OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

May 20, 2016

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, 2016. 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 5,541 ERS and GRIP active members and 6,380 retirees participating in the ERS as of June 30, 2015.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 2.09%, 42 basis points behind the 2.51% gain recorded by the policy benchmark. For the one-year period ending March 31, 2016 the ERS' gross return (before fees) was a loss of 2.07%, in line with the 2.08% loss recorded by the policy benchmark. The one-year gross return places the ERS' performance in the fourth quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 5.70% for the three-year period and 7.28% for the five-year period ranked at the fourth and first quartile of the universes, respectively. The asset allocation at March 31, 2016 was: Domestic Equities 19%, International Equities 15.4%, Global Equities 3.6%, Fixed Income 24.5%, Inflation Linked Bonds 10.4%, Commodities 2.5%, Private Equity 7.1%, Private Real Assets 5.4%, Private Debt 0.5%, REITS 6%, Opportunistic 3.4%, MLPs 0.7%, and Cash 1.6%. We estimate that the funded status of the ERS was 90% as of March 31, 2016. 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.

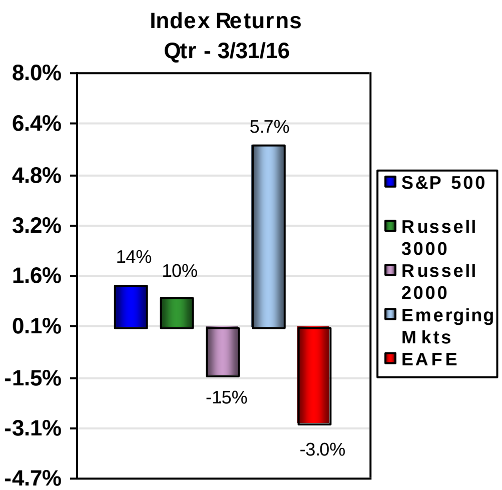
Major Initiatives

During the quarter, the following commitments were made: $13 million to TC Growth Partners I, LP, a private equity fund, $9 million to Thoma Bravo Discover Fund, a private equity fund, $10 million to PineBridge Structured Capital Partners, a private debt fund, $19 million to DW Healthcare Partners IV, a private equity fund, and Cornerstone Real Estate Advisors, LLC., a global real estate manager.

Capital Markets and Economic Conditions

Economic data reflected that GDP increased at a 0.5% annual rate in the first quarter of 2016, a decline of approximately 90bps from the economy's fourth quarter expansion of 1.4%. This 0.5% GDP reading was the slowest pace of growth in two years. The slowing rate of economic growth can be attributed primarily to a sharp decrease in business investment, which saw its sharpest drop since Q2 of 2009. Consumer spending, which accounts for almost 70% of U.S. GDP, increased 1.9%, which is somewhat disappointing given cheap energy prices, low borrowing costs, and an improving employment and wage picture. Despite tepid economic growth, household finances remain in solid shape with debt service ratios remaining near all-time lows and household net worth increasing to all-time highs. The residential real estate sector of the economy was mixed during Q1 as median house prices increased to post-crisis highs while housing starts and building permits both dropped to one-year lows. The economy added over 600,000 jobs during the first quarter and saw the unemployment rate remain unchanged at 5.0%. Additionally, the labor force participation rate increased to 63.0%, which represents the highest reading in two years and the employment-to-population ratio increased to a post-crisis high of 59.9%. Inflation continues to be muted as CPI posted a modest 0.9% growth rate year-over-year due to declining food prices. Core CPI, which excludes food and energy, has seen a modest uptick to 2.2% due to increases in medical care costs and rent.

Public Equity Markets: U.S. stocks ended the quarter in positive territory after the aggressive actions of some of the world's central banks eased concerns over the weak global economic outlook. Investors also welcomed the strong economic reports on employment growth and the housing market that were released during the quarter. Larger cap stocks outperformed smaller cap stocks, while growth lagged value. Eight of the ten sectors of the S&P 500 Index advanced with Telecom and Utilities performing the best. Healthcare and Financials were the only sectors that posted negative returns during the quarter. Our combined domestic equity performance was a loss of 1.76%, underperforming the 0.97% gain recorded by the Russell 3000 benchmark.



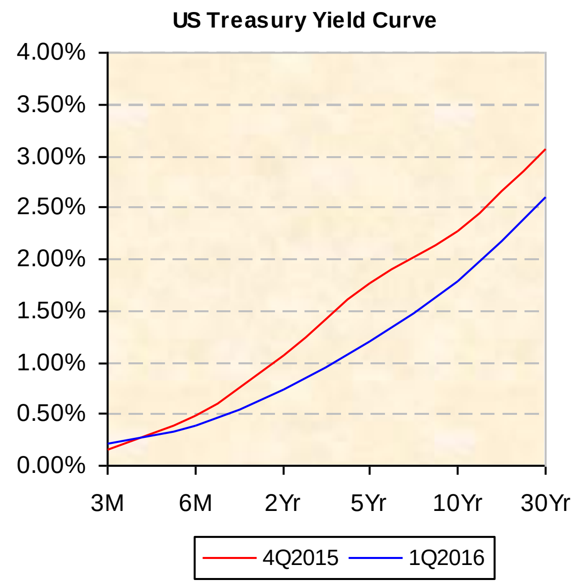
International markets found some support after the decline in crude oil found a floor in February. Europe's overall economic challenges were compounded by the anxiety over the upcoming vote in the U.K regarding continued participation in the European Union. In Asia, the results varied with losses in Japan and China offset by the rallies in smaller markets such as Thailand and Indonesia. The majority of the emerging markets were up with the Latin America region posting strong returns led by Brazil and Peru. Results within developed markets were mixed with Italy and Israel declining the most while New Zealand and Canada posting strong returns. During the quarter, developed markets, as measured by the MSCI EAFE Index, were down 3.01%, while Emerging Markets were up 5.71%. Our combined international equity performance was a loss of 1.45% for the quarter, underperforming the 0.34% loss recorded by the custom MCERS International Equity Index. Our global equity manager recorded a gain of 3.52%, outperforming the 0.24% gain of the MSCI ACWI benchmark.

Private Equity: Buyout funds raised $14 billion during the first quarter, down from the $26 billion raised in the previous quarter. There were a total of 611 private equity-backed buyout deals in the first quarter, slightly up from the previous quarter. Invested capital was considerably low versus the highs of last year. Pricing multiples continued to expand from 9.9x in last quarter to 10.1x presently, while leverage multiples have dropped slightly to 5.5x from 5.6x in 2015. Within venture capital, investment activity declined by 18% while invested capital saw an 8% decline versus the previous quarter. Exit activity (primarily through IPOs and M&A transactions) in U.S. buyout and venture markets slowed versus the previous quarter. During the quarter, our private equity managers called a combined $13 million and paid distributions of $7.9 million. Our current allocation to private equity is 7.09%, with a market value of $250 million. From its 2003 inception through September 30, 2015, the private equity program has generated a net internal rate of return of 8.7% versus a 11.1% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps). The direct private equity program generated a 15.1% return versus the 15.2% for the benchmark since inception (2009).

Opportunistic: Hedge funds, as measured by the HFRI Fund Weighted Composite Index, lost 0.8% in the first quarter. On a sub-strategy basis, the HFRI Event-Driven Index lost 1% due to a tough trading environment as many popular event-driven trades faced significant antitrust or other regulatory issues. On the positive side, global macro strategies continue to perform well as the HFRI Macro Index was up 1.2%.

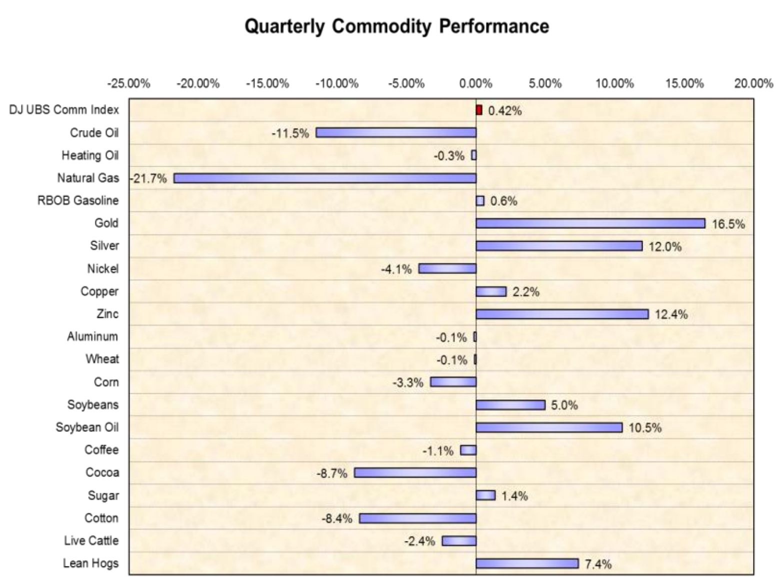
The opportunistic portfolio lost 2.84% in the first quarter, compared to the 3.09% decline in the HFRI Fund of Funds Index.

Fixed Income: U.S. Treasury yields declined sharply across the curve during the quarter as stock market volatility drove safe-haven trades into longer-term Treasuries. Short-term yields also fell primarily due to the Fed's decision to place further interest rate increases on hold. The Fed cited weak global growth as one of the factors for delaying further monetary tightening. The market is currently pricing in only two interest rate increases in 2016 vs. the four that were expected at the start of the year. The yield on the 30-year bond decreased 46 bps during the quarter, and ended the period at 2.61%. 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, tightened by 16 bps to 105 bps. For the quarter, the 2-year Treasury yield ended at 0.73%, down by 33 bps from the prior period, while the 10-year Treasury yield moved down by 49 bps to 1.78%. For the quarter, the Merrill High Yield Index rose by 3.25%, the Barclays Aggregate was up 3.03%, and the Barclays Long Govt/Credit Index increased by 7.30%, as the long end of the yield curve declined sharply. The fixed income performance for the quarter was a gain of 5.37% performing in line with the custom benchmark's return of 5.38%. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, returned 5.72% for the quarter, underperforming the benchmark's 8.02% return.



Private Real Assets: U.S. real estate values rose 2.2% during the quarter according to the NCREIF Fund Index and the increase was evenly split between income and capital appreciation. In the energy markets, WTI and Brent oil prices were volatile – oil prices fell to a low of $26/bbl in February only to rebound close to $40/bbl by the end of quarter. Oil producers are responding to the steep price declines by cutting their investments in exploration and production. U.S. oil production has already declined by over 600 kb/d from the peak in mid-2015 and U.S. exploration and production 2016 capex budgets are over 50% smaller than 2015 levels. During the quarter, our private real assets managers called a combined $6.3 million and paid distributions of $11.6 million. Our current allocation to private real assets is 5.4%, with a market value of $191.3 million. From its 2006 inception through September 30, 2015, the private real assets program has generated a net internal rate of return of 4.5% versus a 6.6% gain for the long-term benchmark CPI plus 500 bps.

Public Real Assets: The Bloomberg Commodity Index was up 0.42% with significant dispersion across commodity sectors. Precious metals rallied strongly as investors viewed gold as a safe haven surrounding financial and monetary stability concerns. Industrial metal prices rebounded from intra quarter cyclical lows as unease about the slowing global economy appears to have subsided. Agriculture & livestock returns were mixed. Lean hog and soybean prices advanced on better than anticipated demand whereas corn prices declined due to robust supplies. Spot oil prices started the quarter under extreme pressure driven by concerns that



storage would reach full capacity due to the continued surplus of oil, driving down prices to a 13-year low of $26/bbl in February. Oil rebounded from the February lows, reaching close to $40/bbl, as storage concerns eased due to production declines in the US, and healthy oil demand from China.

Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index advanced 5.23% for the quarter. However, returns for the quarter were volatile as the Index was down 10% by early February, only to rebound sharply along with other growth oriented asset classes later in the quarter. Returns were mostly positive across countries, led by Canada, Australia, and Germany, with the UK and Hong Kong the notable exceptions producing negative returns. Within the US, Free Standing, Specialty, and the Data Centers sectors posted the strongest performance with double digit returns. Data Centers, a new sector classification in the Index, outperformed on strong demand from enterprise outsourcing, cloud computing, and e-commerce. The Office sector underperformed due to concerns that volatile capital markets would result in weak office demand from banks.

Master Limited Partnerships (MLPs), as measured by the Alerian MLP Total Return Index, experienced heightened volatility intra quarter. The Index experienced steep declines in January and early February on concerns that an increasing percentage of their customers, major US exploration and production (E&P) companies such as Chesapeake, would file for bankruptcy protection. As bankruptcy risks to major US (E&P) companies subsided, MLPs rebounded as investors took advantage of the historically attractive valuations. The sector ended the quarter with a 4.17% loss.

For the quarter, the public real asset portfolio advanced 3.27%, outperforming the custom benchmark by 61 bps.

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, 2016 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 3/31/2016	Fiscal YTD
Employer Contributions	$ 34.1	$ 104.3
Member Contributions	5.9	17.8
Net Investment Gain/(Loss)	10.2	(64.8)
	$ 50.2	$ 57.3

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 3/31/2016	Fiscal YTD
Benefits	$ 59.3	$ 173.5
Refunds	1.9	5.0
Administrative Expenses	0.8	2.2
	$ 62.0	$ 180.7

Outlook

Fed president Janet Yellen continued her dovish stance reiterating that the Fed will move forward with interest rate increases in a very cautious manner. Going into 2016, the Fed hinted at the potential of four interest rate hikes during the year. In Ms. Yellen's March speech, she suggested that U.S. Dollar strength and concerns about the global economy could mean only one, or possibly no rate hikes in 2016. In addition to the Fed's softening stance, the Bank of Japan enacted a negative interest rate policy for the first time ever in January and the European Central Bank cut rates further to negative 0.4% in March, representing all-time low levels.

Recession fears in the U.S. seem to have abated throughout the quarter as a weakening U.S. Dollar has provided a support mechanism to corporate profits, commodity prices, and U.S. growth. As long as consumption and housing remain steady, it is tough to envision a U.S. recession in the near term given that these sectors comprise about 75% of GDP.

The domestic economy is likely to continue to grow at a moderate pace throughout 2016 as consumer spending is supported by low energy costs, rising employment and wages, and cheap borrowing costs. Additionally, the U.S. Dollar weakened in Q1, which should provide some much needed support to the export sector of the economy. Globally, the Fed's restraint in normalizing interest rates in addition to improving commodity prices should mitigate the pressure on emerging market economies which have struggled for the past several years.

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, U.S. Bureau of Labor Statistics.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF FIDUCIARY NET POSITION
March 31, 2016

Assets		
Equity in pooled cash and investments	$	999,197
Investments:		
Northern Trust		3,524,355,817
Aetna		978,193
Fidelity - Elected Officials Plan		501,829
Fidelity - DRSP		3,883,182
Fidelity - DROP		644,569
Total investments		3,530,363,590
Contributions receivable		11,606,805
Capital assets		900,043
Less depreciation		525,025
Net capital assets		375,018
Total assets		3,543,344,610
Liabilities		
Benefits payable and other liabilities		5,119,464
Net position restricted for pensions	**$**	**3,538,225,146**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
March 31, 2016

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 34,159,812	$ 104,293,313
Member	5,852,907	17,825,353
Total contributions	40,012,719	122,118,666
Investment income/loss	13,969,586	(52,549,220)
Less investment expenses	3,802,026	12,263,635
Net investment income/loss	10,167,560	(64,812,855)
Total additions	50,180,279	57,305,811
Deductions		
Retiree benefits	44,376,041	129,098,914
Disability benefits	12,557,464	37,654,021
Survivor benefits	2,359,182	6,759,391
Refunds	1,908,698	4,980,475
Administrative expenses	794,330	2,249,108
Total deductions	61,995,715	180,741,909
Net decrease	**(11,815,436)**	**(123,436,098)**
Net position restricted for pensions		
Beginning of period	**3,550,040,582**	**3,661,661,244**
End of period	**$ 3,538,225,146**	**$ 3,538,225,146**