OFFICES OF THE COUNTY EXECUTIVE

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County Executive

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December 17, 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 September 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 5,490 ERS and GRIP active members and 6,290 retirees participating in the ERS as of September 30, 2014.

Performance Results

The total return achieved by the ERS assets for the quarter was a loss of 1.27%, 14 basis points ahead of the 1.41% loss recorded by the policy benchmark. For the one year period ending September 30, 2014 the ERS' gross return (before fees) was a gain of 10.76%, 78 basis points ahead of the 9.98% 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 12.90% for the three-year period and 11.29% for the five-year period ranked at the median and top quartile of the universe, respectively. The asset allocation at September 30, 2014 was: Domestic Equities 18.6%, International Equities 15.8%, Global Equities 4.0%, Fixed Income 23.5%, Inflation Linked Bonds 10.2%, Commodities 5%, Private Equity 7.0%, Private Real Assets 5.1%, Private Debt 0.2%, REITS 5.5%, Opportunistic 3.9%, and Cash 1.2%. We estimate that the funded status of the ERS was 87.0% as of September 30, 2014, a 3.2% increase from the June 30, 2014 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

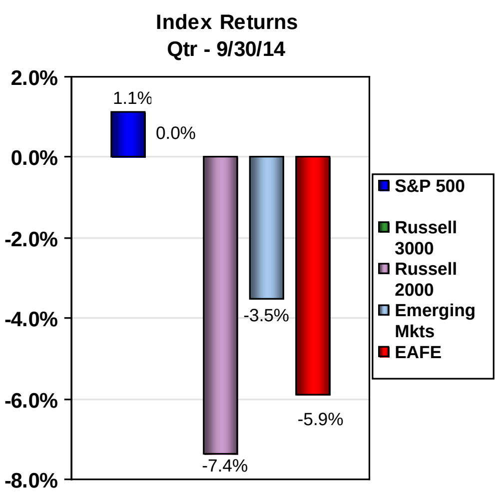
During the quarter, the Board made a commitment of $17,000,000 to K1 Investment Management within the private equity sector. The Board also hired Hudson Bay to manage $12,000,000 within the opportunistic sector. In addition, Staff conducted meetings with several investment managers, including emerging 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

U.S. exports reached a record high during the summer, and September revisions showed that GDP during the second quarter grew at a 4.6% annualized rate – more than offsetting the first quarter's 2.1% decline. Slack in the labor market continued to be absorbed, as employers added 671,000 new jobs to their payrolls during the third quarter. This increase in hiring has helped move the unemployment rate down from 6.1% in June to a post-recession low of 5.9%.

In September, the Federal Open Market Committee (FOMC) took steps towards officially winding down the Fed's easy money policies which have been a direct response to the 2008 financial crisis and recession. While interest rates are expected to remain near zero for "a considerable time," the asset purchasing program will likely end during the early fourth quarter. The housing market has continued its rebound as August new homes sales saw an 18% increase month-over-month and a 33% increase on a year-over-year basis. Home price appreciation did decelerate nationally during the third quarter, but is still higher on an annual basis. The ISM Manufacturing Index also rose from 55.3 in June to 56.6 in September primarily due to accelerating capital expenditures on industrial equipment and machinery, expansion in new orders, and a strong employment outlook.

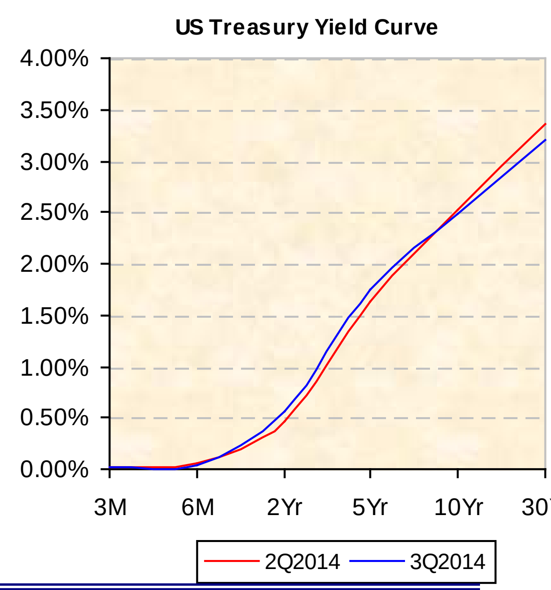
Public Equity Markets U.S. stocks ended the quarter flat after experiencing volatility as investors were faced with numoreous geopolitical events including problems in Ukraine, Iraq and Syria. Despite strong U.S. economic data, concerns over the Fed's unwinding its stimulus impacted the markets. Larger capitalization stocks (as represented by the S&P 500 Index) strongly outperformed their smaller counterparts. Five of the ten sectors of the S&P 500 Index were up with Healthcare and IT performing the best. Our combined domestic equity performance was a gain of 0.34%, outperforming the 0.01% gain recorded by the Russell 3000 benchmark.



International markets trailed their domestic counterparts as problems between Russia and Ukraine, and continued unrest in the Middle East heightened investors' concerns. Growth worries in the Eurozone further weighed on the markets. The European Central Bank drove short-term rates into negative territory to spark economic activity in the region. Pacific regional markets posted moderate gains despite a second-quarter contraction in the Japanese economy. During the quarter, developed markets, as measured by the MSCI EAFE Index, returned a loss of 5.88% with the markets of Portugal, Austria, and Germany detracting the most. Emerging Markets posted a loss of 3.50% with Greece, Russia, and Hungary posting double digit losses. The international equity performance was a loss of 5.45% for the quarter, underperforming the 5.27% loss recorded by the MSCI ACWI ex-US Index

Global equities recorded a loss of 3.21%, underperforming the 2.31% loss of the MSCI ACWI benchmark.

Fixed Income: Short and intermediate term U.S. Treasury yields finished higher in the third quarter while longer dated Treasury yields declined. With the Fed's bond purchasing program on target to conclude at the end of October, the market began to listen more closely to the mixed dialogue coming from the members of the central bank for clues as to when interest rates in the United States would rise above their almost zero level for the first time in 6 years. Positive economic data, including the release of an unexpected increase in GDP for Q2, portrayed a clearer growth picture in the U.S. than in the previous quarter. 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 15 bps to 192 bps. For the quarter, the 2-year Treasury yield ended at 0.57%, up 11 bps, while the 10-year Treasury yield declined by 4 bps to 2.49%. Perceived credit risk increased causing credit spreads,



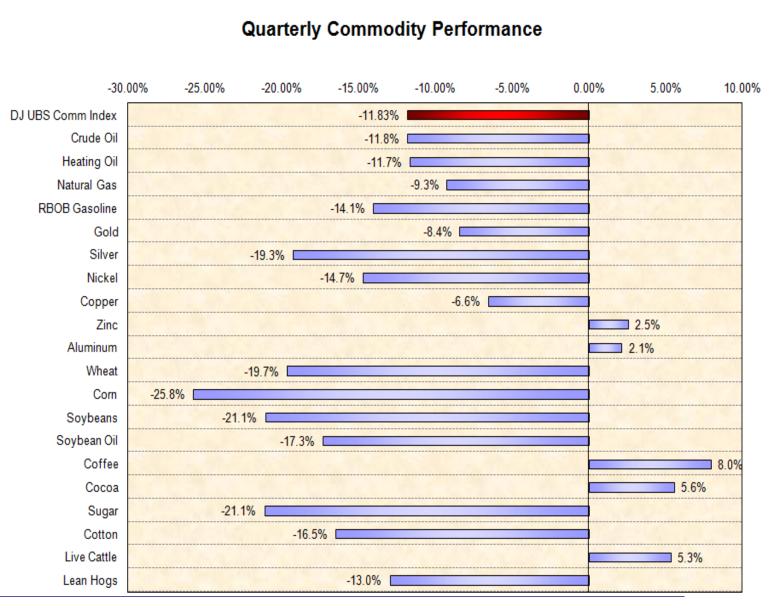
which had been tightening in the first half of the year, to widen over the quarter resulting in Treasuries outperforming similar duration credit. For the quarter, the Merrill High Yield Index declined 1.92%%, the Barclays Aggregate returned 0.17%, and the Barclays Long Govt/Credit Index was the best performer, returning 1.04%. Our combined fixed income performance was a gain of 0.35%, outperforming the 0.19% decline of the custom benchmark. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, declined 0.52% for the quarter, underperforming the benchmark's 0.83% return.

Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 0.30% in the third quarter but with material dispersion across and within strategies. Global Macro gains partially offset declines in other strategies with the HFRI Global Macro Index gaining 3.03% for the quarter. Gains were driven by more systematic, model based, trading strategies than discretionary strategies, as factors within currency produced solid returns. Relative Value was also slightly positive, returning 0.3% in the quarter, driven by strong advances in asset-backed strategies that were up over 2% and offset by corporate credit, which was down almost 1%. Most other broad strategies posted negative performance for the quarter. Equity Hedge and Event Driven strategies, both of which are more beta exposed to the equity markets, each declined 1.2% in quarter. Fund-of-Funds returns, as measured by the HFRI Fund-of-Funds Index, returned 0.26% in the quarter. Our opportunistic portfolio declined -0.32%, net of management fees, for the quarter, underperforming the HFRI Fund-of-Funds benchmark by 58bps.

Private Equity: Private equity fundraising saw a decrease in the third quarter compared to the previous quarter. A total of 199 private equity funds raised an aggregate $80 billion this quarter, representing 21% fewer vehicles and a 44% decrease in capital commitments compared to the second quarter. However, the relatively low number of funds with higher fund sizes indicates that investors seem to be more inclined to commit capital to the larger, more established private equity fund managers. The number of private equity-backed buyout deals was slightly lower, from 816 to 803, while the aggregate value of deals was higher at $84 billion vs. $80 billion in the previous quarter. Our current allocation to private equity is 7.0%, with a market value of $248.5 million. From its 2003 inception through March 31, 2014, the private equity program has generated a net internal rate of return of 8.2% 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 down for the quarter. All commodities sectors declined during the quarter impacted by expanding surpluses, a surging dollar, and slowing growth in China. The agriculture sector detracted the most led by corn which reached the lowest price level in five years after a U.S. government report showed that domestic inventories exceeded analysts' forecasts. Crude oil prices continued to decline on abundant supply. Gold fell near to lowest level since last January, as a stronger dollar and signs of an improving U.S.



economy cut demand for a protection of wealth. Industrial metals, which were already under pressure from concern that Chinese demand was slowing, were further impacted by the dollar's strength. During the quarter, our commodities portfolio declined 10.87%, outperforming the Bloomberg Commodity Index by 96 basis points. The allocation consists of two active managers and one passive manager.

REITs: Global listed real estate securities declined about 4% in the third quarter. September was a difficult month for Global REITs, as they declined 6% due to rising interest rates in the U.S. and weak economic data coming from China and Europe. In the U.S., all property sectors declined for the quarter, led by Mixed-Industrial/Office and Apartments. The U.S. region outperformed Non-U.S. listed real estate as the strengthening U.S. dollar had a negative impact on international real estate securities. The U.S. declined 3.2% for the quarter whereas the worst performing regions, Europe ex UK and Japan, declined 9.5% and 8.8%, respectively. Our global REIT portfolio declined 5.63% in the third quarter, underperforming the benchmark by 104 bps. The allocation consists of a passive global REIT manager.

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, 2014 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 9/30/2014	Fiscal YTD
Employer Contributions	$ 37.6	$ 37.6
Member Contributions	6.7	6.7
Net Investment Income	(67.2)	(67.2)
	$ (22.9)	$ (22.9)

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 9/30/2014	Fiscal YTD
Benefits	$ 58.9	$ 58.9
Refunds	0.7	0.7
Administrative Expenses	0.5	0.5
	$ 60.1	$ 60.1

Outlook

The strong divergence of economic growth rates across the globe will likely trigger a shift in monetary policy in a number of economies; however, monetary conditions should remain supportive in all major regions of the world. Due to this continued monetary support, global growth should see an increase into 2015 given the favorable financial conditions, growing consumer confidence, and generally rising employment rates.

U.S. employment remains at its healthiest levels since coming out of the 2008 financial crisis. Strong employment numbers should also act as a tailwind for consumer spending and higher levels of GDP growth going forward. With the latest round of asset purchases set to end during the upcoming quarter, investors are now keenly anticipating any signs from the Fed that an interest rate hike is near. Futures have currently priced an interest rate rise by July 2015; however, the Fed has considerable ability to delay any increase should inflation continue to track below their target. It is expected that both business balance sheets and corporate earnings will continue to grow stronger into the future as the economic recovery firms and takes hold.

The current growth rates in the Eurozone remain sluggish which has led to increased pessimism around the region. Inflation continues to trend considerably lower than the 2% target, and the ECB has responded with an asset purchase plan designed to stimulate the Eurozone economies. While overall sentiment remains negative, there are some underlying positive forces helping to drive economic expansion - unemployment across the region, while still very high, continues to see declines. Also, the euro-dollar exchange rate has fallen considerably in the near term which has also helped to ease worrisome deflationary pressures.

In Asia, China's economy is still showing signs of weakness, although there are some signs that moderate growth is beginning to take hold. China's banking regulators are again reducing the amount of reserves that some banks are required to hold in order to facilitate lending to small businesses and first time homebuyers. In Japan, the focus has been on structural reform to exit from a persistent deflationary environment. Wages are finally beginning to rise which has accommodated strong corporate profit growth and widening margins.

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 FIDUCIARY NET POSITION
September 30, 2014

Assets	
Equity in pooled cash and investments	$ 1,021,517
Investments:	
Northern Trust	3,555,073,998
Aetna	1,070,797
Fidelity - Elected Officials Plan	442,735
Fidelity - DRSP/DROP	4,762,950
Total investments	3,561,350,480
Contributions receivable	12,073,728
Capital assets	900,043
Less depreciation	(75,004)
Net capital assets	825,039
Total assets	3,575,270,764
Liabilities	
Benefits payable and other liabilities	5,500,544
Net position restricted for pensions	**$ 3,569,770,220**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
September 30, 2014

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 37,642,189	$ 37,642,189
Member	6,664,111	6,664,111
Total contributions	44,306,300	44,306,300
Investment income	(63,089,719)	(63,089,719)
Less investment expenses	4,156,879	4,156,879
Net investment income	(67,246,598)	(67,246,598)
Total additions	(22,940,298)	(22,940,298)
Deductions		
Retiree benefits	44,243,221	44,243,221
Disability benefits	12,442,653	12,442,653
Survivor benefits	2,256,315	2,256,315
Refunds	703,304	703,304
Administrative expenses	511,086	511,086
Total deductions	60,156,579	60,156,579
Net increase (decrease)	**(83,096,877)**	**(83,096,877)**
Net position restricted for pensions		
Beginning of period	**3,652,867,097**	**3,652,867,097**
End of period	**$ 3,569,770,220**	**$ 3,569,770,220**