

INTRODUCTORY SECTION



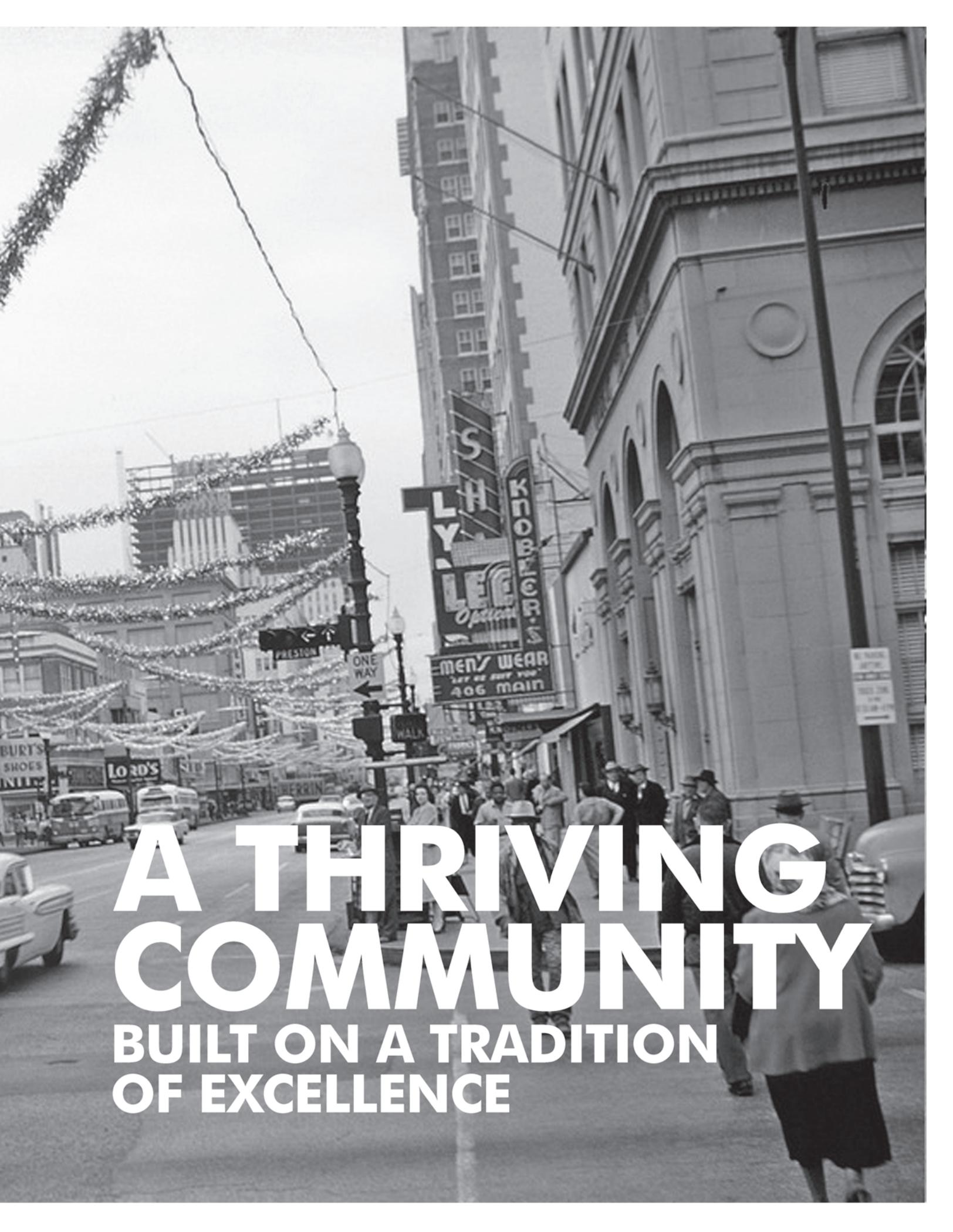
HMEPS

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM



Main and Preston Street, 1957





A THRIVING COMMUNITY

BUILT ON A TRADITION
OF EXCELLENCE

Board of Trustees CHAIRMAN Sherry Mose VICE CHAIRMAN Roy W. Sanchez SECRETARY Lonnie Vara
Barbara Chelette | Roderick J. Newman | Asha Patnaik | Lenard Polk
Denise Castillo-Rhodes | David Donnelly | Edward J. Hamb II | Adrian Patterson

Executive Director David L. Long



December 20, 2018

Tantri Emo, Finance Director
Finance Department
611 Walker, 10th Floor
Houston, Texas 77002

Dear Ms. Emo:

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the Houston Municipal Employees Pension System (the System), a Component Unit of the City of Houston, Texas (the City), for the fiscal years ended June 30, 2018 and June 30, 2017. The accuracy, fairness of presentation and completeness of this report are the responsibility of the Board of Trustees (the Board) of the System. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of the operations of the System. The System's basic financial statements will be included in the annual financial report of the City.

Accounting System and Internal Controls

The financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) and presented in accordance with guidance provided by applicable statements issued by the Governmental Accounting Standards Board (GASB).

The System's independent auditors have audited the financial statements and issued an unmodified opinion as of June 30, 2018 and 2017 (pages 12-13). The purpose of the audit is to give reasonable assurance to users of those financial statements, the Board, and participants of the System, that the financial statements present fairly, in all material respects, information regarding the System's net position held in trust for pension benefits and in conformity with accounting principles generally accepted in the United States of America.

A significant responsibility of the Board is to ensure that the System has in place an adequate system of internal controls. A system of internal controls is an entity's plan of organization and its coordinated methods and measures adopted to safeguard its assets, ensure the accuracy and reliability of the accounting system and promote adherence to management policies. These controls include strategic design of the entity's business systems, the appropriate segregation of duties and responsibilities, sound practices in the performance of those duties, retaining capable personnel, and the organizational structure itself. For each implemented control, the cost of the control should not exceed the benefits to be derived. An objective of these controls is to provide reasonable assurance that the financial statements are free of any material misstatement. We believe the System's internal controls are adequate and are working as designed.

Financial Information

The Management's Discussion and Analysis (MD&A) that immediately follows the Independent Auditors' Report provides condensed financial information and activities for the current and prior two fiscal years of the System. It provides a narrative introduction, overview, and analysis of the basic financial statements. The MD&A complements this letter of transmittal and should be read in conjunction with it.

Plan History and Profile

The System was created in 1943 under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, Article 6243g, Vernon's Annotated Revised Texas Civil Statutes, and was reenacted and continued under HB1573, 77th Texas Legislature, as Article 6243h, Vernon's Annotated Revised Texas Civil Statutes, as amended (the Statute).

The System is a multiple-employer, defined benefit pension plan that provides service retirement, disability retirement and death benefits for eligible participants, which includes all municipal employees, except police officers and fire fighters (other than certain police officers in the System as authorized by the Statute) employed full time by the City, elected City officials, and the full-time employees of the System (collectively referred to as “participants”). The System’s plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group D. The System is administered by an eleven-member Board of Trustees. The Trustees include four elected trustees who are members of the System, two elected trustees who are retirees of the System, a trustee appointed by the elected trustees, the mayor’s appointee, the controller’s appointee, and two city council appointees.

The Statute was amended by SB 2190 in the 85th Texas Legislature, with most funding and benefit changes effective July 1, 2017. The Actuarial Section of this CAFR contains additional information on the funding and benefit changes, as well as the annual risk sharing valuation process for purposes of the funding corridor, corridor midpoints, and legacy liability that are integral to the amended contribution requirements.

Budget

The costs of administering the System, consisting of operating administrative expenses and capitalized items, are paid by the System from current earnings pursuant to an annual fiscal budget adopted by the Board.

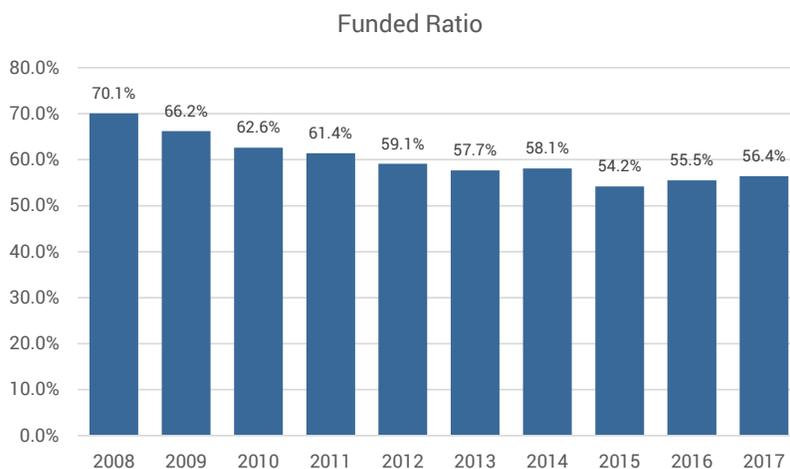
Funding Status

The System’s funding objective is to establish contributions which, when combined with present assets and future investment returns, will be sufficient to meet the financial obligations to present and future retirees and beneficiaries.

HMEPS receives contributions from two sources: employer contributions and member contributions. Under the Statute as amended by SB 2190, the System’s actuary assumes that the System’s investments will return 7.0 percent annualized over the long-term. The differences between the assumed and actual investment return are phased in over 5 years, yielding an actuarial value of assets. This smoothing is intended to avoid extreme volatility in employer contribution rates due to short-term fluctuations in the investment markets. However, as part of SB 2190, all prior years’ bases were fully recognized as of July 1, 2016, and therefore the smoothing process recommenced for purposes of the actuarial valuation as of July 1, 2017. The funded ratio, the ratio of the actuarial value of assets (AVA) to the actuarial accrued liability (AAL), is a standard measure of a plan’s funded status. In the absence of benefit improvements or reduced funding, a plan’s funded ratio should increase over time, until it reaches 100%. The funded status alone is not appropriate for assessing the sufficiency of plan assets to cover the estimated cost of settling the plan’s benefit obligations.

As of July 1, 2017, HMEPS’ AVA and AAL were \$2.74 billion and \$4.87 billion, respectively, resulting in a funded ratio of 56.4%. This is higher than the funded ratio as of July 1, 2016, which was 55.5%. This change is primarily the result of positive investment performance.

A historical perspective of the System’s funding levels is presented in the following graph.



Market Environment

Strong macroeconomic indicators provided a positive economic environment heading into fiscal year 2018. The expansion in U.S. GDP accelerated as the fiscal year began. By the end of the fiscal year, real quarterly GDP growth topped 4% for the first time since 2014, propelled by strong, steady personal consumption and increased business spending. The U.S. labor market showed strength leading to wage increases and lower unemployment. Despite low inflation, the Federal Reserve continued a well-communicated policy of gradual interest rate hikes. Investors generally set aside geopolitical risks such as concern of increased trade tariffs and the U.S. threat to withdraw from the Iran nuclear deal and reinstate sanctions. The Federal Open Markets Committee raised rates three times during the fiscal year, beginning FY2018 with a Discount Rate of 1.75% and ending the year at 2.50%.

U.S. equity markets enjoyed steady gains throughout the fiscal year with the Wilshire 5000 index advancing 14.7%. The Wilshire 5000's gain marked the ninth consecutive positive fiscal year for the index since the credit crisis of 2008-2009. Growth stocks once again outperformed value stocks during the fiscal year, and smaller capitalization stocks tended to do better than larger stocks.

Over the first three quarters of the fiscal year, the U.S. Dollar depreciated against a basket of foreign currencies, but the U.S. Dollar experienced a sharp rebound in the quarter ending June 30, 2018. Concern about trade tensions dominated headlines throughout the fiscal year, but international stock markets were able to post modest gains as many observers questioned whether broad tariffs and retaliation would materialize. Similar to U.S. markets, strong GDP momentum in the Eurozone and Japan supported local currency gains in stock prices for those markets. International equities as represented by the MSCI ACWI ex-U.S. (net) Index were up 7.3% during FY 2018.

Investment grade fixed income securities generated flat to slightly negative returns in fiscal year 2018. As expected with the Federal Reserve's rate hikes, the yield curve rose and flattened during fiscal year 2018. Although yield spreads for corporate and high yield bonds tended to widen, spreads remained at low levels in historical terms. These factors dampened returns for fixed income securities. Investment grade bonds as represented by the Barclay's U.S. Aggregate bond index were essentially flat (-0.4%) for the second straight year in fiscal year 2018. High yield bonds as represented by the Merrill Lynch High Yield Master Trust II Index were up 2.5% for the fiscal year.

Among the alternative asset classes, Real Estate and Private Equity returned 9.9% and 17.2% respectively in FY 2018. Real estate occupancy rates are near 16-year highs, driving returns for the asset class this fiscal year. Inexpensive credit, sound earnings, and strong valuations provided the foundation for another good year in Private Equity.

Overall, the System's investments returned 9.3% for fiscal year 2018. Through the efforts of the Board of Trustees, the System's investment portfolio is more broadly diversified than most public pension plans and exhibits less volatility, particularly during extreme market events. During the 10-year period ending June 30, 2018, the System's annualized return was 7.0%.

Major Current and Future Initiatives

Member Services

The Benefits Division has continued its effort to provide information relating to pension benefits by holding seminars at City departments and individual benefit meetings at HMEPS. In FY 2018, HMEPS:

- Responded to continued demand for the Outreach Program, which reaches hundreds of members with individual and group sessions provided by our benefits counselors and our Certified Financial Planner. This past year, these staff members conducted 195 individual counseling sessions and hosted 37 joint presentations for various City departments as well as new employee orientations for the benefit of 1,855 attendees.
- Conducted 128 one-on-one counseling sessions between the HMEPS financial counselor and participants in addition to numerous presentations in the field with the Benefits Division, including seminars to inform over 2,000 participants of the July 1, 2017 legislative changes.

- Processed 2,144 benefit applications, including retirements, the Deferred Retirement Option Plan, survivor benefits, refunds, and lump-sum payments.
- Participated in the Fall Financial Retirement Employees Educational Summit, an annual event co-sponsored by the System that help City of Houston employees better plan for their financial futures.

Investments

The System's strategic asset allocation policy is designed to manage risk by diversifying among public and private asset classes. In order to develop a strategic asset allocation policy, risk-return assumptions and correlations for asset classes are examined taking into account current and forecasted economic conditions. During the first quarter of fiscal year 2018, the Board adopted a new strategic asset allocation policy effective October 2017. The information provided in this letter reflects the policy adopted at that time.

The target allocation to Global Equity is 32.5%. The target allocation to Fixed Income is 10%, while Real Estate is 12.5% and Private Equity is 17%. The target allocation of the Absolute Return asset class is 8%, and the target allocation for the Inflation Linked asset class is 15%, and the target allocation for Private Credit is 5%. During fiscal year 2018, the System rebalanced its portfolio to move closer to these strategic asset allocation policy targets. With the help of the System's alternative investment consultant, Cliffwater LLC, the System committed to seven private equity partnerships, a private real estate partnership, two private real asset (inflation-linked asset class) partnerships, and a private credit partnership.

The System's investment portfolio closed its 2018 fiscal year at \$3.0 billion. The gross investment return for the fiscal year was 9.3%. The System's investment performance was 7.8%, 8.6% and 7.0% for the past three-, five- and ten-year periods. Compared to similar investment portfolios (TUCS Master Trusts – Public Universe), the fund posts above-median investment returns over both long and short time periods. The best performing asset classes for fiscal year 2018 were Private Equity (+17.2%) and Real Estate (+9.9%).

In the upcoming fiscal year, the System will continue to work with consultants Wilshire Associates and Cliffwater LLC to identify attractive public and private market investments consistent with the new strategic asset allocation policy.

Board Governance

During FY 2018, elections were held for three Trustee positions. Sherry Mose was unopposed and re-elected to employee trustee position 5. Roy W. Sanchez was re-elected to employee trustee position 6 and Roderick J. Newman was re-elected to retiree trustee position 8.

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Houston Municipal Employees Pension System for its comprehensive annual financial report for the fiscal year ended June 30, 2017. This was the 24th consecutive year that the System has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

Acknowledgement

This CAFR was prepared through the combined efforts of the System staff and was subject to the scrutiny of the Board. It is intended to provide information to its user that may be a basis for a general understanding of the System. This CAFR is being forwarded to the City of Houston, the Texas Pension Review Board, the GFOA, and other interested parties who may from time to time request it.

LETTER OF TRANSMITTAL

In Closing...

A core purpose of the System is to help provide for the financial security of its participants when they are eligible to receive benefits. Municipal public sector employees are vital to providing and maintaining important city services for Houston residents, workers and visitors. Quality employees are attracted to and retained by the public sector in part by the security and benefits offered by a sound pension system. The System is proud to serve the dedicated municipal employees who have made tremendous contributions to Houston and its citizens.

Sincerely,



Sherry Mose
Chairman



David L. Long
Executive Director

BOARD OF TRUSTEES



Sherry Mose
Chairman



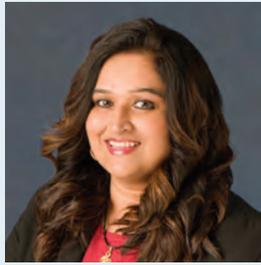
Roy W. Sanchez
Vice Chairman



Lonnie Vara
Secretary



Roderick J. Newman
Elected Trustee



Asha Patnaik
Elected Trustee



Lenard Polk
Elected Trustee



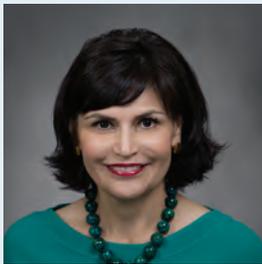
Barbara Chelette
Appointed Trustee



David Donnelly
Mayoral Appointee



Edward J. Hamb II
Controller Appointee



Denise Castillo-Rhodes
Council Appointee



Adrian Patterson
Council Appointee



David L. Long
Executive Director

BOARD COMMITTEES

- Audit Committee
- Budget and Oversight Committee
- Disability Committee
- External Affairs Committee
- Investment Committee
- Personnel and Procedures Committee

ADMINISTRATIVE ORGANIZATION

Executive Director

General Counsel

Chief Investment Officer

- Investment Managers' Services
- Market Research
- Performance Measurement

Member Services

- Benefit Administration Services
- Communications
- Financial Counseling
- Member Services

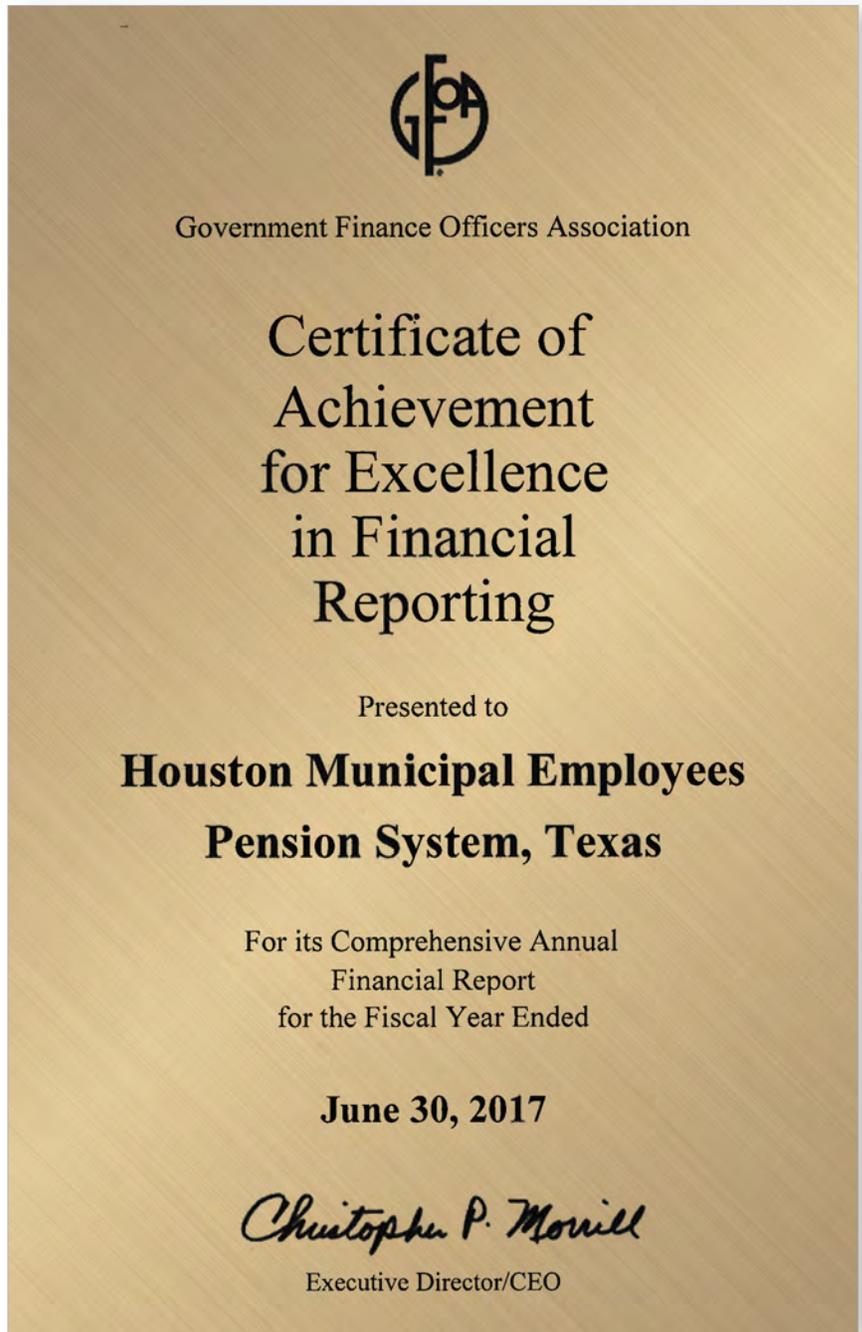
Operations

- Accounting
- Financial Reporting
- Records
- Technology Support

For more information on investment professionals who provide services to HMEPS, refer to the Investment Expenses table under the Other Supplementary Information on page 56 and the Schedule of Fees and Commissions Paid table on page 66.

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Professional Consultants (FY 2018)

Actuary

Gabriel, Roeder, Smith & Company

Auditor

Weaver and Tidwell, L.L.P.

Board Medical Advisor

Charles Schuhmacher, M.D.

Communication Services

LT Communications, L.L.C.

Governmental Representation

Harris Law Firm, P.C.

HillCo Partners, L.L.C.

Locke Lord L.L.P.

Investment Consultants

Cliffwater, L.L.C.

Wilshire Associates, Inc.

Investment Performance Analysis

Cliffwater, L.L.C.

Wilshire Associates, Inc.

Legal Counsel

Baker Botts, L.L.P.

Jackson Walker, L.L.P.

Locke Lord L.L.P.

Smyser Kaplan & Veselka, LLP

Master Custodian/Trustee

State Street Bank and Trust Company

Investment Managers (FY 2018)

Absolute Return

Anchorage Capital Group LLC

Angelo, Gordon & Co.

Brevan Howard US LLC

Brigade Capital Management

Claren Road Asset Management, LLC

Davidson Kempner Capital Management, LLC

Graham Capital Management

Highland Capital Management

MKP Capital Management, LLC

Och-Ziff Capital Management Group

Samlyn Capital, LLC

Scopia Capital

Soroban Capital Partners, LLC

Fixed Income

Alliance Bernstein Institutional

Investments

BlackRock, Inc.

DDJ Capital Management, L.L.C.

GMO LLC

Loomis, Sayles & Co.

Pugh Capital Management

Smith Graham & Co.

Whippoorwill Associates, Inc.

Inflation-Linked

BlackRock, Inc.

Cohen & Steers

EnCap Investments LP

Envest, Ltd

Global Forest Partners, L.P.

NGP Energy Capital

Oaktree Capital Management

Quantum Energy Partners

Riverstone Holdings

Salient Partners

Taurus Funds Management

Tillridge Global Agribusiness

The Carlyle Group

Tortoise Capital Advisors

Global Equity

Ariel Investments

Baring International

BlackRock, Inc.

DePrince, Race & Zollo, Inc.

INTECH Investment Management, L.L.C.

Neumeier Investment Counsel, L.L.C.

OFI Institutional Management

PanAgora Asset Management, Inc.

State Street Global Advisors

Private Credit

DRC Capital

Mesa West Capital

Private Equity

Adams Street Partners

Anchorage Capital Group LLC

Brera Capital Partners, L.L.C.

Brockway Moran & Partners, Inc.

Carrick Capital Partners

Centerbridge Partners

Clearlake Capital Partners

CVE Kaufman Fellows Endowment

GTCR Management LC

Goldman, Sachs & Co.

HarbourVest Partners, L.L.C.

Hellman & Friedman, L.L.C.

ICV Partners, L.P.

J.W. Childs Associates, L.P.

JMI Equity

Lexington Partners, Inc.

Matlin Patterson Global Advisors

New Enterprise Associates

New Mainstream Capital

Oaktree Capital Management

Onex Corporation

Pacven Walden Management Co., Ltd.

Pegasus Investors, L.P.

Pharos Capital Partners, L.L.C.

Platinum Equity Capital Partners

Siris Capital Group

Summit Partners

Sun Capital Partners, Inc.

Technology Ventures

The Carlyle Group

The Jordan Company, L.P.

Valor Equity Partners

Vista Equity Partners

Wayzata Investment Partners, LLC

Real Estate

Aetos Capital

Aermont Capital

Angelo, Gordon & Co.

Artemis Real Estate Partners

CB Richard Ellis Investors

Crow Holdings

Fortress Investment Group, L.L.C.

GEM Realty Capital

Grove International Partners

IC Berkeley Partners

Kildare Partners

Lone Star U.S. Acquisitions, L.L.C.

Long Wharf Real Estate Partners

Morgan Stanley Asset Management, Inc.

Olympus Real Estate Corp.

Orion Capital Managers, LLP

Prime Storage Group

RREEF America L.L.C.

State Street Global Advisors

Starwood Capital Group Global LP