OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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Chief Administrative Officer

February 25, 2010

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, 2009. 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 (effective July 1, 2009). There were approximately 4,990 active members and 5,840 retirees participating in the ERS as of December 31, 2009.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 3.90%, 28 basis points above the 3.62% gain recorded by the policy benchmark. For the one year period ending December 31, 2009 the ERS' gross return (before fees) was a gain of 21.53%, 20 basis points ahead of the 21.33% gain recorded by the policy benchmark. The one-year return, after fees, places the ERS' performance in the top 30% of a universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was a gain of 0.22%, after fees, ranking in the top 13% of the universe. The asset allocation at December 31, 2009 was: Domestic Equities 27.2%, International Equities 20.4%, Fixed Income 26.5%, Inflation Linked Bonds 9.4%, Commodities 5.3%, Private Equity 6.1%, Real Estate 3.4%, Opportunistic 1.0%, and Cash 0.7%. We estimate that the funded status of the ERS was 79.2% as of December 31, 2009, a slight decrease from the September 30, 2009 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.

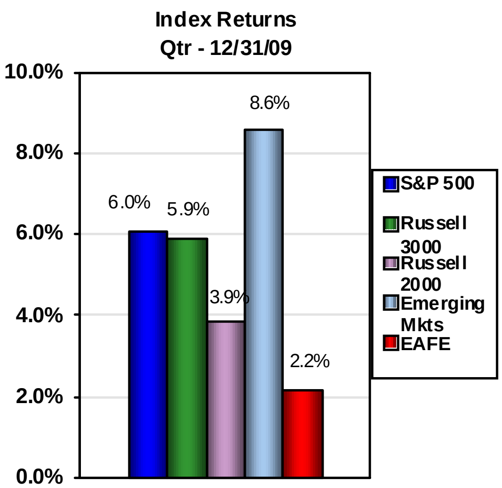
Major Initiatives

During the quarter, the Board approved transmittal of their 2009 Annual Report to all participants, which includes the results of the audit of the ERS. In addition, the Board was notified by an ERS separate account manager that Wartsila Oyj, a company that is in violation of the County Code related to doing business in Sudan, was sold due to the twelve month holding period restriction in the County Code, recognizing a loss of $113,469. Another holding, Smith International, was also required to be placed on the restricted list for future investment due to their involvement in Sudan.

Capital Markets and Economic Conditions

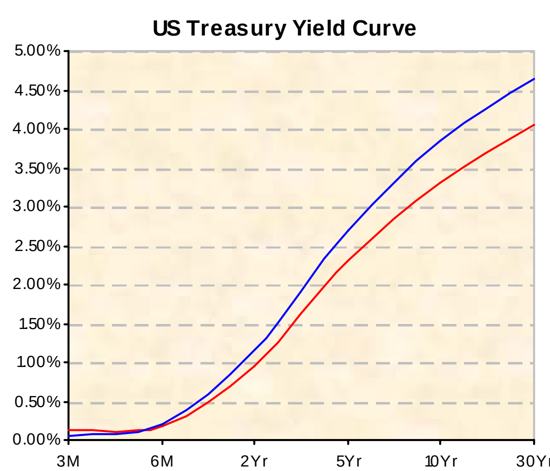
Real GDP rose 5.7% in the fourth quarter with positive contributions from private inventory investment, exports, and personal consumption expenditures. Nondurable goods increased 4.3%, compared to an increase of 1.5% in the third quarter. The U.S. manufacturing sector, as measured by the Institute of Supply Management's (ISM) composite, expanded for the sixth consecutive month in January. These statistics are indicative of economic growth and the potential for business expansion and higher employment in the future. However, despite these positive signs, unemployment remains at historically high levels and economists continue to be concerned that unemployment may remain at these levels for a longer time period than in past recoveries. The burgeoning recovery in residential real estate is also showing signs of uncertainty, with December new home sales falling relative to both November and year over year.

Public Equity Markets: The U.S. equity markets continued to deliver strong returns during the fourth quarter on the positive economic data points mentioned and better-than-expected earnings reports. As shown in the chart to the left, larger capitalization companies (S&P 500 Index) outperformed their smaller counterparts (Russell 2000 Index). The fourth quarter market rally allowed the S&P 500 Index to experience its largest annual increase in six years. All sectors of the S&P 500, excluding Financials, posted positive returns with IT, Consumer Discretionary, and Health Care taking the lead. Our combined domestic equity performance was a gain of 7.10%, outperforming the 5.90% return recorded by the Russell 3000 benchmark. For the one year period ending December 31, our combined domestic equity portfolio recorded a gain of 32.57%, outperforming the benchmark's 28.34% gain by 423 basis points.



Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were up 2.18% for the quarter, compared to emerging markets which advanced 8.55% on strong export growth in the Asia Pacific region and robust economic growth in Brazil, Russia, India and China (BRIC countries). The majority of EAFE markets were up with Norway (+14.88%) and Singapore (+9.76%) recording the strongest performance. The markets of Chile (+15.29%) and Israel (+14.03%) took the lead within the emerging markets sector. Our combined international equity performance was a gain of 3.32% for the quarter, 42 basis points behind the benchmark's gain of 3.74%. Our combined international equity performance for the year ending December 31 was a gain of 42.47%, outperforming the benchmark by 102 basis points.

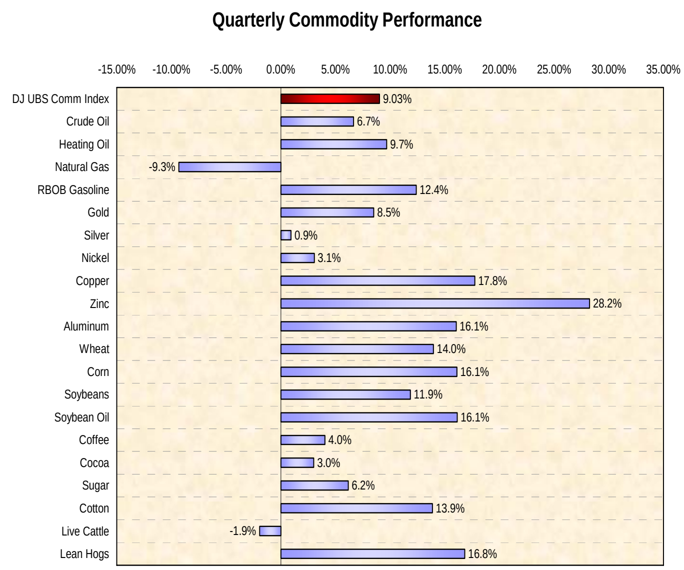
Fixed Income: Treasury yields rose this quarter, led by the long-end of the curve. Short term rates remain close to zero given the FOMC's decision to keep a very accommodative interest rate policy throughout the year. The yield curve (shown in the chart to the right) steepened to historically wide levels as the 2 year Treasury bond rose 19 bps from 0.95% to 1.14% and the 10 year Treasury bond rose 53 bps from 3.31% to 3.84%. A steep yield curve can be a signal that investors are expecting strong economic growth and potential inflationary pressures. Credit spreads narrowed and outperformed similar duration Treasuries as investors continued to move into riskier assets in search of higher yields. The high yield bond market, represented by the Merrill Lynch High Yield Master II Index, gained 6.03% and recorded its 10th straight month of gains in December. Long investment grade credit issues posted a loss, with the Barclays Long Govt/Credit Index declining 3.29%, due to rising interest rates. Our combined fixed income performance for the quarter was a gain of 2.25%, outperforming the 0.98% gain recorded by the benchmark index. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 2.04% for the quarter, compared to the 1.04% return of the benchmark.



Private Equity: Private equity showed a third consecutive quarter of increasing investment activity with the majority of deals happening at the small end of the size spectrum. Liquidity for private equity firms also increased during the fourth quarter, particularly for buyout firms. Both the initial public offering and mergers and acquisitions exit routes showed marked improvement, with the majority of 2009 IPOs for buyout deals taking place within a matter of several weeks, some resulting in attractive returns to fund sponsors. During the quarter, our private equity managers called a combined $5.6 million and paid distributions of $1.3 million. Our current allocation to private equity is 6.1%, with a market value of $151.2 million.

Private Real Assets: Led by China, global real estate investment increased during all four quarters of 2009. In spite of an increasing number of distressed properties, U.S. market activity remains subdued due to banks' willingness to lengthen loan maturities, even for borrowers whose loan value exceeds market value. During 2009, residential real estate values showed signs of improvement as measured by the S&P/Case-Shiller Home Price Index which recorded 10 consecutive months of improving values. However, the index was down 5.3% for all of 2009 due to sharp drops early in the year. Commercial real estate, which lags the broad economy, has continued to fall in value. Although there has been insufficient transaction activity to draw firm conclusions on valuations, many sources report double-digit percentage declines in commercial pricing. In energy markets, Exxon's December acquisition of XTO Energy may presage a boost in deal activity as Exxon sells non-core XTO assets to other industry players. During the quarter, our managers called a total of $8.9 million and paid distributions of $0.2 million. Our current allocation to private real assets is 3.3%, with a market value of $82.3 million.

Commodities: The DJ UBS Index advanced 9.03% during the quarter with all major commodity sectors contributing to performance. Industrial metals (+16.9%) were the best performing sector due to the continuation of China's demand for raw materials. On an individual commodity level, zinc performed best, appreciating +28.2%, on both Chinese and OECD demand. Corn and wheat prices soared with the general uptrend in the other commodities markets. Oilseeds rose strongly, driven by low inventory levels and strong Chinese imports. Lean hog prices rebounded sharply as a result of reduced concerns about eating pork as well as higher demand from China (which lifted its ban on U.S. pork imports). Within the energy sector, natural gas posted negative returns as higher inventory levels continued to depress prices. During the quarter, our commodities portfolio advanced 8.48%, trailing the DJ UBS Commodities Index by 55 basis points.



Additions

The primary sources of additions for the ERS include contributions from members and employers, investment income and the transfer of RSP account balances to the GRIP. The following table displays the source and amount of additions for the quarter ending December 31, 2009 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 12/31/2009	Fiscal YTD
Employer Contributions	$ 29.0	$ 57.9
Member Contributions	5.6	10.6
GRIP Transfers	-	30.5
Net Investment Income	58.3	322.6
	$ 92.9	$ 421.6

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 12/31/2009	Fiscal YTD
Benefits	$ 41.4	$ 82.8
Refunds	-	0.3
Administrative Expenses	0.8	1.6
	$ 42.2	$ 84.7

Outlook

After a negative year in 2008, the equity markets rose strongly and fixed income credit spreads narrowed in 2009. On the economic front, there have been hints of stabilization and even modest recovery, especially through the second half of 2009. Investors will continue to weigh new economic data over the next several quarters to assess whether current financial asset prices are attractive based on forward expectations. Broadly speaking, companies have reported earnings that are at or above expectations for the fourth quarter, but management outlooks have come in less optimistic than analysts expected.

For the United States, any economic recovery will need to be rooted in increased consumer spending as the consumer accounts for approximately 70% of GDP growth. With unemployment levels hovering near historic highs, it is unclear whether consumers will have the wherewithal to drive GDP growth unless employment conditions improve. Unemployment, coupled with the continued deterioration in the housing market, has led many economists to forecast a slower recovery than in past recessions.

The Federal Reserve has voted to maintain interest rates at "exceptionally low levels for an extended period" in anticipation of a slow economic recovery. Despite this accommodative language, interest rates have begun to rise reflecting investor concern over the impact of the Federal Reserve winding down its mortgage backed securities purchase operations and various other liquidity-providing programs.

Internationally, the economic situation is varied. Emerging markets have shown strength but developed economies have faced problems similar to those of the United States. Government deficits have also begun to play a larger role in international markets, especially in the European Union where several member countries have yet to resolve large budgetary shortfalls. Investors continue to monitor these issues and assess the risk of contagion that could result from European Union instability.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
December 31, 2009

Assets		
Equity in pooled cash and investments	$	25,154
Investments:		
Northern Trust		2,465,214,907
Aetna		13,791,169
Fidelity - Elected Officals Plan		849,314
Fidelity - DRSP		2,907,983
Total investments		2,482,763,373
Contributions receivable		4,683,498
Total assets		2,487,472,025
Liabilities		
Benefits payable and other liabilities		4,502,660
Net assets held in trust for pension benefits	**$**	**2,482,969,365**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
December 31, 2009

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 28,989,223	$ 57,933,647
GRIP Transfers		$ 30,500,217
Member	5,568,947	10,643,796
Total contributions	34,558,170	99,077,660
Investment income	62,062,969	329,053,102
Less investment expenses	3,734,477	6,441,362
Net investment income	58,328,492	322,611,740
Total additions	92,886,662	421,689,400
Deductions		
Retiree benefits	29,929,874	60,082,669
Disability benefits	9,550,927	18,981,611
Survivor benefits	1,896,023	3,778,022
Refunds	5,556	308,152
Administrative expenses	833,529	1,568,776
Total deductions	42,215,909	84,719,230
Net increase (decrease)	**50,670,753**	**336,970,170**
Net asset held in trust for pension benefits		
Beginning of period	**2,432,298,612**	**2,145,999,195**
End of period	**$ 2,482,969,365**	**$ 2,482,969,365**