

FINANCIAL SECTION



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HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM



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INDEPENDENT AUDITORS REPORT

To the Board of Trustees of the
Houston Municipal Employees Pension System

Report on the Financial Statements

We have audited the accompanying financial statements of the Houston Municipal Employees Pension System (the System), which comprise the statements of fiduciary net position as of June 30, 2018 and 2017, and the related statements of changes in fiduciary net position for the fiscal years then ended and notes to the basic financial statements.

Management's Responsibility for the Financial Statements

The Plan's management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the System as of June 30, 2018 and 2017, and the respective changes in financial position for the fiscal years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplemental Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis (MD&A) and the Schedules of Changes in Net Pension Liability and Related Ratios, Net Pension Liability, Contributions, Investment Returns, and Changes in Total Other Post Employment Benefits Liability and Related Ratios be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplemental information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audits of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Supplemental and Other Information

Our audits were conducted for the purpose of forming opinion on the financial statements that collectively comprise the System's basic financial statements. The Other Supplemental Information and the Introductory, Investment, Actuarial and Statistical Sections, as listed in the Table of Contents, are presented for the purpose of additional analysis and are not a required part of the basic financial statements.

The Other Supplemental Information is the responsibility of the System's management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Other Supplemental Information is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

The Introductory, Investment, Actuarial and Statistical Sections have not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on them.

Weaver and Tidwell, L.L.P.

WEAVER AND TIDWELL, L.L.P.

Houston, Texas
September 27, 2018

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The Board of Trustees (the Board) of the Houston Municipal Employees Pension System (the System) is pleased to provide this overview and analysis of the financial performance and activities of the System for the fiscal years ended June 30, 2018 and 2017. We encourage the readers to consider the information presented here in conjunction with the basic financial statements.

OVERVIEW OF THE FINANCIAL STATEMENTS

The discussion and analysis is intended to serve as an introduction to the System's financial statements. The financial section consists of (1) System's Basic Financial Statements, (2) Notes to Basic Financial Statements, and (3) Supplemental Information. The year-end financials for fiscal years 2018 and 2017 Notes to the Basic Financial Statements, and the Required Supplemental Information and other Supplemental Information in this report were prepared in conformity with generally accepted accounting principles established by the Governmental Accounting Standards Board (GASB).

SYSTEM'S BASIC FINANCIAL STATEMENTS

There are two basic financial statements presented herewith. The Statements of Fiduciary Net Position as of June 30, 2018 and 2017 indicate the net position available to meet future payments and give a snapshot at a particular point in time. The Statements of Changes in Fiduciary Net Position for the fiscal years ended June 30, 2018 and 2017 provide a view of the fiscal year's additions to and deductions from the System.

NOTES TO BASIC FINANCIAL STATEMENTS

The notes are an integral part of the basic financial statements and provide additional background information that is essential for a complete understanding of the data provided in the System's financial statements. The Notes to the Basic Financial Statements can be found on pages 23 to 45 of this report.

SUPPLEMENTAL INFORMATION

The required supplemental information consists of:

Schedule 1 – Schedule of Changes in Net Pension Liability and Related Ratios – Information about the components of the net pension liability and related ratios includes the pension plan's fiduciary net position as a percentage of the total pension liability, and the net pension liability as a percentage of covered payroll. It should be noted though that actuarial information is based upon assumptions about future events, and therefore, the figures presented are estimates.

Schedule 2 – Schedule of Net Pension Liability – This schedule provides the historical liability of employers and non-employer contributing entities to plan members for benefits provided through a defined benefit pension plan.

Schedule 3 – Schedule of Contributions – Details the actuarially determined contribution calculated for employers, actual contributions, covered payroll, and actual contributions as a percentage of payroll.

Schedule 4 – Schedule of Investment Returns – A 10-year schedule presenting the annual money-weighted rate of return on pension plan investments for each fiscal year.

Schedule 5 – Schedule of Changes in Total OPEB Liability and Related Ratios - Fiscal Year Ending June 30, 2018 – These are calculations made by the System's actuary that provide actuarial information that contributes to the understanding of the changes in the actuarial funding of and the funded status of the OPEB over a number of years. It should be noted that actuarial information is based upon assumptions about future events, and therefore, the figures presented are estimates.

The other supplemental information consists of:

Schedule 6 – Investment Summary – This lists the System's investments by type presented both at cost and fair market value.

Schedule 7 – Investment Expenses, Professional Services and Administration Expenses – This provides additional information for purposes of a more detailed analysis.

Schedule 8 – Details of Investment Expenses and Professional Services – This provides additional information for purposes of a more detailed analysis.

COMPARATIVE FINANCIAL STATEMENTS

Below is a condensed and comparative summary of major classes of Fiduciary Net Position at fair value. (In thousands of dollars)

	June 30, 2018	June 30, 2017	June 30, 2016
Assets			
		(Restated)	
Cash and cash equivalents	\$ 31,377	\$ 7,917	\$ 7,551
Investments	2,959,795	2,594,843	2,396,798
Receivables on asset sales	6,059	4,751	9,041
Contribution receivable - City of Houston	7,751	7,363	-
Other receivables	4,493	3,661	4,337
Collateral on securities lending	49,472	47,371	73,941
Furniture, fixtures and equipment, net	133	178	298
Total assets	<u>3,059,080</u>	<u>2,666,084</u>	<u>2,491,966</u>
Liabilities			
Payables on asset purchase	9,149	9,784	12,133
Accrued liabilities	11,520	10,871	5,868
Collateral on securities lending	49,472	47,371	73,941
Total liabilities	<u>70,141</u>	<u>68,026</u>	<u>91,942</u>
Deferred inflows of resources	75	-	-
Net position restricted for pensions	<u>\$ 2,988,864</u>	<u>\$ 2,598,058</u>	<u>\$ 2,400,024</u>

Below is a comparative summary of Statements of Changes in Fiduciary Net Position available for pension benefits. (In thousands of dollars)

	Fiscal Year 2018	Fiscal Year 2017	Fiscal Year 2016
Additions:			
		(Restated)	
Contributions	\$ 449,467	\$ 198,459	\$ 175,832
Investment and interest income, net	231,815	290,911	27,988
Other income	701	1,272	1,303
Total additions	<u>681,983</u>	<u>490,642</u>	<u>205,123</u>
Deductions:			
Benefits paid	283,928	280,456	253,178
Contribution refunds	807	718	1,105
Administrative expenses and professional fees	6,442	6,827	7,360
Total deductions	<u>291,177</u>	<u>288,001</u>	<u>261,643</u>
Net increase (decrease) in net position	390,806	202,641	(56,520)
Net position restricted for pensions			
Beginning of year	<u>2,598,058</u>	<u>2,400,024</u>	<u>2,456,544</u>
End of year, as previously stated		2,602,665	
Prior years adjustments for OPEB		4,607	
End of year	<u>\$ 2,988,864</u>	<u>\$ 2,598,058</u>	<u>\$ 2,400,024</u>

FINANCIAL HIGHLIGHTS (In thousands of dollars, unless otherwise noted)**CONTRIBUTIONS**

For fiscal year 2018, employee contributions increased by \$12,003 or 75.5% to \$27,905, compared to \$15,902 in fiscal year 2017. Fiscal year 2017, employee contributions represented an increase of \$28 or 0.2% over fiscal year 2016. The increase in fiscal year 2018 was primarily the result of Senate Bill 2190 of the 85th Texas Legislature ("SB 2190") which increased contributions by all active participants.

Also as a result of SB 2190, beginning in fiscal year 2018, the City is required to contribute the "Total City Contribution" to the System, which consists of the sum of (a) an actuarially determined percentage of payroll ("City Contribution Rate") multiplied by actual payroll and (b) a fixed dollar amount ("City Contribution Amount"). In fiscal year 2018, the City Contribution Rate was 8.17% of payroll, and the City Contribution Amount was \$124,030, for a Total City Contribution of \$171,562 (excluding Pension Obligation Bond proceeds).

In addition to these ongoing employer contributions, SB 2190 required a one-time contribution of \$250 million in Pension Obligation Bond proceeds ("POB proceeds") to the System. This payment was made during fiscal year 2018.

The System received cash contributions from the City of Houston (the City) of \$421,562, \$182,558 and \$159,959 (which are net of contributions to the replacement benefit plan of \$2,148, \$1,801 and \$1,612) for fiscal years 2018, 2017 and 2016, respectively.

BENEFIT PAYMENTS

Total benefit payments were \$283,928, \$280,456 and \$253,178 in fiscal years 2018, 2017 and 2016, respectively. The increases in total benefit payments for these years were 1.2%, 10.8% and 7.8%, respectively.

Refunds amounted to \$807, an increase of 12.4%, in fiscal year 2018 over fiscal year 2017. Refunds were \$718 and \$1.1 million in fiscal years 2017 and 2016, respectively.

Monthly recurring benefits represented 87.1% (\$247,225) of total benefit payments in fiscal year 2018. This compares with 84.1% (\$235,832) and 88.4% (223,731) in fiscal years 2017 and 2016, respectively. Monthly recurring benefits increased 4.8%, 5.4% and 5.0%, respectively, in fiscal years 2018, 2017 and 2016.

Distributions to Deferred Retirement Option Plan (DROP) participants represented 12.8% (\$36,478) of total benefit payments in fiscal year 2018. This compares with 15.8% (\$44,724) and 11.5% (\$29,195) in fiscal years 2017 and 2016, respectively. DROP distributions decreased 17.6%, increased 51.6% and increased 34.9%, respectively, in fiscal years 2018, 2017 and 2016.

DROP distributions in fiscal year 2018 can be broken down into \$34,698 in lump sum payments and \$1,780 in monthly distributions. In 2017, the breakdown was \$42,492 in lump sum payments and \$1,782 in monthly distributions. In 2016, the breakdown was \$27,420 (lump sum) and \$1,775 (monthly).

Total employee and employer contributions exceeded benefit payments in fiscal year 2018 by \$165,539. Total benefit payments exceeded total employee and employer contributions by \$81,996 and \$77,346 in fiscal years 2017 and 2016, respectively.

ACCOUNTING AND ADMINISTRATION

Costs of administering the benefit programs of the System, including professional fees, decreased to \$6,442 for fiscal year 2018 from \$6,826 for fiscal year 2017, down 5.6%. This decrease is mainly due to a reduction in costs of staff and benefits and in professional services expenses. Fiscal year 2017 administrative expenses were down 7.3% versus fiscal year 2016 mainly due to a decrease in legal services.

The System capitalizes expenditures for furniture, fixtures and equipment in accordance with Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as amended. Furniture, fixtures and equipment, net of accumulated depreciation, as of fiscal year ends 2018, 2017, and 2016 were \$133, \$178, and \$298, respectively.

ACTUARIAL VALUATIONS AND FUNDING

The funded ratio is a standard measure of a plan's funded status representing the ratio of the actuarial value of assets to the actuarial accrued liability. The funded ratio as of the last actuarial report, July 1, 2017, is 56.4%, compared to 55.5% on July 1, 2016, and 54.2% on July 1, 2015. As of July 1, 2017, the Systems' unfunded actuarial accrued liability was \$2.123 billion. In determining contribution rates, an actuarial value of assets is used rather than a market value of assets, with the actuarial value of assets (AVA) based on smoothed returns. This "smoothing method" is intended to help reduce the volatility of the contribution rates from year to year. The method used to compute the AVA takes the difference between the actual market value of assets and the expected actuarial value of assets (based on the assumed 7.0% investment return rate), and establishes a base each year which is equal to this difference less any unrecognized bases from prior years. If the current year's base is of opposite sign from the prior years' bases then it is offset dollar for dollar against the prior years' bases (oldest bases first) until either the prior years' bases or the current year's base is reduced to zero. Any remaining bases are then recognized over the remaining period for the base (5 less the number of years between the base year and the valuation year) in equal dollar amounts.

INVESTMENTS

The net investment and interest income of the System was \$231,815 during fiscal year 2018, a decrease of \$59,096 from fiscal year 2017's income of \$290,911. The investment and interest income of the System consists of:

	Fiscal Year 2018	Fiscal Year 2017	Dollar Change	Fiscal Year 2017	Fiscal Year 2016	Dollar Change
Interest	\$ 10,530	\$ 21,741	\$ (11,211)	\$ 21,741	\$ 17,753	\$ 3,988
Dividends	19,974	19,455	519	19,455	18,844	611
Earnings from limited partnerships and real estate trusts	5	5,102	(5,097)	5,102	1,034	4,068
Realized gain/(loss) on investments	92,478	39,151	53,327	39,151	22,164	16,987
Change in unrealized gain/(loss) on investments	116,195	212,501	(96,306)	212,501	(24,618)	237,119
Net proceeds from lending securities	301	352	(51)	352	349	3
Less: cost of investment services	(7,668)	(7,391)	(277)	(7,391)	(7,538)	147
Net investment and interest income (loss)	<u>\$ 231,815</u>	<u>\$ 290,911</u>	<u>\$ (59,096)</u>	<u>\$ 290,911</u>	<u>\$ 27,988</u>	<u>\$ 262,923</u>

The System's gross rate of return on investments during fiscal year 2018 was 9.3% compared with the fiscal year 2017 rate of return of 12.7%. The decrease in the rate of return was due primarily to higher market performance in fiscal year 2017.

- Fiscal year 2018 saw global equity continue to rise following tax cuts in the United States. Domestic equities (Wilshire 5000) ended the year with a gain of 14.7%, and international equities (MSCI All Country ex-US) recorded a gain of 7.3%.
- High yield bonds as represented by the Merrill Lynch High Yield II Total Return recorded a small gain, returning 2.5%. High quality investment grade bonds lagged, ending the year with a slight loss of 0.4%. Real Estate had another year of strong performance, as the NCREIF Property Index returned 7.2% in fiscal year 2018.
- At June 30, 2018, the Systems' total pension liability was \$5.11 billion. The System's Fiduciary Net Position was \$2.99 billion leaving a Net Pension Liability of \$2.12 billion. The Plan's Fiduciary Net Position as a percentage of total pension liability was 58.45%.
- The Fiduciary Net Position of \$2.99 billion increased by \$391 million or 15.1% during fiscal year 2018 due primarily to the receipt of \$250 million in Pension Obligation Bond proceeds and strong investment income returns. This compares to an increase of \$203 million or 8.4% in the Fiduciary Net Position during fiscal year 2017.

INVESTMENT REVIEW

The System’s investment portfolio closed its 2018 fiscal year at \$3.0 billion, up from \$2.6 billion at the beginning of the year. The total gross investment return for the fiscal year was 9.3%. The System’s performance, including the total fund, each asset class and their corresponding benchmark(s), for fiscal year 2018 and the trailing three, five, and ten-year periods are listed in Table 1 on the next page.

The System’s gross investment performance was 9.3%, 7.8% and 8.6% for the past one-, three- and five-year periods. The System outperformed its policy benchmark during the fiscal year.

Relative to its peer group (Wilshire TUCS Master Trusts – Public) the fund continues to post attractive investment returns over the long term, with returns above median over the trailing ten, five and three-year period.

The best performing asset classes for fiscal year 2018 were Private Equity, up 17.2% and Real Estate, up 9.9%. For fiscal year 2017, Global Equity and Private Equity were the top two performing asset classes. The benefits of a well-diversified asset allocation are evidenced by the System’s ability to perform very competitively over multi-year periods where different asset classes drive overall returns. For the past three-year and ten-year periods, Private Equity and Domestic Equity were the System’s best performing asset classes, providing returns of 13.3% and 10.1%, respectively.

The System continuously monitors the actual allocation with the goal of moving it toward the target. The Target Allocation and Actual Asset Allocation charts below reflect the System’s target and actual asset allocation mix as of June 30, 2018.

Asset Class	Target Allocation	Actual Allocation
Global Equity	32.5%	33.0%
Private Equity	17.0%	20.7%
Fixed Income	10.0%	13.7%
Private Credit	5.0%	0.5%
Real Estate	12.5%	10.3%
Absolute Return	8.0%	5.7%
Inflation Linked	15.0%	14.4%
Cash/Liquidation	-	1.7%
Total	<u>100.0%</u>	<u>100.0%</u>

Table 1

Periods Ended June 30, 2018

	Assets		Performance			
	(\$Millions)	(%)	1-year	3-year	5-year	10-year
Total Global Equity	988.3	33.0	9.8%	8.4%	9.7%	-.-%
Global Equity Policy ¹			10.2%	8.4%	9.5%	-.-%
Global Low Volatility Equity	219.1	7.3	7.9%	8.8%	-.-%	-.-%
MSCI ACWI Min Vol (Net)			7.3%	8.3%	-.-%	-.-%
Domestic Equity	388.0	13.0	12.9%	11.4%	12.7%	10.1%
Wilshire 5000			14.7%	11.9%	13.4%	10.2%
International Equity	381.1	12.7	7.8%	5.2%	5.9%	2.5%
MSCI ACWI ex-US (Net)			7.3%	5.1%	6.0%	2.5%
Global Fixed Income	408.5	13.7	1.5%	4.2%	4.5%	6.1%
Global Fixed Income Policy ²			1.1%	3.7%	3.9%	6.1%
Real Estate	307.9	10.3	9.9%	10.6%	10.4%	1.4%
NCREIF Property			7.2%	8.3%	9.8%	6.2%
Private Equity	618.8	20.7	17.2%	13.3%	12.9%	9.6%
S&P 500 + 3%			17.4%	14.9%	16.4%	13.2%
Absolute Return	169.1	5.7	4.7%	1.4%	2.8%	-.-%
Custom Benchmark ³			5.8%	5.1%	4.8%	-.-%
Inflation Linked	430.4	14.4	5.8%	0.2%	2.3%	-.-%
Custom Benchmark ⁴			6.9%	5.8%	5.5%	-.-%
Private Credit	14.9	0.5	-.-%	-.-%	-.-%	-.-%
Custom Benchmark ⁴			-.-%	-.-%	-.-%	-.-%
Cash	48.9	1.7	0.9%	0.6%	1.8%	1.8%
Total Fund	2,992.4	100.0	9.3%	7.8%	8.6%	7.0%
Policy Index			8.3%	8.0%	8.9%	7.5%
TUCS Ranking (6/30/18) ⁵			27 (142)	29 (142)	46 (141)	50 (137)

1. **Global Equity Policy:** 3Q13 - Present: 75% MSCI All-Country World IMI (Net), 25% MSCI All-Country World Minimum Volatility Index (Net).

2. **Global Fixed Income Policy:** 1Q04 - Present: 50% Barclays US Aggregate Bond Index, 50% ML High Yield Master II.

3. **Absolute Return Custom Benchmark:** 2Q11 - Present: Libor 3-Month Yield + 4% annually; Prior to 2Q11: Libor 3-Month Yield + 5% annually.

4. **Inflation-Linked Assets Custom Benchmark:** 2Q11 - Present: CPI + 4% annually; Prior to 2Q11: CPI + 5% annually.

5. **Wilshire TUCS:** total returns of all public DB plans, as of date noted; ranking is based on percentile within universe. Number in parentheses is number of observations for period.

SECURITIES LENDING PROGRAM

The System's securities lending program obtains additional income by lending securities to broker dealers and banks. During the years ended June 30, 2018 and 2017, the System's custodian lent the System's securities and received cash, securities issued or guaranteed by the United States government, and irrevocable bank letters of credit as collateral. The Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested in a collective investment pool.

LIMITED PARTNERSHIP COMMITMENT

The System's investments in limited partnerships are included in the first table appearing in Note 9 on page 32. In connection with those investments, the System has remaining commitments as of June 30, 2018, 2017, and 2016 of approximately \$872 million, \$725 million, and \$700 million, respectively, pursuant to terms of the respective limited partnerships.

Other Comments

ACTUARIAL VALUATION

In compliance with the System's policy, an actuarial valuation along with an experience study will be performed by the System's actuary. Under SB 2190, experience studies comparing plan assumptions against plan experience will be performed at least once every four years effective 2021.

CONTACTING THE SYSTEM'S FINANCIAL MANAGEMENT

This financial report is designed to provide our participants, business partners, and other stakeholders with a general overview of the System's financial activities. Questions about this report should be directed to the Executive Director of the Houston Municipal Employees Pension System at 1201 Louisiana, Suite 900, Houston, Texas 77002.

Statements of Fiduciary Net Position

As of June 30, 2018 and 2017 (in whole dollars)

Assets	2018	2017 (Restated)
Cash and cash equivalents	\$ 31,377,585	\$ 7,916,715
Receivables:		
Contribution receivable - City of Houston	7,751,408	7,363,413
Receivables on asset sales	3,966,451	4,303,047
Receivables on foreign exchanges	2,092,990	447,945
Other receivables	4,492,668	3,660,945
Total receivables	18,303,517	15,775,350
Investments, at fair value:		
Short-term investment funds (valued at cost)	61,456,739	54,125,554
Government securities	69,614,794	72,675,493
Corporate bonds	198,328,385	202,121,498
Capital stocks	683,339,878	540,683,622
Commingled funds	787,745,946	653,822,339
Real assets	230,983,496	261,822,756
Alternative investments	928,325,587	809,591,991
Total investments	2,959,794,825	2,594,843,253
Collateral on securities lending arrangements	49,471,751	47,371,287
Furniture, fixtures and equipment, net	132,786	177,788
Total assets	3,059,080,464	2,666,084,393
Liabilities		
Payables on asset purchases	7,050,805	9,335,017
Payables on foreign exchanges	2,098,408	448,630
Accrued liabilities	3,242,257	3,010,519
Total OPEB liability	8,277,557	7,860,712
Collateral on securities lending arrangements	49,471,751	47,371,287
Total liabilities	70,140,778	68,026,165
Deferred inflows of resources	75,408	-
Net position restricted for pensions	\$ 2,988,864,278	\$ 2,598,058,228

FY 2017 Net Position was restated to reflect the Total OPEB Liability as of June 30, 2017 due to implementation of GASB 75. See accompanying notes to financial statements.

Statements of Changes in Fiduciary Net Position

Years Ended June 30, 2018 and 2017 (in whole dollars)

	2018	2017 (Restated)
Additions:		
Contributions:		
City of Houston	\$ 421,561,725	\$ 182,557,829
Participants	27,904,931	15,901,600
Total contributions	449,466,656	198,459,429
Other income	701,079	1,271,670
Investment income:		
Interest on bonds and deposits	10,530,217	21,741,207
Dividends	19,974,256	19,454,578
Earnings from limited partnerships and real estate trusts	4,966	5,101,591
Net appreciation (depreciation) on investments	208,672,351	251,652,270
Total investment income	239,181,790	297,949,646
Proceeds from lending securities	918,260	715,280
Less costs of securities lending	(617,170)	(362,739)
Net proceeds from lending securities	301,090	352,541
Less investment expenses	(7,667,752)	(7,391,470)
Total investment income	231,815,128	290,910,717
Total additions to plan net position	681,982,863	490,641,816
Deductions:		
Benefits paid to participants	283,928,131	280,455,603
Contribution refunds to participants	806,722	718,176
Professional services	655,785	805,413
Administration expenses	5,786,175	6,021,146
Total deductions	291,176,813	288,000,338
Net increase in net position	390,806,050	202,641,478
Net position restricted for pensions		
Beginning of year	2,598,058,228	2,400,023,240
End of year, as previously stated		2,602,664,718
Prior years adjustments for OPEB		(4,606,490)
End of year	\$ 2,988,864,278	\$ 2,598,058,228

FY 2017 Net Position was restated to reflect the Total OPEB Liability as of June 30, 2017 due to implementation of GASB 75.
See accompanying notes to financial statements.

NOTE 1 – DESCRIPTION OF PLAN

The Houston Municipal Employees Pension System (the System) was created under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, 1943 (Article 6243g, Vernon’s Texas Civil Statutes) and reenacted and continued under HB1573, 77th Texas Legislature, Article 6243h, Vernon’s Texas Civil Statutes (the Pension Statute), as amended. The System is a cost-sharing multiple-employer defined benefit pension plan with two participating employers covering all municipal employees, except police officers and firefighters (other than certain police officers in the System as authorized by the Pension Statute), employed full time by the City of Houston, Texas (the City), elected City Officials, and the full time employees of the System (collectively referred to as participants). The system includes three contributory groups (Groups A, B and D) and provides for service, disability and death benefits for eligible participants. The System’s plan net position is used to pay benefits for eligible participants of Group A, Group B, and Group D. The System is a governmental plan and therefore is not subject to the Employee Retirement Income Security Act of 1974. The System is governed by a Board of Trustees (the Board) consisting of eleven trustees – four elected by the active plan members, two elected by the retired plan members, one appointed by the mayor of the city, one appointed by the controller of the city, one appointed by the elected trustees, and two appointed by the governing body of the city. The appointed trustees must have expertise in at least one of the following areas: accounting, finance, pension, investment or actuarial science. The System can only be terminated or amended by an act of the Legislature of the State of Texas or by an agreement between the City and the Board pursuant to the Pension Statute.

PARTICIPATION

Participants newly hired on or after January 1, 2008 automatically become members of Group D.

Participants hired before September 1, 1981 participate in Group A, unless they elected before December 1, 1981 or after May 1, 1996 to transfer to Group B. Participants hired or rehired after September 1, 1981 but before September 1, 1999, may make a one-time irrevocable election to participate in Group A; otherwise, they participate in Group B. Participants hired or rehired on or after September 1, 1999 and before January 1, 2008 participate in Group A; except that Executive Officials of the City and the Executive Director of the System (Executive Officials) participated in Group C. Effective January 1, 2005, the Executive Officials of the City and the Executive Director of the System automatically became Group A members pursuant to the First Amendment to Meet and Confer Agreement, dated December 21, 2004.

The most recent actuarial report shows the following System participants as of July 1, 2017:

	<u>2017</u>	<u>2016</u>
Retirees and beneficiaries currently receiving benefits	10,601	10,289
Former employees - vested but not yet receiving benefits	3,409	3,432
Former employees - non-vested	2,167	2,174
Vested active participants	7,791	7,966
Non-vested active participants	<u>4,275</u>	<u>4,137</u>
Total participants	<u><u>28,243</u></u>	<u><u>27,998</u></u>

RETIREMENT ELIGIBILITY

Effective January 1, 2008, new employees participate in Group D with: Normal retirement eligibility of age 62 and 5 years of credited service:

- Option to elect an early reduced retirement benefit.

A former employee who is rehired as an employee by the City or by the System on or after January 1, 2008 is a member of the group in which the employee participated at the time of the employee’s immediately preceding separation from service.

For those participants in Group A and Group B employed effective January 1, 2005, a participant who terminates employment with the City or the System is eligible for a normal retirement pension beginning on

the member's effective retirement date after the date the member completes at least five years of credited services and attains:

- 62 years of age, or
- A combination of years of age and years of credited service, including parts of years, the sum of which equals the number 75, provided the participant is at least 50 years of age, or
- Any combination of age and credited service that when added together equal 70 or more, provided that the member, prior to January 1, 2005 completed at least 5 years of credited service and attained a combination of age and credited service that when added together equal 68 or more.

PENSION BENEFITS

Pension benefits are based on a participant's average monthly salary and years of credited service, as defined in the Pension Statute. The maximum normal retirement pension is 90.0% of the participant's average monthly salary.

As a result of SB 2190, pension benefits are increased annually by a Cost of Living Adjustment (COLA) equal to a calculated percentage of the original benefit amount, not compounded, for all persons receiving a pension or survivor benefit as of January 1 of the year in which the increase is made (except for Group D members who terminated employment prior to July 1, 2017 who do not receive COLAs). The amount of the COLA is the rolling five-year net investment return minus 5.0%, and then multiplied by 50.0%, but not less than 0% or more than 2.0%.

A participant who is eligible to receive a deferred benefit may elect to receive his or her pension benefit in an early lump sum distribution if the actuarial present value of the participant's benefit is less than \$20,000 on the date of termination. Early lump-sum distributions are subject to approval by the Board.

DISABILITY BENEFITS

Service-connected disability benefits for covered participants are based on the participant's normal accrued benefit, but are not less than 20.0% of the participant's average monthly salary. There is no minimum credited service requirement to qualify for service-connected disability benefits.

Participants with at least five years of credited service who become disabled may qualify for a non-service connected disability allowance equal to the participant's normal accrued pension benefit.

SURVIVOR BENEFITS

Survivor benefits are provided for a member's surviving spouse and/or dependent children. A deceased member must have had at least five years of credited service at the time of his or her death to qualify for survivor benefits unless death was caused by a service-connected incident as defined by the Pension Statute. For a Group D member, eligibility for survivor benefits for a death that occurs while actively employed is determined in the same manner as for Group A and Group B. For a death that occurs after the Group D member's termination of employment, the payment of a death benefit depends on whether the participant elected an optional annuity.

A Group D participant with at least five years of credited service has the option to elect an actuarially equivalent amount under one of three joint annuity options in lieu of a normal benefit with no survivor benefit. If a Group D participant with at least five years of credited service elects a normal benefit, no death or survivor benefit is payable. If a Group D participant with at least five years of credited service makes no optional annuity election and dies prior to retirement, the surviving spouse is eligible to receive an amount equal to the amount that would have been paid if the participant had elected a 50.0% joint and survivor annuity and named the surviving spouse as the designated beneficiary.

Effective July 1, 2011, eligible unmarried Group A and Group B members who terminate service on or after June 30, 2011 have the option to select a joint and survivor (J&S) annuity option in lieu of a normal benefit.

The optional annuity election, which was already available to vested Group D members and vested Group B members who separated from service prior to September 1997, allows eligible participants to elect to take

a reduced pension and provide an annuity (50.0% J&S, 100.0% J&S, or 10-year Guarantee) to a designated annuitant.

In order to qualify for survivor benefits other than under an annuity option, a surviving spouse must have been married to the deceased participant at the time the participant's employment with the City or System was terminated and at the time of the participant's death. To qualify for benefits, a child must be the unmarried natural or legally adopted dependent child of the deceased participant at the time of the participant's death and (a) must be under age 21 or (b) have been totally and permanently disabled before age 18 and before the participant's termination of employment. Dependent benefits are payable to the legal guardian of the dependents(s) unless the dependent is at least 18 years of age.

DEFERRED RETIREMENT OPTION PLAN (DROP)

A Group A or Group B participant who is eligible to retire, except that he or she has not retired and remains a full-time employee of the City, or the System, or has been separated from service for not more than thirty calendar days, may elect to participate in the Deferred Retirement Option Plan (DROP). The DROP provides that a monthly amount (monthly DROP credit) will be credited to a notional account (DROP Account). Beginning January 1, 2018 interest is credited to the DROP Account at a rate equal to half of the System's rolling five-year net investment return, but not less than 2.5% or more than 7.5%. Interest is compounded at an interval approved by the Board. The first day of DROP participation is the DROP Entry Date. The day a participant's fully executed DROP election is accepted by the System is the DROP Election Date. Normal pension benefits cease to accrue on the DROP Entry Date, except that all Cost-of-Living- Adjustments (COLA) noted previously apply to DROP participants who are active employees under the Pension Statute. As a result of SB 2190, beginning in 2018, DROP participants who are active employees receive the COLA if the employee is at least age 62 on January 1 of that year.

Effective January 1, 2005, a participant's election to participate in DROP cannot establish a DROP entry date that occurs prior to the date of the System's receipt of the member's request to participate in DROP. The monthly DROP credit is based on the participant's years of credited service and average monthly salary as of DROP Entry Date, and benefit accrual rates in effect on DROP Election Date.

DROP participation terminates when a DROP participant's employment with the City, or the System, terminates. The balance of the participant's notional DROP account (DROP Benefit) at the time of such termination is an amount equal to the sum of a participant's monthly DROP credits and interest accrued on such amount up to the time the participant's employment terminates. A DROP Benefit is subject to approval by the Board. A DROP participant eligible to receive a DROP Benefit distribution may elect to receive the distribution in a lump-sum, partial distribution, in substantially equal periodic payments over a period of time approved by the Board, or in a combination of a lump-sum followed by substantially equal periodic payments over a period of time approved by the Board until the balance of the DROP Benefit is depleted. The DROP Benefit is not available to a DROP participant until such participant's employment with the City or the System has terminated and the participant has made a DROP distribution election.

Group D participants do not participate in DROP.

GROUP D CASH BALANCE PLAN

In addition to the required Group D member contributions, Group D members contribute an additional 1% of salary to a notional cash balance account beginning in calendar year 2018. On separation from service, if a Group D participant has less than one year of service while contributing to the account, the participant is eligible to receive only a distribution of the contributions credited to the account, without interest. If the participant has at least one year of contributions to the account, the participant is eligible to receive a distribution of contributions credited to the account, including interest.

The Group D Cash Balance interest rate is equal to half of the System's rolling five-year net investment return, with a minimum of 2.5% and maximum of 7.5%.

REFUNDS OF PARTICIPANT CONTRIBUTIONS (BESIDES THE GROUP D CASH BALANCE PLAN)

All participants who terminate employment prior to being approved for retirement may request a refund of their accumulated employee contributions, if any, without interest, in lieu of a pension or in the event the participant has fewer than five years of credited service.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The accompanying basic financial statements are presented in accordance with generally accepted accounting principles established by the Governmental Accounting Standards Board (GASB), which designates the accounting principles and financial reporting standards applicable to state and local governmental units. The accompanying basic financial statements include solely the accounts of the System, which include all programs, activities and functions relating to the accumulation and investment of the assets and related income necessary to provide the pension benefits required by the governing statutes and amendments thereto.

BASIS OF ACCOUNTING

The economic resources basis of accounting is the method by which revenues and expenses are recognized in the accounts and reported in the basic financial statements. The accompanying basic financial statements are presented on the accrual basis of accounting. Under the accrual basis of accounting, revenues, which include investment and other income, are recognized when they are earned and collection is reasonably assured, and expenses are recognized when the liability is incurred. Accrued income, when deemed not collectible, is charged to operations.

Participant and employer contributions are recognized as revenues in the period in which they are due pursuant to the Pension Statute and formal commitments. Benefits and refunds are recognized when due and payable in accordance with the terms of the Pension Statute.

REPORTING ENTITY

The System is a component unit of the City. Therefore, its basic financial statements and required supplemental information are included in the City's Comprehensive Annual Financial Report.

INVESTMENT VALUATION AND INCOME RECOGNITION

Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. The fair value of limited partnerships and real estate trusts are based on the System's valuation of estimates and assumptions from information and representations provided by the respective general partners, in the absence of readily ascertainable market values. Short-term investments are carried at amortized cost, which approximates fair value.

Purchases and sales of investments and forward foreign exchange contracts are recorded on the trade date. Gains or losses on the forward foreign exchange contracts are recognized when the contract is complete. Dividend income is recorded on the ex-dividend date. Interest and income from other investments are recorded when earned. Net appreciation/depreciation on investments represents realized gains and losses on sales of investments during the year and the change in the fair value of investments between years.

FURNITURE, FIXTURES AND EQUIPMENT

Furniture, fixtures and equipment are recorded at cost less accumulated depreciation and amortization. Depreciation and amortization expense is computed using the straight-line method over the estimated useful lives of the related assets ranging from three to ten years. Any gain or loss on the retirement of assets is recognized currently. Maintenance and repairs are charged to expense while expenditures for improvements greater than or equal to \$5,000 are capitalized.

COMPENSATED EMPLOYEE ABSENCES

The System employees earn paid leave (vacation and sick leave) based on years of service and may

accumulate them subject to certain limitations and be paid upon termination or resignation from the System. The amount paid is determined based on the departing employee's regular rate of pay at separation. Compensated employee absences (vacation, compensatory time off, annual leave and sick leave) are accrued as an expense and liability in the basic financial statements at their most current rate.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the basic financial statements and the reported amounts of additions and deductions during the reporting period. Accordingly, actual results could differ from those estimates.

INCOME TAX STATUS

The System obtained its latest determination letter on April 14, 2017, in which the Internal Revenue Service stated that the System is in compliance with the applicable requirements of the Internal Revenue Code. The System has been amended since receiving the determination letter. However, the System's management and Board believe that the System is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code.

COSTS OF ADMINISTERING THE SYSTEM

The costs of administering the System are paid by the System from current earnings pursuant to an annual fiscal budget adopted by the Board.

NEW ACCOUNTING PRONOUNCEMENTS

GASB Statement No. 75, Accounting and Financial Reporting for Post-employment Benefits Other Than Pensions (OPEB)

This Statement establishes new accounting and financial reporting requirements for governments whose employees are provided with OPEB. The requirements of this Statement are effective for financial statements for fiscal years beginning after June 15, 2017. The provisions of this statement were implemented by the System effective for its June 30, 2018 financial statements.

NOTE 3 – CONTRIBUTIONS AND FUNDING POLICY

All active participants are required to contribute to the System. Effective July 2017, Group A participants contribute 7% of salary, Group B participants contribute 2% of salary, and Group D participants contribute 2% of salary. Effective July 2018, the required contributions for Group A and Group B participants will increase to 8% and 4% respectively. Beginning in January of 2018, Group D participants contributed an additional 1% of salary (see discussion of Cash Balance Plan on page 25).

As a result of SB 2190, beginning in fiscal year 2018, the City is required to contribute the "Total City Contribution" to the system, which consists of the sum of (a) an actuarially determined percentage of payroll ("City Contribution Rate") multiplied by actual payroll and (b) a fixed dollar amount ("City Contribution Amount") which is based on the Unfunded Actuarial Accrued Liability (UAAL) as of July 1, 2016 ("Legacy Liability"). The Legacy Liability payment is amortized over 30 years, beginning on July 1, 2017 and grows at 2.75% per year regardless of the actual payroll growth rate.

In fiscal year 2018, the City Contribution Rate was 8.17% of payroll, and the City Contribution Amount was \$124,030,357. In fiscal year 2017, the required city contribution was 29.36% of payroll, and in fiscal year 2016 it was 27.36% of payroll.

Also, SB 2190 required a one-time payment of \$250 million to the System in Pension Obligation Bond proceeds during fiscal year 2018.

Historical contribution trend information is provided as required supplemental information on page 49.

NOTE 4 – NET PENSION LIABILITY

The Total Pension Liability as of June 30, 2018 is based on the actuarial valuation date of July 1, 2017, and rolled-forward using generally accepted actuarial procedures. The net pension liability is measured as the total pension liability, less the amount of the pension plan’s fiduciary net position. In actuarial terms, this will be the accrued liability less the market value of asset.

The Schedule of Net Pension Liability presents multi-year trend information (beginning with fiscal year 2014) about whether the plan fiduciary net positions are increasing or decreasing over time relative to the total pension liability. In addition to the table below, this information is presented as a required schedule in the Required Supplemental Information section beginning on page 46.

FY Ending June 30	Total Pension Liability	Fiduciary Net Position	Net Pension Liability	Fiduciary Net Position as a % of Pension Liability
2014	\$ 4,366,635,542	\$ 2,464,438,877	\$ 1,902,196,665	56.44%
2015	4,531,179,075	2,456,543,559	2,074,635,516	54.21%
2016	5,034,389,959	2,400,023,240	2,634,366,719	47.67%
2017	4,959,510,179	2,602,664,718	2,356,845,461	52.48%
2018	5,113,358,193	2,988,864,278	2,124,493,915	58.45%

Actuarial valuation of the System involves estimates and assumptions about events in the future. Amounts determined regarding the net pension liability are subject to revision as actual results are compared with past expectations and new estimates are made regarding the future. The last experience study was performed in 2015 based on the July 1, 2014 valuation. A summary of the actuarial assumptions as of the latest actuarial valuation is shown below.

Valuation Date: July 1, 2017

Methods and Assumptions Used to Determine Contribution Rates:

Actuarial Cost Method	Entry Age Normal
Asset Valuation Method	5 year smoothed market, direct offset of deferred gains or losses
Inflation	2.25%
Salary Increases	3.00% to 5.25% including inflation Investment Rate of Return 7.00%
Retirement Age	Experience-based table of rates that are specific to the type of eligibility condition. Last updated for the 2015 valuation pursuant to an experience study of the period 2009 – 2014.
Mortality	RP-2000 Mortality Table scaled by 125% for males and 112% for females. The rates are then projected on a fully generational basis by scale BB.
Note	The actuarially determined contribution includes the Legacy Liability payment as specified by the January 1, 2016 Risk Sharing Valuation and a calculated employer rate equal to the normal cost and the amortization of any new unfunded liabilities over a closed 30 year period from the valuation date the liability base was created.

Sensitivity of Net Pension Liability to the Single Discount Rate Assumption

A single discount rate of 7.0% was used to measure the total pension liability. This single discount rate was based on the statutory rate of return of 7.0% under SB 2190. This rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

The following table illustrates the sensitivity of the net pension liability to changes in the discount rate. In particular, the table presents the plan’s net pension liability if it were calculated using a single discount rate that is 1-percentage-point lower or 1-percentage point higher than the single discount rate.

1% Decrease 6.00%	Current Single Rate Assumption 7.00%	1% Increase 8.00%
\$ 2,686,429,392	\$ 2,124,493,915	\$ 1,655,389,383

NOTE 5 – DEFERRED RETIREMENT OPTION PLAN (DROP) BALANCES

The DROP provides that a monthly amount (monthly DROP credit) will be credited to a notional account (DROP Account) for eligible DROP participants. A DROP Benefit is subject to approval by the System’s Board. The DROP Benefit is not available to a DROP participant until such participant’s employment with the City or the System has terminated and the participant has made a DROP distribution election. For a more detailed description of DROP terms, see Note 1.

DROP balances for all active and inactive participants totaled \$570.9 million in fiscal year 2018, and \$529.0 million in fiscal year 2017.

NOTE 6 – CASH AND CASH EQUIVALENTS

For cash deposits and cash equivalents, Custodial Credit Risk is the risk that in the event of a bank failure, the System’s deposits may not be returned to it. The System’s deposits are held by State Street Bank and Trust Company. As of June 30, 2018 and 2017, the System had fair value bank balances of \$31,193,296 and \$7,727,344, respectively, which are in demand deposit accounts subject to coverage by Federal Deposit Insurance Corporation (FDIC) but not collateralized. The standard deposit insurance coverage limit is \$250,000. The System does not have a deposit policy for custodial credit risk; however, the management believes that the System’s credit risk exposure is mitigated by the financial strength of the banking institution in which the deposits are held.

NOTE 7 – DEFERRED COMPENSATION PLAN

The System offers its employees a deferred compensation plan (DCP) created in accordance with Internal Revenue Code Section 457. The DCP, available to all full-time employees of the System, permits employees to defer a portion of their salary until future years. Distributions from the DCP are not available to employees until termination, retirement, death or unforeseeable emergency. The DCP has a third party administrator, Empower Retirement, formerly Great-West Retirement Services, and the cost of administration and funding is borne by the DCP participants. Amounts deferred are held in trust by Empower Retirement and, since the System has no fiduciary responsibility for the DCP, these amounts are not reflected in the accompanying financial statements in accordance with GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*.

NOTE 8 –POST-EMPLOYMENT BENEFITS OTHER THAN PENSIONS (OPEB)

GENERAL INFORMATION ABOUT THE OPEB

The System has established an Employee Welfare Benefit Plan as defined by the Employee Retirement Income Security Act (ERISA). The medical and prescription benefits are self-funded by the System. The System is fully responsible for the self-funded benefits. Cigna processes claims and provides other services to the System related to the self-funded benefits. Cigna does not insure or guarantee the self-funded benefits. The System’s plan includes an Excess Loss Insurance established with Cigna Life & Annuity Insurance Company. The System is insured for the aggregate excess loss of \$20,000 maximum per covered person.

The OPEB Plan is a single employer plan and is administered by the System.

Article 6243h, Tex. Rev. Civ. Stats., Sec. 3(f), authorizes the pension board to establish and amend employee benefit terms and financing requirements.

No assets are accumulated in a trust that meets the criteria in paragraph 4 of Statement 75.

BENEFITS PROVIDED

Retired employees of the System are eligible to receive full retiree health care benefits, which include medical, prescription, dental and life insurance. An eligible retired employee is a person who has at least five (5) years of full-time service with the System and meets at least one of the conditions:

- Has retired due to disability.
- Age 62 or greater.
- Years of full-time service plus age is greater than or equal to 70.
- Employee is eligible to begin receiving a retirement pension within 5 years after the employee’s termination of employment.

Spouses of retired employees are eligible to receive retiree health care benefits. The System- paid coverage continues for a surviving spouse of deceased retired member as provided under the health benefit plan.

Eligible children of retired the System’s employees may receive retiree health care benefits. Eligible children include a natural child, a stepchild, an adopted child, a foster child or a child recognized under a medical child support order. The child must be under age 26 (except in the case of a disabled child).

For the Preferred Provider Organization plan (PPO), the eligible retiree pays 25% of the retiree health insurance premium and the System pays the remaining 75% of retiree health care coverage. For the High Deductible Health Plan (HDHP), the retiree pays the lesser of: (1) the HDHP premium minus the net cost to the System of the PPO premium (PPO premium – PPO retiree contribution); or (2) 12.5% of the HDHP premium.

If an employee does not enter retirement directly after termination, the employee must be eligible to begin receiving a retirement pension within five (5) years of termination of the System employment in order to be eligible for retiree health insurance. If the employee elects to continue coverage as a retiree within the 5-year window prior to receiving a retirement pension, the employee must pay 100% of the total premium owed until the earlier of the date the retiree reaches normal retirement eligibility or the date the retiree discontinues coverage.

The System employees and dependents retiring with retiree health care benefits are eligible for dental benefits.

Retired employees are insured for up to \$5,000 of Life Insurance. All other insurance under the policy, including Dependent Life Insurance, if any, ends on the last day of active employment.

Retirees can continue coverage under the System’s Plan until covered by Medicare, when the System’s Plan becomes secondary. The premium for coverage continues at the same level as pre-Medicare.

Employees covered by benefit terms

At June 30, 2017, the following employees were covered by the benefit terms:

Inactive Plan Members or Beneficiaries Currently Receiving Benefits	11
Inactive Plan Members Entitled To but Not Yet Receiving Benefits	0
Active Plan Members	26
Total Plan Members	37

TOTAL OPEB LIABILITY

The OPEB plan’s total liability is based on an actuarial valuation performed as of June 30, 2017. Update procedures were used to roll forward the liability to the measurement date of June 30, 2018. The total liability as of June 30, 2018 was \$8,277,557.

Actuarial assumptions and other inputs

Valuation Date: June 30, 2017

Methods and Assumptions:

Actuarial Cost Method	Individual Entry-Age Discount Rate 3.62% as of June 30, 2018
Inflation	2.25%
Salary Increases	0.00% to 2.25%, not including inflation of 3.00%
Demographic Assumptions	Based on the experience study covering the five year period ending June 30, 2014 as conducted for the pension plan
Mortality	Gender-distinct RP-2000 Combined Healthy Mortality Tables with Blue Collar Adjustment. Male rates are multiplied by 125% and female rates are multiplied by 112%. The rates are projected in a fully generational basis by Scale BB to account for future mortality improvements.
Healthcare Trend Rates	Initial rate of 7.20% declining to an ultimate rate of 4.00% after 15 years.
Cadillac Tax	The liabilities were increased by 10% to reflect the anticipated impact of the excise tax.
Participation Rates	It was assumed that 100% of the eligible retirees would choose to maintain their retiree health care benefits through the System. Furthermore, 70% were assumed to elect two-person coverage.

Other Information:

Note The discount rate changed from 3.56% as of June 30, 2017 to 3.62% as of June 30, 2018.

The discount rate was based on the daily rate closest to but not later than the measurement date of the Fidelity "20-Year Municipal GO AA Index."

Changes in the Total OPEB Liability

Total OPEB liability		
Service cost	\$	358,166
Interest on the total OPEB liability		283,797
Changes in benefit terms		-
Difference between expected and actual experience of the total OPEB liability		(14,484)
Changes of assumptions		(74,720)
Benefit payments		(135,914)
Net change in total OPEB liability		416,845
Total OPEB liability-beginning		7,860,712
Total OPEB liability-ending		<u>8,277,557</u>
Covered-employee payroll	\$	2,104,735
Total OPEB liability as a percentage of covered employee payroll		393.28%

Sensitivity of the total OPEB liability to changes in the discount rate

1% Decrease 2.62%	Current Discount Rate Assumption 3.62%	1% Increase 4.62%
\$ 9,656,584	\$ 8,277,577	\$ 7,159,081

Sensitivity of the total OPEB liability to changes in the healthcare cost trend rates

1% Decrease	Current Healthcare Cost Trend Rate Assumption	1% Increase
\$ 6,940,160	\$ 8,277,557	\$ 9,989,236

OPEB Expense and Deferred Outflows of Resources and Deferred Inflows of Resources Related to OPEB

For the year ended June 30, 2018, the OPEB Plan recognized negative OPEB expense of \$13,796. At June 30, 2018, the OPEB plan reported deferred outflows and inflows related to OPEB from the following sources:

	Deferred Outflows of Resources	Deferred Inflows of Resources
Difference between expected and actual experience	\$ -	\$ 12,244
Changes in Assumptions	-	63,164
Total	<u>\$ -</u>	<u>\$ 75,408</u>

Amounts reported as deferred outflows of resources and deferred inflows of resources related to OPEB will be recognized in OPEB expense as follows:

Year Ending June 30	Net Deferred Outflows/(Inflows)
2019	\$ (13,796)
2020	(13,796)
2021	(13,796)
2022	(13,796)
2023	(13,796)
Thereafter	<u>(6,428)</u>
Total	\$ (75,408)

GASB 75 was only implemented effective 7/1/17, since it would be impracticable to restate all prior periods individually.

NOTE 9 – INVESTMENTS

Portions of the System’s investments are classified as security investments. A security is a transferable financial instrument that evidences ownership or creditorship. Investments in commingled funds, limited partnerships, real estate trusts, and loans and mortgages are investments that are evidenced by contracts rather than securities. The fair values of the System’s investments at June 30 are presented by type:

	2018	2017
Short-term investment funds	\$ 61,456,739	\$ 54,125,554
Government securities	69,614,794	72,675,493
Corporate bonds	198,328,385	202,121,498
Capital stocks	683,339,878	540,683,622
Commingled funds	787,745,946	653,822,339
Real assets	230,983,496	261,822,756
Alternative investments	<u>928,325,587</u>	<u>809,591,991</u>
Total investments	<u>\$ 2,959,794,825</u>	<u>\$ 2,594,843,253</u>

RATE OF RETURN

For the fiscal year ended June 30, 2018, the annual money-weighted rate of return on pension plan investments, net of pension plan investment expenses, was 8.7% vs. 12.2% at June 30, 2017. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested. In addition, the money-weighted rate of return is similar to the gross time-weighted return of 9.3% that appears in Table 1 on page 19. The two approaches are slightly different methods of calculating investment returns.

INVESTMENT POLICY

The Board has the authority to establish the investment policy and the asset allocation policy. The general investment objective is to obtain a reasonable long-term total return consistent with the degree of risk assumed while emphasizing the preservation of capital. The allocation is 32.5% to Global Equity, 10.0% to Fixed Income, 12.5% to Real Estate, 15.0% to Inflation Linked, 17.0% to Private Equity, 8.0% to Absolute Return and 5.0% to Private Credit. For the System's actual allocation, see the table on page 18.

Expected Return Arithmetic Basis

Asset Class	Target Weight	Real Return Arithmetic Basis	Long Term Expected Portfolio Return
Global Equity	32.5	6.0	1.9
Private Equity	17.0	10.4	1.8
Core Fixed Income	5.0	2.0	0.1
High Yield	5.0	3.5	0.2
Private Credit	5.0	3.0	0.1
Real Estate	12.5	4.8	0.6
Absolute Return	8.0	4.0	0.3
Inflation Linked	15.0	8.7	1.3
Totals	100.0		6.4
			2.1
			8.5

These returns are developed on a 10-year forward looking basis, using historical risk and correlation adjusted to recent trends. Return expectations represent a passive investment in the asset class and do not reflect value added from active management. An optimizer is used to generate an efficient frontier using these estimates; the efficient frontier represents the asset class distribution which would generate the maximum return for a given level of risk. The Board chooses an asset allocation that aims to maximize the safety of promised benefits while minimizing the cost of funding those benefits.

In the first quarter of fiscal year 2018, a new target allocation was adopted by the Board, which created a new asset class (Private Credit) and included other minor changes effective October 2017.

THE MASTER CUSTODIAN

The System's Board, in accordance with the power and authority conferred under the Texas Statutes, engaged State Street Bank and Trust Company (Custodian) as custodian of the assets of the System, and in said capacity, the Custodian is a fiduciary of the System's assets with respect to its discretionary duties including safekeeping of the System's assets. The Custodian has established and maintains a custodial account to hold, or direct its agents to hold, for the account of the System all assets that the Board shall from time to time deposit with the Custodian. All rights, title and interest in and to the System's assets shall at all times be vested in the System.

NOTES TO BASIC FINANCIAL STATEMENTS

In holding System assets, the Custodian shall act with the same care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in like capacity and familiar with matters of this type would use in the conduct of an enterprise with a like character and with like aims.

Further, the Custodian shall hold, manage and administer the System's assets for the exclusive purpose of providing the benefits to the members and the qualified survivors of the System.

The Board shall manage the investment program of the System in compliance with all applicable Federal and State statutes and regulations concerning the investment of pension assets. The Board has adopted an Investment Policy Statement to set forth the factors involved in the management of investment assets for the System and which is made part of every investment management agreement.

CUSTODIAL RISK

For an investment, custodial risk is the risk that, in the event of the failure of the counterparty, the System will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial risk if the securities are uninsured, are not registered in the name of the System, and are held by either the counterparty or the counterparty's trust department or agent but not in the System's name.

CONCENTRATION RISK

The allocation of assets among various asset classes is set by the Board. For major asset classes (e.g., global equity, fixed income, real estate, private equity, inflation-linked, absolute return and private credit), the System will further diversify by employing managers with demonstrated skills in complementary areas of expertise. The managers retained will utilize varied investment approaches, but, when combined will exhibit characteristics that are similar, but not identical, to the asset class proxy utilized in the strategic asset allocation plan. The Investment Policy Statement of the System provides that no public market investment manager shall have more than 20.0% (at market value) of the System's assets.

Representative guidelines by type of investment are as follows:

U.S. Equity Managers

- A manager's portfolio shall contain a minimum of twenty-five issues.
- No more than 5.0% of the manager's portfolio at market shall be invested in American Depository Receipts (ADRs).
- No individual holding in a manager's portfolio may constitute more than 5.0% of the outstanding shares of an issuer.
- No individual holding may constitute more than 5.0% of a manager's portfolio at cost or 10.0% at market.
- Short sales, purchases on margin, non-negotiable or otherwise restricted securities are prohibited, other than where expressly permitted.
- While there are no restrictions on cash, a manager must notify the System if the cash position exceeds 10.0%.

International Equity Managers

- No more than 5.0% at cost and 10.0% at market value of a manager's portfolio shall be invested in the securities of any one issuer.
- No more than 30.0% of the assets of a manager's portfolio (at market value) shall be invested in any one country with the exception of Japan.
- While there are no restrictions on cash, a manager must notify the System if the cash position exceeds 10.0%.
- Forward foreign currency exchange contracts will be limited as follows:
 - a) Forward and future exchange contracts of any currency may be used to hedge up to 100.0% of the currency exposure of the portfolio in aggregate or the currency exposure to any single country,
 - b) Foreign exchange contracts with a maturity exceeding 12 months may not be made, and

- c) Currency options may be entered into in lieu of or in conjunction with forward sales of currencies. The same effective limitations specified in (a) and (b) above will apply to currency options.

Fixed Income Managers

- No more than 10.0% of a manager's portfolio at market shall be invested in the securities of any single issuer, with the exception of the U.S. government and its agencies.

As of June 30, 2018, across all asset classes, the System held two securities with a market value over 5.0% of the System's fiduciary net position. The security, BlackRock MSCI ACWI Minimum Volatility Index, had a fair value of \$219 million, representing 7.3% of the System's portfolio as of June 30, 2018. In addition, the BlackRock ACWI Index had a fair market value of \$224 million, representing 7.5% of the System's portfolio as of June 30, 2018. These two investments also exceeded the 5% threshold last year.

INTEREST RATE RISK

The System invests in fixed income securities including, but not limited to, investments representing instruments with an obligated fixed rate of interest including public and private debentures, mortgages, investments in life insurance general accounts and guaranteed investment contracts, with maturities greater than one year, and options/futures. Instruments may have an investment grade or non-investment grade rating. Purchases and sales, investment selection and implementation of investment strategies are delegated to the discretion of the investment manager, subject to compliance with its management agreement and the Investment Policy Statement.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of the investment. Duration is a measure of a debt investment's exposure to fair value changes arising from changes in interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price. The greater the duration of a bond, or a portfolio of bonds, the greater its price volatility will be in response to a change in interest rates and vice-versa. Duration is the measure of a bond price's sensitivity to a 100-basis point change in interest rates. The duration of the System's debt securities is managed by the active managers.

At June 30, 2018, the following table shows the System's investments by type, amount and the effective duration rate.

	Effective Duration	Domestic	International	Fair Value
Collateralized mortgage obligations	4.25	\$ 9,351,951	\$ -	\$ 9,351,951
Convertible bonds	4.41	5,869,508	-	5,869,508
Corporate bonds	4.71	139,384,230	301,871	139,686,101
GNMA/FNMA/FHLMC	3.27	31,194,186	-	31,194,186
Municipal	7.50	1,586,994	-	1,586,994
Government issues	7.69	34,723,210	2,110,404	36,833,614
Misc. receivable (auto/credit card)	1.75	11,839,350	-	11,839,350
Other ABS	1.42	2,501,870	-	2,501,870
Bank Loan ¹	N/A	29,079,604	-	29,079,604
Total		<u>\$ 265,530,904</u>	<u>\$ 2,412,275</u>	<u>\$ 267,943,179</u>

¹ The bank loan market, or "leveraged loan" market as it is sometimes known, comprises debt with below investment grade credit ratings. Bank loans generally rank senior to the company's other debt, and offer higher credit ratings and less risk than high yield bonds. Bank loans typically use floating rather than fixed interest rates. Companies often access this market to fund leveraged buyouts.

NOTES TO BASIC FINANCIAL STATEMENTS

At June 30, 2017, the following table shows the System's investments by type, amount and the effective duration rate.

	Effective Duration	Domestic	International	Fair Value
Collateralized mortgage obligations	4.25	\$ 8,700,210	\$ -	\$ 8,700,210
Convertible bonds	4.50	9,446,867	-	9,446,867
Corporate bonds	5.86	143,316,558	363,645	143,680,203
GNMA/FNMA/FHLMC	3.07	30,653,502	-	30,653,502
Municipal	7.50	782,602	-	782,602
Government issues	6.85	37,996,374	3,243,014	41,239,388
Misc. receivable (auto/credit card)	4.10	9,958,569	-	9,958,569
Bank Loan	N/A	30,335,650	-	30,335,650
Total		<u>\$ 271,190,332</u>	<u>\$ 3,606,659</u>	<u>\$ 274,796,991</u>

CREDIT RISK

The quality ratings of investments in fixed income securities are set forth in the Investment Policy Statement as follows:

- All issues purchased by investment grade fixed income managers must be of investment grade quality Baa (Moody's) or BBB (S&P) unless expressly authorized by the Board, in which case a minimum B rating shall apply, with a maximum limit of non-investment grade credits of 20.0% at market.
- For global opportunistic fixed income/high yield securities, more than 50.0% of a manager's portfolio at market shall be invested in non-investment grade fixed income securities, i.e. those with ratings of BA1 (Moody's), BB+ (Standard & Poor's), or lower, or unrated bonds, including but not limited to corporate bonds, convertible bonds, and preferred stocks.

The quality ratings of investments in fixed income securities as described by nationally recognized statistical rating organizations at June 30, 2018 are as follows:

QUALITY RATING	ASSET BACKED SECURITIES	CORP BONDS & BANK LOANS	CMO	US GOV'T AGENCIES	GOV'T ISSUES	MUNICIPALS	TOTAL	% OF HOLDINGS
AAA	\$ 6,536,369	\$ 322,467	\$ 1,201,286	\$ -	\$ -	\$ 683,505	\$ 8,743,627	0.30%
AA	2,007,069	1,250,204	-	-	435,842	903,489	4,596,604	0.15%
A	520,409	13,568,761	-	-	1,991,792	-	16,080,962	0.54%
BBB	270,224	34,518,460	-	-	-	-	34,788,684	1.18%
BB	-	21,093,900	-	-	-	-	21,093,900	0.71%
B	-	29,900,558	-	-	118,612	-	30,019,170	1.01%
CCC	-	31,854,902	-	-	-	-	31,854,902	1.08%
CC	-	964,700	-	-	-	-	964,700	0.03%
C	-	872,355	-	-	-	-	872,355	0.03%
D	-	-	-	-	-	-	-	-
NA*	5,007,149	40,288,907	8,150,665	31,194,186	34,287,368	-	118,928,275	4.02%
TOTAL FIXED INCOME SECURITIES	\$ 14,341,220	\$ 174,635,214	\$ 9,351,951	\$ 31,194,186	\$ 36,833,614	\$ 1,586,994	\$ 267,943,179	9.05%
OTHER INVESTMENTS							\$ 2,691,851,646	90.95%
TOTAL INVESTMENTS							<u>\$ 2,959,794,825</u>	<u>100.00%</u>

*NA = Not Available

The quality ratings of investments in fixed income securities as described by nationally recognized statistical rating organizations at June 30, 2017 are as follows:

QUALITY RATING	ASSET BACKED SECURITIES	CORP BONDS & BANK LOANS	CMO	US GOV'T AGENCIES	GOV'T ISSUES	MUNICIPALS	TOTAL	% OF HOLDINGS							
AAA	\$ 4,885,456	\$ 431,684	\$ 1,837,838	\$ -	\$ -	\$ 363,806	\$ 7,518,784	0.29%							
AA	754,253	4,542,040	-	-	442,041	376,335	6,114,669	0.24%							
A	-	15,789,985	430,527	-	2,284,689	42,461	18,547,662	0.71%							
BBB	340,771	35,110,741	-	-	-	-	35,451,512	1.37%							
BB	-	23,059,840	-	-	-	-	23,059,840	0.89%							
B	-	39,926,933	-	-	101,526	-	40,028,459	1.54%							
CCC	-	22,317,690	-	-	-	-	22,317,690	0.86%							
CC	-	997,500	-	-	-	-	997,500	0.04%							
C	-	138,750	-	-	-	-	138,750	0.01%							
D	-	73,493	-	-	-	-	73,493	0.00%							
NA*	3,978,089	41,074,064	6,431,845	30,653,502	38,411,132	-	120,548,632	4.65%							
TOTAL FIXED INCOME SECURITIES							\$ 9,958,569	\$ 183,462,720	\$ 8,700,210	\$ 30,653,502	\$ 41,239,388	\$ 782,602	\$ 274,796,991	10.59%	
OTHER INVESTMENTS													\$ 2,320,046,262	89.41%	
TOTAL INVESTMENTS														\$ 2,594,843,253	100.00%

*NA = Not Available

FOREIGN CURRENCY RISK

International securities investment managers are expected to maintain diversified portfolios by sector and by issuer using the System’s Investment Policy Statement.

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. The System has an indirect exposure to foreign currency fluctuation as of June 30, 2018 and June 30, 2017 as follows:

	2018 Fair Value	2017 Fair Value
Australian Dollar	\$ 2,684,534	\$ 3,231,720
Brazilian Real	430,669	577
Canadian Dollar	5,683,507	5,674,371
Danish Krone	4,794,324	5,129,917
Euro Currency	74,994,092	66,971,157
Hong Kong Dollar	1,185,944	-
Japanese Yen	14,052,158	9,637,241
Malaysian Ringgit	-	19,482
Mexican Peso	1,991,792	2,284,689
New Israeli Sheqel	-	33
New Zealand Dollar	-	275
Pound Sterling	18,078,959	30,425,317
South African Rand	1,806,020	1,570,222
South Korean Won	28	95,681
Swedish Krona	2,854,501	2,462,658
Swiss Franc	13,718,888	11,801,532
Thailand Baht	1,043,489	2,159,398
	<u>\$ 143,318,906</u>	<u>\$ 141,464,270</u>

Schedule 8 on page 56 lists the System’s investment and professional service providers.

SECURITIES LENDING

The System is authorized under its Investment Policy Statement to participate in a securities lending program through its agent and Custodian. Under this program, for an agreed upon fee, System-owned investments are loaned to a borrowing financial institution. During the years ended June 30, 2018 and 2017, the Custodian lent the System’s securities and received cash and securities issued or guaranteed by the United States government as collateral. The cash collateral received on each loan is invested together with the cash collateral of other lenders, in a collective investment pool comprised of a liquidity pool and a duration pool. As of June 30, 2018, and June 30, 2017, the liquidity pool had an average duration for USD collateral of 27.21 and 29.38 days, and an average weighted final maturity of 113.66 and 107.80 days, respectively. As of June 30, 2018 and 2017, the duration pool for USD collateral had an average duration of 19.63 and 22.55 days, respectively, and an average weighted final maturity of 1,666 and 3,187 days, respectively. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral.

Borrowers are required to deliver collateral for each loan equal to: (i) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102.0% of the market value of the loaned securities; and (ii) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105.0% of the market value of the loaned securities. The Custodian does not have the ability to pledge or sell securities delivered for collateral, absent a borrower’s default. The Board and the borrowers maintained the right to terminate all securities lending transactions on demand.

On March 26, 2009, the Board amended its securities lending agreement with its Custodian to clarify responsibilities regarding borrower defaults. The amendment requires that if at the time of a default by a borrower, the Custodian shall indemnify the System against the failure of the borrower to return the loaned securities by purchasing a number of replacement securities equal to the number of such unreturned loaned securities, to the extent that such replacement securities are available on the open market. To the extent that such proceeds are insufficient or the collateral is unavailable, the purchase of replacement securities shall be made at the Custodian’s expense. If replacement securities are unavailable, the Custodian will credit to the System’s account an amount equal to the market value of the unreturned loaned securities for which replacement securities are not purchased. The Board also approved a motion limiting the System’s securities lending program utilization level (on-loan balance as a percentage of lendable assets) at 33.5%.

At year-end, the System had no credit risk exposure to borrowers because the amount of collateral received exceeded the value of securities on loan. The cash collateral held and the fair value of securities on loan as of June 30, 2018 (USD) was \$49,471,751 and \$54,835,672, respectively and \$47,371,287 and \$54,432,020 as of June 30, 2017, respectively.

The fair values of the underlying securities lent as of June 30, are as follows:

	2018				2017			
	Collateral Received			Fair Value of Cash and Securities on Loan	Collateral Received			Fair Value of Cash and Securities on Loan
	Cash	Securities	Total		Cash	Securities	Total	
Domestic Bond and Equities	\$ 44,563,363	\$ 6,605,301	\$ 51,168,664	\$ 48,753,062	\$ 44,501,403	\$ 8,274,712	\$ 52,776,115	\$ 51,184,963
International Equities	4,908,388	-	4,908,388	6,082,610	2,869,884	-	2,869,884	3,247,057
Total	<u>\$ 49,471,751</u>	<u>\$ 6,605,301</u>	<u>\$ 56,077,052</u>	<u>\$ 54,835,672</u>	<u>\$ 47,371,287</u>	<u>\$ 8,274,712</u>	<u>\$ 55,645,999</u>	<u>\$ 54,432,020</u>

Since the Custodian does not have the ability to pledge or sell securities delivered for collateral, absent a borrower’s default, the securities collateral received are not shown on the Statements of Fiduciary Net Position.

DERIVATIVE INVESTING

The System’s investment managers may invest in derivatives if permitted by the guidelines established by the System’s Board. Derivatives are generally defined as contracts whose values depend on, or are derived from, the value of an underlying asset, reference rate or index. Short options positions will generally be hedged with cash, cash equivalents, current portfolio security holdings, or other options or futures positions.

During fiscal year 2018, the System recognized a gain of \$208,780 compared to 2017 recognized gains of \$209,190 related to derivatives.

The System’s investment guidelines allow fixed income managers to hold stock rights and warrants acquired as a result of reorganization. Domestic equity managers may use index futures as a cash flow hedge. Two of the System’s domestic investment managers held rights and warrants on behalf of the System during fiscal year 2018. No managers held such rights in fiscal year 2017.

One of the System’s international investment managers during fiscal year 2018, and one in fiscal year 2017, held foreign exchange forwards and stock rights and warrants to mitigate the risk associated with the investments.

As of June 30, 2018 and 2017, the System held derivatives with a notional value of \$25,000 and \$31,169 and a fair value of \$478,949 and \$687,729, respectively.

The following is a summary of derivatives held directly by the System:

<u>Fair Value</u>	<u>2018</u>		<u>2017</u>	
	<u>Amount</u>	<u>Notional</u>	<u>Amount</u>	<u>Notional</u>
Classification				
Common Stock	\$ 478,949	\$ 25,000	\$ 687,729	\$ 31,169

Changes in Fair Value

<u>Investment Derivatives</u>	<u>Classification</u>	<u>2018</u>	<u>2017</u>
FX Forwards	Investment Revenue	\$ -	\$ 2,064
Rights	Investment Revenue	-	(1,581)
Warrants	Investment Revenue	208,780	208,707
		<u>\$ 208,780</u>	<u>\$ 209,190</u>

In addition to the above, the System has exposure to derivatives through its investments in hedge funds, reported in alternative investments in the financial statements.

FORWARD FOREIGN EXCHANGE CONTRACTS

A currency forward is a contractual agreement between two parties to pay or receive specific amounts of foreign currency at a future date in exchange for another currency at an agreed upon exchange rate. Forward commitments are not standardized and carry credit risk due to the possible nonperformance by one of the counter-parties. The maximum potential loss is the aggregate face value in U.S. dollars at the time the contract was opened; however, the likelihood of such loss is remote. No such losses occurred during fiscal years 2018 and 2017. Forwards are usually traded over-the-counter. These transactions are entered into in order to hedge risks from exposure to foreign currency rate fluctuation and to facilitate trade settlement of foreign security transactions. Forwards carry market risk resulting from adverse fluctuations in foreign exchange rates. Recognition of realized gain or loss depends on whether the currency exchange rate has moved favorably or unfavorably to the contract holder upon termination of the contract. Prior to termination of the contract, the System records the unrealized currency transaction gain or loss based on the applicable forward exchange rates.

MORTGAGE-BACKED SECURITIES

A mortgage-backed security depends on the underlying pool of mortgage loans to provide the cash flow to make principal and interest payments on the security. A decline in interest rates can result in prepayments,

called contraction risk. This risk occurs as mortgages are pre-paid or refinanced which reduces the expected return of the security. If interest rates rise, the likelihood of prepayments decreases, resulting in extension risk. Since loans in a pool underlying a security are being prepaid at a slower rate, investors are unable to capitalize on higher interest rates because their investments are locked in at a lower rate for a longer period of time. A collateralized mortgage obligation (CMO) is a type of mortgage-backed security that creates separate pools of pass-through rates for different classes of bondholders with varying maturities, called tranches. The repayments from the pool of pass-through securities are used to retire the bonds in the order specified by the bonds' prospectus.

The System may invest in mortgage-backed securities to enhance fixed-income returns. The mortgaged-backed securities are subject to credit risk, in that the borrower may be unable to meet its obligations.

FAIR VALUE MEASUREMENT

GASB Statement No. 72, *Fair Value Measurement and Application*, specifies a hierarchy of valuation classifications based on whether the inputs to the valuation techniques used in each valuation classification are observable or unobservable. These classifications are summarized in three broad levels listed below:

- Level 1: Unadjusted quoted prices for identical instruments in active markets.
- Level 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value-drivers are observable.
- Level 3: Valuations derived from valuation techniques in which significant inputs or significant value-drivers are unobservable.

Inputs used to measure fair value might fall in different levels of the fair value hierarchy, in which case the System defaults to the lowest level input that is significant to the fair value measurement in its entirety. These levels are not necessarily an indication of the risk or liquidity associated with the investments.

The following table presents fair value measurements as of June 30, 2018 (in thousands of dollars), as further explained below:

	Level 1	Level 2	Level 3	Total
Equities				
Limited Partnership Units	\$ 190,929	\$ -	\$ -	\$ 190,929
Common Stock	460,747	-	6,516	467,263
Other	24,584	-	140	24,724
Fixed Income				
Corporate Bonds	-	133,577	6,508	140,085
Other	-	125,091	2,768	127,859
Warrants	-	-	479	479
Total	\$ 676,260	\$ 258,668	\$ 16,411	\$ 951,399
Short Term Investment Funds measured at amortized cost				61,456
Investments held at NAV				1,947,000
Total Investments				<u>\$ 2,959,795</u>

The following table presents fair value measurements as of June 30, 2017 (in thousands of dollars):

	Level 1	Level 2	Level 3	Total
Equities				
Limited Partnership Units	\$ 114,625	\$ -	\$ -	\$ 114,625
Common Stock	404,184	-	1,249	405,433
Other	20,010	-	125	20,135
Fixed Income				
Corporate Bonds	-	135,922	7,758	143,680
Other	-	130,696	420	131,116
Warrants	-	-	688	688
Total	<u>\$ 538,819</u>	<u>\$ 266,618</u>	<u>\$ 10,240</u>	<u>\$ 815,677</u>
Short Term Investment Funds measured at amortized cost				54,126
Investments held at NAV				<u>1,725,040</u>
Total Investments				<u>\$ 2,594,843</u>

Level 1 Limited Partnership investments consist of Master Limited Partnerships that are publicly traded and listed on a national securities exchange.

Level 1 Common Stock investments are valued using exchange listed prices or broker quotes in active markets.

Level 1 "Other" Equity investments are valued using exchange listed prices or broker quotes in active markets.

Level 2 Corporate Bonds are valued using evaluated prices which are based on a compilation of primarily observable market information or a broker quote in an inactive market.

Level 2 "Other" Fixed Income investments are valued using evaluated prices which are based on a compilation of primarily observable market information or a broker quote in an inactive market. The valuation of convertible securities may be imputed based on the conversion ratio or other security specific information or broker quotes in a non-active market.

Level 3 investments in all categories are securities in which no indications are available, and the company's financials and other market indicators are used to calculate valuation. These include common stocks and bonds of companies undergoing reorganization, tradable bank loans and similar instruments.

The following table presents investments measured at Net Asset Value as of June 30, 2018 (in thousands of dollars):

	NAV	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Real Estate Limited Partnerships	\$ 230,921	\$ 304,181	Not Applicable	Not Applicable
Event Driven Hedge Funds	13,497	-	Quarterly	65-90 Days
Global Macro Hedge Funds	49,412	-	Quarterly or Monthly	30-90 Days
Equity Long / Short Hedge Funds	44,000	-	Quarterly or Semiannually	45-90 Days
Credit Hedge Funds	27,917	-	Quarterly or Annually	60-90 Days
Multi-Strategy Hedge Funds	35,004	-	Annually	45-90 Days
Private Equity Funds	758,558	567,408	Not Applicable	Not Applicable
Common Collective Trusts	787,691	-	Typically Daily	Less than 1 month
TOTAL	<u>\$ 1,947,000</u>	<u>\$ 871,589</u>		

NOTES TO BASIC FINANCIAL STATEMENTS

The following table presents investments measured at Net Asset Value as of June 30, 2017 (in thousands of dollars):

	NAV	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Real Estate Investment Trusts	\$ 150	\$ -	Quarterly	Not Applicable
Real Estate Limited Partnerships	250,484	186,186	Not Applicable	Not Applicable
Event Driven Hedge Funds	12,997	-	Quarterly	65-90 days
Global Macro Hedge Funds	52,584	-	Quarterly or Monthly	30-90 days
Equity Long / Short Hedge Funds	42,832	-	Quarterly or Semiannually	45-90 days
Credit Hedge Funds	27,772	-	Quarterly or Annually	60-90 days
Multi-Strategy Hedge Funds	47,993	-	Annually	45-90 days
Private Equity Funds	636,603	539,267	Not Applicable	Not Applicable
Common Collective Trusts	653,625	-	Typically Daily	Less than 1 month
TOTAL	\$ 1,725,040	\$ 725,453		

Real Estate Limited Partnerships. This category includes investments in 30 limited partnerships that own direct real estate and real estate related debt instruments. Investments in Real Estate Limited Partnerships are diversified by property type, geographic location, and capital structure. The fair values of Real Estate Limited Partnership investments have been determined using the NAV of the System's interest in the partnership provided by the General Partner. Real Estate Limited Partnerships cannot be redeemed because they are private market investments. Distributions from Real Estate Limited Partnerships are determined by the General Partner. Real Estate Limited Partnerships typically have 10-year terms.

Event Driven Hedge Funds. This category consists of one hedge fund. Event Driven Hedge Funds seek to add value by exploiting pricing inefficiencies that may occur before or after a corporate event such as a bankruptcy, merger, acquisition or spinoff. Event Driven managers may invest in announced corporate events, or the manager may anticipate a corporate event and position the portfolio accordingly. Event Driven Hedge Fund managers may invest in either debt or equity positions, and often hedge out market risk. The fair values of Event Driven Hedge Fund investments have been determined using the NAV provided by the administrator of the hedge fund.

Global Macro Hedge Funds. This category includes investments in three hedge funds. Global Macro Hedge Funds invest in long and short positions in a wide variety of assets including equities, fixed income, currencies, commodities, and futures. Global Macro Hedge Fund managers seek to add value by accurately anticipating overall macroeconomic trends in various countries. The fair values of Global Macro Hedge Fund investments have been determined using the NAV provided by the administrator of the hedge fund. Two of the System's Global Macro managers have monthly liquidity, and one has quarterly liquidity.

Equity Long / Short Hedge Funds. This category includes investments in four hedge funds. Equity Long / Short Hedge Funds employ a strategy that involves taking long positions in stocks that are expected to increase in value and short positions in stocks that are expected to decrease in value. Equity Long / Short Hedge Funds will often short stock market indexes in order to lessen total market risk. The fair values of Equity Long / Short Hedge Fund investments have been determined using the NAV provided by the administrator of the hedge fund. Two of the System's Equity Long / Short managers have quarterly liquidity, and one has semiannual liquidity.

Credit Hedge Funds. This category includes investments in five hedge funds. Credit Hedge Fund managers look for relative value between senior and junior securities of the same issuer. They will also trade securities of equivalent credit quality from different corporate issues, or different tranches in complex capital structures such as mortgage-backed securities or collateralized loan obligations. Credit Hedge Funds typically focus on credit rather than interest rates. In fact, many managers will sell short interest rate futures or Treasury

bonds to hedge their interest rate exposure. The fair values of Credit Hedge Fund investments have been determined using the NAV provided by the administrator of the hedge fund. The System is redeeming one of its Credit Hedge Fund managers, and another is liquidating under court supervision.

Multi-Strategy Hedge Funds. This category includes investments in two hedge funds. Multi-Strategy Hedge Funds may employ any combination of the hedge fund strategies listed above. The fair values of Multi-Strategy Hedge Fund investments have been determined using the NAV provided by the administrator of the hedge fund. Both of the System's Multi Strategy managers have annual liquidity.

Private Equity Limited Partnerships. This category includes the System's investments in 93 limited partnerships that own equity in privately held companies including equity in energy and commodity investments. Investments in Private Equity Limited Partnerships are diversified by industry sector, geographic location, and capital structure. The fair values of the Private Equity Limited Partnership investments have been determined using the NAV of the System's interest in the partnership provided by the General Partner. Private Equity Limited Partnerships cannot be redeemed because they are private market investments. Distributions from Private Equity Limited Partnerships are determined by the General Partner. Private Equity Limited Partnerships typically have 10-year terms.

Common Collective Trusts. This category includes investments in 11 common collective trusts. Common Collective Trusts may have active or passive strategies in publicly traded equity and fixed income securities. The fair values of Common Collective Trusts investments have been determined using the NAV provided by the administrators of the common collective trusts. Common Collective Trusts usually have higher liquidity than other investment strategies valued at NAV.

NOTE 10 – FURNITURE, FIXTURES AND EQUIPMENT

Furniture, fixtures and equipment are comprised as follows at June 30:

	2018	2017
Office furniture and equipment	\$ 74,382	\$ 74,382
Computer equipment	843,167	857,070
Leasehold improvements	163,234	141,829
	1,080,783	1,073,281
Less: Accumulated depreciation and amortization	(947,997)	(895,493)
	<u>\$ 132,786</u>	<u>\$ 177,788</u>

Depreciation expense for fiscal years 2018 and 2017 are \$52,504 and \$130,666, respectively.

NOTE 11 – COMMITMENTS

As described in Note 1, certain participants of the System are eligible to receive, upon request, a refund of their accumulated contributions, without interest, upon termination of employment with the City or System prior to being eligible for pension benefits. As of June 30, 2018 and 2017, aggregate contributions for these eligible participants of the System were \$176,288,209 and \$161,590,424, respectively. In addition, terminated Group D members who have contributed to the Group D Cash Balance Plan are eligible to receive, upon request, the balance in their Cash Balance account. The Cash Balance account distribution includes interest if the member had paid into the Cash Balance account for at least one year.

The System's investments in limited partnerships and real estate trusts are included in the first table appearing in Note 9. In connection with those investments, the System has remaining commitments as of June 30, 2018 and 2017 of approximately \$872 million and \$725 million, respectively, pursuant to terms of the respective limited partnerships and real estate trusts.

The System leased office facilities under a five-year lease, ending October 31, 2016, and extended the term of the lease by ten years, ending October 31, 2026. This lease agreement began with a base rent of \$14 per

square foot for the first eighteen months. Subsequently, the rent is \$23.50 per square foot for 12 months, increasing by \$0.50 per square foot per year for the remainder of the term.

The payments under the lease will be:

Year Ending June 30,	Amount
2019	\$ 458,026
2020	467,438
2021	476,849
2022	486,261
2023	495,672
Thereafter	<u>1,719,168</u>
Total	<u>\$ 4,103,414</u>

Additional amounts are assessed for use of common areas, utilities and maintenance. Total rental expense, including these assessments, amounted to approximately \$636,858 and \$477,533 during the years ended June 30, 2018 and 2017, respectively.

The System has other annual and/or monthly lease services for copiers, miscellaneous office equipment, and offsite storage totaling approximately \$55,430 and \$53,426 for fiscal years 2018 and 2017, respectively. Each of these contracts contains a cancellation provision.

NOTE 12 – RISKS AND UNCERTAINTIES

The System invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, foreign currency, liquidity and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the value of investment securities will occur in the near term and that such change could materially affect the amounts reported in the statements of fiduciary net position.

The City’s contribution rates are made, and the actuarial information included in the Notes and Schedules 1, 2 and 3 are based, on certain assumptions pertaining to interest rates, inflation rates and participant demographics, all of which are subject to change. Due to uncertainties inherent in the estimations and assumptions process, it is at least reasonably possible that changes in these estimates and assumptions in the near term could be material to the basic financial statements.

NOTE 13 – CONTINGENCIES

On March 20, 2015, the Texas Supreme Court in the Klumb v. Houston Municipal Employees Pension System case issued a decision confirming the authority of the System’s Board to determine that persons employed by Houston First Corporation (“HFC”), Houston First Foundation (“HFF”), and CCSI, Inc. (“CCSI”) constitute employees of the City of Houston for purposes of membership in the System’s pension plan. Following unsuccessful attempts by the System to obtain compliance by the City with the Texas Supreme Court’s ruling and its statutory duties to provide information and pay contributions into the plan for HFC, HFF and CCSI employees, the System filed Houston Municipal Employees Pension System v. City of Houston et al., No. 2016-35252, in the 333rd Judicial District Court of Harris County, Texas against the City and its representatives. The lawsuit seeks, among other things, writs of mandamus compelling the City and its representatives to provide payroll and other information regarding the HFC, HFF, and CCSI employees and to make the contributions and pick up payments owed for those employees. On September 17, 2015, the City filed a counterclaim and third-party claim against the System and its Board alleging breach of agreement, violation of unspecified statutory provisions, and inverse condemnation. The City also subsequently filed a Plea to Jurisdiction, which the System disputed, alleging that the court did not have jurisdiction to hear the System’s causes of action. The System and its Board denied the City has any viable claims, and that such claims are barred by, among other things, the Klumb decision. On October 9, 2015, a hearing was held in the 333rd district court on the City’s Plea to the Jurisdiction. Following arguments of counsel, the court

denied the City's Plea to the Jurisdiction. The City immediately appealed. The appeal was assigned to the Fourteenth Court of Appeals.

On November 22, 2016, the Fourteenth Court of Appeals reversed and rendered in part, remanded in part and affirmed in part the trial court's denial of the Plea to the Jurisdiction and provided the information specified in the Statute is subject to the Texas Public Information Act for HFC, HFF and CCSA employees. The court of appeals reversed that the City is legally obligated under an ultra vires cause of action to make contributions different than the Statute as modified by the Meet and Confer Agreement between the System and the City. The System filed a Motion for Rehearing on the last point. The City also filed a Motion for Rehearing on the court of appeals' decision. The Court of Appeals denied both motions for rehearing.

The System filed a Petition for Review with the Texas Supreme Court on whether the System can maintain an ultra vires action against the City and its officials for their failure to pay pension contributions according to the rates and groups specified by the Meet and Confer Agreement. The City filed its own Petition for Review seeking reversal of the court of appeals' ruling that the City is subject to ultra vires actions for making contributions and providing employee information under the Statute for enforcement of the Texas Public Information Act. The Texas Supreme Court granted the dueling Petitions for Review and then heard oral arguments on March 20, 2018. On June 8, 2018, the Court affirmed the Court of Appeals rulings in denying the City's review and reversed the Court of Appeals as to the System's ability to bring ultra vires claims against the City for its failure to make contribution payments for the HFC, HFF and CCSI employees. The Court also found the City is not immune as to these claims. The City did not seek rehearing, and the case has been remanded to the trial court for further proceedings on the System's mandamus claims as to the City and its officials.

NOTE 14 – SUBSEQUENT EVENTS

Management has evaluated subsequent events through September 27, 2018, the date the financial statements were available to be issued.

REQUIRED SUPPLEMENTAL INFORMATION (UNAUDITED)

Schedule of Changes in Net Pension Liability and Related Ratios
Schedule 1 (Unaudited)

Fiscal year ending June 30,	2018	2017	2016	2015	2014
Total Pension Liability					
Service Cost	\$ 78,148,819	\$ 75,960,564	\$ 68,968,481	\$ 59,465,512	\$ 61,480,204
Interest on the Total Pension Liability	341,276,247	331,166,519	379,781,300	363,639,884	348,418,895
Benefit Changes	-	(724,683,000)	-	-	-
Difference between Expected and Actual Experience	19,157,801	(38,387,084)	(16,194,133)	(22,057,834)	-
Assumption Changes	-	562,237,000	324,938,905	-	-
Benefit Payments	(283,928,131)	(280,455,603)	(253,178,363)	(234,954,625)	(221,925,083)
Refunds	(806,722)	(718,176)	(1,105,306)	(1,549,404)	(1,213,474)
Net Change in Total Pension Liability	153,848,014	(74,879,780)	503,210,884	164,543,533	186,760,542
Total Pension Liability - Beginning	4,959,510,179	5,034,389,959	4,531,179,075	4,366,635,542	4,179,875,000
Total Pension Liability - Ending (a)	\$ 5,113,358,193	\$ 4,959,510,179	\$ 5,034,389,959	\$ 4,531,179,075	\$ 4,366,635,542
Plan Fiduciary Net Position					
Employer Contributions	\$ 421,561,725	\$ 182,557,829	\$ 159,958,607	\$ 145,007,059	\$ 128,274,419
Employee Contributions	27,904,931	15,901,600	15,873,664	16,198,216	16,579,600
Pension Plan net Investment Income	231,815,128	290,910,717	27,639,567	73,370,310	352,522,858
Benefit Payments	(283,928,131)	(280,455,603)	(253,178,363)	(234,954,625)	(221,925,083)
Refunds	(806,722)	(718,176)	(1,105,306)	(1,549,404)	(1,213,474)
Pension Plan Administrative Expense	(6,441,960)	(6,826,559)	(7,360,139)	(7,007,422)	(6,414,668)
Other	(3,905,411)	1,271,670	1,651,651	1,040,548	-
Net Change in Plan Fiduciary Net Position	386,199,560	202,641,478	(56,520,319)	(7,895,318)	267,823,652
Plan Fiduciary Net Position - Beginning	2,602,664,718	2,400,023,240	2,456,543,559	2,464,438,877	2,196,615,225
Plan Fiduciary Net Position - Ending (b)	\$ 2,988,864,278	\$ 2,602,664,718	\$ 2,400,023,240	\$ 2,456,543,559	\$ 2,464,438,877
Net Pension Liability - Ending (a) - (b)	2,124,493,915	2,356,845,461	2,634,366,719	2,074,635,516	1,902,196,665
Plan Fiduciary Net Position as a Percentage of Total Pension Liability	58.45%	52.48%	47.67%	54.21%	56.44%
Covered Payroll	\$ 611,493,104	\$ 604,895,264	\$ 640,528,652	\$ 624,205,549	\$ 598,245,952
Net Pension Liability as a Percentage of Covered Payroll	347.43%	389.63%	411.28%	332.36%	317.96%

See accompanying independent auditor's report.

See accompanying note to required supplemental schedules.

Schedule is intended to show information for 10 years. Additional years will be displayed as they become available.

Schedule of Net Pension Liability

Schedule 2 (Unaudited)

FY Ending June 30	Total Pension Liability	Fiduciary Net Position	Net Pension Liability	Fiduciary Net Position as a % of Pension Liability	Covered Payroll ¹	Net Pension Liability as a % of Covered Payroll
2014	\$ 4,366,635,542	\$ 2,464,438,877	\$ 1,902,196,665	56.44%	\$ 598,245,952	317.96%
2015	4,531,179,075	2,456,543,559	2,074,635,516	54.21%	624,205,549	332.36%
2016	5,034,389,959	2,400,023,240	2,634,366,719	47.67%	640,528,652	411.28%
2017	4,959,510,179	2,602,664,718	2,356,845,461	52.48%	604,895,264	386.63%
2018	5,113,358,193	2,988,864,278	2,124,496,915	58.45%	611,493,104	347.43%

1. The covered payroll reported prior to fiscal year 2014 is based on pensionable pay. With the adoption of GASB Statement No. 67, GASB changed the definition of Covered Payroll to be total gross compensation. The Covered Payroll for fiscal year 2014- 2016 used this new definition. In 2017, GASB amended GASB 67/68 to change the definition of covered payroll to pensionable pay. Therefore, beginning in fiscal year 2017 the covered payroll shown is pensionable pay.

See accompanying independent auditor's report.

See accompanying note to required supplemental schedules.

Schedule is intended to show 10 years. Additional years will be displayed as they become available.

Schedule of Employer Contributions

Schedule 3 (Unaudited)

FY Ending June 30,	Actuarially Determined Contribution	Actual Contribution	Contribution Deficiency (Excess)	Covered Payroll ¹	Actual Contribution as a % of Covered Payroll ²
2007	\$ 106,568,897	\$ 70,264,721	\$ 36,304,176	\$ 448,925,000	15.65%
2008	116,281,212	73,271,799	43,009,413	483,815,000	15.14%
2009	102,257,047	76,837,216	25,419,831	539,023,000	14.25%
2010	107,535,744	82,052,013	25,483,731	550,709,000	14.90%
2011	107,472,679	87,284,737	20,187,942	544,665,000	16.03%
2012	122,465,396	97,161,723	25,303,673	534,394,000	18.18%
2013	124,317,102	111,858,885	12,458,217	549,971,000	20.34%
2014	144,953,327	128,274,419	16,678,908	598,245,952	21.44%
2015	155,299,296	145,007,059	10,292,237	624,205,549	23.23%
2016	162,229,984	159,958,607	2,271,377	640,528,652	24.97%
2017	184,732,840	182,557,829	2,175,011	604,895,264	30.18%
2018	423,989,344 ³	421,561,725 ³	2,427,619	611,493,104	68.94%

1. The covered payroll reported prior to fiscal year 2014 is based on pensionable pay. With the adoption of GASB 67/68, GASB changed the definition of Covered Payroll to be total gross compensation. The Covered Payroll for fiscal year 2014-2016 used this definition. In 2017, GASB amended GASB 67/68 to change the definition of Covered Payroll to pensionable pay. Therefore, beginning fiscal year 2017 the Covered Payroll shown is pensionable pay.

2. The Actual Contribution as a % of Covered Payroll does not correspond to the funding requirements of the Amended and Restated Meet and Confer Agreement and should not be used for funding purposes.

3. The Actuarially Determined Contribution and the Actual Contribution includes the Pension Obligation Bond proceeds of \$250 million.

Notes to Required Supplemental Information

Note to Schedules 1 and 2 – The total pension liability contained in this schedule was provided by the System’s retained actuary, Gabriel, Roeder, Smith & Company. The net pension liability is measured as the total pension liability less the amount of the fiduciary net position of the System.

Note to Schedule 3 – The required employer contributions and percent of those contributions actually made are presented in the schedule. The information presented was used in the actuarial valuation for purposes of determining the actuarially determined contribution rate. The assumptions and methods used for this actuarial valuation were recommended by the actuary and adopted by the Board. Additional information as of the latest actuarial valuation is presented in the table below.

Valuation Date: July 1, 2017

Notes: Actuarially determined contribution rates are calculated as of July 1, which is 12 months prior to the beginning of the fiscal year in which they are contributed. The assumptions shown below apply to the ADEC for fiscal year 2018 which was determined by the July 1, 2016 actuarial valuation. These assumptions are the same as those used to determine the Net Pension Liability as of June 30, 2018.

Methods and Assumptions Used to Determine Contribution Rates:

Actuarial cost method	Entry Age Normal
Amortization method	Level Percentage of Payroll, Open (see notes)
Remaining amortization period	30 years
Asset valuation method	5 Year smoothed market, direct offset of deferred gains and losses
Inflation	2.25%
Salary increases	3.00% to 5.25% including inflation
Investment rate of return	7.00%
Retirement age	Experience-based table of rates that are specific to the type of eligibility condition. Last updated for the 2015 valuation pursuant to an experience study of the period 2009 – 2014.
Mortality	RP-2000 Mortality Table scaled by 125% for males and 112% for females. The rates are then projected on a fully generational basis by scale BB.

Other Information:

Note: The actuarially determined contribution includes the Legacy Liability payment as specified by the January 1, 2016 Risk Sharing Valuation and a calculated employer rate equal to the normal cost and the amortization of any new unfunded liabilities over a closed 30 year period from the valuation date the liability base was created.

Schedule of Investment Returns

Schedule 4 (Unaudited)

<u>FY Ending June 30,</u>	<u>Annual Return¹</u>
2018	8.72%
2017	12.18%
2016	0.90%
2015	3.47%
2014	16.42%

¹ Annual money-weighted rate of return, net of investment fees.
Schedule is intended to show information for 10 years. Additional years will be displayed as they become available.

Schedule of Changes in Total OPEB and Related Ratios

Schedule 5 (Unaudited)

Fiscal Year Ending June 30, 2018¹

Total OPEB liability		
Service cost	\$	358,166
Interest on the total OPEB liability		283,797
Changes in benefit terms		-
Difference between expected and actual experience of the total OPEB liability		(14,484)
Changes of assumptions		(74,720)
Benefit payments		<u>(135,914)</u>
Net change in total OPEB liability		416,845
Total OPEB liability-beginning		<u>7,860,712</u>
Total OPEB liability ending		<u>8,277,557</u>
Covered-employee payroll	\$	2,104,735
Total OPEB liability as a percentage of covered employee payroll		393.28%

¹ Schedule is intended to show information for 10 years. Additional years will be displayed as they become available.

OTHER SUPPLEMENTAL INFORMATION

Investment Summary

(Schedule 6)

	June 30, 2018		
	Cost	Fair Value	Unrealized Appreciation (Depreciation)
Fixed income:			
Government securities	\$ 72,625,935	\$ 69,614,794	\$ (3,011,141)
Corporate bonds	202,359,471	198,328,385	(4,031,086)
Total fixed income	274,985,406	267,943,179	(7,042,227)
Short-term investment funds	61,456,739	61,456,739	-
Capital stocks	611,555,820	683,339,878	71,784,058
Commingled funds	641,379,899	787,745,946	146,366,047
Real assets	205,760,545	230,983,496	25,222,951
Alternative investments	655,784,557	928,325,587	272,541,030
Total investments	<u>\$ 2,450,922,966</u>	<u>\$ 2,959,794,825</u>	<u>\$ 508,871,859</u>
	June 30, 2017		
	Cost	Fair Value	Unrealized Appreciation (Depreciation)
Fixed income:			
Government securities	\$ 74,209,295	\$ 72,675,493	\$ (1,533,802)
Corporate bonds	197,885,238	202,121,498	4,236,260
Total fixed income	272,094,533	274,796,991	2,702,458
Short-term investment funds	54,125,554	54,125,554	-
Capital stocks	468,638,051	540,683,622	72,045,571
Commingled funds	524,003,851	653,822,339	129,818,488
Real assets	265,833,005	261,822,756	(4,010,249)
Alternative investments	619,212,093	809,591,991	190,379,898
Total investments	<u>\$ 2,203,907,087</u>	<u>\$ 2,594,843,253</u>	<u>\$ 390,936,166</u>

Space and cost restrictions make it impractical to print the entire investment portfolio in this report. A portfolio listing is available for review at the System's office by appointment, upon request.

See accompanying independent auditor's report

Investment Expenses, Professional Services, and Administration Expenses

(Schedule 7)

	2018	2017
Investment Expenses:		
Custodial services*	\$ 370,305	\$ 382,842
Investment management services*	5,382,277	5,210,780
Consulting services*	834,000	834,000
Legal services*	53,657	26,707
Other investment expenses	<u>1,027,513</u>	<u>937,141</u>
Total investment expenses	<u>\$ 7,667,752</u>	<u>\$ 7,391,470</u>
Professional services:		
Actuarial services*	\$ 109,785	\$ 240,912
Auditing and professional services*	53,512	24,620
Legal services*	102,488	168,879
Other professional services*	<u>390,000</u>	<u>371,002</u>
Total professional services	<u>\$ 655,785</u>	<u>\$ 805,413</u>
Administration expenses:		
Office costs	\$ 645,093	\$ 483,977
Insurance costs	174,139	170,773
Costs of staff and benefits	4,098,922	4,395,899
Costs of equipment and supplies	736,622	739,447
Depreciation and amortization	52,504	130,666
Costs of continuing education	<u>78,895</u>	<u>100,384</u>
Total administration expenses	<u>\$ 5,786,175</u>	<u>\$ 6,021,146</u>

*See details on the next page.

See accompanying independent auditor's report.

Summary of Costs of Investment and Professional Services

(Schedule 8)

	Investment Expenses		Professional Services	
	2018	2017	2018	2017
Investment Manager Fees			Actuary	
Ariel Investments, LLC	\$ 241,704	\$ 220,582	Gabriel, Roeder, Smith & Co.	\$ 109,785
Baring Asset Management	162,655	314,103		\$ 240,912
BlackRock (formerly Barclays)	345,747	201,394	Auditing and Professional Services	
Cohen & Steers Capital Management, Inc.	46,229	-	McConnell & Jones, LLP	\$ 2,992
DDJ Capital Management, LLC	470,098	541,468	Weaver and Tidwell LLP	50,520
DePrince, Race and Zollo, Inc.	274,287	233,330	Election-America Inc.	-
Earnest Partners, LLC	-	98,484		(4,175)
Enhanced Investment (INTECH)	255,699	226,566	Legal Services	\$ 53,512
Global Forest Partners, LP/UBS Timber Investors	56,525	56,767	Baker Botts, LLP	\$ 74,423
Loomis, Sayles and Company, LP	400,716	429,952	Jackson Walker LLP	18,101
Neumeier Investment Counsel, LLC	692,155	579,700	Smyser Kaplan & Veselka, LLP	9,964
OFI Institutional	614,381	521,883		\$ 102,488
Panagora Asset Management	183,248	154,183	Other Professional Services	\$ 168,879
Pugh Capital Management	168,082	132,250	Harris Law Firm	\$ 30,000
Salient Capital Advisors, LLC	176,116	-	HillCo Partners, LLC	102,000
Smith Graham & Company	335,745	346,539	Locke Lord LLP	210,000
State Street Global Advisors	205,666	118,047	LT Communications	48,000
Thomas White International, Ltd	-	255,694		43,000
Tortoise Capital Advisors	734,493	775,068		\$ 390,000
UBS Global Asset (formerly Brinson Part)	18,731	4,770		\$ 371,002
	<u>\$ 5,382,277</u>	<u>\$ 5,210,780</u>		
Custodial Services				
State Street Bank and Trust Company	\$ 370,305	\$ 382,842		
Investment Consulting Fees				
Wilshire Associates, Incorporated	284,000	284,000		
Cliffwater LLC	550,000	550,000		
	<u>\$ 834,000</u>	<u>\$ 834,000</u>		
Legal Services (Investment)				
Locke Lord LLP	\$ 53,657	\$ 26,707		

See accompanying independent auditor's report.

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