BOARD OF INVESTMENT TRUSTEES

MONTGOMERY COUNTY EMPLOYEE RETIREMENT PLANS

ALTERNATIVE INVESTMENT POLICY

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Board of Investment Trustees
Montgomery County Employees' Retirement System

ALTERNATIVE INVESTMENT POLICY

The Board of Investment Trustees (the "Board") adopts this policy statement as a guide to the exercise of its stewardship over the investment of the Employees' Retirement System (ERS) assets. In this regard, the Board recognizes its fiduciary responsibility to manage ERS assets prudently and solely in the interest of plan participants and their beneficiaries and for the exclusive purpose of paying benefits and reasonable administrative expenses.

I. GENERAL

A. Definition - Alternative investments are investment opportunities that have not been identified by the traditional public equity or fixed income capital markets. The alternative asset class offers the potential for significantly greater returns than those available in the public markets. The returns are commensurate with risks presented by the class, such as illiquidity, lack of standard historical evaluation data, use of derivative securities and/or leverage. Examples of the types of investments considered as alternative or non-traditional investments include:

1. **Private Equity**
    - Venture capital
    - Mezzanine
    - Acquisition/buyouts
    - Restructuring
    - Subordinated debt
    - Special situations
2. **Natural Resources**
    - Oil and gas
    - Agriculture
3. **Managed Futures/Commodities**
    - Active
    - Indexed
    - Long-only and long/short
4. **Hedge Funds and Portfolio Overlay**
    - Macro
    - Long/short
    - Event-driven
    - Market neutral

While this policy encompasses all types of Alternative Investments, the Board is currently investing only in private equity, through a fund-of-funds investment vehicle. Many statements in this policy refer only to private equity investments, and, as the Board expands its investment in the Alternative Investment asset class, this policy will be amended to include guidelines for each investment type.

Private equity investments are often made through entities which are legally organized as limited partnerships, trusts, or special purpose operating companies. Investments in these vehicles often represent opportunities to finance plans which feature a sharply targeted use of proceeds. The target may be an industrial one, such as telecommunications, or the use of a special financing structure, such as mezzanine financing. Private equity investments may also represent opportunities to make investments in corporate restructuring through financing acquisitions, spin-offs, mergers, or changes in capitalization.

II. INVESTMENT OBJECTIVES

A. Return Objectives – To earn, over the long term, an average total return that provides a substantial real return and experiences a risk level commensurate with return. In early years, the investment return may be zero or even negative after considering expenses. Due to the inevitability of short-term market fluctuations that may cause variations in the investment performance, it is intended that the return objectives will be achieved by the investment managers over the life of the fund-of-funds vehicle, generally 10 to 12 years. Performance objectives are net of fees and expenses. Performance on both the portfolio and the benchmark shall be calculated on an internal, or dollar weighted, rate of return (IRR) basis. For private equity investments the minimum expectations are as follows:

1. It is anticipated that the private equity program will, over rolling 5-year periods, provide net of fee returns in excess of those available in the public markets.
2. The long-term (7 to 10 year) expectation for this asset class will be the Russell 3000 plus 3-5% per year. At the total fund level, the benchmark will be the Russell 3000.
3. The fund's IRR performance will also be benchmarked against peer groups in the Venture Economics Vintage Year Private Equity Database. These return comparisons will be net of underlying partnership fees and expenses, but gross of fund-of-funds managers' expenses. It is expected that the manager will attain performance rankings consistent with the above-median levels of return evidenced in the database.

B. Risk Management - While focusing on maximizing returns, the ERS investment program pursued by the Board will at all times limit risk to acceptable levels. Alternative investments have been incorporated into the portfolio to provide both enhanced returns and risk diversification over market cycles. While alternative investments may have a higher risk profile than more traditional asset classes, e.g., fixed income and public stocks, the Board recognizes that the primary risk within a well-diversified portfolio of alternative investments is illiquidity, particularly in the investment phase of each partnership's life cycle. That risk/return trade-off is acceptable to the Board given the enhanced returns relative to other asset classes and the relatively low co-variance between alternative investments and the more traditional asset classes. In addition, ERS liquidity needs are such that having a component of the portfolio with a longer duration to liquidity is not a problem within the context of the portfolio as a whole. The asset allocation target is 5% with an allowable range of 2-8%.

The individual alternative investments, as well as the overall portfolio, will be evaluated by the standards of prudence appropriate in administration of public trusts. To reduce risk, a prudent level of diversification should be maintained. The portfolio will be diversified in a manner consistent with other professionally managed institutional private equity portfolios. The following types of diversification should be maintained as part of a portfolio of commingled fund-of-funds:

1. Industry sectors – Private investments should be diversified among industry groups;
2. Form of investment – Private investments should be diversified throughout various forms and categories of investment (i.e., early stage, LBOs, mezzanine, etc)
3. Geographical – Geographical diversification in investment selection, though this is a secondary issue; and
4. Time – The fund-of-funds managers will endeavor to invest in a consistent manner over time, unless a specific sub-market is deemed to be extremely overvalued.

III. ALLOCATION OF ASSETS

The Alternative Investment Program is targeted to be 5% with a range of +/-3% of the total assets of the System at market value. The private equity class is considered an equity-type investment with a high expected return and restricted liquidity. The Board recognizes that it will be necessary to make capital commitments in excess of the target allocation in order to achieve and maintain a 5% net asset value. An important implementation goal for the private equity program is to spread out the timing of new commitments so as to avoid an undue concentration of commitments in any one fiscal year. Over the long term it is expected that approximately equal amounts of new funding will be committed each fiscal year to garner the benefits of time diversification.

IV. INVESTMENT FORMAT AND VEHICLES

The ERS will invest in private equity exclusively through institutional commingled private equity fund-of-funds vehicles managed by investment managers. The manager, as a fiduciary, will conduct prudent expert due diligence on all of the fund-of-funds' underlying partnership investments. The manager will have discretion with respect to the management of the fund-of-funds investment program, operating within the parameters delineated in the commingled fund's legal documentation.

The management structure of the ERS private equity portfolio will include both diversified broad market and specialty or complementary fund-of-funds vehicles.

A. Broad Market Fund-of-Funds – The broad market private equity fund-of-funds allocation will pursue a proven investment strategy, investing predominantly in proven "top-tier" private equity partnerships. The vehicle will employ a long-term strategy mix diversified along all investment strategies consistent with the general market conditions. The fund-of-funds manager may incorporate a small component of international and perhaps direct co-investments. Key characteristics associated with the allocation will be "proof of principal" regarding the fund-of-funds manager's historical investment success, strategy diversification and access to recognized top-tier partnerships. The broad market investment portion of the private equity portfolio, in total, will be diversified by industry, number of transactions, and stage of company maturity.

B. Specialty or Complementary Fund-of-Funds – The specialty fund-of-funds can be any other provider that does not meet stringent tenure requirements or employ a broad-market diversification mandate. Examples would be fund-of-funds managers that have shorter track records or that are seeking to invest in first-time partnerships. The specialty fund-of-funds portion of the private equity portfolio, in total, will be diversified by industry and by the number of transactions, however, likely to a lesser degree than the broad market mandate. These strategies would be no more than 35% of the entire allocation to the alternative investment sector.

V. INVESTMENT OVERSIGHT

Alternative investments involve complex, non-standard business and legal relationships, resulting in contract documentation which is both highly complex and specialized. Due to the non-standard nature of these contracts, serious consideration shall always be given to obtaining special counsel and other advisers qualified to represent the ERS' legal and business interests. In addition, Board staff will pursue membership on limited partner advisory boards, when appropriate, to maximize the communication with the general partner and to strengthen the oversight of these investments.

The private equity fund-of-funds managers will monitor and administer the underlying limited partnership investments in a prudent manner, in part by:

A. Administering capital calls and distributions;
B. Employing suitable financial monitoring and reporting systems;

C. Maintaining an understanding of the limited partnership's holdings and activities, including periodic discussions with the general partners and attending partnership investor meetings as appropriate;
D. Attending to partnership amendments or other matters related to the underlying partnerships in the perceived best interest of the investors; and
E. Liquidating stock distributions.

Reporting requirements will be governed by the fund-of-funds' or stand-alone partnerships' legal documentation, which at a minimum will provide for quarterly unaudited financial statements and other relevant investment holdings-related exhibits, and annual audited financial statements and relevant investment holdings-related exhibits. At the time of reviewing any investment vehicles' legal documents, the Board staff and legal counsel should negotiate by incorporation in the agreement, or by side-letter, the ERS' specific reporting requirements for the partnership, which may include:

A. A listing of assets with historical cost and market valuations by security and in total;
B. Holding by sector segmentations;
C. Performance results quarter-to-date, fiscal year-to-date and since inception;
D. Changes in personnel or firm composition;
E. Investor sales and purchases;
F. Major changes in market condition; and
G. Acceptance of this policy.

It is expected that the fund-of-funds investment manager will meet with the Board as reasonably required, and at least annually.

Staff oversight and responsibilities in monitoring the fund-of-funds manager will include:

A. Developing, evaluating, reviewing and making recommendations to the Board on the strategic plan developed in conjunction with the Board's consultant.
B. Evaluating current alternative investment managers, including:
    1. Making recommendations on retention and/or hiring;
    2. Conducting due diligence trips;
    3. Developing policies for addressing distribution management issues; and
    4. Ensuring that adequate measurement systems are implemented to monitor the performance of alternative investment managers.

VI. INVESTMENT RESTRICTIONS

Specific investments are prohibited for use by the ERS to the extent they are restricted by federal, state or local laws.

VII. ALTERNATIVE INVESTMENTS DEFINITIONS

A. Types of Alternative Investments

1. Early-stage – Refers to companies that do not have material and sustainable revenues from operations. Early-stage companies frequently have not achieved profitability.
2. Intermediate-stage – Includes companies which have achieved success in generating meaningful levels of revenues and are in a revenue/market growth phase with the expectation of achieving profitability. However, due to the heavy capital requirements needed to support growth, these companies may experience negative cash flows.

3. Late-stage – Refers to companies in development when the rate of growth is slowing but the business is established. Late-stage companies are expected to demonstrate profitability and positive cash flow. These companies often have a dominant position in their primary markets.
4. Mezzanine funds – Include investments in subordinated debt and/or equity of publicly owned companies. They combine features typically associated with debt instruments, including current income and covenant protections, with the opportunity to enhance returns through warrants, conversion rights or options.
5. Buyouts/Acquisitions – Partnerships which provide funding to acquire majority or controlling interests in a business or product lines from either a public or private company.
6. Restructuring/Recovery – Investments made in distressed or poorly performing companies, with the intent of initiating a recovery via financial restructuring or the introduction of management expertise. Partnership investments may include debt and/or equity securities.
7. International – Refers to funds which make the majority of their investments by strategy and policy outside of the United States.
8. Managed Futures – The management of contracts involving the obligation to purchase, or deliver, a specified commodity, or financial instrument, at a specified price at some specific future period.
9. Hedge Funds – Partnerships which use investment and risk management skills to seek positive returns regardless of market direction.
10. Market Neutral Strategies – Investments wherein both long and short positions are taken by the manager, and, as long as the long position outperforms the short position, market returns have no bearing on the outcome.
11. Subordinated Debt – A debt obligation that has unsecured junior claims to interest and principal subordinated to ordinary debentures or other debt obligations of the issuing corporation.
12. Special Situations – Unusual investment opportunities due to some special development (i.e., a merger, oil discovery, new product development, etc) that is expected to most favorably affect the earnings outlook for the public's psychology with respect to the prospects for a particular company.
13. Venture Capital – Capital that is subject to more than a normal degree of risk, usually associated with a new business or venture, made either directly or indirectly in a commingled fund.

B. Alternative Investment Vehicles

1. Partnerships – Limited partnerships or other commingled vehicles.
2. Co-Investment with partnership – The investor invests in an operating company in parallel with the company and the partnership.
3. Direct investment – A direct equity investment in a company not using a partnership or fund vehicle.
4. Secondaries – Investment in a previously owned limited partnership or investment in a previously owned limited partnership via a secondary fund.
5. Fund-of-funds – Multiple manager vehicles with investments in more than one partnership.