OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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November 21, 2013

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, 2013. 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 5,425 active members and 5,675 retirees participating in the ERS as of September 30, 2013.

Performance Results

The total return achieved by the ERS assets for the quarter was a return of 4.88%, 82 basis points ahead of the 4.06% return recorded by the policy benchmark. For the one year period ending September 30, 2013 the ERS' gross return (before fees) was a gain of 10.28%, 314 basis points ahead of the 7.14% return recorded by the policy benchmark. The one-year gross return places the ERS' performance just below median of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 11.10% for the three-year period and 9.67% for the five-year period, ranked in the top 20% of the universe for both periods. The asset allocation at September 30, 2013 was: Domestic Equities 23.7%, International Equities 16.6%, Global Equities 3.0%, Fixed Income 22.9%, Inflation Linked Bonds 8.9%, Commodities 4.8%, Private Equity 7.2%, Private Real Assets 5.5%, REITS 2.9%, Opportunistic 3.3%, and Cash 1.2%. We estimate that the funded status of the ERS was 80.3% as of September 30, 2013, a 1.5% 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.

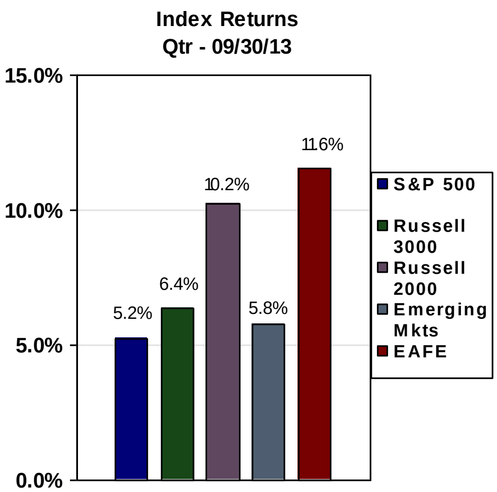
Major Initiatives

During the quarter, the Board made a commitment of $14,000,000 in LBA Realty Fund V, within the private real assets sector. In addition, Staff conducted meetings with several investment managers, including emerging managers, to discuss their market outlook, investment process and various strategies. Staff continues to review opportunities within the private real assets, private equity and opportunistic allocations.

Capital Markets and Economic Conditions

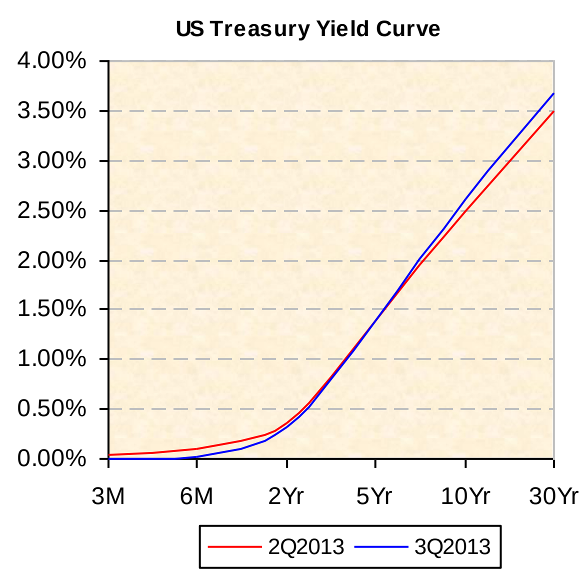
The U.S. economy expanded at a 2.5% real annualized rate during the second quarter of 2013, as opposed to a 1.1% real annualized rate in the first quarter. The acceleration of GDP was primarily driven by upturns in exports and nonresidential fixed investments, which were partially offset by a reduction in government spending. The economy added 148,000 new jobs in September, which came in below economist's estimates. The biggest net hiring gains in September were in construction, wholesale trade, and transportation & warehousing. The unemployment rate remains at 7.2%, but has declined by 40 basis points since June 2013. The Consumer Price Index rose 0.8% in September, with the energy index accounting for almost half of the increase. August home prices were up 12.8% from a year earlier, the biggest 12 month gain since February 2006. However, the pace of the monthly price increases are starting to slow as speculation over when the Federal Reserve will begin cutting its large scale asset purchasing is causing interest rates to move upward.

Public Equity Markets: U.S. equities rallied in the third quarter on the prospects of continued economic growth. The S&P 500 Index reached a new high in September after the Fed announced its decision against scaling back the stimulus program. Larger capitalization stocks (as represented by the S&P 500 Index) continued to underperform their smaller counterparts. All of the ten sectors of the S&P 500, except Telecom, advanced with Materials, Industrials, and Consumer Discretionary performing the best. Our combined domestic equity performance was a gain of 9.16%, outperforming the 6.35% gain recorded by the Russell 3000 benchmark.



International developed markets outperformed their domestic counterparts during the quarter as economic data for the Eurozone continued to look promising, indicating that the recovery is gaining momentum. Investor sentiment turned more positive on news that Japan's aggressive initiatives continued to positively impact economic growth. Within emerging markets, investors were pleased with signs of stabilization in China and the Fed's decision to postpone tapering. During the quarter, developed markets, as measured by the MSCI EAFE Index, posted a 11.56% return. All of the developed markets, led by Greece, Finland, and Spain, rallied during the quarter. Emerging Markets advanced 5.77%, trailing their developed counterparts, with Poland, Korea, and Russia posting double digit returns. Our combined international equity was up 9.26% for the quarter, underperforming the 10.09% gain recorded by the MSCI ACWI ex-US Index.

Fixed Income: U.S. Treasury yields declined for shorter maturities but rose on the longer end of the yield curve during the quarter. Market expectations of Fed tapering pushed yields higher on the 10-year Treasury towards 3.00% by mid-September. However, the Fed's commitment to quantitative easing at their September meeting quickly sent rates lower to close the quarter at 2.61%. The tightening of financial conditions observed in recent months, which could slow the pace of improvement in the economy and labor market, contributed to the Fed's maintaining a highly accommodative monetary policy. The yield curve steepened (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 by 16bps to 229bps. For the quarter, the 2-year Treasury yield ended at 0.32%, down 4bps, while the 10-year Treasury yield increased by 12bps to 2.61%. Credit spreads tightened and credit outperformed similar duration Treasuries with high yield the best performing sector. For the quarter, the Merrill High Yield Index returned 2.25%, the Barclays Aggregate returned 0.57% and the Barclays Long Govt/Credit Index declined 83 bps. Our combined fixed income performance for the quarter was a gain of 1.02%, outperforming the custom benchmark's 0.45% return. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 3.05% for the quarter, outperforming the 70bps return recorded by the benchmark.

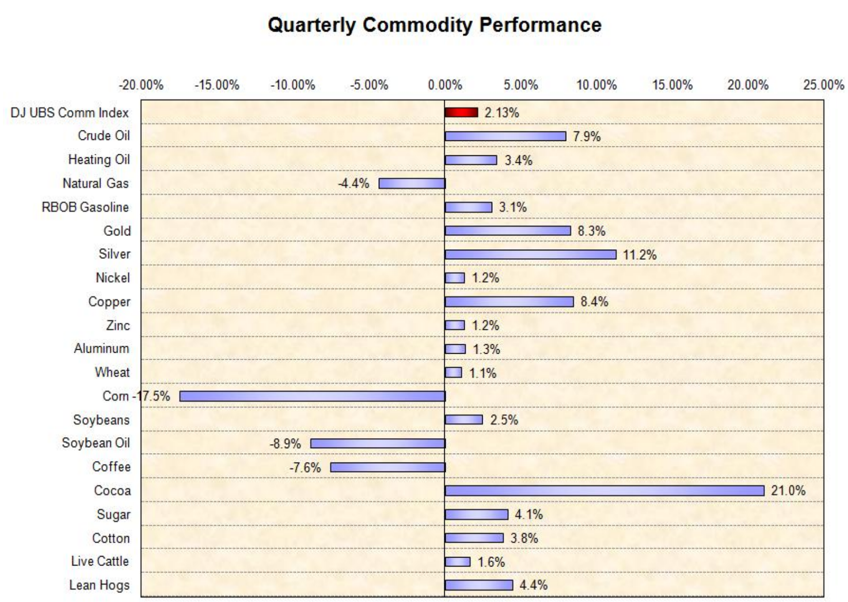


Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 2.3% in the third quarter and have returned 5.6% for the year. Equity Hedge and Event Driven were the best performing strategies. The HFRI Equity Hedge Index gained 4.2% in quarter. Performance was led by long biased equity hedge fund strategies who benefitted from the equity markets rally during the quarter. The HFRI Event Driven Index returned 2.8% for the quarter driven by successful IPO issuance, M&A activity and activist strategies. Global Macro funds declined 1.14% in the quarter and have posted declines in 2013 with the HFRI Macro Index down 2.1% year to date as sharp reversals in currencies and commodities detracted from performance. Fund-of-Hedge Funds returns, as measured by the HFRI Fund-of-Funds index, returned 1.78% in the quarter. Our opportunistic portfolio returned 1.03%, net of management fees, in the third quarter, underperforming the HFRI Fund-of-Funds benchmark.

Private Equity: Through the third quarter, private equity firms had raised fewer new funds but more aggregate new capital than in the same period the prior year – the increased capital raised was a result of a substantial pick-up in European buyout fundraising. Exit activity is down versus the prior year, but exits through initial public offerings showed a welcome increase for both buyout and venture managers. Purchase valuations remain almost exactly in line with 10-year averages, while leverage use is above its historic average due to low interest rates and attractive financing terms from lenders. During the quarter, our private equity managers called a combined $3.8 million and paid distributions of $7.8 million. Our current allocation to private equity is 7.2%, with a market value of $235.7 million. From its 2003 inception through June 30, 2013, the private equity program has generated a net internal rate of return of 6.8% versus a 10.0% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 basis points).

Private Real Assets: Commercial real estate transaction activity year-to-date through the end of the third quarter continues to be robust, up 24% globally versus the same period a year earlier. Asia and North America (primarily the U.S.) are driving the robust markets. Pricing for major properties in major markets continues to be high relative to recent years, though investors continue to show appetite for increasing risk exposure to non-major markets. In energy markets, both pricing and transaction volumes are down compared to 2012. During the quarter, our managers called a total of $5.9 million and paid distributions of $4.0 million. Our current allocation to private real assets is 5.5%, with a market value of $182.1 million. From its 2006 inception through June 30, 2013, the private real assets program has generated a net loss of 0.1% versus a 6.9% gain 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 advanced 2.13% during the quarter led by the metals and energy sectors. The best performing sector was precious metals, supported by the continuation of U.S. monetary stimulus. All industrial metals rose, bolstered by hopes for a cyclical recovery in China. Concerns over tensions in the Middle East (Syria) put upward pressure on oil prices, contributing to strong returns in the energy sector. Within the agriculture sector, corn, which was impacted by strong crop yields, was the primary source of weakness. During the quarter, our commodities portfolio advanced 3.06%, 93bps ahead of the DJ UBS Commodities Index.



REITs: During the third quarter, global REITs generated moderate positive returns, in spite of continued uncertainties around global central bank actions. This uncertainty was felt most in U.S. REITs, which experienced losses for the quarter; Asian and European property securities both saw significant gains, which offset the U.S. weakness. Global REITs, as measured by the FTSE EPRA/NAREIT Developed Index, earned 2.28% for the quarter, while our global REIT portfolio returned 2.01%, 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 September 30, 2013 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 9/30/2013	Fiscal YTD
Employer Contributions	$ 35.6	$ 35.6
Member Contributions	6.4	6.4
Net Investment Income	138.2	138.2
	$ 180.2	$ 180.2

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 9/30/2013	Fiscal YTD
Benefits	$ 57.9	$ 57.9
Refunds	0.2	0.2
Administrative Expenses	0.5	0.5
	$ 58.6	$ 58.6

Outlook

Early predictions suggest that U.S. growth slowed as a direct result of the federal government shutdown which occurred during the beginning of the third quarter. The expected economic slowdown is pushing back investor expectations for when the Federal Reserve will begin to taper its quantitative easing program, with the general consensus now being March 2014 for a likely start. Despite the continued quantitative easing from the Fed, inflation has stayed relatively tame. Interest rates continue to remain near historical lows; however, the recent short-term upward pressure in rates has caused slower growth in housing prices over the past quarter.

The recent "soft" economic data continues to paint a picture of an economy that is slowly moving towards recovery. The impact to GDP output as a result of the government shutdown still remains to be seen, and it has already caused economists to temper their forecasts. Current employment growth is less robust than what policymakers expected, however the unemployment rate continues to tick downward to the Fed's target level of 6.5%. As continued debates in Washington loom into the turn of the next year, it is expected that the growth of government spending will continue to slow as it focuses efforts on reducing the budget deficit further.

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 POSITION
September 30, 2013

Assets		
Equity in pooled cash and investments	$	1,411,649
Investments:		
Northern Trust		3,288,180,861
Aetna		1,130,244
Fidelity - Elected Officals Plan		365,101
Fidelity - DRSP		9,921,282
Total investments		3,299,597,488
Contributions receivable		11,100,019
Total assets		3,312,109,156
Liabilities		
Benefits payable and other liabilities		6,299,634
Net assets held in trust for pension benefits	**$**	**3,305,809,522**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET POSITION
September 30, 2013

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 35,555,742	$ 35,555,742
Member	6,447,442	6,447,442
Total contributions	42,003,184	42,003,184
Investment income	142,653,570	142,653,570
Less investment expenses	4,429,629	4,429,629
Net investment income	138,223,941	138,223,941
Total additions	180,227,125	180,227,125
Deductions		
Retiree benefits	43,840,729	43,840,729
Disability benefits	11,964,118	11,964,118
Survivor benefits	2,140,160	2,140,160
Refunds	210,719	210,719
Administrative expenses	507,088	507,088
Total deductions	58,662,814	58,662,814
Net increase (decrease)	**121,564,311**	**121,564,311**
Net asset held in trust for pension benefits		
Beginning of period	**3,184,245,211**	**3,184,245,211**
End of period	**$ 3,305,809,522**	**$ 3,305,809,522**