OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

September 19, 2014

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, 2014. 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 5,400 ERS and GRIP active members and 5,750 retirees participating in the ERS as of June 30, 2014.

Performance Results

The total return achieved by the ERS assets for the quarter was a return of 4.55%, 3 basis points ahead of the 4.52% return recorded by the policy benchmark. For the one year period ending June 30, 2014 the ERS' gross return (before fees) was a gain of 17.66%, 158 basis points ahead of the 16.08% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the second quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 11.16% for the three-year period and 13.87% for the five-year period ranked in the top decile and top quarter of the universe, respectively. The asset allocation at June 30, 2014 was: Domestic Equities 18.2%, International Equities 16.5%, Global Equities 4.0%, Fixed Income 23.3%, Inflation Linked Bonds 10.0%, Commodities 5.5%, Private Equity 6.7%, Private Real Assets 4.9%, Private Debt 0.1%, REITS 5.7%, Opportunistic 3.5%, and Cash 1.6%. We estimate that the funded status of the ERS was 83.2% as of June 30, 2014, a 4.4% increase from the June 30, 2013 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.

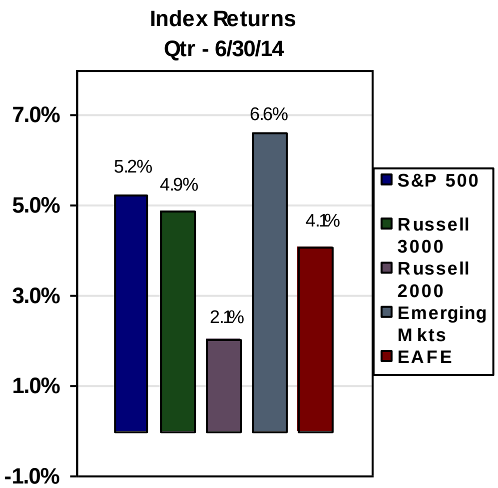
Major Initiatives

During the quarter, the Board approved reducing the target allocation to commodities from 6% to 4% and adding a 2% allocation to Master Limited Partnerships. Within the opportunistic sector, the Board hired Och-Ziff and Luxor Capital to each manage $12,000,000 and MKP to manage $10,000,000. In addition, the Board made a commitment of $17,000,000 to Thoma Bravo within the private equity sector.

Capital Markets and Economic Conditions

Economic data released during the second quarter showed the economic landscape remained mixed, after the effects of severe weather in the first quarter lingered. The Bureau of Labor Statistics lowered its third estimate of first quarter gross domestic product (GDP) to -2.9%, reflecting a broad-based contraction in many areas of the economy, including consumer spending, exports and business investment. It was the largest decline in GDP in five years. The employment situation continued its trend of modest improvement, with an average of about 200,000 jobs added each month during the quarter. In addition, payroll employment finally exceeded the pre-financial crisis peak, having recovered the 8.7 million jobs lost in the recession. The unemployment rate in May remained unchanged from April at 6.3% as a result of little change in the labor force participation rate. The June PMI registered 55.3 indicating expansion in manufacturing for the 13th consecutive month. The Consumer Price Index (CPI) rose 0.8% for the three months ending in May and 2.1% over the last 12 months. During the quarter the Federal Open Market Committee (FOMC) announced few changes other than making further reductions in its asset purchase program. After somewhat of a pause in the first quarter, the housing sector once again proved to be a bright spot in the economy. Existing-home sales advanced at an annualized rate of 4.9 million units, the highest monthly percentage gain since August 2011. However, the pace of sales remains below the 5 million unit rate established in 2013.

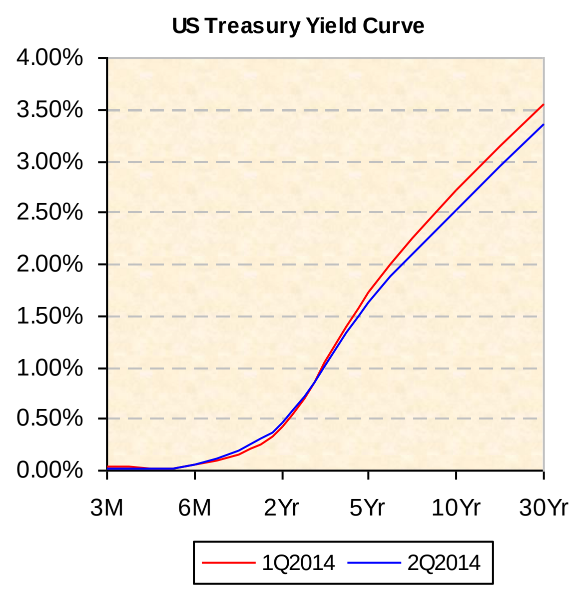
Public Equity Markets: U.S. stocks advanced despite macroeconomic concerns such as the escalating violence in the Ukraine and Iraq, slowing growth and credit concerns in China, and mixed U.S. economic data. Larger capitalization stocks (as represented by the S&P 500 Index) outperformed their smaller counterparts. All ten sectors of the S&P 500 Index were up with Energy and Utilities the best performers. Our combined domestic equity performance was a gain of 3.87%, underperforming the 4.87% gain recorded by the Russell 3000 benchmark.



International markets posted strong returns in the second quarter, with emerging markets outperforming developed markets overall. European stocks posted gains as economic growth appears to be gradually improving. The European Central Bank (ECB) announced further stimulus measures in an attempt to revive growth and spark inflation. Asian markets generated positive returns as risk aversion declined. During the quarter, developed markets, as measured by the MSCI EAFE Index, returned 4.09% with the markets of Norway, Hong Kong, and the UK recording the strongest performance while Ireland was the largest detractor. Emerging Markets returned 6.60% with Turkey, India, Russia and Taiwan all posting double digit returns. Our combined international equity was 3.50% for the quarter, underperforming the 5.03% gain recorded by the MSCI ACWI ex-US Index.

Global equities recorded a gain of 5.25%, outperforming the 5.05% return of the MSCI ACWI benchmark.

Fixed Income: U.S. Treasury yields finished lower in the second quarter. Themes of a weaker U.S. growth picture and geopolitical concerns in the Ukraine carried forward from the previous quarter and had the effect of keeping Treasuries in demand. In addition, the unrest in Iraq was added to the mix. In terms of the growth picture, the final 1Q14 GDP number fell to -2.9% from the already lower revised -1.0%. The yield curve flattened (shown in the chart to the right) as the spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, narrowed by 23 bps to 207 bps. For the quarter, the 2-year Treasury yield ended at 0.46%, up 4 bps, while the 10-year Treasury yield declined by 19 bps to 2.53%. Credit yield spreads tightened over the quarter as investors searched for yield resulting in investment-grade and high-yield corporate bonds outperforming Treasuries. For the quarter, the Merrill High Yield Index returned 2.57%, the Barclays Aggregate returned 2.04%, and the Barclays Long Govt/Credit Index was the best performer, returning 4.93%. Our combined fixed income performance was a gain of 4.08%,



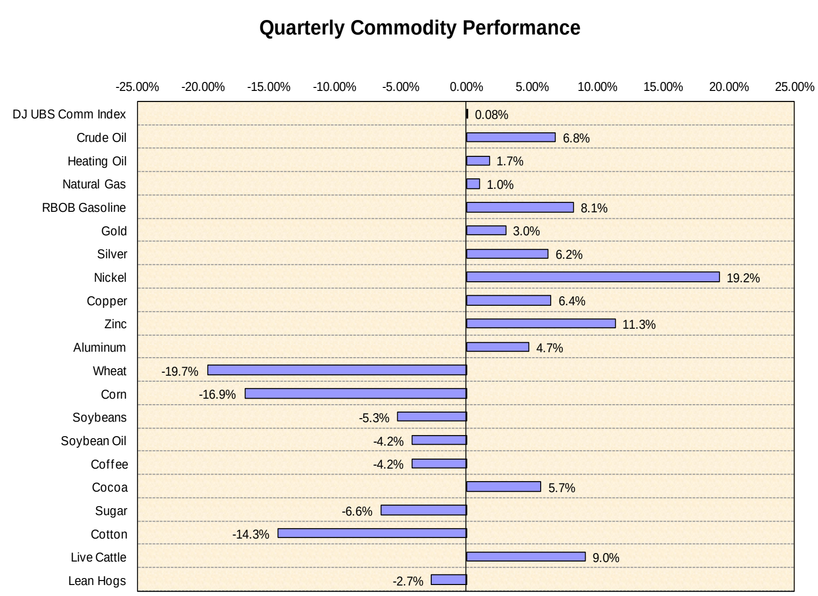
outperforming the custom benchmark's 3.84% return. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 8.81% for the quarter, outperforming the benchmark's 6.28% return.

Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 2.07% in the second quarter. Relative Value and Event Driven were the best performing strategies. The HFRI Relative Value Index gained 2.44% for the quarter due to credit spreads tightening and bond yields falling. The HFRI Event Driven Index gained 2.24% for the quarter, led by the continuation of the M&A, distressed and shareholder activism. The HFRI Equity Hedge Index posted a gain of 2.20% as equities reached record levels and implied volatility fell despite geopolitical concerns. The HFRI Macro Index strategies returned 1.46% for the quarter. These strategies have had a difficult performance environment over the last few years having struggled with central bank driven monetary and fiscal policies and sharp reversals in certain currencies and commodities. Fund-of-Funds returns, as measured by the HFRI Fund-of-Funds Index, returned 1.60% in the quarter. Our opportunistic portfolio returned 0.76%, net of management fees, for the quarter, underperforming the HFRI Fund-of-Funds benchmark by 71bps.

Private Equity: Private equity saw an increase in fundraising, investments and exit activity in the second quarter compared with the previous quarter. Funds raised an aggregate $132 billion this quarter, $28 billion more than the previous quarter. The number and value of private equity-backed buyout deals increased from 732 to 766 and the value of the exits increased to $138 billion compared to $90 billion last quarter. The exit value was the highest for any quarter since the financial crisis. During the quarter, our private equity managers called a combined $8.5 million and paid distributions of $15.4 million. Our current allocation to private equity is 6.7%, with a market value of $243.7 million. From its 2003 inception through December 31, 2013, the private equity program has generated a net internal rate of return of 8.0% versus a 11.9% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps).

Private Real Assets: Commercial real estate transaction activity in the U.S. increased modestly (approximately 3%) quarter-over-quarter, although these levels remained 24% above volumes from the same period last year. Year-over-year property values continued to increase across various sectors (multi-family, industrial, retail, office) each rising between 12 – 16%. Globally, major European markets witnessed increased transaction levels with London and Paris experiencing a year-over-year increase of 19% and 71% respectively, while Hong Kong recorded a 24% decline in annual transaction levels. During the quarter, our private real assets managers called a combined $4.9 million and paid distributions of $7.7 million. Our current allocation to private real assets is 4.9%, with a market value of $179.1 million. From its 2006 inception through December 31, 2013, the private real assets program has generated a net internal rate of return of 1.4% versus a 6.9% gain for the long-term benchmark CPI plus 500 bps.

Commodities: The Bloomberg Commodity Index (formerly known as the Dow Jones – UBS Commodity Index) was essentially flat for the quarter. Energy, Base Metals, Precious Metals, and Livestock sectors rose, with all underlying commodities appreciating in price. Natural Gas continued to reflect the effects of the severe winter that depleted inventories to critically low levels. Aluminum, Copper, and Zinc all rallied on supportive global economic data and declining warehouse inventories. Precious Metal prices were boosted during the quarter by the ECB's announcement of a negative nominal rate policy and strongly negative US GDP numbers. Safe haven asset purchases were spurred by geopolitical concerns in conflict zones. Livestock prices traded to record highs as the U.S. Live Cattle inventory reached its



lowest level in over 60 years. Grain prices declined as the second half of the quarter brought more favorable weather conditions. During the quarter, our commodities portfolio returned 1.17%, 109 bps ahead of the Bloomberg Commodity Index.

REITs: REITS extended their 2014 rally into the second quarter. A worldwide environment of easy monetary policy served to keep interest rates low and bolster the attractiveness of income-producing asset classes such as real estate. The Asia Pacific region led performance, with a return of 9.2%, as investor confidence began to return to the region following concerns over growth earlier in the year. Global REITs, as measured by the FTSE EPRA/NAREIT Developed Index, returned 7.62% for the quarter, while our global REIT portfolio returned 6.93%, underperforming the benchmark.

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, 2014 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 6/30/2014	Fiscal YTD
Employer Contributions	$ 36.8	$ 144.7
Member Contributions	6.5	26.5
Net Investment Income	151.9	518.2
	$ 195.2	$ 689.4

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 6/30/2014	Fiscal YTD
Benefits	$ 59.6	$ 229.8
Refunds	0.6	4.2
Administrative Expenses	0.6	2.3
	$ 60.8	$ 236.3

Outlook

The outlook for the global economy continues to be dominated by moderate growth and stimulatory monetary policies. While still expected to strengthen, the growth trajectory is slightly lower than previously forecast. The key question is whether the global economy can transition from assisted growth to self-sustaining growth. Market volatility remains low but could increase if geopolitical events, such as the Ukraine, Gaza and Iraq, escalate.

The negative first quarter GDP data notwithstanding, the U.S. economy seems poised to accelerate in the coming months. Despite the frustratingly sluggish employment gains, payrolls now exceed the peak reached prior to the financial crisis in 2008. The Fed is expected to maintain an accommodative monetary policy stance for at least the remainder of the year. Rising consumer optimism fueled by higher asset prices, steady job growth and gradually easing credit conditions, will likely drive consumption growth.

Europe is showing signs of fading momentum following a growth spurt. The recovery has come to include both the eurozone core and periphery, but some of the peripheral countries are still trying to implement aggressive structural reforms and meet the fiscal targets that were established in the midst of the crisis. The eurozone economy also continues to struggle with low levels of inflation, and the European Central Bank moved its policy rate to near zero, and is looking towards “unconventional” monetary policy tools to avoid deflation.

The economic activity in Asia appears to be recovering from a brief setback with China’s economic growth rate appearing to be bottoming out as leading economic indicators showed signs of stability. However, the country continues to face the need to transition from an export oriented growth model to one that relies more heavily on domestic consumption. India is seeing renewed confidence with the election of a new, business-friendly government. The impact that a rise in U.S. rates and an increase in the dollar could have on EM capital flows, particularly for countries with current account deficits, remains a key concern as any efforts to defend a currency against a rising dollar could tighten financial conditions further.

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.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET POSITION
June 30, 2014

Assets		
Equity in pooled cash and investments	$	971,114
Investments:		
Northern Trust		3,629,828,718
Aetna		1,043,366
Fidelity - Elected Officials Plan		438,045
Fidelity - DRSP/DROP		4,569,066
Total investments		3,635,879,195
Contributions receivable		7,725,150
Total assets		3,644,575,459
Liabilities		
Benefits payable and other liabilities		7,210,074
Net position restricted for pensions	**$**	**3,637,365,385**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET POSITION
June 30, 2014

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 36,770,660	$ 144,714,300
Member	6,470,730	26,463,913
Total contributions	43,241,390	171,178,213
Investment income	158,109,841	538,379,191
Less investment expenses	6,161,769	20,121,158
Net investment income	151,948,072	518,258,033
Total additions	195,189,462	689,436,246
Deductions		
Retiree benefits	45,111,776	172,584,561
Disability benefits	12,310,593	48,606,540
Survivor benefits	2,168,127	8,585,891
Refunds	629,045	4,235,010
Administrative expenses	555,868	2,304,070
Total deductions	60,775,409	236,316,072
Net increase (decrease)	**134,414,053**	**453,120,174**
Net position restricted for pensions		
Beginning of period	**3,502,951,332**	**3,184,245,211**
End of period	**$ 3,637,365,385**	**$ 3,637,365,385**