OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

May 22, 2013

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 March 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 5,930 retirees participating in the ERS as of March 31, 2013.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 4.13%, 37 basis points ahead of the 3.76% gain recorded by the policy benchmark. For the one year period ending March 31, 2013 the ERS' gross return (before fees) was a gain of 11.33%, 50 basis points ahead of the 10.83% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top 25% of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 11.56% for the three-year period and 6.78% for the five-year period, ranked in the top 10% of the universe for both periods. The asset allocation at March 31, 2013 was: Domestic Equities 25.3%, International Equities 16.9%, Fixed Income 25.4%, Inflation Linked Bonds 10.1%, Commodities 4.1%, Private Equity 7.1%, Private Real Assets 5.2%, REITS 1.0%, Opportunistic 3.6%, and Cash 1.3%. We estimate that the funded status of the ERS was 77% as of March 31, 2013, a slight increase from the June 30, 2012 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.

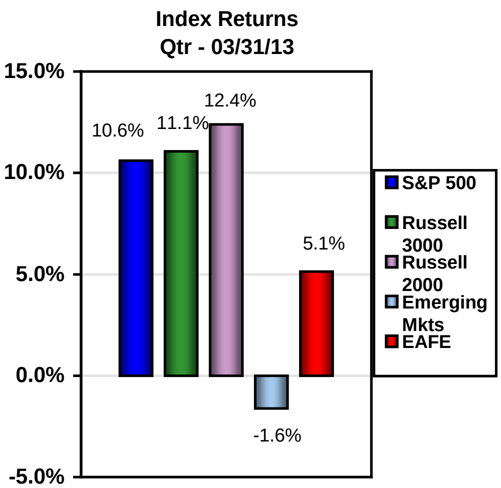
Major Initiatives

During the quarter, the Board conducted an asset-liability study resulting in changes in the allocations within the fixed income, commodities, and opportunistic sectors. The Board approved the 2013 commitment paces for both private equity and private real assets. Within the private equity sector, the Board approved an investment of $15,000,000 in KPS Special Situations Fund IV, L.P. and an investment of $14,000,000 in Altaris Health Partners III L.P. The Board also approved a $125,000,000 investment in the Aberdeen Asset Management global equity strategy and the hiring of a hedge fund consultant, Albourne, to assist staff with further implementation of the opportunistic program.

Capital Markets and Economic Conditions

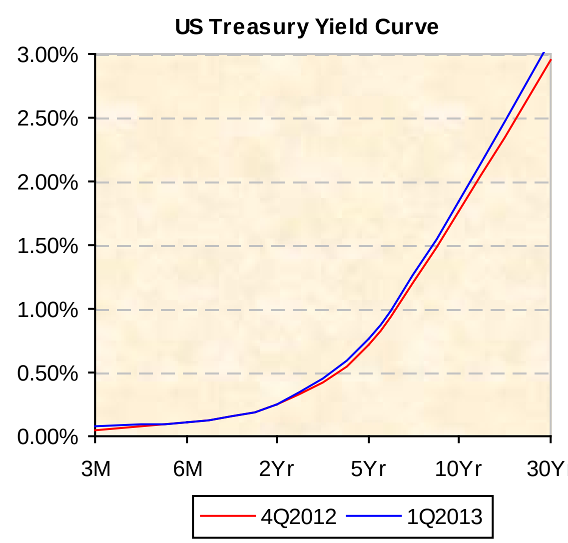
The US economy expanded at a 0.4% annualized rate during the fourth quarter of 2012, following a 3.1% gain in the third quarter. Cuts in federal spending during the quarter, coupled with the continued need to deleverage and bring down deficits to improve longer-term prospects, present a challenging economic environment. The labor market registered disappointing numbers in March, a meager gain of only 88,000 jobs disappointed economists' consensus estimates. While the unemployment rate dipped to 7.6%, it did so for discouraging reasons, as roughly 496,000 individuals departed the labor force over the month, bringing the labor participation rate to its lowest level since 1979. After three consecutive months of falling prices, the Consumer Price Index rose 0.3% in January and 0.8% in February, raising the one year change to 2.0%. Home prices continued to rise strongly in recent months, leading to 11 consecutive monthly gains for the Case–Schiller Index. Over the twelve months ending January, home prices are up over 7%.

Public Equity Markets: U.S. equities rallied strongly during the first quarter on signs of a strengthening U.S. economy and sustained monetary stimulus which encouraged investors to bid up equities. The S&P 500 Index ended the quarter at the highest level since October 2007. Larger capitalization stocks (as represented by the S&P 500 Index) underperformed their smaller counterparts. All sectors of the S&P 500 advanced with Health Care, Consumer Staples and Utilities performing the best. Our combined domestic equity performance was a gain of 10.90%, underperforming the 11.07% gain recorded by the Russell 3000 benchmark.



International developed markets lagged their domestic counterparts as Europe's weak performance, due to the issues related to maintaining the solvency of another member (Cyprus), pulled down developed market returns. The Asia-Pacific region rallied strongly driven by the anticipated actions of the Bank of Japan to stimulate their stagnant economy. Emerging markets declined during the quarter on a slowdown in overall growth, particularly in China, and inflation concerns in Brazil. During the quarter, developed markets, as measured by the MSCI EAFE Index, rose 5.13%. Most of the developed markets were positive performers with Greece rallying the most (14.02%). Emerging Markets declined by 1.62%, underperforming their developed counterparts, with all members of the BRIC countries posting negative returns. Our combined international equity performance was a gain of 5.05% for the quarter, outperforming the 3.17% gain recorded by the MSCI ACWI ex-US Index.

Fixed Income: U.S. Treasury yields rose during the first part of the quarter with the 10-year Treasury yield briefly trading above 2% for the first time since April 2012. However, economic turmoil in the Eurozone, and uncertainty in the U.S. over the effects of the U.S. Government's March 1 automatic spending cuts, led to a late quarter flight to quality. The yield curve steepened slightly (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 to 160bps. For the quarter, the 2-year Treasury yield ended at 0.24%, down 1bp, while the 10-year Treasury yield rose 9bps to 1.85%. High yield bonds were the best performer as market participants sought yield in an environment of low interest rates. For the quarter, the Merrill High Yield Index returned 2.89%, the Barclays Aggregate declined 12bps and the Barclays Long Govt/Credit Index declined 1.98%. Our combined fixed income performance for the quarter was a gain of 0.80%, outperforming the custom benchmark, which returned 0.15%. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 0.73% for the quarter, underperforming the 0.80% gain recorded by the benchmark.

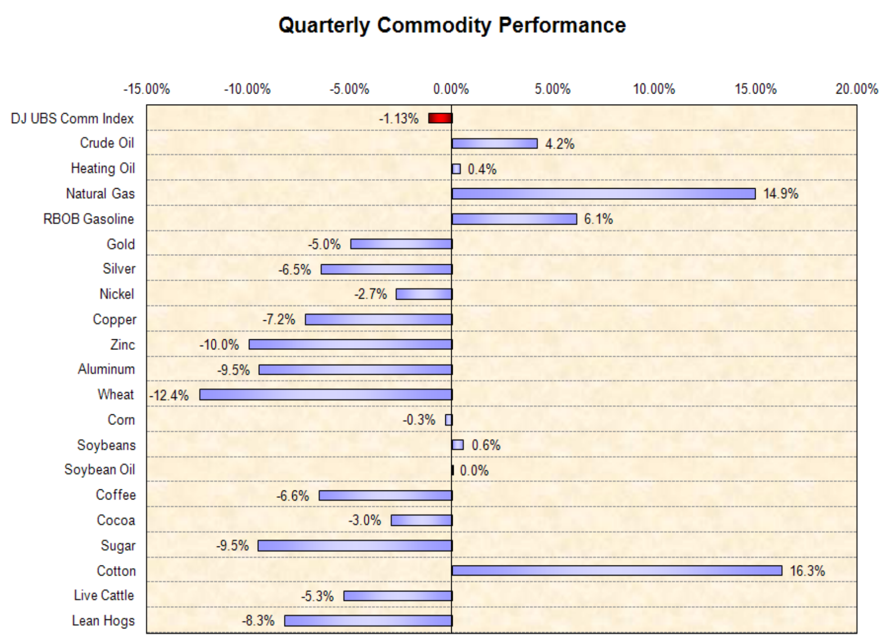


Opportunistic: The HFRI hedge fund index gained 3.9% in the first quarter. Long/Short equity strategies were the best performers returning 5.3%, led by directional equity hedge fund strategies, as equity markets rallied. Event driven strategies returned 3.8% in the quarter due to corporate transactions and increased shareholder activist pressures. Hedge Funds that focus on Special Situations advanced 4.7% for the quarter, while Activist managers gained 8.6%. Macro funds posted gains of 1.4% in the first quarter. Gains for the sector were tempered by commodity declines, currency reversals and falling equity volatility. Fund-of-Hedge Funds gained 3.37%. Our opportunistic portfolio returned 4.45%, net of management fees, in the first quarter.

Private Equity: During the first quarter, aggregate investments by private equity firms were greater than any single quarter in 2012, led by an increase in the average size of venture capital deals. However, exit activity was subdued, running at its lowest quarterly pace in two years, due to a fall in sales to corporate acquirers. Purchase valuations are almost exactly in line with 10-year averages, while leverage use is slightly above its historic average due to attractive financing terms from lenders. During the quarter, our private equity managers called a combined $5.5 million and paid distributions of $9.5 million. Our current allocation to private equity is 7.1%, with a market value of $230.3 million. From its 2003 inception through September 30, 2012, the private equity program has generated a net internal rate of return of 6.3% versus an 8.3% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 basis points).

Private Real Assets: In commercial real estate, non-major markets outperformed an index of properties in 6 major U.S. cities – this is a recent reversal of earlier trends in which investors sought the safety of the major markets. In energy investing, the number of actively-drilling natural gas rigs continued to decrease, though production continues to be strong (fueled by unconventional energy projects). Favorable oil pricing continues to drive oil drilling activity, which increasingly targets unconventional opportunities such as the Bakken Shale in North Dakota. During the quarter, our managers called a total of $3.8 million and paid distributions of $2.8 million. Our current allocation to private real assets is 5.2%, with a market value of $167.3 million. From its 2006 inception through September 30, 2012, the private real assets program has generated a net loss of 2.6% versus a 7.1% 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 1.13% during the quarter led by the Industrial Metals sector due to the weak demand outlook in China. Wheat prices dropped sharply due to a lack of weather concerns and weak exports. After an upward trend earlier in the quarter, Corn prices fell in March following the release of a bearish USDA report. Precious Metals retreated on concerns that the monetary easing could come to an end. Energy was the only advancing sector as Natural Gas benefited from cold weather and Crude Oil gained on hopes that signs of a U.S. economic rebound could create greater oil demand. During the quarter, our commodities portfolio declined 1.84%, 71bps behind the DJ UBS Commodities Index.



REITs: During the first quarter, global REITs rose as investors continued to seek yielding assets in the wake of low interest rates in developed countries worldwide. Weak performance in European real estate securities markets was offset by strong performance in North America and Asia, particularly in Japan where markets have rebounded significantly due to the Bank of Japan's planned monetary easing. Global REITs, as measured by the FTSE EPRA/NAREIT Developed Index, rose by 6.11% for the quarter, while our global REIT portfolio returned 2.95%, underperforming 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 March 31, 2013 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 3/31/2013	Fiscal YTD
Employer Contributions	$ 31.6	$ 96.2
Member Contributions	6.0	18.6
Net Investment Income	124.0	341.5
	$ 161.6	$ 456.3

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 3/31/2013	Fiscal YTD
Benefits	$ 52.6	$ 156.7
Refunds	0.3	1.5
Administrative Expenses	0.6	1.6
	$ 53.5	$ 159.8

Outlook

Following modest improvements witnessed in late-2012, the U.S. economic recovery continued to gain traction in the first quarter of 2013, even if the data occasionally appeared mixed. Nominal GDP is growing, household net worth has dramatically recovered from crisis lows, corporate earnings and margins are strong, and the prevailing interest rate and liquidity dynamics are extraordinarily supportive of the economy. Household sector buying power has increased substantially in recent quarters, lifted by gains in home equity, adding to the "wealth effect" sought by the Federal Reserve policymakers.

In addition to consumer and corporate balance sheet improvement, positive longer-term trends in energy industry development, the residential housing market recovery, and convergence between consumer and corporate spending patterns should support the recovery, despite occasional reversals we may see in the data.

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 ASSETS
March 31, 2013

Assets	
Equity in pooled cash and investments	$ 1,035,928
Investments:	
Northern Trust	3,215,417,556
Aetna	1,135,375
Fidelity - Elected Officals Plan	330,324
Fidelity - DRSP	11,753,264
Total investments	3,228,636,519
Contributions receivable	9,460,415
Total assets	3,239,132,862
Liabilities	
Benefits payable and other liabilities	5,852,491
Net assets held in trust for pension benefits	**$ 3,233,280,371**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
March 31, 2013

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 31,625,401	$ 96,150,835
Member	6,018,664	18,596,912
Total contributions	37,644,065	114,747,747
Investment income	128,448,069	353,718,956
Less investment expenses	4,412,200	12,177,663
Net investment income	124,035,869	341,541,293
Total additions	161,679,934	456,289,040
Deductions		
Retiree benefits	38,754,930	115,495,356
Disability benefits	11,643,803	34,906,501
Survivor benefits	2,152,532	6,283,145
Refunds	297,803	1,497,966
Administrative expenses	630,983	1,599,395
Total deductions	53,480,051	159,782,363
Net increase (decrease)	**108,199,883**	**296,506,677**
Net asset held in trust for pension benefits		
Beginning of period	**3,125,080,488**	**2,936,773,694**
End of period	**$ 3,233,280,371**	**$ 3,233,280,371**