Merrill Lynch High Yield Master II Constrained + 300 bps).

**Private Real Assets:** The NCREIF Property Index (NPI), a measure of private commercial real estate properties in the U.S., gained 1.8% in the second quarter 2018, up slightly from 1.7% last quarter. The total return consisted of a 1.1% income return and 0.7% capital appreciation. Occupancy levels are strong and increased to a new 16-year high, at 93.8%. Cap rates increase slightly to 4.9%. The Industrial sector continued to be the stellar performer with a 3.6% return in the second quarter which also has the highest occupancy at 96.7%. The other major property sectors, office, apartments and retail returned 1.5%, 1.5% and 1.3% respectively. The U.S. oil and gas sector experienced $76 billion in deal value, which was the highest second quarter deal value on record. The bulk of the second quarter deal activity was concentrated in a few large transactions in the downstream and midstream sectors. In contrast, deal-making tapered for private investments in the oil and gas space after several quarters of strong interest. The Permian continues to dominate activity with 475 rigs drilling in June 2018 (compared to 132 in April 2016). During the quarter, our private real assets managers called a combined $11.7 million and paid distributions of $21.5 million. Our current allocation to private real assets is 4.7%, with a market value of $192.4 million. From its 2006 inception through December 31, 2017, the total private real assets program (including fund-of-funds) has generated a net internal rate of return of 5.8% versus a 6.7% gain for the long-term benchmark CPI plus 500 bps. Excluding two large commitments prior to 2008, the private real assets program generated a 11.0% return versus 6.6% for the benchmark.

**Public Real Assets:** The Bloomberg Commodity Index increased 0.4% for the quarter largely led by gains in the energy sector. Crude oil prices continued to rally on fears of global supply disruptions and strong demand; natural gas prices also increased due to above average temperatures in the U.S. Industrial metals rebounded over the quarter and posted gains with nickel prices increasing as inventories on exchanges fell and demand strengthened; aluminum prices also increased, benefiting from supply disruption concerns due to U.S. sanctions. Precious metals declined for the quarter on anticipation of Fed rate hikes and as the U.S. dollar strengthened. Agriculture declined for the quarter, also broadly impacted by a stronger U.S. dollar. Soybean prices fell on trade tensions between the U.S. and China and corn prices declined on favorable weather expectations and an above average crop. Livestock broadly benefited from lower corn and grain prices to record gains during the quarter.




Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index advanced by 5.1%, led by strength in the U.S and Australia. U.S. REIT returns surged on improved earnings outlook and attractive yields and valuations which were caused by share price weakness in the previous quarter. All U.S. REIT property sectors had positive returns, with several posting double-digit returns. The strongest performing sectors were Self-Storage, Health Care and Hotels. Self-Storage and Hotels outperformed as operating results came in stronger than expected. Whereas U.S. Health Care and Australian REITs benefited from M&A activity and declining bond yields. In contrast, European listed real estate was weak due to peaking rent growth and valuations reaching fair values. Listed real estate in Asia declined due to the threat of trade wars with the U.S.

Listed infrastructure increased 4.5% for the quarter as measured by the Dow Jones Brookfield Global Infrastructure Index. The strongest infrastructure sectors were gas midstream, pipeline companies, and gas distribution utilities. Gas distribution utilities benefited from strong fundamentals in China and activist investor activity in the U.S. Gas midstream and pipeline companies experienced a strong reversal in share price performance relative to Q1 for many reasons: strong earnings season, several announced corporate simplification transactions, favorable clarification on the FERC regulatory changes, positive outcomes on major pipeline projects, and higher crude prices. In contrast, the communication sector underperformed due to lackluster earnings combined with the potential adverse impact of a Sprint/T-Mobile merger. From a regional perspective, infrastructure companies in Spain, Italy, Brazil and Mexico experienced notable weakness due to political concerns over future fiscal policy decisions.

For the quarter, the public real asset portfolio advanced 3.53%, underperforming the custom benchmark by 83 bps due to underperformance in the REIT and listed infrastructure sectors due to underweights in the more yield oriented segments of the market.

***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, 2018 and fiscal year-to-date.

**Employees' Retirement System**
**Contributions and Investment Income (millions)**

| | Qtr 6/30/2018 | Fiscal YTD |
|---|---|---|
| Employer Contributions | $ 23.6 | $ 93.1 |
| Member Contributions | 7.3 | 29.0 |
| Net Investment Gain | 97.8 | 340.1 |
| | $ 128.7 | $ 462.2 |

***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 6/30/2018 | Fiscal YTD |
|---|---|---|
| Benefits | $ 59.9 | $ 239.0 |
| Refunds | 0.8 | 4.6 |
| Administrative Expenses | 0.6 | 2.8 |
| | $ 61.3 | $ 246.4 |

***Outlook***

During the second quarter, the U.S. Federal Reserve ("the Fed") raised the benchmark interest rate another 25 bps to a targeted range of 1.75% - 2.0%. In a testimony before Congress, Federal Reserve Chairman Jerome Powell, described risks to growth as roughly balanced, and reiterated his plan to continue raising interest rates gradually. The market is currently pricing in two additional interest rate hikes for the remainder of 2018, which is roughly in-line with the Fed's expectations. Inflation, a closely watched metric by the Fed, remains near their 2% annual long-term target. The Fed has previously noted that they expect inflation to continue to rise over the next 12 months, as a strong employment environment pushes up wage growth. However, longer-term risks to the domestic economy do remain, as higher interest rates and fading tailwinds from last year's fiscal stimulus (e.g. tax cuts) could materially begin to slow growth.

In the Eurozone region, the European Central Bank ("ECB") made no changes to the benchmark interest rate, as it remains at 0%. The ECB has continued to gradually wind down their bond purchases, and now expects that the stimulus program will be completely phased out by the end of the calendar year. While the timing of eventual interest rate hikes will ultimately depend on the path of economic growth, the market is pricing in the first benchmark increase to occur in September 2019. During the second quarter, the Bank of England ("BOE") raised rates from 0.5% to 0.75% due to strong labor market and credit growth. This was the BOE's second interest rate hike since the 2008 global financial crisis. Brexit negotiations, which are nearing a pivotal inflection point, continue to be a lingering uncertainty over the country ahead of the U.K's formal departure date of March 29th. The Bank of Japan ("BOJ") pledged to keep interest rates low for the foreseeable future, while also announcing more flexible measures to its stimulus program which is expected to provide further ammunition to spur the country's persistently low inflation rate.

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

## EMPLOYEES' RETIREMENT SYSTEM
## STATEMENTS OF FIDUCIARY NET POSITION
June 30, 2018

| | |
|---|---|
| **Assets** | |
| Equity in pooled cash and investments | $ 2,014,964 |
| Investments: | |
| Northern Trust | 4,132,839,313 |
| Aetna | 815,091 |
| Fidelity - Elected Officials Plan | 680,720 |
| Fidelity - DRSP/DROP | 10,713,890 |
| Total investments | 4,145,049,014 |
| Contributions receivable | 7,425,120 |
| Total assets | 4,154,489,098 |
| **Liabilities** | |
| Benefits payable and other liabilities | 5,181,657 |
| **Net position restricted for pensions** | **$ 4,149,307,441** |

## EMPLOYEES' RETIREMENT SYSTEM
## STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION

June 30, 2018

| | Quarter | Fiscal YTD |
|---|---|---|
| **Additions** | | |
| Contributions: | | |
| Employer | $ 23,578,255 | $ 93,163,298 |
| Member | 7,331,693 | 28,964,769 |
| Total contributions | 30,909,948 | 122,128,067 |
| Investment income | 106,105,502 | 363,022,824 |
| Less investment expenses | 8,346,310 | 22,938,330 |
| Net investment income | 97,759,192 | 340,084,494 |
| Total additions | 128,669,140 | 462,212,561 |
| **Deductions** | | |
| Retiree benefits | 44,830,926 | 178,267,822 |
| Disability benefits | 12,688,106 | 50,864,259 |
| Survivor benefits | 2,451,441 | 9,783,701 |
| Refunds | 812,634 | 4,624,066 |
| Administrative expenses | 601,540 | 2,870,683 |
| Total deductions | 61,384,647 | 246,410,531 |
| **Net increase** | **67,284,493** | **215,802,030** |
| **Net position restricted for pensions** | | |
| Beginning of period | **4,082,022,948** | **3,933,505,411** |
| **End of period** | **$ 4,149,307,441** | **$ 4,149,307,441** |