OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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September 20, 2011

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, 2011. 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 5,400 active members and 5,900 retirees participating in the ERS as of June 30, 2011.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 1.96%, 36 basis points ahead of the 1.60% gain recorded by the policy benchmark. For the one year period ending June 30, 2011 the ERS' gross return (before fees) was a gain of 21.88%, 193 basis points ahead of the 19.95% gain recorded by the policy benchmark. The one-year gross return places the ERS' performance above the median 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 gross gain of 5.52%, ranking in the top third in the universe and the five-year return, a gain of 6.40% ranked in the top decile. The asset allocation at June 30, 2011 was: Domestic Equities 26.6%, International Equities 18.4%, Fixed Income 24.6%, Inflation Linked Bonds 10.9%, Commodities 5.3%, Private Equity 7.1%, Private Real Assets 4.0%, Opportunistic 2.8%, and Cash 0.3%. We estimate that the funded status of the ERS was 78.1% as of June 30, 2011, an increase from the June 30, 2010 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.

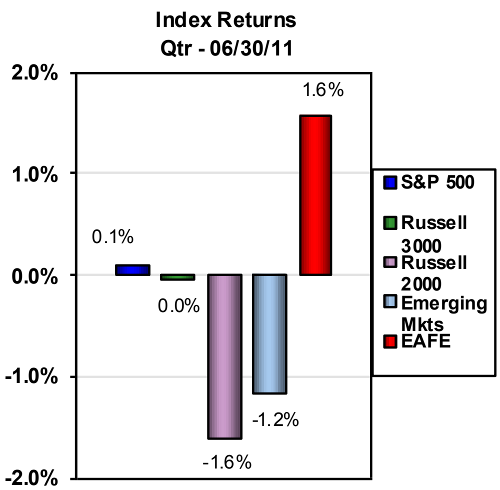
Major Initiatives

The Board approved an investment of $12,000,000 in Altus Capital Partners II, L.P. within the private equity sector bringing the total committed to $36,000,000 for FY11. Staff continues to review opportunities within the private real assets, private equity and opportunistic allocations.

Capital Markets and Economic Conditions

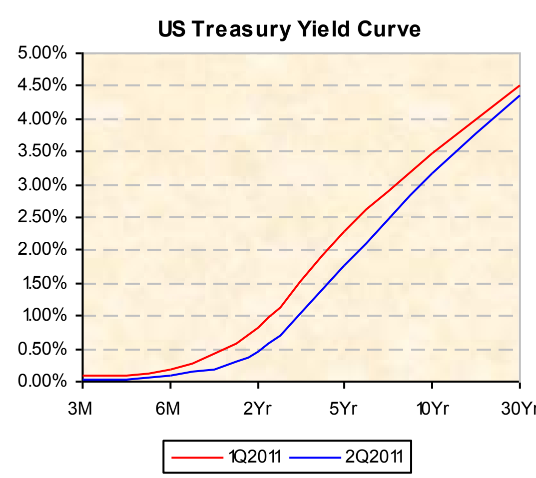
Second quarter employment data indicated that the labor market recovery has stagnated as the unemployment rate rose to 9.1% and initial jobless claims exceeded 400,000 per month by the end of the quarter. June 30th marked the end of the Federal Reserve's second round of quantitative easing, but interest rates are still expected to stay low for an extended period of time. The headwinds from high unemployment have contributed to the stalled housing market recovery. Core inflation remained subdued for the quarter, with a year-over year inflation rate of 1.5% as of quarter end. Manufacturing remains a bright spot in the economy with the Institute for Supply Management's manufacturing index consistently coming in above 50 (readings above 50 indicate the sector is still expanding), but falling short of the robust growth experienced in the first quarter. Outside of the U.S., renewed focus was placed on the debt crisis in Europe with downgrades of sovereign debt in Greece and Ireland. Emerging markets continue to struggle with high inflation rates due to higher agriculture and energy prices.

Public Equity Markets: The U.S. equity markets experienced a volatile ride in the second quarter driven by softer domestic economic data and increased geopolitical concerns abroad. Domestic indices showed mixed results as shown in the chart below with smaller capitalization (as represented by the Russell 2000 Index) and stocks underperforming their larger counterparts. Healthcare, Utilities, and Consumer Staples were the best performing sectors of the S&P 500 while the sensitive Financials and Energy sectors were the worst performers in the second quarter. Our combined domestic equity performance was a gain of 0.46%, outperforming the 0.03% loss recorded by the Russell 3000 benchmark.



International markets experienced strong headwinds due to the Middle East conflict and the debt crises in Europe. Developed markets, as measured by the MSCI EAFE Index, advanced by 1.56% (-0.80% in local currency terms) on a weak dollar and surprising strength in markets such as Germany, Switzerland, and the UK. Emerging markets, which declined 1.15% (-2.68% in local currency terms) during the quarter, continue to underperform their developed counterparts on rising inflation and interest rate hike concerns in these countries. Our combined international equity performance was a gain of 1.91% for the quarter, outperforming the 0.38% gain recorded by the MSCI ACWI ex-US Index due to stock selection in Europe (Germany), Japan, Hong Kong, Brazil and Taiwan, and positioning in Russia and Indonesia.

Fixed Income: Treasury yields fell during the second quarter as concerns over a potential double-dip recession and the debt crises in Europe led to a flight to quality. A possible US default without a debt limit increase and the ending of the Fed's monetary stimulus program, QE2, also created uncertainty in the markets. The Fed maintained its target rate at a 0% - 0.25% range, while reiterating its view that current economic conditions warrant exceptionally low levels for an extended period. In April, the Fed held the first ever post meeting press conference in which the Chairman stated the Federal Open Market Committee had reduced its growth projection and increased inflation expectations. The yield curve (shown in the chart to the right) steepened slightly as the 2-year Treasury bond fell 37bps to 0.46% while the 10-year Treasury bond declined 31 bps to 3.16%. Investor concern over the sluggishness of the economy resulted in credit spreads widening over the quarter with both investment-grade and high yield credits underperforming relative to Treasuries. For the quarter, the Merrill Lynch High Yield Master II Index rose 0.99% while the Barclays Aggregate Bond Index returned 2.29% and the Barclays Long Government/Credit Index rose 3.30%. Our combined fixed income performance for the quarter was a gain of 2.18%, underperforming the custom benchmark which returned 2.29%. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 9.50% for the quarter, compared to the 6.75% gain recorded by the benchmark.

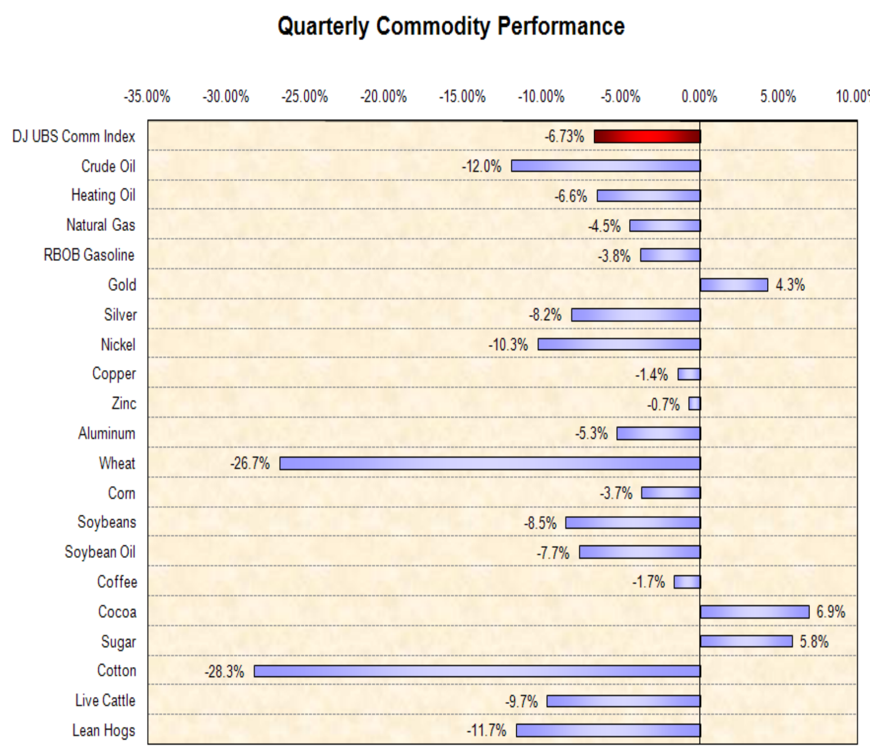


Opportunistic: Credit strategies including long biased credit and distressed performed well in the second quarter. However, residential and commercial mortgage-backed securities detracted due to an influx of supply as the Federal Reserve Bank of New York sold a large portion of its holdings. Relative value strategies, primarily convertible bond arbitrage managers, detracted as credit spreads widened and the equity markets were flat. Market neutral equity strategies were generally positive amid strong corporate earnings. Macro strategies were also positive this quarter from interest rate trading strategies as various countries' monetary and fiscal policies differed. Tail risk protection strategies were the largest detractor from performance due to short currency positions in the Euro and Australian dollar. The return of the opportunistic allocation was a loss of 0.33%, outperforming the 1.21% decline of the HFRI Fund-of-Funds benchmark.

Private Equity: Industry data suggests that global private equity investment activity for the second quarter reached its highest level since 2008. North American markets, led by the U.S., saw the most new deal activity. The strong deal environment has led to robust exit activity, with both number of exits and the dollar value of exits near all-time highs. During the quarter, our private equity managers called a combined $3.5 million and paid distributions of $5.2 million. Our current allocation to private equity is 7.1%, with a market value of $203.1 million. From its 2003 inception through December 31, 2010, the private equity program has generated a net internal rate of return of 5.4% versus a 6.2% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 basis points).

Private Real Assets: U.S. real estate prices as measured by the Moody's/REAL U.S. Commercial Property Price Index rebounded slightly during the quarter from a post-financial crisis low reached during April. There continues to be a large divergence in how the price recovery plays out with major properties in major markets recovering significantly more value than all other properties. Real estate transaction activity was up a healthy 24% versus the same half-year in 2010. The U.S. became the key driver of increased deal activity during the quarter. In energy investing, the high level of 2010 activity has carried into the first half of the year, still driven largely by companies selling conventional assets in order to acquire unconventional ones (generally, energy reserves trapped in previously inaccessible areas often requiring newer drilling techniques). During the quarter, our managers called a total of $11.4 million and paid distributions of $2.5 million. Our current allocation to private real assets is 4.0%, with a market value of $115.1 million. From its 2006 inception through December 31, 2010, the private real assets program has generated a net loss of 11.6% versus a 13.0% loss for a broad real estate price index (the Moody's/REAL U.S. Commercial Property Price Index).

Commodities: The DJ UBS Commodity Index ended the quarter in negative territory with all sectors, except Precious Metals, declining substantially during the quarter, driven by the slowdown in global economic growth. Geopolitical unrest, headline inflation in emerging markets and the European debt crises continued to weigh on commodity prices with a few exceptions such as gold moving in the opposite direction. The Agriculture and Soft Commodities sectors were down, lead by wheat (-26.7%) and cotton (-28.3%), due to increases in global supply. Soft demand for raw materials and fuel also pushed Industrial Metals and Energy prices down. Livestock was also down on a combination of high feed costs and weakening demand. During the quarter, our commodities portfolio declined 7.57%, underperforming the 6.73% loss recorded by 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 June 30, 2011 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 6/30/2011	Fiscal YTD
Employer Contributions	$ 19.5	$ 108.0
Member Contributions	5.9	20.0
Net Investment Income	49.5	497.7
	$ 74.9	$ 625.7

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 6/30/2011	Fiscal YTD
Benefits	$ 44.5	$ 178.7
Refunds	0.2	1.6
Administrative Expenses	0.9	3.2
	$ 45.6	$ 183.5

Outlook

The outlook for the global economy and markets remains highly uncertain due, in part, to high debt levels in the developed markets and large trade imbalances between the developed and emerging markets, especially between the U.S. and China. Massive levels of monetary and fiscal stimulus supporting the U.S. economy cannot be sustained indefinitely and it is unclear whether the private sector can support growth when stimulus policies wane. A low GDP growth rate makes it likely that the unemployment rate will continue to hover at relatively high levels for the foreseeable future, which will increase pressure on politicians to find ways to create jobs. However, due to political gridlock in Congress and fiscal borrowing constraints, the Federal Reserve may be the only remaining entity that can provide meaningful stimulus, and uncertainty surrounding the effects of more monetary easing may outweigh any perceived benefits. It will also be challenging for the U.S. housing market to recover if employment remains weak. Core inflation will likely remain relatively low as long as economic growth is subdued and consumers continue to display reluctance to borrow for consumption.

Lenders are concerned about the high debt levels and ongoing financing needs in several European nations including Greece, Portugal, Spain, and Italy. Because these nations have linked currencies they cannot devalue their currencies to solve their debt problems, and thus are being forced to enact austerity measures to cut back on government spending. The risk is that the ensuing austerity measures will result in slower growth and lead to lower government revenues that would further reduce their ability to repay debt. Fears of contagion effects from this potential European debt crisis may weigh on markets as these countries face debt refinancing and other new borrowing requirements over the coming quarters.

Sources: Bloomberg, Northern Trust, MSCI, S&P, Pyramis Global Advisors, FRM, 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
June 30, 2011

Assets		
Equity in pooled cash and investments	$	563,008
Investments:		
Northern Trust		2,855,496,866
Aetna		15,360,687
Fidelity - Elected Officals Plan		789,242
Fidelity - DRSP		9,743,928
Total investments		2,881,390,723
Contributions receivable		9,502,414
Total assets		2,891,456,145
Liabilities		
Benefits payable and other liabilities		6,586,595
Net assets held in trust for pension benefits	**$**	**2,884,869,550**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
June 30, 2011

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 19,535,713	$ 107,955,344
Member	5,921,517	20,029,826
Total contributions	25,457,230	127,985,170
Investment income	54,870,698	518,825,305
Less investment expenses	5,392,844	21,127,728
Net investment income	49,477,854	497,697,577
Total additions	74,935,084	625,682,747
Deductions		
Retiree benefits	32,074,006	129,896,793
Disability benefits	10,405,011	40,906,886
Survivor benefits	2,019,038	7,944,401
Refunds	202,826	1,606,420
Administrative expenses	857,285	3,151,020
Total deductions	45,558,166	183,505,520
Net increase (decrease)	**29,376,918**	**442,177,227**
Net asset held in trust for pension benefits		
Beginning of period	**2,855,492,632**	**2,442,692,323**
End of period	**$ 2,884,869,550**	**$ 2,884,869,550**