OFFICES OF THE COUNTY EXECUTIVE

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County Executive

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February 26, 2015

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 December 31, 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 5,500 ERS and GRIP active members and 6,300 retirees participating in the ERS as of December 31, 2014.

Performance Results

The total return achieved by the ERS assets for the quarter was 1.45%, 25 basis points ahead of the 1.20% return recorded by the policy benchmark. For the one year period ending December 31, 2014 the ERS' gross return (before fees) was a gain of 8.31%, 62 basis points ahead of the 7.69% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 11.72% for the three-year period and 10.78% for the five-year period ranked at the median and top quartile of the universes, respectively. The asset allocation at December 31, 2014 was: Domestic Equities 19.5%, International Equities 15.2%, Global Equities 3.8%, Fixed Income 23.9%, Inflation Linked Bonds 10.5%, Commodities 4.3%, Private Equity 6.7%, Private Real Assets 5.0%, Private Debt 0.3%, REITS 5.8%, Opportunistic 3.3%, and Cash 1.7%. We estimate that the funded status of the ERS was 87.2% as of December 31, 2014, a 0.2% increase from the September 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.

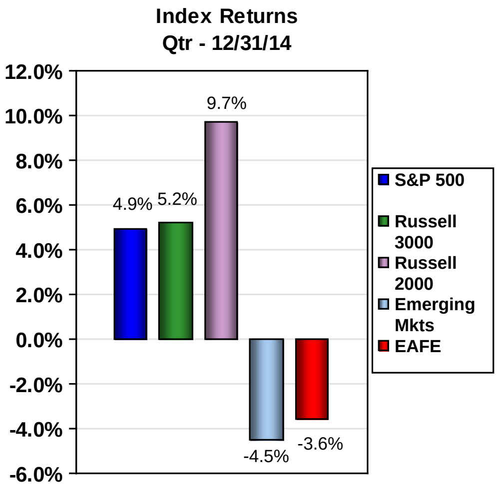
Major Initiatives

During the quarter, the Board made a commitment of $17,000,000 to Siris Partners III, a private equity fund, and a $13,000,000 commitment to Meridian Realty Partners II, a private real assets fund.

Capital Markets and Economic Conditions

Economic data released during the fourth quarter showed that the economy continued to expand at a healthy pace supported by increased consumer spending on services. The Bureau of Labor Statistics increased its estimate of third quarter gross domestic product (GDP) to 5.0%, the fastest pace of growth in the economy since the third quarter of 2003. The employment situation continues to improve as U.S. nonfarm payroll job growth averaged 261,000 per month and the unemployment rate declined slightly to 5.8%. The NFIB Small Business Optimism Index increased to its highest level since February 2007, signaling improvements in small business hiring plans – an important consideration as small businesses account for the majority of private sector employment. November headline retail sales exceeded consensus expectations and rose 5.1% year-over-year led by strong motor vehicle sales. Household spending is benefiting from cheaper gas, a more optimistic economic outlook, and a faster pace of hiring. The ISM Manufacturing Index indicated that manufacturing growth accelerated as the index averaged 58.9 over the fourth quarter compared to 57.6 in the third quarter. The broad based strength in the manufacturing sector suggests that deteriorating foreign demand and a stronger dollar are currently having a limited impact on the manufacturing sector. The Case-Shiller Home Price Index increased 0.8% in October, confirming that home prices are still increasing but at a slower pace. Headline CPI year-over-year for the quarter averaged 0.8%, below the Federal Reserve's 2.0% target due to a notable decline in energy prices.

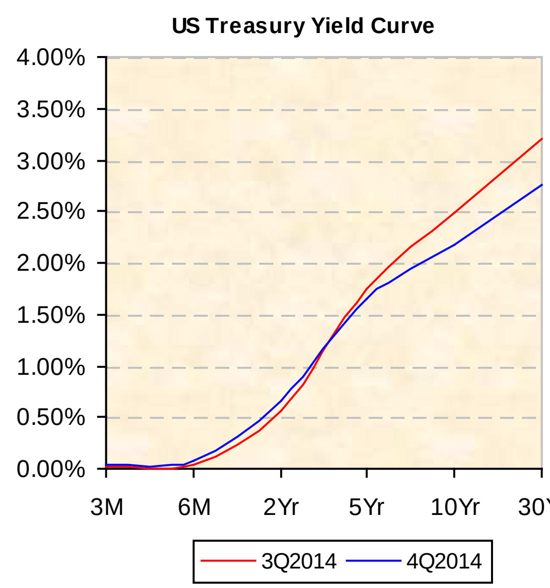
Public Equity Markets: U.S. stocks advanced on stronger than expected economic reports during the quarter. Smaller capitalization stocks (as represented by the Russell 2000 Index) outperformed their larger counterparts. Seven of the ten sectors of the S&P 500 Index were up with Utilities reporting the strongest returns and Energy the weakest. Our combined domestic equity performance was a gain of 6.08%, outperforming the 5.24% gain recorded by the Russell 3000 benchmark.



International markets declined during the quarter impacted by concerns about global economic growth. The IMF cut their global growth forecast while the ECB reduced forecasts for growth in the European region; in response some major central banks eased monetary policy. Emerging markets detracted further on disappointing manufacturing data in China and worries about elections in Brazil and Greece. During the quarter, developed markets, as measured by the MSCI EAFE Index, declined 3.57% with the markets of Norway, Portugal, and Italy recording the largest losses. Emerging Markets declined 4.5% with Russia, Greece, and Columbia declining the most. Our combined international equity performance was a loss of 2.71% for the quarter, outperforming the 3.87% loss recorded by the MSCI ACWI ex-US Index.

Global equities recorded a loss 3.68%, underperforming the 0.41% return of the MSCI ACWI benchmark, due to the manager's underweight to U.S. markets.

Fixed Income: Short and intermediate term U.S. Treasury yields rose modestly in the fourth quarter after the Federal Reserve officially ended its QE3 bond buying program. Longer dated Treasury yields continued falling in response to economic pressures from slowing global growth and lower than projected inflation across the developed markets. The yield on the 30 year bond fell 29 bps during the quarter, and ended the year at 2.75%. Geopolitical risks and divergent monetary policies of central banks across the globe continue to be a prevailing economic theme heading into the New Year. In the United States, the expectations are for the Fed to make their first rate hike in 2015, while persistently weak economies in Europe and Japan are forcing policy makers to accelerate stimulative efforts to combat lingering deflationary pressures. 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 41 bps to 151 bps. For the quarter, the 2-year Treasury yield ended at 0.66%, up 9 bps, while the 10-year Treasury yield declined by 32 bps to 2.17%. For the quarter, the Merrill High Yield Index declined 1.06%, the Barclays Aggregate returned 1.79%, and the Barclays Long Govt/Credit Index used

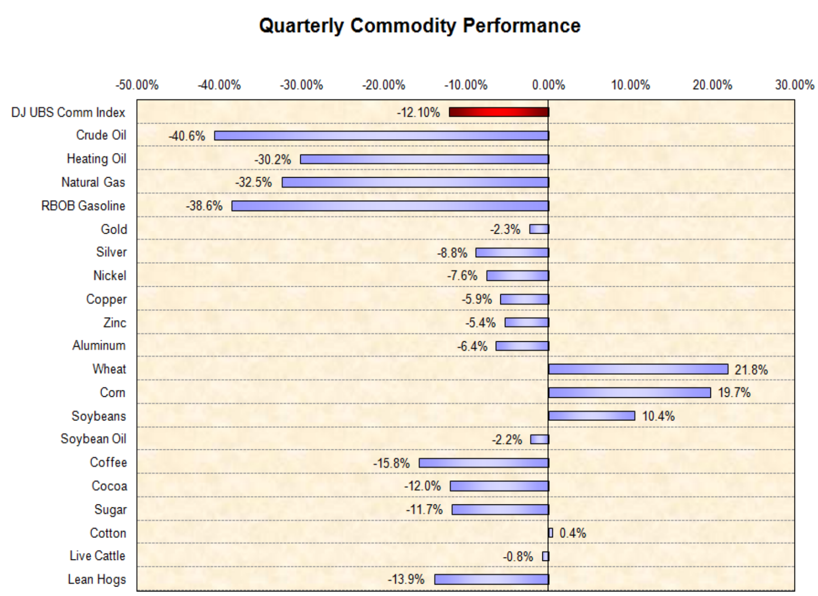


the declining long-term yields as a tailwind to return 5.60%. The fixed income performance for the quarter was a positive return of 2.48%; however, the combined performance underperformed the custom benchmark's gain of 2.72%. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, returned 4.18% for the quarter, outperforming the benchmark's 3.71% return.

Opportunistic: Hedge funds, as measured by the HFRI Composite Index, gained 0.71% in the fourth quarter but with material dispersion across and within strategies. Global Macro gains partially offset declines in Event Driven and Relative Value strategies with the HFRI Global Macro Index gaining 3.07% for the quarter as macro oriented funds were able to profit from the oil price decline. Equity Hedge strategies were up 0.40%, profiting from quantitative strategies that were long Chinese equities as the CSI 300 was up 25.8% for the month. Event Driven strategies as measured by the HFRI Event-Driven Index were down 1.43%. Most event managers experienced notable declines in October due to a large announced healthcare merger not being completed. Relative Value strategies declined 0.45% as most markets experienced increased correlations. The HFRI Fund of Funds Index was up 0.79% for the quarter. The opportunistic portfolio declined 33 bps in the fourth quarter, underperforming the 93 bps return for the HFRI Fund of Funds Index.

Private Equity: Private equity, at a global level, saw a decrease in fundraising in the fourth quarter compared with the previous quarter. Nevertheless, fundraising for both buyout and venture capital in 2014 marked the second highest level since 2008. Exit markets in the U.S. were robust during 2014, supported by favorable public market conditions which led to the highest level for buyout in the last ten years. Purchase prices, particularly for larger transactions continued to remain at relatively high levels similar to the level seen in 2007. During the quarter, our private equity managers called a combined $5.5 million and paid distributions of $17.5 million. Our current allocation to private equity is 6.7%, with a market value of $239.4 million. From its 2003 inception through June 30, 2014, the private equity program has generated a net internal rate of return of 8.3% versus a 12.2% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps).

Private Real Assets: Commercial real estate transaction values in the U.S. increased by 13% quarter over quarter and these levels remained 5% above Q4'13 volumes. The U.S. real estate market experienced a strong 2014 with transaction values over $420B as compared to approximately $360B in 2013 (17% increase). Within the energy markets, U.S. oil prices continued to decline meaningfully from approximately $90/barrel in early October to below $55/barrel by the end of December. As a result of the changing market dynamics, many upstream oil and gas companies have announced decreased capital expenditure programs due to the lower price environment. During the quarter, our private real assets managers called a combined $8.3 million and paid distributions of $16.0 million. Our current allocation to private real assets is 5.0%, with a market value of $180.6 million. From its 2006 inception through June 30, 2014, the private real assets program has generated a net internal rate of return of 3.0% versus a 7.0% gain for the long-term benchmark CPI plus 500 bps.



Commodities: The Bloomberg Commodity Index (formerly known as the Dow Jones – UBS Commodity Index) fell sharply during the quarter led by a precipitous decline in the energy markets. U.S. Dollar strength, downward revised expectations for global growth, and lower expectations for inflation, all weighed on the commodity markets. Crude Oil declined by 40% in the quarter on concerns about lower demand, and OPEC's announcement that it would not curtail member production quotas despite abundant global supplies. Natural Gas sold off 30% on the significant uptick in onshore U.S. production, specifically from the Marcellus and Eagle Ford shale formations. Precious Metal prices retraced their previous gains as an improved U.S. economy and accommodative monetary policy abroad boosted the U.S. dollar index and diminished gold's safe haven appeal. Industrial Metal prices declined on a robust supply outlook and weakness in the Chinese housing sector. Grain prices rallied strongly as delayed harvest in the U.S. along with adverse planting conditions in South America supported prices. During the quarter, our commodities portfolio declined 12.36%, 26 bps behind the Bloomberg Commodity Index.

REITs: Global listed real estate securities had a strong 4th quarter. U.S. REITs led performance, helped by the momentum of the economic recovery in the U.S. and due to a flight to quality. Real estate fundamentals in general strengthened and the asset class continued to benefit from investors seeking higher yield. Global REITs, as measured by the FTSE EPRA/NAREIT Developed Index, returned 7.89% for the quarter, while our global REIT portfolio returned 7.99%, outperforming 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 December 31, 2014 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 12/31/2014	Fiscal YTD
Employer Contributions	$ 38.5	$ 76.1
Member Contributions	6.8	13.5
Net Investment Income	45.9	(21.3)
	$ 91.2	$ 68.3

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 12/31/2014	Fiscal YTD
Benefits	$ 57.2	$ 116.1
Refunds	0.6	1.3
Administrative Expenses	1.0	1.5
	$ 58.8	$ 118.9

Outlook

The outlook for the global economy continues to be dominated by divergent monetary policies between central banks of the developed markets. The United States, Europe, and Japan all took very different monetary and fiscal policy paths since the financial crisis of 2008, and those choices have ultimately led to varying levels of economic recovery. While the U.S. has seen equity market resurgence that has exceeded pre-crisis highs, growth in Europe and Japan is waning and deflationary pressures are becoming a real risk of causing economic contraction in both regions of the world.

The U.S. economy is continuing to grow at a moderate pace in an economic environment consisting of near-zero interest rates, low inflation, and falling unemployment. Consumer spending during the fourth quarter grew at the fastest rate in eight years, as a sustained drop in energy prices helped to increase the amount of other domestic goods and services purchased. With global demand beginning to contract, and a global oversupply of oil reserves, it is plausible that a low energy price environment could persist for the foreseeable future. As a result of increased consumer spending, business investment will also likely expand in an effort to build out capacity to meet new demand. The Federal Reserve is expected to begin increasing short term rates by the middle of the year, although persistently low inflation and a strong U.S. dollar could prompt the Fed to keep interest rates unchanged a little longer.

Like the United States, Europe should reap the benefits of low energy costs as net oil importers. It is widely expected that after years of pursuing hardline austerity measures, the European Central Bank will announce a quantitative easing plan similar to the asset purchasing program enacted by the Fed as a way to help stimulate growth. A devaluing Euro should add further stimulatory tailwinds to an economy that is under pressure to create inflation. Similar to its European counterparts, Japan is also facing a challenging environment of falling core inflation and declining quarterly GDP. The Prime Minister has implemented a more aggressive program of quantitative easing, and has postponed 2015's planned sales tax increase. If Japan is ultimately successful in boosting long-term economic growth, the current government will likely have to take a more aggressive stance in removing restrictive regulations that stymie productivity, innovation, and free trade.

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
December 31, 2014

Assets	
Equity in pooled cash and investments	$ 791,814
Investments:	
Northern Trust	3,591,605,857
Aetna	1,064,133
Fidelity - Elected Officials Plan	466,130
Fidelity - DRSP/DROP	4,417,966
Total investments	3,597,554,086
Contributions receivable	8,942,232
Capital assets	900,043
Less depreciation	(150,007)
Net capital assets	750,036
Total assets	3,608,038,168
Liabilities	
Benefits payable and other liabilities	5,874,214
Net position restricted for pensions	**$ 3,602,163,954**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
December 31, 2014

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 38,465,998	$ 76,108,187
Member	6,808,222	13,472,333
Total contributions	45,274,220	89,580,520
Investment income	51,708,588	(11,381,131)
Less investment expenses	5,761,528	9,918,407
Net investment income	45,947,060	(21,299,538)
Total additions	91,221,280	68,280,982
Deductions		
Retiree benefits	42,531,246	86,774,467
Disability benefits	12,407,256	24,849,909
Survivor benefits	2,243,848	4,500,163
Refunds	635,291	1,338,595
Administrative expenses	1,009,905	1,520,991
Total deductions	58,827,546	118,984,125
Net increase (decrease)	**32,393,734**	**(50,703,143)**
Net position restricted for pensions		
Beginning of period	**3,569,770,220**	**3,652,867,097**
End of period	**$ 3,602,163,954**	**$ 3,602,163,954**