



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett  
*County Executive*

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*Chief Administrative Officer*

September 12, 2008

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, 2008. 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. There were approximately 5,000 active members and 5,300 retirees participating in the ERS as of June 30, 2008.

### ***Performance Results***

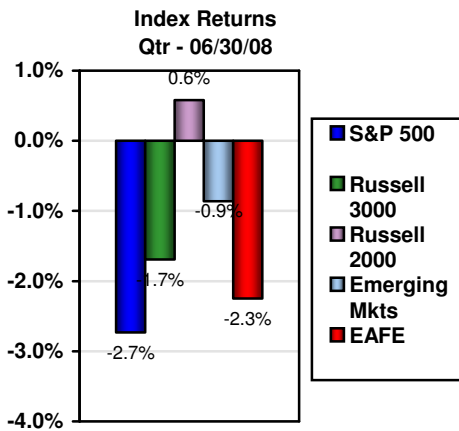
The total return achieved by the ERS assets for the quarter was a gain of 0.11%, 101 basis points ahead of the 0.90% loss recorded by the policy benchmark. For the one year period ending June 30, 2008 the estimated ERS' gross return (before fees) was a loss of 2.26%, 282 basis points ahead of the 5.08% loss recorded by the policy benchmark. The one-year return places the ERS' performance in the top third of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 8.22%, before fees, ranking in the top 6% of the universe. The asset allocation at June 30, 2008 was: Domestic Equities 35.1%, International Equities 20.2%, Fixed Income 24.5%, Inflation Linked Bonds 11.7%, Private Equity 5.7%, Real Estate 2.7% and Cash 0.1%. We estimate that the funded status of the ERS was 83.3% as of June 30, 2008, an increase of 1.1% from 82.2% at March 31, 2008. 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 the hiring of two real asset managers, TA Associates with a \$20m allocation in real estate and a \$25m allocation to FLAG Real Assets Partners, which invests in both real estate and natural resources. The Board also hired KLD Research and Analytics to provide advisory services related to compliance with the recently passed Sudan Divestment legislation. In addition, the Board approved conducting a search for a private equity consultant. There is also continuing work to broaden out the investment allocation including the review of commodities managers with the aim to provide diversification as well as downside protection.

### ***Capital Markets and Economic Conditions***

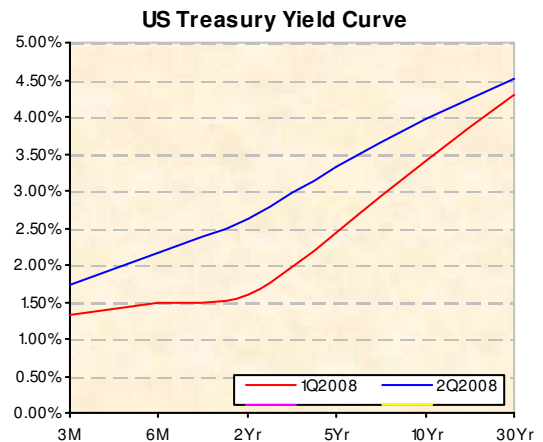
Although the economic climate continues to be fragile, the watchword for the quarter suddenly turned into inflation with the headline CPI reaching 4.2% year over year in May. Oil prices soared during the quarter (crude oil prices rose to over \$140 per barrel) and brought with them a marked increase in food and energy costs. Broader economic issues still appear to be unresolved – in particular, the housing market continues in the doldrums with foreclosures boosting inventories higher. Each month this year has also brought more job losses and unemployment stands at 5.5%, 1% higher than 12 months earlier. The Federal Reserve chose to cut the Fed Funds rate by 25bps to 2.0% at the end of April but took no action at their June 25<sup>th</sup> meeting counting on the slowing economy to ease price pressures.



**Public Equity Markets:** U.S. equity markets recorded mixed results for the quarter amid continuing concerns with credit markets, surging commodity prices, and a further weakening in the housing market. As shown in the chart to the left, small capitalization companies (as represented by the Russell 2000 Index) outperformed their larger counterparts (S&P 500 Index) for the quarter. Growth stocks outperformed value stocks across the capitalization spectrum. The top performing sectors of the S&P 500 during the quarter were energy and basic materials while financials were the worst performing sector. Our combined domestic equity performance was a gain of 1.52%, 321 basis points ahead of the Russell 3000 benchmark. For the one year period ending June 30, our combined domestic equity portfolio recorded a loss of 9.81%, 288 basis points better than the 12.69% loss recorded by the benchmark.

Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were down 2.25% for the quarter compared to emerging markets which fell 0.86%. Among the EAFE markets Belgium (-19.45%) and Ireland (-17.69%) detracted the most from returns. The markets of Pakistan (-26.60%), Philippines (-24.91%), and India (-19.70%) led the underperformance within the emerging markets sector. Our combined international equity performance was a loss of 2.32% (2.78% after including the performance of our currency managers) for the quarter, 120 basis points behind the benchmark loss of 1.12%. For the one year period ending June 30, our combined international equity return was a loss of 6.60% (6.01% after including the currency managers), outperforming the benchmark by 4 basis points.

**Fixed Income:** With the Federal Reserve opting to leave rates on hold at 2.0% and signaling an end to their cutting cycle, there was a significant increase in short term yields during the quarter (the spread between 2yr and 10yr rates narrowed by 47 basis points). Spread sectors did well for the quarter with corporates, CMBS, high yield and emerging market debt all outperforming Treasuries by over 250bps during the quarter. At the end of June, the yield on 2-year Treasuries was up over 1.0% for the quarter to 2.62% and 10-year Treasuries rose by over 0.5% to 3.97%. Combined fixed income performance for the quarter was a loss of 0.08%, slightly outperforming the 0.13% loss recorded by the benchmark index. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, recorded a slightly positive return for the quarter, up 0.33%, 6 basis points ahead of the benchmark's return of 0.27%. Strong performance continues to come from commodities as well as the Euro currency and bond positions.



**Private Equity:** Buyout industry activity has remained sluggish due to spillover effects from the banking industry's credit troubles. Venture capitalists have continued a robust fundraising and investment pace, though exit channels are currently weak. During the second quarter, our private equity managers called a combined \$12.2m and paid distributions of \$1.2 million. Our current allocation to private equity is 5.7%, with a market value of \$147.3 million.

**Real Estate:** Real estate transaction volume has fallen in comparison with 2007. In spite of this, some high-profile assets traded hands during June, several relating to overextended borrowers' liquidity needs. New York's General Motors Building, for one, was bought by a consortium of investors. During the quarter, there were capital calls from our real estate managers totaling \$1.3 million and distributions of \$0.5 million. Our current allocation to real estate is 2.8%, with a market value of \$73.5 million.

**Additions**

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending June 30, 2008 and fiscal year-to-date.

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

	<b>Qtr 6/30/2008</b>	<b>Fiscal YTD</b>
Employer Contributions	\$ 29.5	\$ 117.7
Member Contributions	4.7	18.9
Net Investment Income (Loss)	(1.3)	(77.7)
	<u>\$ 32.9</u>	<u>\$ 58.9</u>

**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)**

	<b>Qtr 6/30/2008</b>	<b>Fiscal YTD</b>
Benefits	\$ 37.2	\$ 147.0
Refunds	0.2	0.7
Administrative Expenses	0.7	2.8
	<u>\$ 38.1</u>	<u>\$ 150.5</u>

**Outlook**

The financial markets are experiencing pressure due to financial company weakness, declines in housing prices and employment, as well as rising commodities prices and inflation. These pressures create a temporary dislocation in the markets, where fear is the primary driver of asset pricing rather than their fundamental value. The mortgage sector (MBS, ABS and CMBS securities) in particular, is suffering from extremely poor liquidity and distressed pricing with forced sellers creating a market where there is no differentiation between good bonds and those that are at risk of default.

It seems certain that these uncertain conditions will prevail for the short to medium term and the portfolio allocation is structured to manage the market volatility by maintaining a diversified allocation. Our approach to managing investment risk is to continue to diversify the Plan's asset allocation across a number of different asset classes, as well as allocating assets to skilled investment managers who can add value independent of market direction. This combination of strategic asset allocation, as well as dedicated active management, will help us manage our exposure to market volatility and meet the long-term targets of the retirement system.

**EMPLOYEES' RETIREMENT SYSTEM  
STATEMENTS OF PLAN NET ASSETS**

June 30, 2008

**Assets**

Equity in pooled cash and investments	\$ <u>189,770</u>
Investments:	
Northern Trust	2,602,208,796
Aetna	16,221,931
Fidelity - Elected Officials Plan	<u>1,037,426</u>
Total investments	<u>2,619,468,153</u>
Contributions receivable	<u>8,369,431</u>
Total assets	<u>2,628,027,354</u>

**Liabilities**

Benefits payable and other liabilities	<u>5,346,643</u>
<b>Net assets held in trust for pension benefits</b>	<b><u>\$ 2,622,680,711</u></b>

**EMPLOYEES' RETIREMENT SYSTEM**  
**STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
 June 30, 2008

	Quarter	Fiscal YTD
<b>Additions</b>		
Contributions:		
Employer	\$ 29,460,283	\$ 117,686,375
Member	<u>4,702,307</u>	<u>18,850,881</u>
Total contributions	<u>34,162,590</u>	<u>136,537,256</u>
Investment income (loss)	3,063,639	(64,532,428)
Less investment expenses	<u>4,374,963</u>	<u>13,118,489</u>
Net investment income (loss)	<u>(1,311,324)</u>	<u>(77,650,917)</u>
Total additions	<u>32,851,266</u>	<u>58,886,339</u>
<b>Deductions</b>		
Retiree benefits	26,358,356	105,368,941
Disability benefits	9,080,174	34,934,780
Survivor benefits	1,691,445	6,723,276
Refunds	179,577	672,951
Administrative expenses	<u>744,415</u>	<u>2,773,339</u>
Total deductions	<u>38,053,967</u>	<u>150,473,287</u>
<b>Net increase (decrease)</b>	<u><b>(5,202,701)</b></u>	<u><b>(91,586,948)</b></u>
<b>Net asset held in trust for pension benefits</b>		
Beginning of period	<u>2,627,883,412</u>	<u>2,714,267,659</u>
<b>End of period</b>	<u><b>\$ 2,622,680,711</b></u>	<u><b>\$ 2,622,680,711</b></u>