OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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December 5, 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 September 30, 2016. 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 5,550 ERS and GRIP active members and 6,470 retirees participating in the ERS as of September 30, 2016.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 4.44%, 98 basis points ahead of the 3.46% gain recorded by the policy benchmark. For the one-year period ending September 30, 2016 the ERS' gross return (before fees) was a gain of 11.24%, 52 basis points behind the 11.76% gain recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 7.08% for the three-year period and 9.81% for the five-year period ranked in the first and second quartile of the universes, respectively. The annualized return for the ten-year period was 7.02%, and ranks first in Wilshire's Large Public Funds Universe. The asset allocation at September 30, 2016 was: Domestic Equities 19.3%, International Equities 15.3%, Global Equities 3.1%, Fixed Income 24.0%, Inflation Linked Bonds 11.0%, Public Real Assets 9.2%, Private Equity 6.9%, Private Real Assets 5.4%, Private Debt 0.6%, Opportunistic 3.8%, and Cash 1.4%. We estimate that the funded status of the ERS was 92.2% as of September 30, 2016. 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.

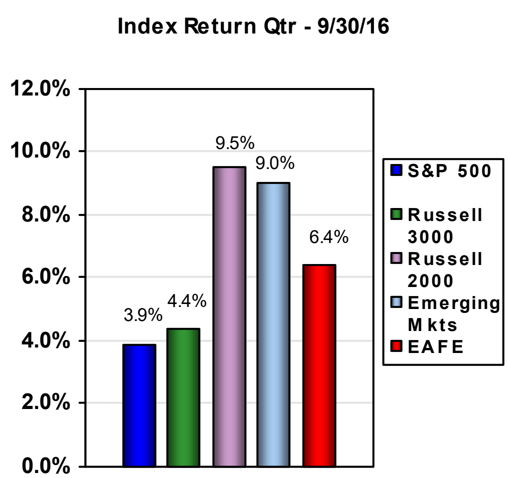
Major Initiatives

During the quarter, the following commitments were made: $7 million to Altaris Constellation, a private equity fund, $12 million to Davidson Kempner Institutional Partners, a hedge fund, $12 million to HBK Investments, a hedge fund, $10 million to EMR Capital Resources II, a private real assets fund, $20 million to Homestead Capital USA Farmland II, a private real assets fund, $6.5 million to Kimmeridge Energy III, a private real assets fund, $10 million to Bison Capital Partners V, a private debt fund, and $20 million to FCP Realty III, a private real assets fund.

Capital Markets and Economic Conditions

Economic data reflected that the GDP increased at a 2.9% annual rate in the third quarter of 2016, a significant increase of 190 bps from the economy's second quarter expansion of 1.2%. The GDP reading was well above the 2.5% consensus estimate of economists. This GDP increase represents the largest growth in two years. Despite consumer spending decreasing a bit from its robust Q2 reading, strong exports and inventory investment led the impressive growth reading. Consumer spending increased 2.1% in Q3, less than its 4.2% increase in Q2. After decreasing in the last quarter, inventories contributed positively to GDP in Q3 for the first time since 2015. Net exports contributed over 0.8% to GDP, which represents the biggest contribution from exports since 2013. Household finances remain in solid shape with the household debt service ratio remaining at all-time lows of 10% and household net worth increasing to a record level of $90.3 trillion. The residential real estate sector of the economy showed signs of stalling in Q3 as housing starts dropped to their lowest level since early 2015. The economy added 619,000 jobs during the third quarter, which was an increase from Q2's 460,000 gain. Despite strong job gains, the unemployment rate increased from 4.9% to 5.0% due to an increase in labor force participation. Inflation showed slight signs of positive pressure as CPI posted a 1.5% growth rate year over year due to an increase in housing related costs and a stabilization in energy prices. Core CPI, which excludes food and energy, remained constant at 2.2%.

Public Equity Markets: U.S. stocks advanced during the quarter as risk assets broadly recovered following the sharp downturn immediately following the Brexit decision. The Utilities, Telecom, Consumer Staples, and REIT sectors underperformed the market as higher yielding stocks, which had led the markets in prior quarters, experienced a selloff due to an increase in interest rates. The seven other sectors in the S&P 500 advanced during the quarter with the Technology, Financials, and Consumer Discretionary delivering the strongest performance. Small cap stocks significantly outperformed large cap stocks during what was a risk-on quarter for the equity markets. Additionally, growth outperformed value as higher beta cyclicals outpaced less volatile names during the quarter. Our combined domestic equity performance was a gain of 5.96%, outperforming the 4.40% gain recorded by the Russell 3000 benchmark.

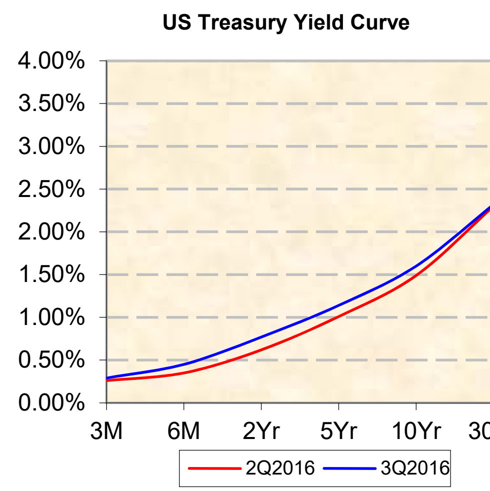


International developed markets also experienced a strong rebound after the sharp selloff following the Brexit vote as the UK economic activity remained resilient and global central banks continued with accommodative monetary policy. The economically sensitive sectors of the MSCI EAFE performed the strongest, with the Technology, Consumer Discretionary, Financials, and Materials sectors all posting double digit gains. Conversely, the more defensive sectors of Healthcare, Utilities, Telecom, and Consumer Staples delivered flat to slightly negative performance during the quarter. The weakness of the US Dollar was a tailwind to international developed markets as well as emerging markets in Q3 as the USD Indices for both the MSCI EAFE and MSCI Emerging Markets Index outperformed their local counterparts. Emerging markets rallied during the quarter, led by China, which posted a 13.9% return as fears of a slowdown in growth abated to some degree. Additionally, Brazil returned 11.3% as markets were pleased with the impeachment of their troubled president, Dilma Rousseff. During the quarter, developed markets, as measured by the MSCI EAFE Index, were up 6.43%, while Emerging Markets were up 9.03%. Our combined international equity performance was a gain of 7.48% for the quarter, outperforming the 7.02% gain recorded by the benchmark index. Our global equity manager recorded a gain of 3.32%, underperforming the 5.30% gain of the MSCI ACWI benchmark, primarily due to the underperformance of their holdings in U.S. technology and consumer staples stocks.

Private Equity: Buyout fund activity in the U.S. held relatively steady from the second quarter, both in deal numbers and dollar terms. After a slow start to the year, buyout funds have raised a total of $96 billion through the third quarter - already exceeding the cumulative 2015 fundraising activity by approximately 20%. U.S. venture capital activity has slowed relative to the peaks in 2015; however, investor interest remains strong, as fundraising activity this year has already surpassed the post-financial crisis high of $31 billion in 2014. Although venture fundraising activity remains robust, the average length of time for U.S. venture fundraising has begun to increase, suggesting that momentum may be beginning to slow. During the quarter, our private equity managers called a combined $15.9 million and paid distributions of $23.4 million. Our current allocation to private equity is 6.85%, with a market value of $256.8 million. From its 2003 inception through March 31, 2016, the private equity program has generated a net internal rate of return of 8.8% versus a 11.4% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps). The direct private equity program generated a 15.1% return versus 15.6% for the benchmark since inception (2009).

Opportunistic: Hedge funds, as measured by the HFRI Fund Weighted Composite Index, gained 2.69% in the third quarter. On a sub-strategy basis, the HFRI Event-Driven Index rose 3.74%, the HFRI Relative Value Index gained 2.67%, and the HFRI Macro Index was up 1.62%. The opportunistic portfolio returned 0.13% in the third quarter, compared to the 1.45% gain in the HFRI Fund of Funds Index.

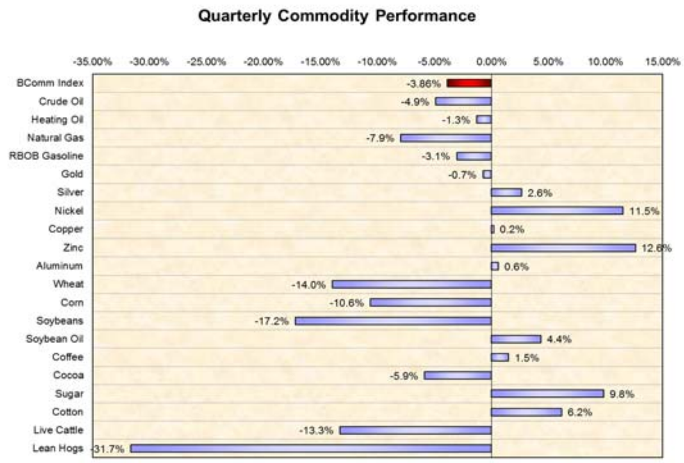
Fixed Income: U.S. Treasury yields increased modestly across the curve during the quarter as economic conditions improved and yields reverted back to roughly their pre-Brexit levels. However, yields are still significantly lower than at year end 2015 (the 10-year yield is 67 bps lower YTD), as investors continue to gauge lingering uncertainties surrounding the global financial markets. The yield on the 30-year bond increased by 2 bps during the quarter, and ended the period at 2.32%. The yield curve continued to flatten in Q3 (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 8bps to 83 bps. For the quarter, the 2-year Treasury yield ended at 0.77%, up by 15 bps from the prior period, while the 10-year Treasury yield moved up by 11 bps to 1.60%. For the quarter, the Merrill Lynch High Yield II Constrained Index rose by 5.49%, the Barclays Aggregate was up 0.46%, and the Barclays Long Govt/Credit Index increased by 1.24% as credit spreads tightened. The fixed income performance for the quarter was a gain of 3.30%, outperforming the custom benchmark's return of 2.87%. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, returned 6.46% for the quarter, outperforming the benchmark's 5.66% return.



Private Debt: U.S. private debt funds closed on approximately $8.6 billion across 14 different funds during the third quarter. Mezzanine funds accounted for the highest number of new commitments; however, in dollar terms, they trailed distressed fundraising activity. Compared to the same time period in 2015, the aggregate number of private debt funds and targeted capital commitments have both increased. Direct lending funds represent the largest universe of private debt funds currently in the market. During the quarter, our private debt managers called a combined $2.1 million and paid distributions of $271,000. Our current allocation to private debt is 0.62%, with a market value of $23.4 million. From inception through March 31, 2016, the private debt program generated a net internal rate of return of 10.6% return versus an 8.1% return for the dollar-weighted public market equivalent benchmark (BofA Merrill Lynch High Yield Master II Constrained + 300 bps).

Private Real Assets: U.S. real estate values continued to slow on weaker appreciation. The total return was 1.8% in the third quarter 2016, down from 2.0% last quarter and 3.1% in the third quarter 2015, according to the NCREIF Property Index (NPI). Industrial maintained its lead for quarterly and yearly total returns. Transaction volume for NPI properties totaled $9.6 billion in third quarter 2016, for a 24% increase in volume over the same quarter a year ago. Within the upstream oil and gas sector, stabilizing commodity prices and cautious optimism narrowed bid-ask spreads and increased deal volumes in low cost basins such as the Permian and Marcellus. During the quarter, our private real assets managers called a combined $5.2 million and paid distributions of $8.7 million. Our current allocation to private real assets is 5.4%, with a market value of $200.5 million. From its 2006 inception through March 31, 2016, the private real assets program has generated a net internal rate of return of 4.5% versus a 6.5% gain for the long-term benchmark CPI plus 500 bps.

Public Real Assets: The Bloomberg Commodity Index declined 3.9%, with three out of the four sectors posting losses. Energy ended the quarter lower as successive increases to the active rig count and concerns over the economic impact of Brexit weighted on the petroleum complex and natural gas inventories remain at elevated levels. However, crude oil prices began to recover late in the quarter as OPEC announced a tentative agreement for its first potential production cut since 2008. Precious metals were down slightly for the quarter after seeing the third consecutive quarter of net inflows into precious metal ETFs partially attributed to the continued global issuance of low and negative-interest rate bearing debt. Industrial metals advanced due to continued production cuts, mine closures and robust Chinese demand. Agriculture & livestock declined following extremely favorable weather for growing soybeans, wheat, and corn.



Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index advanced 1.25% for the quarter. Returns were mostly positive across countries, led by Hong Kong, Sweden, France, Spain and Singapore. Hong Kong real estate is benefiting from low valuations and strong property fundamentals. European real estate companies are benefitting from low fixed income yields and are locking in long-term low cost financing. Singaporean real estate is expected to benefit from Brexit, as investors and companies who were planning to invest in London real estate are looking at real estate in Singapore and other Asian countries. Within the U.S., most property sectors declined due to concerns that new supply is catching up with demand and that interest rates will begin increasing. REIT sectors that were most overvalued relative to their underlying assets such as net-leased, data centers and healthcare, experienced some of the steepest losses for the quarter.

Master Limited Partnerships (MLPs), as measured by the Alerian MLP Total Return Index, advanced 1.1% for the quarter with significant dispersion among individual companies. Stronger companies with higher valuations and lower yields declined whereas companies that had more depressed valuations rebounded as they benefitted from the improved sentiment around the sector as concerns related to counterparty risk and access to capital markets eased.

For the quarter, the public real asset portfolio advanced 0.25%, outperforming the custom benchmark by 66 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 September 30, 2016 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 9/30/2016	Fiscal YTD
Employer Contributions	$ 28.7	$ 28.7
Member Contributions	6.0	6.0
Net Investment Gain (Loss)	(18.0)	(18.0)
	$ 16.7	$ 16.7

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 9/30/2016	Fiscal YTD
Benefits	$ 57.9	$ 57.9
Refunds	1.9	1.9
Administrative Expenses	0.7	0.7
	$ 60.5	$ 60.5

Outlook

At the Federal Open Market Committee meeting in late September, Fed president Janet Yellen indicated that the odds of interest rate hikes later in the year have increased. While Mrs. Yellen did not provide a timeline for the hike, most market participants expect the next hike will occur at the December meeting, following the U.S. election. While inflation has failed to meet the Fed's 2% target, the Fed expects this target to be reached in 2017 due to an improving wage picture and energy prices relative to the start of 2016. Evidence of an increase in inflation expectations can be seen by the 50bps increase in the 10-year break-even inflation rate over the past 6 months.

In August, the Bank of England cut its benchmark interest rate to 0.25%, which marks the lowest level in the BOE's 322-year history. This action was taken in conjunction with a bond-buying program in an attempt to cushion the economy from the impacts of the June Brexit vote. The BOE also slashed its 2017 growth forecast from 2.3% to 0.8%, citing that the economic outlook has weakened markedly following the EU Referendum. The Bank of Japan held its benchmark rate constant at negative 0.10% during Q3, while also pushing back the expected timing for reaching its 2% inflation target to 2018. The European Central Bank held its benchmark deposit rate constant at negative 0.4% while announcing a continuation of the monthly asset purchase program of €80 million through early 2017.

The domestic economy is likely to continue to grow at a slow but steady pace throughout the rest of 2016 as an improving wage, employment, and housing sector counteract the negative impacts of weak global growth and a high level of global political uncertainty.

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, PwC Deals, NCREIF.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF FIDUCIARY NET POSITION
September 30, 2016

Assets	
Equity in pooled cash and investments	$ 895,369
Investments:	
Northern Trust	3,590,447,430
Aetna	983,533
Fidelity - Elected Officials Plan	544,416
Fidelity - DRSP/DROP/MCGEO DROP	5,972,339
Total investments	3,597,947,718
Contributions receivable	8,143,860
Capital assets	900,043
Less depreciation	675,032
Net capital assets	225,011
Total assets	3,607,211,958
Liabilities	
Benefits payable and other liabilities	9,408,394
Net position restricted for pensions	**$ 3,597,803,564**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
September 30, 2016

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 28,748,576	$ 28,748,576
Member	5,998,009	5,998,009
Total contributions	34,746,585	34,746,585
Investment income (loss)	(14,419,586)	(14,419,586)
Less investment expenses	3,656,280	3,656,280
Net investment income (loss)	(18,075,866)	(18,075,866)
Total additions	16,670,719	16,670,719
Deductions		
Retiree benefits	42,935,795	42,935,795
Disability benefits	12,686,194	12,686,194
Survivor benefits	2,269,099	2,269,099
Refunds	1,854,775	1,854,775
Administrative expenses	723,906	723,906
Total deductions	60,469,769	60,469,769
Net increase (decrease)	**(43,799,050)**	**(43,799,050)**
Net position restricted for pensions		
Beginning of period	**3,641,602,614**	**3,641,602,614**
End of period	**$ 3,597,803,564**	**$ 3,597,803,564**