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OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

March 22, 2013

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, 2012. 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. There were approximately 5,450 active members and 5,900 retirees participating in the ERS as of December 31, 2012.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 2.21%, 69 basis points ahead of the 1.52% gain recorded by the policy benchmark. For the one year period ending December 31, 2012 the ERS' gross return (before fees) was a gain of 15.02%, 227 basis points ahead of the 12.75% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the top 10% of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 11.20% for the three-year period and 5.04% for the five-year period, ranked in the top 10% of the universe for both periods. The asset allocation at December 31, 2012 was: Domestic Equities 24.2%, International Equities 16.6%, Fixed Income 26.2%, Inflation Linked Bonds 10.3%, Commodities 4.4%, Private Equity 7.5%, Private Real Assets 5.3%, REITS 0.5%, Opportunistic 3.6%, and Cash 1.4%. We estimate that the funded status of the ERS was 78% as of December 31, 2012, a slight increase from the June 30, 2012 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

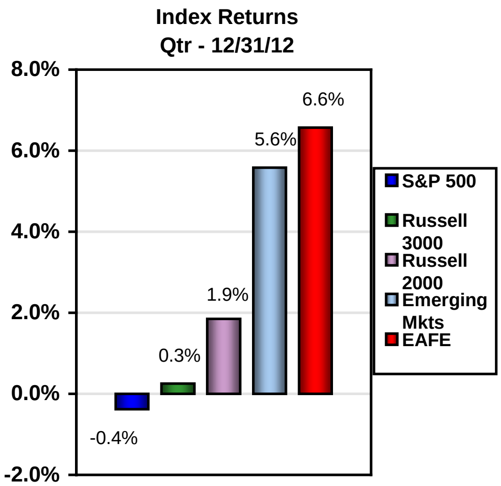
During the quarter, the Board approved proposed changes to their Due Diligence and Continuing Education policy located in the Board's Governance Manual. Staff continues to evaluate opportunities within the private real assets, REITs, private equity and opportunistic allocations.

Capital Markets and Economic Conditions

The latest GDP report indicated that the U.S. economy grew 3.1% during the third quarter after posting modest gains of just 2.0% and 1.3% during the prior two quarters. In late December, lawmakers approved a package of tax relief extensions, avoiding the "fiscal cliff" of automatic tax hikes and fiscal spending cuts set to go into effect on January 1, 2013. Job growth continued at a slow pace of 139,000 jobs per month for the quarter and the unemployment rate fell to 7.7% the first time it was below 8% since January 2009. After rising 0.4% in September, consumer prices were flat in October and declined 0.5% in November. The Consumer Price Index was up 1.8% year-over-year, still below the Fed's 2% long-term target. National home prices continued to rise from recent lows, with the S&P Case-Schiller 10- and 20-city

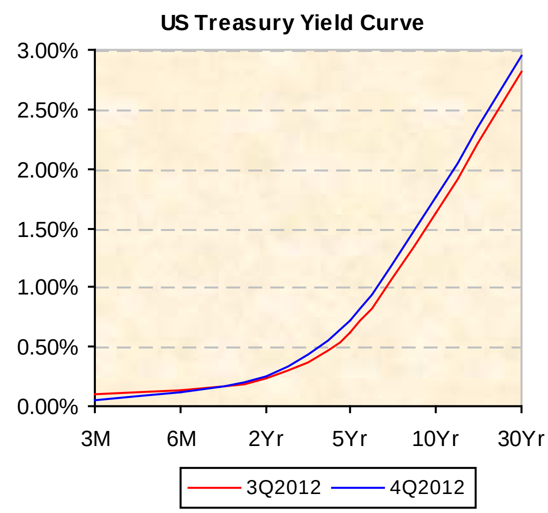
Home Price Indices rising 4.8% and 5.4%, respectively. The Institute for Supply Management's manufacturing index declined to 49.5 (readings above 50 indicate the sector is still expanding). Outside of the U.S., developed and emerging markets rose on central bank intervention by the U.S. Fed, European Central Bank, and Band of Japan, as well as notable improvement of the Chinese economy in the fourth quarter.

Public Equity Markets: U.S. equities posted modest gains during the fourth quarter. In the weeks before and after the U.S. elections, markets declined by more than 6%, due to investor concerns over the pending tax hikes and spending cuts. However, markets rallied at the end of the year as lawmakers agreed to a deal avoiding the "fiscal cliff." Larger capitalization stocks (as represented by the S&P 500 Index) underperformed their smaller counterparts. Among the sectors of the S&P 500, Financials, Materials, Industrials, and Consumer Discretionary were all positive. Telecom was the largest decliner, falling 6.0%. Our combined domestic equity performance was a gain of 0.67%, outperforming the 0.25% gain recorded by the Russell 3000 benchmark.



European equities were the top-performing region among developed markets, despite high employment and a recession, as European Central Bank intervention boosted investor confidence. During the quarter, developed markets, as measured by the MSCI EAFE Index, rose 6.57%. All countries were positive performers with the exception of Israel for the quarter. Greece was the best performer, returning of 28.1%. Emerging Markets rose 5.58%, underperforming their developed counterparts. Among the BRICs, Chinese stocks surged 12.9%. Brazil, Russia, and India lagged the overall Index returning 3.6%, 2.5% and 0.5%, respectively. Our combined international equity performance was a gain of 6.34% for the quarter, outperforming the 5.85% gain recorded by the MSCI ACWI ex-US Index.

Fixed Income: U.S. Treasury yields rose slightly during the quarter, primarily on the longer end of the yield curve. Central bank intervention in the U.S., Europe, and Japan moved investors away from the perceived "safe-haven" of the U.S. Treasury market and into riskier, higher-yielding markets. The Fed announced it would continue the Treasury buying portion of its expiring Operation Twist program. They implemented a new long-term Treasury purchase program of $45 billion per month, while maintaining the mortgage-backed securities (MBS) purchases of $40 billion per month. Federal Reserve Chairman Ben Bernanke, for the first time, tied the Fed's monetary policy to specific economic indicators by announcing the Fed would keep interest rates at its target range of between 0% - 0.25% until the U.S. unemployment rate fellow below 6.5% (it is currently 7.7%) and until the inflation rate exceeds 2.5%. The yield curve steepened slightly (shown in the chart to the right) as the spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, widened to 150bps. For the quarter, the 2-year Treasury yield ended at 0.25%, up 2bps, while the 10-year Treasury yield rose 13bps to 1.76%. Over the quarter, credit risk was rewarded as credit sectors outperformed government bonds. High yield bonds were the best performer as market participants sought yield in an environment of low interest rates. For the quarter, the Merrill High Yield Index returned 3.18%, the Barclays Aggregate returned 0.21% and the Barclays Long Govt/Credit Index returned 0.45%. Our combined fixed income performance for the quarter was a gain of 2.31%, outperforming the custom benchmark, which returned 1.52%. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 2.91% for the quarter, compared to the 2.74% gain recorded by the benchmark.

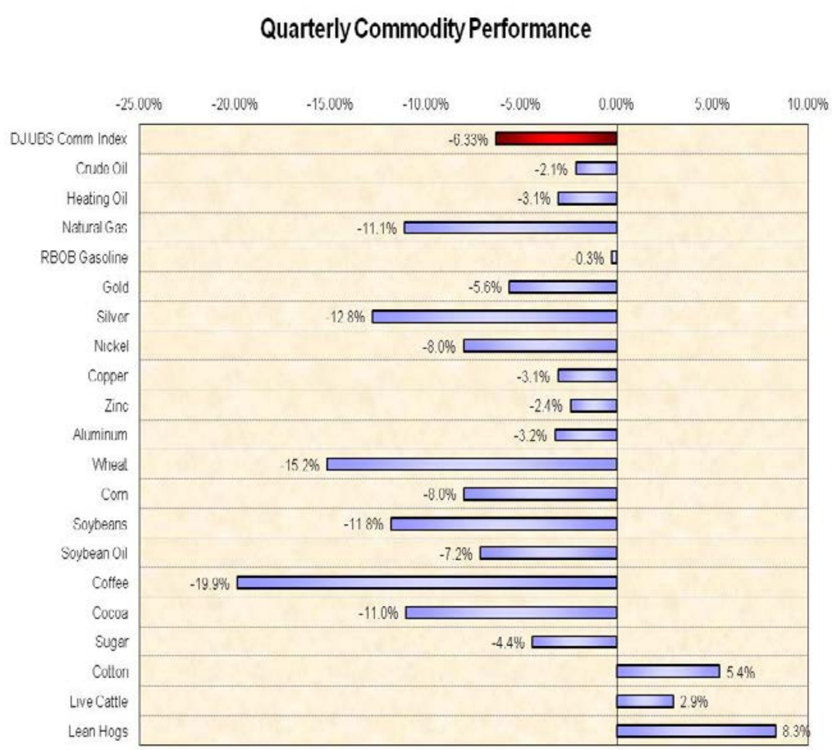


Opportunistic: Hedge funds ended 2012 on a positive note, returning an average of 1.5% in December and 1.8% in the fourth quarter. Returns lagged broad equity markets for the year, but outperformed in the final quarter of 2012. Event Driven was the top performing strategy last quarter with a gain of 3.2% on increased merger activity, accessible credit markets and tightening high yield credit spreads. Equity Hedge strategies turned in positive performance in the volatile quarter, with the HFRI Equity Hedge Index gaining 1.9%. Macro hedge fund strategies declined slightly on weakness in currencies and commodities. Our opportunistic portfolio returned 1.65%, net of management fees, in the fourth quarter.

Private Equity: In 2012, investment by private equity firms decreased slightly compared to 2011, led by a decline in new venture capital investments. Exit activity was robust with a large increase in initial public offering (IPO) exits for both buyout and venture firms. Purchase valuations were down slightly compared to 2011; however, there remains a large disparity between large deal valuations (high versus history) and smaller deal valuations (low versus history). Leverage use is slightly above its historic average. During the quarter, our private equity managers called a combined $9.7 million and paid distributions of $11.1 million. Our current allocation to private equity is 7.5%, with a market value of $232.4 million. From its 2003 inception through September 30, 2012, the private equity program has generated a net internal rate of return of 6.3% versus an 8.3% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 basis points).

Private Real Assets: Global real estate investment activity for 2012 increased slightly over the prior year. This was the net effect of a decrease in European real estate activity and a strong increase in U.S. deal volumes. In the U.S., transaction valuations improved, as investors showed a desire for cash yield and gained comfort in taking risk. In energy investing, pricing for new transactions continues to be highest in both oil-rich and gas assets with large liquids components; de-risked assets with high cash flow components are also commanding higher prices, in part due to public market demand for high yielding assets. During the quarter, our managers called a total of $4.3 million and paid distributions of $5.1 million. Our current allocation to private real assets is 5.3%, with a market value of $163.5 million. From its 2006 inception through September 30, 2012, the private real assets program has generated a net loss of 2.6% versus a 7.1% gain for the long-term benchmark CPI plus 500 basis points. The underperformance versus the benchmark is partially attributable to the young age of the portfolio, with an average maturity of less than four years.

Commodities: The Dow Jones-UBS Commodity Index declined 6.33% during the quarter. The Grains sector was the weakest segment of the index impacted by signs of a strong crop in South America and expectations of record planting in the U.S. Precious metal prices fell following an upward revision to the U.S. GDP data. All components of the Energy sector retreated during the quarter. Natural gas prices fell as a result of an unusually warm start to the winter heating season. Oil prices fell on declining demand from developed markets coupled with increasing production in the U.S. and Iraq, which resulted in a global surplus for three months in a row. Industrial metals fell modestly as a lack of policy clarity in China suppressed demand. During the quarter, our commodities portfolio declined 5.89%, 44bps ahead of the DJ UBS Commodities Index.



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, 2012 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 12/31/2012	Fiscal YTD
Employer Contributions	$ 32.5	$ 64.5
Member Contributions	6.4	12.6
Net Investment Income	63.4	217.5
	$ 102.3	$ 294.6

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 12/31/2012	Fiscal YTD
Benefits	$ 52.4	$ 104.1
Refunds	0.5	1.2
Administrative Expenses	0.3	1.0
	$ 53.2	$ 106.3

Outlook

The outlook for the global economy remains positive with global growth gradually strengthening. Uncertainty from the debt ceiling and sequestration debates in the U.S., the Chinese leadership transition and reforms in the Euro area, will continue to have an impact. While inflationary pressures remain subdued, another downside risk comes from potential rising inflation due to easing monetary and fiscal policies in Europe, Japan and the U.S.

Business confidence should strengthen as the economic situation improves but fiscal consolidation and high unemployment may continue to impede recovery. The current pace of growth is far from sufficient to overcome the continued jobs crisis that many countries are still facing. Several European economies and the euro zone as a whole are already in recession, and euro zone unemployment is at a record high of almost 12%.

Slow economic growth in the developed world is spilling over to developing countries through weaker demand for their exports and heightened volatility in capital flows and commodity prices. However, recent data has confirmed a recovery is underway in China.

Sources: Bloomberg, Northern Trust, MSCI, S&P, Pyramis Global Advisors, 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 PLAN NET ASSETS
December 31, 2012

Assets		
Equity in pooled cash and investments	$	494,414
Investments:		
Northern Trust		3,109,542,673
Aetna		1,168,853
Fidelity - Elected Officals Plan		308,263
Fidelity - DRSP		11,504,373
Total investments		3,122,524,162
Contributions receivable		6,837,030
Total assets		3,129,855,606
Liabilities		
Benefits payable and other liabilities		4,775,118
Net assets held in trust for pension benefits	**$**	**3,125,080,488**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
December 31, 2012

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 32,581,257	$ 64,525,434
Member	6,389,875	12,578,248
Total contributions	38,971,132	77,103,682
Investment income	67,214,338	225,270,887
Less investment expenses	3,840,021	7,765,463
Net investment income	63,374,317	217,505,424
Total additions	102,345,449	294,609,106
Deductions		
Retiree benefits	38,620,919	76,740,426
Disability benefits	11,683,456	23,262,698
Survivor benefits	2,046,884	4,130,613
Refunds	485,393	1,200,163
Administrative expenses	313,672	968,412
Total deductions	53,150,324	106,302,312
Net increase (decrease)	**49,195,125**	**188,306,794**
Net asset held in trust for pension benefits		
Beginning of period	**3,075,885,363**	**2,936,773,694**
End of period	**$ 3,125,080,488**	**$ 3,125,080,488**