OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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December 28, 2012

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, 2012. 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 5,600 active members and 5,850 retirees participating in the ERS as of September 30, 2012.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 5.44%, 15 basis points ahead of the 5.29% gain recorded by the policy benchmark. For the one year period ending September 30, 2012 the ERS' gross return (before fees) was a gain of 17.84%, 51 basis points ahead of the 17.33% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top 40% of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 11.81% for the three-year period ranked in the top 10% of the universe, and 4.47% for the five-year period ranked in the top 10% of the universe. The asset allocation at September 30, 2012 was: Domestic Equities 25.5%, International Equities 15.9%, Fixed Income 26.1%, Inflation Linked Bonds 10.2%, Commodities 4.7%, Private Equity 7.5%, Private Real Assets 5.3%, Opportunistic 3.6%, and Cash 1.2%. We estimate that the funded status of the ERS was 77% as of June 30, 2012, a slight increase from the June 30, 2011 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.

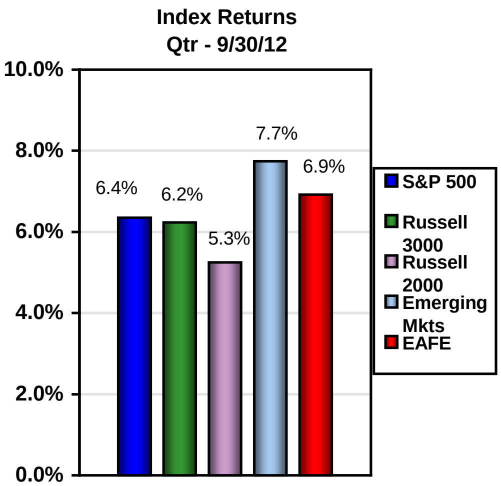
Major Initiatives

During the quarter, the Board approved real assets investments of $69,500,000 with CoreCommodity Management and $76,500,000 with E.I.I. Realty Securities. Staff continues to review opportunities within the private real assets, REITs, private equity and opportunistic allocations.

Capital Markets and Economic Conditions

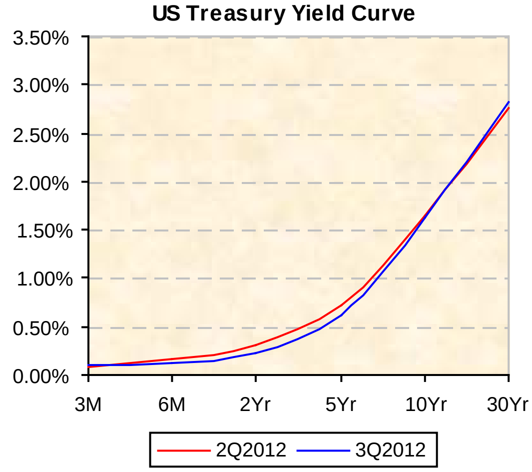
Third quarter employment data indicated that while initial jobless claims are declining, job growth has stagnated, increasing at an average of only 97,000 a month for the last six months, and the unemployment rate remains above 8.0%. U.S. economic growth weakened, growing at an annualized rate of 1.3%, down from the 1.7% reading the previous quarter. The Federal Reserve maintained its target for the Fed Funds rate within the 0%-0.25% range while announcing additional monetary stimulus measures, and indicated that interest rates are expected to stay low until at least mid-2015. Inflation rose slightly, with the year-over-year inflation rate at 1.7%, still below the Fed's 2% long-term target. Housing data has begun to show signs of improvement with housing starts increasing and the Case/Shiller Index of home prices showing that homes values are rising. The Institute for Supply Management's manufacturing index came in at 51.5 (readings above 50 indicate the sector is still expanding) in September, the first time above 50 in four months. Outside of the U.S., European markets rallied as leaders took steps to preserve the euro and emerging markets rose even though there were continued signs of an economic slowdown in China.

Public Equity Markets: U.S. equities rallied during the third quarter, despite recent signs that the U.S. economy is decelerating, and have now recouped nearly all of their losses from the previous high in October, 2007. Investor relief that the sovereign debt situation in Europe is improving, with additional monetary stimulus from central banks, helped bolster returns. Larger capitalization (as represented by the S&P 500 Index) stocks outperformed their smaller counterparts. All sectors of the S&P 500, with the exception of utilities, were in positive territory, led by energy, up 10.14%. Our combined domestic equity performance was a gain of 7.03%, outperforming the 6.23% gain recorded by the Russell 3000 benchmark.



International markets also advanced in the third quarter. European equities were driven higher as investor confidence rose after the European Central Bank announced additional monetary stimulus as well as actions to support the euro. During the quarter, developed markets, as measured by the MSCI EAFE Index, rose 6.92%. Germany was the best performing market, returning 13.97% while the Japanese market was the worst performer, declining 77bps. Emerging Markets gained 7.74% during the quarter, outperforming their developed counterparts. Among the BRICs, Indian stocks surged 15.43%, and Russian stocks returned 9.40%. China and Brazil lagged the overall Index returning 4.73% and 4.77%, respectively. Our combined international equity performance was a gain of 6.92% for the quarter, underperforming the 7.40% gain recorded by the MSCI ACWI ex-US Index.

Fixed Income: U.S. Treasury yields ended the quarter essentially where they started but experienced significant volatility during that time. The markets began the quarter focused on the fiscal crisis in Europe. These concerns moved many investors into the safety of U.S. Treasuries with the 10-year Treasury yield hitting a new all time low of 1.38% in July. Treasuries then reversed course as investor appetite for risk increased when central banks moved to provide an additional round of monetary stimulation. European Central Bank President Mario Draghi commented that the central bank would do "whatever was necessary" to preserve the euro and the Federal Reserve announced an additional form of monetary stimulus through the purchase of mortgage-backed securities. The Fed also indicated they intend to keep rates low through at least mid-2015, longer than the previously announced mid-2014 time frame. 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 140bps. For the quarter, the 2-year Treasury yield ended at 0.23%, down 7bps, while the 10-year Treasury yield was unchanged at 1.63%. Over the quarter, credit risk was rewarded, driven by investor desire for incremental yield. U.S. corporate spreads narrowed by 43 basis points during the quarter resulting in both investment grade and high yield bonds outperforming relative to U.S. Treasuries. For the quarter, the Merrill High Yield Index returned 4.61%, the Barclays Aggregate returned 1.58% and the Barclays Long Govt/Credit Index returned 3.10%. Our combined fixed income performance for the quarter was a gain of 4.73%, outperforming the custom benchmark which returned 3.34%. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 6.84% for the quarter, compared to the 4.75% gain recorded by the benchmark.

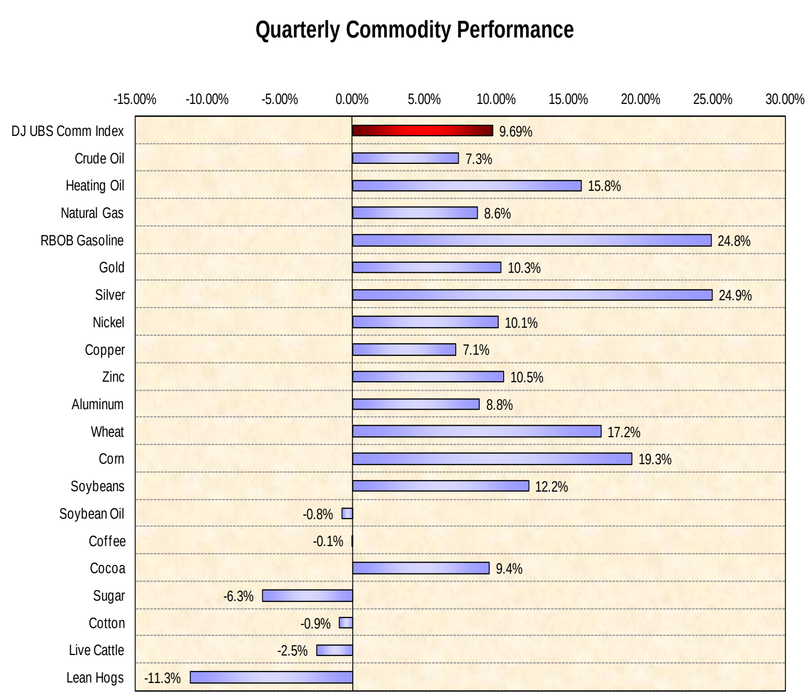


Opportunistic: Hedge funds posted their fourth consecutive month of gains in September and the HFRI Fund Weighted Composite Index returned 2.90% for the third quarter. Performance was led by directional equity hedge fund strategies as investor sentiment improved on positive developments in the European banking and sovereign debt crisis, as well as U.S. stimulus efforts. Relative value arbitrage and event driven strategies also posted gains on continuation of strong merger and acquisition activity. Global macro strategies declined 26bps in September but returned 1.55% for the quarter. Hedge funds-of-funds also posted their best monthly performance since February with the benchmark index returning 2.37% for the quarter. Our opportunistic portfolio returned 2.38% in the third quarter.

Private Equity: Year-to-date investment by private equity firms has decreased slightly compared to the same period in 2011, led by a decline in new venture capital investments. On the other hand, exit activity has been robust with a large increase in initial public offering (IPO) exits. Year-to-date purchase valuations are down slightly compared to 2011; however, there remains a large disparity between large deal valuations (high versus history) and smaller deal valuations (low versus history). Leverage use is roughly in line with historical levels. During the quarter, our private equity managers called a combined $5.8 million and paid distributions of $5.7 million. Our current allocation to private equity is 7.5%, with a market value of $229.0 million. From its 2003 inception through June 30, 2012, the private equity program has generated a net internal rate of return of 6.2% versus a 7.3% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 basis points).

Private Real Assets: 2012 year-to-date U.S. real estate transaction volume has slightly exceeded that recorded for 2011, driven by a strong first quarter. Valuations have increased slightly year-to-date. Multifamily continues to be the highest valued property type, while the retail sector has shown the most improvement. In energy investing, natural gas prices have recovered over 50% of their value since lows reached in April 2012, though they are still hovering near 11-year lows. Oil prices remain generally strong. Pricing for new transactions is highest in oil-rich assets and gas assets with large liquids components; de-risked assets with high cash flow components are also commanding higher prices. During the quarter, our managers called a total of $12.2 million and paid distributions of $2.1 million. Our current allocation to private real assets is 5.3%, with a market value of $162.9 million. From its 2006 inception through June 30, 2012, the private real assets program has generated a net loss of 3.0% versus a 6.9% loss 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 gained 9.69% for the quarter. Grains were the best performing sector, returning 15.82%, on concerns that the drought in the U.S. Midwest could limit supply and might result in higher food prices. Precious metals also posted strong gains, returning 13.42% for the quarter. Silver returned 24.9% in the quarter, and has climbed 35% from its June low, due to strong emerging market demand, primarily China and India. Potential oil supply interruptions in the Middle East, due to the political unrest in the region, and record low inventory levels of gasoline in the U.S. resulted in higher energy commodity prices. During the quarter, our commodities portfolio advanced 9.63%, slightly below the DJ UBS Commodities Index.



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, 2012 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 9/30/2012	Fiscal YTD
Employer Contributions	$ 31.9	$ 31.9
Member Contributions	6.2	6.2
Net Investment Income	154.1	154.1
	$ 192.2	$ 192.2

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 9/30/2012	Fiscal YTD
Benefits	$ 51.8	$ 51.8
Refunds	0.7	0.7
Administrative Expenses	0.7	0.7
	$ 53.2	$ 53.2

Outlook

The outlook for the global economy continues to be a slow recovery but there are several headwinds that could lead to further weakness. These headwinds include uncertainties and instability caused by the European sovereign debt crisis and a recession in Europe. In addition, there are signs of slowing growth in China, India and Brazil.

In the U.S., investors are concerned over the impending fiscal cliff, which, if not resolved, could result in increased U.S. tax rates and significant spending cuts that could potentially decrease growth enough to lead to a recession. Stubbornly high unemployment also remains a headwind for growth but housing appears to be showing signs of recovery. Near-term inflation concerns have been reduced; however, longer-term, the levels of monetary and fiscal stimulus supporting the U.S. economy cannot be sustained and could eventually result in higher inflation.

High employment growth and solid consumption should continue to propel demand in emerging market economies. Low growth and uncertainty in developed economies, primarily Europe, are affecting emerging economies through both trade and financial channels.

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
September 30, 2012

Assets		
Equity in pooled cash and investments	$	1,221,810
Investments:		
Northern Trust		3,058,602,127
Aetna		1,192,452
Fidelity - Elected Officals Plan		436,672
Fidelity - DRSP		10,938,064
Total investments		3,071,169,315
Contributions receivable		9,015,380
Total assets		3,081,406,505
Liabilities		
Benefits payable and other liabilities		5,521,142
Net assets held in trust for pension benefits	**$**	**3,075,885,363**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
September 30, 2012

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 31,944,177	$ 31,944,177
Member	6,188,373	6,188,373
Total contributions	38,132,550	38,132,550
Investment income	158,056,549	158,056,549
Less investment expenses	3,925,442	3,925,442
Net investment income	154,131,107	154,131,107
Total additions	192,263,657	192,263,657
Deductions		
Retiree benefits	38,119,507	38,119,507
Disability benefits	11,579,242	11,579,242
Survivor benefits	2,083,729	2,083,729
Refunds	714,770	714,770
Administrative expenses	654,740	654,740
Total deductions	53,151,988	53,151,988
Net increase (decrease)	**139,111,669**	**139,111,669**
Net asset held in trust for pension benefits		
Beginning of period	**2,936,773,694**	**2,936,773,694**
End of period	**$ 3,075,885,363**	**$ 3,075,885,363**