

*INVESTMENT  
SECTION*

# INVESTMENT SECTION

## INVESTMENT CONSULTANT'S REPORT

### Introduction

This report, prepared for the Baltimore County Employees' Retirement System (the "System") by New England Pension Consultants (NEPC), is based on accounting information supplied by the System's custodian, Mellon Bank. NEPC relies on this source for security pricing, calculation of accruals, and all transactions. NEPC reconciles the monthly rates of return provided by Mellon Trust with those calculated by each investment manager. NEPC exercises reasonable professional care in preparing the performance report, and the performance calculations are reported to the greatest degree possible in compliance with the presentation standards of the Global Performance Investment Standards (GIPS) promulgated by the CFA Institute. The returns, calculated using a time-weighted rate of return methodology based upon market values, are reported on both net of fees and gross of fees to provide comparisons with the appropriate benchmarks.

### Distinction of Responsibilities

The Board of Trustees (the "Trustees") of the System is responsible for establishing the investment goals and objectives for the System's Retirement Fund (the "Fund") and sets the appropriate risk levels and asset allocation policy. The criteria used in developing the System's investment policy include: actuarial information, such as funded status, the actuarial return assumption and benefits obligations; risk and return expectations of the capital markets; the financial conditions of the County; and practices of similar types of funds. The investment policy has been developed after the Trustees have given careful consideration of the potential financial implication of a wide range of investment policies. The policy describes the degree of pension fund risk that the Trustees, as System fiduciaries, deem appropriate.

In carrying out their duties the Trustees follow acceptable standards of prudence. These standards include: 1) acting for the exclusive benefit of the Fund participants and beneficiaries; 2) exercising skill, care and diligence of a prudent person acting in a similar capacity; and 3) diversifying investments to minimize the risk of large losses.

The investment managers required to execute the policy will invest System assets in accordance with the established policy and with their judgments concerning relative investment values. In particular, the investment managers are accorded full discretion to select individual securities, make periodic strategic adjustments and diversify their portfolios.

### Investment Policy/Structure

The System's investment policy was designed to provide broad diversification among asset classes in order to maximize return at an appropriate level of risk and minimize the risk of large losses to the System. In addition, asset allocation ranges have also been implemented to maintain compliance with the investment policy and ensure the System will achieve its long-term risk and return objectives.

The System's investment policy is shown below for the broad investment categories:

**Investment Policy as of 6/30/2012**

<i>Asset Class</i>	<i>Allocation Target</i>	<i>Allocation Range</i>
<i>U. S. Equities</i>	22%	16 - 28%
<i>International Equities</i>	16%	12 - 22%
<i>Private Equities</i>	5%	0 - 7%
<i>Fixed Income</i>	27%	19 - 35%
<i>Hedge FOF</i>	5%	0 - 7%
<i>Real Estate</i>	5%	0 - 7%
<i>Global Asset Allocation</i>	15%	10 - 20%
<i>Real Asset</i>	<u>5%</u>	0 - 7%
<b><i>Total</i></b>	<b><u>100%</u></b>	

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Within each asset class, the Trustees have employed several investment managers to further diversify the investment approach and minimize style bias. The Trustees have employed both active and passive investment strategies in order to obtain the desired asset allocation mix in the most cost effective and efficient manner.

## **Investment Objective**

The System's long-term investment objective is to achieve a total rate of return which exceeds the Policy Index, defined here as the actual asset allocation for each asset class invested in its respective index. The Trustees recognize that there will be short-term deviations from these long-term investment objectives, and therefore, have developed performance expectations for the Fund and individual investment managers.

The overall Fund is also compared to the Independent Consultants Cooperative (ICC) Public Funds Universe, one of the largest, most representative universes of actual institutional performance results in the industry. At June 30, 2012, this universe contained actual public fund data for 120 public plans with an aggregate market value of \$1.2 trillion.

## **Market Overview**

Fiscal year 2012 started and ended with many of the same concerns being present, the Eurozone in crisis and global economic and political issues propelling financial market returns. Each of the four quarters were driven by this "risk on / risk off" environment where asset prices fluctuated significantly. The first quarter of the fiscal year was characterized by declining equity values, a sell-off of the credit sectors in the bond market, and declining US Treasury yields which pushed these prices to near record levels. Markets rebounded in the second and third quarters of the fiscal year driven in large part by improvements in US economic data, which included declining unemployment figures, an increase in consumer spending and confidence. The market rally continued into the New Year and was highlighted by most equity market indices registering double digit returns near the end of the third quarter. The final quarter of fiscal year 2012 ended much the same way it began some nine months earlier, with global equity markets selling off and US Treasury yields dropping to all-time lows.

Investment returns, as a result of this uncertain and ever changing economic environment, deviated greatly. The broad US equity market, as measured by the Russell 3000 Index, generated a small positive return, increasing 3.8% during fiscal year 2012. Developed international equity markets, measured by the MSCI EAFE Index (net), fell 13.8% during the fiscal year. Smaller or emerging markets, represented by the MSCI Emerging Markets Index (net), fell even further, declining 18.2% over fiscal year. The domestic bond market, as measured by the Barclays Aggregate Bond Index, returned 7.5% in fiscal year 2012 easily besting all of the major asset classes considered by institutional investors.

## **Investment Performance**

For the fiscal year ended June 30, 2012, the System's investment portfolio gained 1.1%, including dividends and interest income, unrealized gains and losses, and management fees and expenses.

The System's domestic equity portfolio posted a 1.5% net of fee return over the fiscal year as compared to a 4.0% return of the broad U.S. equity market, as measured by the Wilshire 5000 Index. The "risk on / risk off" environment that persisted throughout the fiscal year proved challenging to the System's active U.S. equity managers. The System's non-US equity portfolio's net of fee return of -12.8% outperformed the -14.6% return of the international equity benchmark. The return from the developed international market portfolio fell short of the benchmark's return by 1.3%, while the emerging market component exceeded its benchmark by nearly 9%. The System's fixed income portfolio returned 8.7% on a net of fee basis over the fiscal year and exceeded the broad domestic bond market by 1.3%. The System's core bond managers, collectively, and its emerging market debt manager exceeded the returns of their respective benchmarks during the fiscal year.

To gauge how the overall fund did relative to other public funds, the System's gross of fee return for the fiscal year was compared to the median public fund in the ICC Universe of Public Funds. The System's gross of fee return of 1.7% ranked above median (43<sup>rd</sup> percentile) of the ICC Public Funds Universe for the fiscal year. The market value of the System's combined assets decreased from \$2.09 billion on June 30, 2011 to \$2.00 billion on June 30, 2012.

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The net of fee returns for the fiscal year ending June 30, 2012 are shown in the following table.

	Market Value (in Millions)	Percent of Total	Fiscal Year Rate of Return	
			System	Benchmark
U S Equities	\$ 455.2	22.8%	1.5%	4.0%
International Equities	296.7	14.8	(12.8)	(14.6)
Private Equity	111.7	5.6	9.5	9.8
Hedge Funds	96.4	4.8	(5.7)	(4.5)
Real Estate	87.1	4.4	13.2	12.4
Fixed Income	548.2	27.4	8.7	7.4
GAA	310.0	15.5	3.5	0.2
Real Assets	87.9	4.4	(11.0)	(14.3)
Cash	6.8	0.3	0.1	0.0
Total Fund*	<u>\$2,000.0</u>	100.0%	1.1%	0.8%

\*The Total Fund shown above in the amount of \$2,000.0 includes short-term investments of \$42.3, accrued interest and dividends receivable of \$2.3, receivables for investment sold of \$13.8 and payables of \$33.0. These items are separately reported from "Total Investments" in the Statement of Plan Net Assets.

## Investment Strategies

During the fiscal year, the Trustees conducted an annual asset allocation review. No new asset were classes were added as a result of this review, although an increase of 2% to emerging market equities and a 2% additional allocation to emerging market debt were funded from their U.S. counterparts. Four new private equity commitments were made by the Board during the fiscal year.

John Krimmel, CPA, CFA  
Partner

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## Outline of Investment Policies

**Investment Policy.** As provided in Article 5 Title 1 of the Baltimore County Code, the Board of Trustees of the Employees' Retirement System of Baltimore County (the "Board") is empowered to invest the System's assets and to take appropriate action regarding the investment, management and custodianship of plan assets. The investment responsibilities include establishing reasonable investment objectives, developing investment policy guidelines, selecting investment managers and evaluating performance results to assure adherence to guidelines and the achievement of objectives.

The Board has carefully exercised these responsibilities by diversifying the assets into common stocks (domestic and foreign), fixed income, real estate, hedge funds, private equity, and real assets. The investment policy targets are 22% in U.S. equities, 16% in international equities, 27% in fixed income investments, 5% in real estate, 5% in hedge funds, 5% in private equity, 15% in global asset allocation strategies and 5% in real assets. The investment policy authorizes the allocation targets to be maintained within the allocation ranges specified in the Investment Consultant's report.

A pension investment consultant has been appointed to advise and consult with the Board and the System staff, prepare recommendations on investment policies, investment management structure and asset allocation, and to monitor and evaluate the performance of the investment managers and the asset custodian.

The Board authorizes the managers to vote all proxies related to stocks in which they invest pension assets. The Board expects the managers to cast votes solely in the best interest of plan beneficiaries. Managers are required to report annually to the Board on its proxy-voting policies and activities on the System's behalf.

## Investment Results

The following schedule compares rates of return, gross of fees, for the System portfolio with a comparative index, market indices and the inflation rate.

The market indices shown below are the Wilshire 5000 Stock Index, Morgan Stanley Capital International All Country World Ex-U.S. Index, the Barclays Capital Universal Index, 60% MSCI World/40% WGBI blended index, the NCREIF Index, the DJ-UBS Commodity index, the HFRI Fund of Funds Index and the Venture Capital Economics Private Equity Index.

The Balanced Index is a blend of market indices and is reflective of the total System's portfolio policy for each time period. In FY 2007, the Balanced Index was comprised of 34% S&P 500; 7% Russell 2000 Index; 12% Morgan Stanley EAFE Index; 3% Morgan Stanley Emerging Markets Free Index; 16% Lehman Aggregate Bond Index; 8% Citigroup World Government Bond Index; 5% Lehman High Yield Index; 5% NCREIF Index; 5% Venture Economics Private Equity Index; 5% HFRI Fund of Fund Index.

From July 1, 2007 to May 31, 2010, the Balanced Index was comprised of 32% S&P 500; 7% Russell 2000 Index; 10% Morgan Stanley EAFE Index; 3% Morgan Stanley Emerging Markets Free Index; 18% Barclays Capital Aggregate Bond Index; 8% Citigroup World Government Bond Index; 7% Merrill Lynch High Yield Index; 5% NCREIF Property Index; 5% Venture Economics Private Equity Index; 5% HFRI Fund of Fund Index.

From June 1, 2010 to May 31, 2011, the Balanced Index was comprised of 19% S&P 500; 7% Russell 2000 Index; 10% Morgan Stanley EAFE Index; 3% Morgan Stanley Emerging Markets Free Index; 9% Morgan Stanley World Index; 17% Barclays Capital Aggregate Bond Index; 8% Citigroup World Government Bond Index; 7% Merrill Lynch High Yield Index; 5% NCREIF Property Index; 5% Venture Economics Index; 5% HFRI Fund of Fund Index; 5% Dow Jones-UBS Commodity Index.

From June 1, 2011 to March 31, 2012, the Balanced Index has been comprised of 17% S&P 500; 7% Russell 2000 Index; 9% Morgan Stanley EAFE Index; 7% Morgan Stanley Emerging Markets Free Index; 9% Morgan Stanley World Index; 14% Barclays Capital Aggregate Bond Index; 8% Citigroup World Government Bond Index; 7% Merrill Lynch High Yield Index; 5% NCREIF Property Index; 5% Venture Economics Index; 5% HFRI Fund of Fund Index; 5% Dow Jones-UBS Commodity Index; 4% JP Morgan Emerging Market Global Bond Index.

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From April 1, 2012 to the present, the Balanced Index has been comprised of 15% S&P 500; 7% Russell 2000 Index; 9% Morgan Stanley EAFE Index; 7% Morgan Stanley Emerging Markets Free Index; 9% Morgan Stanley World Index; 16% Barclays Capital Aggregate Bond Index; 6% Citigroup World Government Bond Index; 7% Merrill Lynch High Yield Index; 5% NCREIF Property Index; 5% Venture Economics Index; 5% HFRI Fund of Fund Index; 5% Dow Jones-UBS Commodity Index; 4% JP Morgan Emerging Market Global Bond Index.

The rate of return measure for the financial asset class managers is time weighted. This investment measure eliminates the influence of contributions and withdrawals that are beyond the control of the investment managers. This investment measure is an effective means of appraising a fund manager's ability to make assets perform.

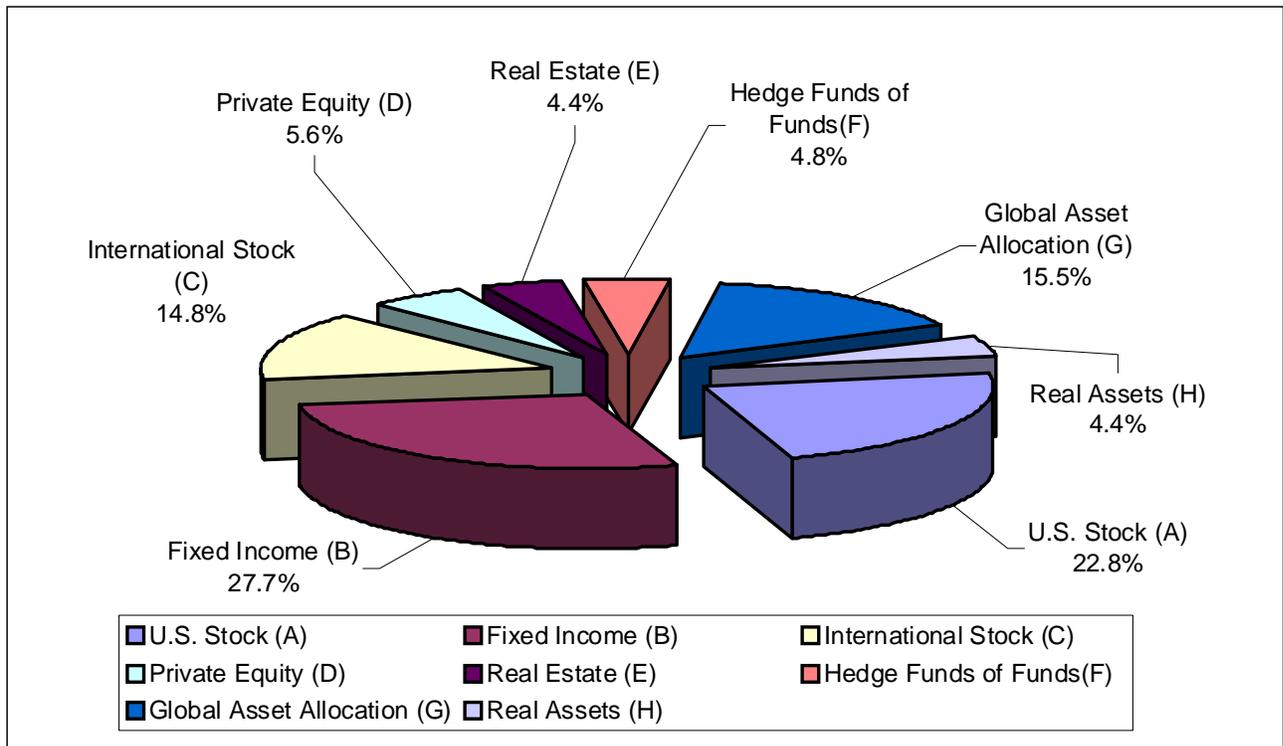
## Investment Return Summary (Percentage Change)

<b><u>Rates of Return</u></b>	<b><u>FY</u></b> <b><u>2008</u></b>	<b><u>FY</u></b> <b><u>2009</u></b>	<b><u>FY</u></b> <b><u>2010</u></b>	<b><u>FY</u></b> <b><u>2011</u></b>	<b><u>FY</u></b> <b><u>2012</u></b>	<b><u>Annualized</u></b> <b><u>Rate Over</u></b> <b><u>3 Years</u></b>	<b><u>Annualized</u></b> <b><u>Rate Over</u></b> <b><u>5 Years</u></b>
U.S. Common Stock	(13.2%)	(26.8%)	17.3%	34.2%	1.9%	17.2%	0.5%
Wilshire 5000 Stock Index	(12.5)	(26.4)	15.7	32.0	4.0	16.7	0.4
International Common Stock	(5.9)	(26.0)	16.1	28.6	(12.3)	9.6	(1.7)
MSCI ACWIXUS	(6.6)	(30.9)	10.4	29.7	(14.6)	7.0	(4.6)
GAA	3.1	(20.2)	17.0	20.4	3.5	13.6	3.8
60% MSCI World / 40% WGBI & 90- day T-Bills plus 6%	(3.7)	(14.7)	8.6	17.8	0.2	8.6	1.0
Fixed Income	4.0	3.2	19.3	8.4	9.1	12.3	8.7
Barclays Universal	6.2	4.9	10.6	4.8	7.4	7.6	6.8
Real Estate	6.4	(37.0)	(8.2)	20.5	13.2	7.7	(3.5)
NCREIF Index	9.2	(30.7)	(1.5)	16.7	12.4	8.4	(0.9)
Hedge Funds	(0.2)	(15.7)	8.8	6.3	(5.7)	2.6	(1.9)
Hedge Fund-of-Funds Index	(0.3)	(15.2)	4.7	6.7	(4.5)	2.2	(2.0)
Private Equity	18.1	(16.8)	12.0	14.6	9.5	11.9	6.5
Venture Economics Index	16.0	(21.0)	13.1	19.9	9.8	13.0	5.2
Total System Portfolio	(4.5)	(17.5)	16.4	21.0	1.7	12.8	2.5
<b><u>Comparative Index</u></b>							
Balanced Index	(3.8)	(14.4)	12.5	19.4	0.8	10.6	2.2
<b><u>Inflation Rate</u></b>							
Consumer Price Index	4.9	(1.2)	1.1	3.6	1.7	2.1	2.0

Note: Performance is gross of fees.

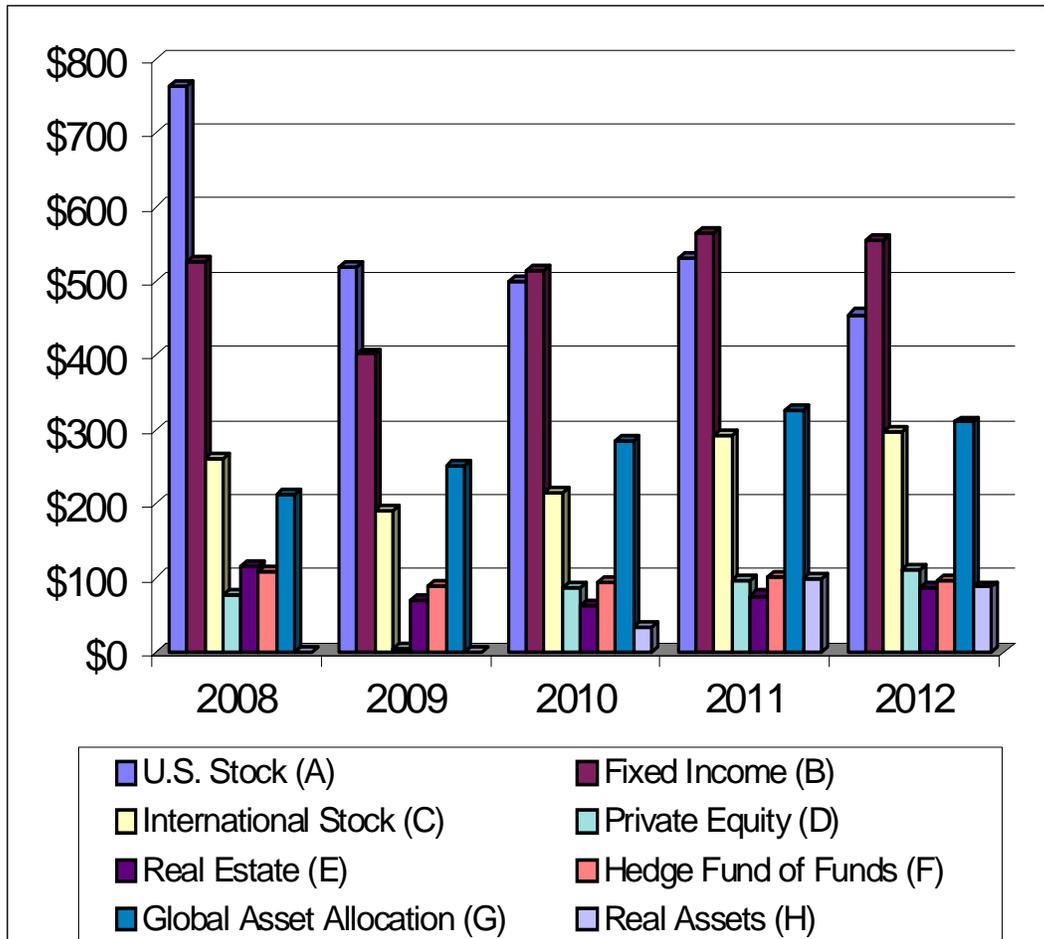
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**Portfolio Composition by Manager Type**  
**Market Value of Investments**  
**Percent of Total Fund**  
**As of June 30, 2012**



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**Portfolio Composition by Manager Type**  
**Market Value of Investments**  
**Percent of Total Fund**  
**As of June 30, 2008, 2009, 2010, 2011 & 2012**  
 (Expressed in Millions)



Investment Type	2008		2009		2010		2011		2012	
U.S. Stock (A)	\$764.4	37.0%	\$520.2	32.6%	\$500.3	28.0%	\$530.4	25.4%	\$455.2	22.8%
Fixed Income (B)	525.6	25.5%	402.1	25.3%	514.1	28.7%	564.4	27.1%	555.0	27.7%
International Stock ©	261.0	12.7%	189.6	11.9%	213.9	12.0%	292.9	14.0%	296.7	14.8%
Private Equity (D)	76.8	3.7%	73.9	4.5%	85.4	4.8%	97.2	4.7%	111.7	5.6%
Real Estate (E)	115.4	5.6%	69.7	4.4%	62.7	3.5%	75.7	3.6%	87.1	4.4%
Hedge Fund of Funds (F)	107.5	5.2%	89.4	5.6%	94.5	5.3%	101.2	4.9%	96.4	4.8%
Global Asset Alloc. (G)	212.4	10.3%	251.1	15.7%	285.2	15.9%	325.4	15.6%	310.0	15.5%
Real Assets (H)	0.0	0.0%	0.0	0.0%	32.7	1.8%	98.9	4.7%	87.9	4.4%
<b>Total</b>	<b>\$2,063.1</b>	<b>100.0%</b>	<b>\$1,596.0</b>	<b>100.0%</b>	<b>\$1,788.8</b>	<b>100.0%</b>	<b>\$2,086.1</b>	<b>100.0%</b>	<b>\$2,000.0</b>	<b>100.0%</b>

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## List of Largest Assets Held (Year Ended June 30, 2012)

Ten Largest Equity Holdings (STOCKS)				PAR VALUE/ SHARES	MARKET VALUE
1)	MasterCard Inc.			7,696	\$3,310,138
2)	Google Inc.			5,347	3,101,887
3)	Wells Fargo & Co.			74,907	2,504,887
4)	Canadian Natl. Railway Co.			29,359	2,477,289
5)	Berkshire Hathaway Inc.			28,479	2,373,174
6)	Occidental Petroleum Corp			27,635	2,370,212
7)	The Walt Disney Co			48,577	2,356,003
8)	Kinder Morgan Inc.			70,933	2,285,466
9)	Core Laboratories			19,267	2,233,025
10)	Hexcel Corp			81,260	2,095,686
Ten Largest Fixed Income Holdings (NOTES & BONDS)		INTEREST RATE	MATURITY DATE	PAR VALUE/ SHARES	MARKET VALUE
1)	US Treasury Note	0.125%	8/31/2013	13,428,799	\$13,406,239
2)	Commit to Purchase FNMA SF MTG	3.000	8/1/2042	7,149,241	7,312,315
3)	US Treasury Bond	3.125	2/15/2042	5,026,322	5,398,572
4)	FNMA Pool	VAR RT	11/1/2020	4,513,432	4,520,654
5)	Commit to Purchase FNMA SF MTG	3.000	7/1/2027	3,121,939	3,270,731
6)	US Treasury Bond	3.000	5/15/2042	2,203,197	2,307,497
7)	FHLMC Pool	6.000	11/1/2039	1,949,927	2,145,524
8)	Commit to Purchase GNMA SF MTG	3.500	7/20/2042	1,873,164	2,001,944
9)	DOT Headquarters II	STEP	12/7/2021	1,692,238	1,870,938
10)	FNMA GTD REMIC P/T	VAR RT	6/25/2022	1,792,885	1,792,885

\*A complete list of the portfolio holdings is available upon request.

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## Supplementary Supporting Schedules Schedule of Fees

(Year Ended June 30, 2012)  
(in Thousands)

<u>Investment Services</u>	<u>Assets Under Management*</u>	<u>Fees</u>
Domestic Equity Managers	\$455,195	\$2,680
International Equity Managers	296,671	1,804
Fixed Income Managers	548,236	2,304
Private Equity Managers	111,686	1,865
Real Estate Managers	87,052	1,006
Hedge Fund of Funds Managers	96,432	966
Global Asset Allocation Managers	309,973	2,398
Real Assets	87,901	713
Short-Term Investment Manager	6,774	-
Other Investment Service Fees:		
Custodian		302
Security lending – Agent Fees		248
Security lending – Borrower rebates		(641)
Investment consultant		284
Total	<u>\$1,999,920</u>	<u>\$13,929</u>

\*Asset Under Management” shown above in the amount of \$1,999,920 includes short-term investments of \$42,272, accrued interest and dividends receivable of \$2,291, receivables for investment sold of \$13,793 and payables of \$33,041. These items are separately reported from “Total Investments” in the Statement of Plan Net Assets.

## Supplementary Supporting Schedules Schedule of Commissions

(Year Ended June 30, 2012)

<u>Investment Broker Firms</u>	<u>Number of Shares Traded</u>	<u>Total Commissions</u>	<u>Commission Per Share</u>
Bernstein Sanford and Co, New York	727,957	\$28,835	0.04
Liquidnet Inc. Brooklyn	660,421	19,709	0.03
Merrill Lynch Pierce Fenner Smith, Inc	467,931	16,098	0.03
William Blair & Co.	450,963	14,153	0.03
Stifel Nicolaus	354,005	12,313	0.03
BNY Convergenx, New York	326,930	12,121	0.04
Morgan Stanley & Co. Inc.	409,677	11,510	0.03
Raymond James & Assoc. Inc.	405,980	10,324	0.03
Rafferty Capital Markets, LLC	327,260	9,793	0.03
RBC Capital Markets, LLC	360,514	9,712	0.03
Credit Suisse, New York	597,802	9,626	0.02
Deutsche BK SECS, Inc.	260,330	9,591	0.04
JP Morgan Securities, Inc	233,268	8,338	0.04
Barclays Capital LE	225,616	8,031	0.04
Miscellaneous (Under \$8,000)	<u>11,914,990</u>	<u>206,849</u>	0.02
Total	<u>17,723,644</u>	<u>\$387,003</u>	

# INVESTMENT SECTION

## Investment Summary (Year Ended June 30, 2012) (in Thousands)

TYPE OF INVESTMENTS	FAIR VALUE	% of FAIR VALUE
Fixed Income:		
U.S. Government & Agencies Securities	\$130,226	6.6%
Municipals	1,709	0.1
Corporate Bonds	132,034	6.7
Foreign Debt	11,060	0.6
Bond Mutual Funds	267,068	13.5
Total Fixed Income	\$542,097	27.5%
Common Stock:		
Financial Services	\$32,957	1.7%
Health Care	27,374	1.4
Retail	21,142	1.1
Software	18,628	0.9
Pharmaceuticals	18,093	0.9
Oil & Gas	17,118	0.9
Commercial Services	16,020	0.8
Computers	14,874	0.7
Insurance	10,277	0.5
Telecommunications	10,853	0.5
Chemicals	10,081	0.5
Internet	10,080	0.5
Food Processing	9,391	0.5
Technology	7,718	0.4
Semiconductors	7,385	0.4
Aerospace/Defense	7,235	0.4
Capital Goods	7,220	0.4
Electronics	7,186	0.3
Transportation	7,149	0.3
General Business	127,889	6.5
Total Common Stock	\$388,670	19.6%
Other Investments:		
Stock Mutual Funds	350,795	17.8
Real Estate Equity Funds	87,052	4.4
Hedge Funds	96,431	4.9
Private Equity Funds	111,686	5.7
Real Assets	87,901	4.4
Global Asset Allocation Funds	309,973	15.7
Total Other Investments	\$1,043,838	52.9%
Total Investments at fair value	\$1,974,605	100.0%