

QUARTERLY REPORT`



OFFICES OF THE COUNTY EXECUTIVE

Marc Elrich
County Executive

Andrew W. Kleine
Chief Administrative Officer

May 20, 2019

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 March 31, 2019. 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 6,150 ERS and GRIP active members and 6,350 retirees participating in the ERS as of March 31, 2019.

Performance Results

The total return achieved by the ERS' assets for the quarter was a gain of 8.07%, 63 basis points behind the 8.70% gain recorded by the policy benchmark. For the one-year period ending March 31, 2019 the ERS' gross return (before fees) was a gain of 6.66%, 57 basis points ahead of the 6.09% gain recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top percentile, or better than 99% of other plans in the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 9.73% for the three-year period ranks in the top quartile and the 6.99% for the five-year period ranks near the first quartile. The annualized return for the ten-year period was 11.09% and ranks in the top quartile of Wilshire's Large Public Funds Universe. The asset allocation on March 31, 2019 was: Domestic Equities 15.1%, International Equities 12.7%, Global Equities 2.8%, Fixed Income 21.0%, Inflation Linked Bonds 12.5%, Public Real Assets 13.2%, Private Equity 9.5%, Private Real Assets 5.2%, Private Debt 1.7%, Opportunistic 5.0%, and Cash 1.3%. We estimate that the funded status of the ERS was 95.0% as of March 31, 2019. 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 following commitments were made: \$8.5 million to Whitehorse Liquidity Partners III, L.P., a private debt fund and \$19 million in Canadian dollars to Woodbourne Canada Partners IV, a private real estate fund. Additionally, we committed to the following diversified hedge fund strategy: Blackstone MC Custom Fund, L.P.

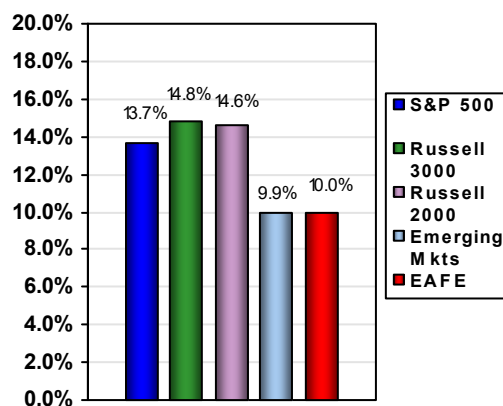
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Capital Markets and Economic Conditions

Economic data reflected that GDP increased at an annualized rate of 3.2% in the first quarter of 2019, outpacing market expectations of 2.5%. This economic growth figure represents the best start for a year since Q1 of 2015. Net trade was a positive contributor to growth as exports grew and imports dropped sharply. While overall growth was strong, consumer spending slowed relative to last quarter, in part due to weak sales of goods, particularly automobiles. The other driver of GDP growth was rising inventories, which comprised 20% of overall growth in the quarter. While the headline number of 3.2% appears strong, many economists expressed caution given the volatile nature of net exports and inventories. The economy added 557,000 jobs during the quarter, a decrease from Q4's 700,000 gain. Following a slight increase at the end of 2018, the U.S. unemployment rate decreased by 0.2% to 3.8% as the labor force participation rate decreased slightly. Q1 inflation was slightly above expectations as the Consumer Price Index increased 1.9% year-over-year relative to expectations of 1.8%. The housing market continued to show signs of sluggishness as new housing starts decreased to an annual rate of 1,139,000 units, which represents the lowest level since 2017. U.S. building permits also trended down following a brief recovery in Q4. Economists attribute the housing market weakness to higher prices and labor shortages in the construction sector.

Public Equity Markets: Following heavy losses in the December quarter, domestic equity markets rebounded strongly during the first quarter of 2019 when it became clear that the Federal Reserve would not be hiking rates in 2019 and left the door open for the next rate move being a cut. Additionally, the market was supported by the ending of the government shutdown and tensions easing in the U.S-China trade negotiations. The market rally was the strongest gain for the S&P 500 since Q2 of 2009. Growth stocks outperformed value stocks and small cap stocks outperformed large cap stocks for the quarter. Within the S&P 500 sectors, technology, real estate, industrials, and energy outperformed while healthcare and financials lagged the market. Healthcare was the worst performing sector due to concerns over regulatory change, particularly with several Democratic presidential candidates announcing support for a Medicare-for-All proposal. Having suffered a difficult Q4, the technology sector was the standout performer, posting a nearly 20% return in Q1. Our combined domestic equity performance was a gain of 14.83%, outperforming the 14.04% gain of the Russell 3000 Index. Outperformance was driven by strong gains from our large cap growth manager.

Index Return-Quarter Ending 3/31/19



International developed markets rallied strongly in Q1 but significantly lagged their domestic counterparts as two of the biggest markets, Japan and Germany, both failed to keep pace with the rally. Europe outperformed Asia as the United Kingdom and Switzerland performed well while Japan struggled due to the weakening Yen. In terms of sectors, technology and healthcare led the market while communication services, financials, and consumer discretionary lagged. Eurozone equities were mixed as sentiment was positive due to central banks moving away from tighter monetary policy but there was still general concern about sluggish economic growth. Much like in the U.S., growth significantly outperformed value and small cap slightly outperformed large cap. Emerging markets finished in line with developed international markets but with much dispersion as China and Russia posted robust gains while Brazil and India failed to keep pace. Our combined international equity performance was a gain of 10.84%, outperforming the 10.31% gain recorded by the benchmark. Our global equity allocation recorded a gain of 15.00%, outperforming the 12.18% gain of the MSCI ACWI Index.

Private Equity: During the first quarter of 2019 a total of 219 funds raised a combined \$100 billion, in line with the \$95 billion secured in the first quarter of 2018. However, the number of funds closed decreased from 340 funds in Q1 2018 as capital is becoming more concentrated among a smaller number of large funds. Funds targeting North America achieved their second highest Q1 fund raising total of 133 funds for \$63 billion. Europe on the other hand remains in a fundraising lull, with 45 funds closing on \$22 billion, the lowest level of Q1 activity since 2015. Similarly, Asia focused funds marked their fifth consecutive quarterly decline in number of funds closed and the second lowest quarterly amount secured in the past five years

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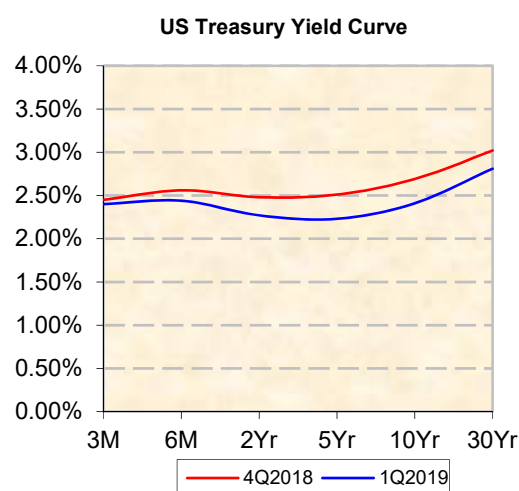
with 28 funds securing \$14 billion. While the number of funds closed globally was low, those funds that did close in the first quarter were able to successfully do so in a short timeframe; the proportion of funds that failed to reach their targets has fallen year over year to a new low of 16%. The private equity market remains competitive with 3,926 funds seeking approximately \$1 trillion at the end of the start of the second quarter. In the first quarter, an aggregated \$101 billion in buyout deals were announced, down from the \$130 billion raised during the same time period in the prior year. The slowdown was primarily driven by a 65% decrease in the value of European deals, from \$53 billion to \$19 billion; the number and value of deals in North American and Asia also declined, but by smaller margins. The number of buyout exits and the aggregated values announced in Q1 2019 declined 27% from the prior quarter, dropping from \$67 billion to \$37 billion. Dry powder continues to reach new highs, with \$1.26 trillion held in private equity funds as of the end of the first quarter.

Venture capital saw 2,944 deals announced in the first quarter for an aggregated \$52 billion, down from the record setting opening quarter in Q1 2018 which had 3,988 deals for \$55 billion. The first quarter represents the third consecutive record high quarterly deal value for North America and the third consecutive quarter where deal value has declined in Greater China. All regions saw a slowdown in the number of deals announced with Greater China and North America falling by 46% and 21% respectively compared to the first quarter of 2018. Exit activity in venture capital has continued to decline as the number of exits has fallen across almost all deal types over the past five years, dropping to 256 in Q1 2019, down from 404 in Q1 2014.

During the quarter, our private equity managers called a combined \$21.5 million and paid distributions of \$12.5 million. Our current allocation to private equity is 9.46%, with a market value of \$394.1 million. From its 2003 inception through September 30, 2018, the total private equity program (including fund-of-funds) has generated a net internal rate of return of 11.0% versus a 12.9% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps). The direct private equity program, which began in 2009, generated a 21.1% return versus 17.8% for the benchmark.

Opportunistic: Hedge funds, as measured by the HFRI Fund of Funds Composite Index, finished up 1.79% in the first quarter. On a sub-strategy basis, the HFRI Event-Driven Index rose 1.99%, the HFRI Relative Value Index gained 1.69%, the HFRI Equity Hedge Index increased 3.18%, and the HFRI Macro Index also posted positive returns of 0.97%. During the first quarter, the System's Diversifying hedge fund portfolio returned a gain of 1.49% versus a 1.90% increase for the HFRI Fund of Funds Conservative Index, and the System's Directional hedge fund portfolio returned a gain of 1.23%, underperforming the 1.75% increase by the HFRI Fund of Funds Strategic Index.

Fixed Income: Yields fell across the curve during the quarter, with the 10-year yield dropping to its lowest level since the end of 2017. The yield curve remains inverted with the 3-month T-Bill being higher than the 10-year bond signaling investor's continued concerns over economic growth and the looming end of the decade long bull-market cycle. The long-end of the curve also fell, further supporting the market's belief that growth and inflation will remain low. The yield on the 30-year bond decreased by 21 bps during the quarter and ended the period at 2.81%. The spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, continued to tighten by 7 bps to 14 bps. For the quarter, the 2-year Treasury yield ended at 2.27%, down 21 bps from the prior period, while the 10-year Treasury yield fell by 28 bps to 2.41%. The high yield portfolio's performance for the quarter was a gain of 6.62%, underperforming the Merrill Lynch High Yield II Constrained Index by 78 bps. The long duration portfolio's return for the quarter was a gain of 6.39%, underperforming the Barclays Long Govt/Credit Index by 6 bps. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, recorded a gain of 4.96%, underperforming the custom benchmark's gain of 7.02%.



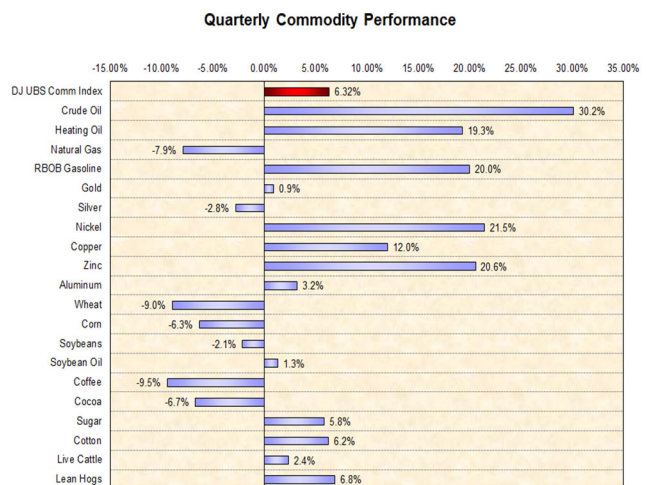
Private Debt: Private debt fundraising slowed significantly in the first quarter, as just 22 funds closed in comparison to the 60 funds that secured capital in Q4 2018. The \$22 billion of total capital closed on during

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Q1 also represents the lowest amount in any quarter since Q3 2016. Direct lending funds generated the most investor interest, as these strategies accounted for 75% of the aggregate capital raised in the quarter. On a positive fundraising note, only 22% of managers closed on capital below their target size in Q1 – an improvement from Q4 2018 when 38% of funds were unable to achieve successful capital raises in excess of their respective targets. Currently, there are 407 private debt vehicles in the market seeking to raise a total of \$182 billion. During the quarter, our private debt managers called a combined \$5.0 million and paid distributions of \$4.5 million. Our current allocation to private debt is 1.71%, with a market value of \$71.4 million. From 2013 through September 30, 2018, the private debt program generated a net internal rate of return of 10.2% versus a 8.3% return for the dollar-weighted public market equivalent benchmark (ICE Merrill Lynch High Yield Master II Constrained + 300 bps).

Private Real Assets: The NCREIF Property Index (NPI), a measure of private commercial real estate properties in the U.S., gained 1.8% in the first quarter 2019, up from 1.4% last quarter. The total return consisted of a 1.1% income return and 0.7% capital appreciation. The acceleration in capital appreciation return indicates that the commercial estate market has not yet peaked as some feared happened last quarter. Returns for retail properties rebounded during the quarter from a negative 0.4% to a positive 1.7% and was the main sector that contributed to the return acceleration. Occupancy came in at 93.8%, down slightly from the occupancy last quarter of 94.0%. Cap rates edged lower to 4.7%, reversing the uptrend and hitting the lowest level in the history of the NPI. The industrial sector continued to be the stellar performer with a 3.0% return in the quarter, although down from the prior quarter return of 3.4%. The other major property sectors lagging were office, apartments and hotel sectors returning 1.7%, 1.4% and 0.4% respectively. During the quarter, total deal volumes and values for the oil and gas sector were the lowest in years as investors remained focused on capital discipline. Midstream was the only segment that recorded solid activity as private investors took advantage of cheaper pricing given that public markets seem to have lost interest in the MLP space. During the quarter, our private real assets managers called a combined \$7.9 million and paid distributions of \$5.0 million. Our current allocation to private real assets is 5.2%, with a market value of \$215.6 million. From its 2006 inception through September 30, 2018, the total private real assets program (including fund-of-funds) has generated a net internal rate of return of 5.9% versus a 6.7% gain for the long-term benchmark CPI plus 500 bps. Excluding two large commitments prior to 2008, the private real assets program generated a 10.8% return versus the 6.7% return for the benchmark.

Public Real Assets: The Bloomberg Commodity Index advanced 6.3% during the quarter, led by the energy sector. Crude oil was up nearly 30% on back of OPEC and Russia coordinated supply cuts and demand from China. Industrial metals benefited from Chinese stimulus and improved sentiment around trade and global growth. Nickel was up 22% after firmer steel prices and zinc benefited from declining inventory levels and concerns about the financial future of a large producer. In addition, aluminum and copper benefited from improving demand outlook. Precious metals were up early in the quarter on a weakening U.S. dollar and global growth outlook; however, the sector gave back some of the gains after dovish comments from central banks and renewed strength in the U.S. dollar. The agriculture sector was down, led by wheat and soybeans on inventory concerns and weaker exports. Lean hogs saw some strength after the African swine flu impacted supply.



Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index increased by 14.6%, led by a rebound in core real estate prices and lower interest rates. U.S. returns were strong, with broad gains across all property sectors. Growth oriented sectors such as retail, office and industrial outperformed defensive sectors such as net lease and healthcare. Hong Kong real estate outperformed the global index on improved trade negotiations between China and U.S. Japanese real estate underperformed but still posted strong gains and outperformed broader Japanese equities.

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Listed infrastructure declined by 15.7% for the quarter as measured by the Dow Jones Brookfield Global Infrastructure Index. Sectors that outperformed included: gas midstream, pipeline companies, communications and toll roads. Electricity transmission & distribution was the primary laggard. Energy infrastructure recovered from the lows of 4Q18 due to favorable fundamentals and energy price recovery. The communication sector, which is perceived as a defensive sector, benefited from lower interest rates. The toll road sector benefited from expectations of strong GDP growth. The electricity transmission & distribution sector was hurt by the bankruptcy of PG&E.

For the quarter, the public real asset portfolio declined 12.61%, outperforming the custom benchmark by 29 bps due to outperformance by our REITs and MLP managers.

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 March 31, 2019 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr 3/31/2019	Fiscal YTD
Employer Contributions	\$ 23.3	\$ 67.7
Member Contributions	7.3	22.2
Net Investment Gain	308.2	142.3
	<u>\$ 338.8</u>	<u>\$ 232.2</u>

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 3/31/2019	Fiscal YTD
Benefits	\$ 64.8	\$ 194.1
Refunds	0.9	4.4
Administrative Expenses	0.7	2.2
	<u>\$ 66.4</u>	<u>\$ 200.7</u>

Outlook

During the first quarter of 2019, the U.S. Federal Reserve ("the Fed") left the benchmark interest rate unchanged after raising the rate to the 2.25% to 2.5% range at the end of 2018. Despite indication that the labor market remains strong, the Fed's sentiment softened during the quarter as the growth of economic activity slowed from its solid rate in the fourth quarter of 2018. It is now anticipated that there will be zero rate hikes for the remainder of 2019. GDP is forecasted to grow at 2.1% in 2019 and inflation is expected to be 1.8% in 2019 and 1.9% in 2010. With the economy operating near its objectives, the Fed conveyed that it will be patient when it comes to further policy moves and will remain data dependent.

The European Central Bank ("ECB") expects policy rates to remain at the present levels at least through the end of 2019 and potentially longer if necessary. The ECB slashed its GDP growth projections for the

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eurozone to 1.1% in 2019, compared to the 1.7% forecasted in December. The outlook for inflation is for a falling rate through the fourth quarter of 2019. With the eurozone economy and inflation both slowing, the ECB unveiled more stimulus through a series of cheap loans to banks in the euro area. Negotiations for a Brexit deal remain ongoing and the European Union agreed to extend the deadline until the end of October 2019. The Bank of Japan (“BOJ”) put a timeframe on its forward guidance for the first time, conveying that the current very low interest rate levels would be maintained at least until the spring of 2020. The International Monetary Fund (“IMF”) cut its outlook for global growth to 3.3%, the lowest level since the financial crisis, amid a weaker outlook in most major developed economies and signs that higher tariffs are weighing on trade.

Sources: BlackRock, Bloomberg, Bridgewater, Eagle, FRM, Gryphon, JP Morgan MSCI, NCREIF, Northern Trust, Oil & Gas Investor, PE Hub, Private Equity Analyst, Pitchbook, Preqin, PwC Deals, Real Capital Analytics, RE Alert, S&P Schroders, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Wilshire Associates.

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EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF FIDUCIARY NET POSITION

March 31, 2019

Assets

Equity in pooled cash and investments	\$	<u>6,041,807</u>
Investments:		
Northern Trust		4,165,698,184
Aetna		790,871
Fidelity - Elected Officials Plan		424,728
Fidelity - DRSP/DROP		<u>9,138,952</u>
Total investments		<u>4,176,052,735</u>
Contributions receivable		<u>4,757,392</u>
Total assets		<u>4,186,851,934</u>

Liabilities

Benefits payable and other liabilities		<u>5,708,099</u>
Net position restricted for pensions	\$	<u><u>4,181,143,835</u></u>

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EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION

March 31, 2019

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 23,267,124	\$ 67,697,188
Member	7,253,753	22,234,262
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Total contributions	30,520,877	89,931,450
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Investment income	313,001,656	159,959,747
Less investment expenses	4,799,921	17,336,839
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Net investment income	308,201,735	142,622,908
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Total additions	338,722,612	232,554,358
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Deductions		
Retiree benefits	49,071,798	146,441,135
Disability benefits	13,142,302	39,981,034
Survivor benefits	2,596,808	7,697,945
Refunds	869,338	4,429,717
Administrative expenses	681,636	2,168,133
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Total deductions	66,361,882	200,717,964
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Net increase	272,360,730	31,836,394
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Net position restricted for pensions		
Beginning of period	3,908,783,105	4,149,307,441
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End of period	\$ 4,181,143,835	\$ 4,181,143,835
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