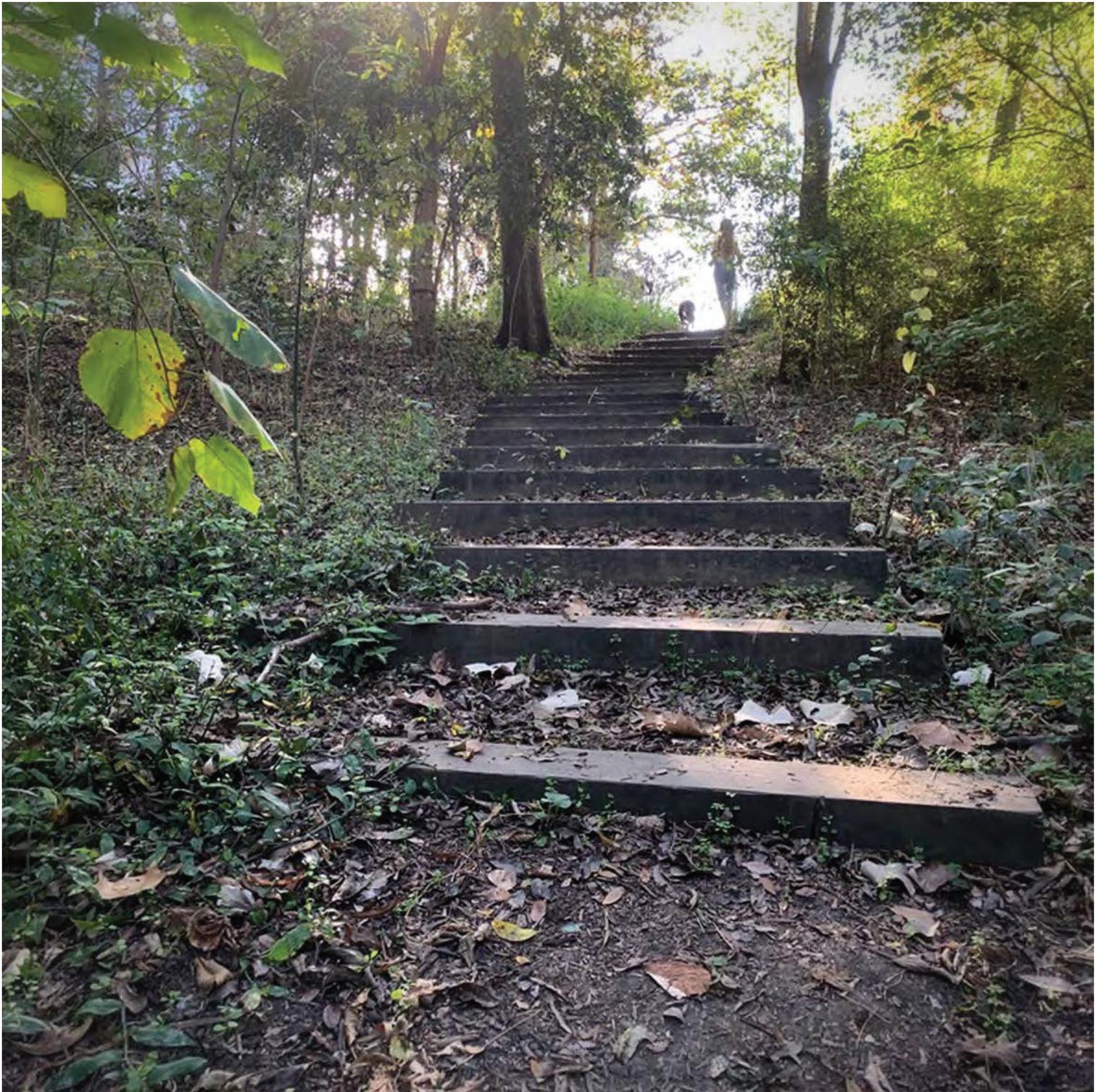


# INTRODUCTION

- SECTION 1 -

**The same path  
can transform  
each of us  
differently.**

*The Houston Electric Company announced in 1903 that it would build a grand new park. **Highland Park**, the park's original name, was built on 30 acres of the Beauchamp Springs tract between Houston Avenue and Little White Oak Bayou. A dam was built across Little White Oak Bayou, which created a large artificial lake. In the early days, the park boasted a dance pavilion, roller coaster, gun range, boating and a "Shoot the Chute" slide into the lake. A streetcar line deposited park goers right at the entrance of the park. The city of Houston purchased the park in 1911 and in 1914 the name was changed to Woodland Park.*



**HMEPS**  
HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

**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 17, 2020

Tantri Emo  
Director, Finance Department  
City of Houston  
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, 2020 and June 30, 2019. 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, 2020 and 2019 (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.

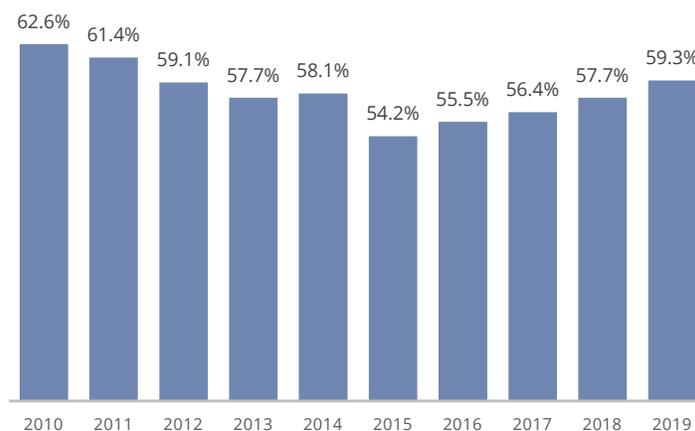
### FUNDING STATUS

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, 2019, HMEPS’ AVA and AAL were \$3.10 billion and \$5.09 billion, respectively, resulting in a funded ratio of 59.3%. This is higher than the funded ratio as of July 1, 2018, which was 57.7%. 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

Fiscal year 2020 saw record volatility in the equity markets due to the uncertainty about the economic impact of COVID-19, in addition to the energy market shock caused by the Saudi government unexpectedly increasing oil production in March. The Federal Reserve responded by lowering the federal funds rate by 1.5% and signaled that rates would remain near zero through 2022. Congress passed a \$2 trillion stimulus bill to financially assist both households and businesses. Partial economic reopening in May reduced unemployment from 14.7%, the highest level since the Great Depression.

U.S. equity markets emerged from volatility with the Wilshire 5000 index up 6.8% for the trailing 12-months ending June 30, 2020. This marked the eleventh consecutive positive fiscal year for the index since the global financial crisis of 2008-2009. Growth stocks once again outperformed value stocks during the fiscal year, and larger capitalization stocks tended to do better than small-cap stocks.

International equities followed a similar pattern to the United States, but the second quarter recovery was not as strong. International equities as represented by the MSCI ACWI ex-U.S. (net) Index returned -4.8% during FY 2020.

Investment grade fixed income securities generated positive returns in fiscal year 2020 as investors concerned about the volatility in the equity market engaged in a flight to safety. Investment grade bonds as represented by the Barclay's U.S. Aggregate Bond index posted a return of 8.7% for the fiscal year. High yield bonds as represented by the Merrill Lynch High Yield Master Trust II Index returned -1.2% for the fiscal year. Private credit returned 4.0% for the fiscal year.

Among the alternative asset classes, Real Estate and Private Equity returned -4.0% and 3.4% respectively in FY 2020. Due to the lag in reporting valuations in these asset classes, these numbers capture the March market decline but little of the rebound in the following months. The Inflation-Linked asset class was the lowest performing asset class of the portfolio, returning -28.2% due to the decline in prices of commodities, especially oil.

Overall, the System's investments returned -0.9% for fiscal year 2020. Through the efforts of the Board of Trustees, the System's investment portfolio is more broadly diversified than many other public pension plans and tends to exhibit less volatility, particularly during extreme market events. During the 10-year period ending June 30, 2020, the system's annualized return was 8.3%.

## MAJOR CURRENT AND FUTURE INITIATIVES

### MEMBER SERVICES

Fiscal Year 2020 included the early months of the coronavirus (COVID-19) pandemic (March – June 2020), during which national, state and local leaders announced sweeping changes in an attempt to control the spread of the virus. The System quickly implemented technology and processes for employees to successfully work remotely in order to timely pay pension benefits and to process new applications, including retirements, DROP distributions, refunds and survivor benefits.

The following information summarizes the activities of the Benefits Division during the pre-COVID-19 months of the fiscal year (July 2019 – February 2020), and during the COVID-19 period from March to June 2020. In FY 2020, HMEPS:

- Responded to continued demand for the Outreach Program, which reaches hundreds of members with individual and group sessions provided by our benefits counselors. This past year, these staff members conducted 187 individual counseling sessions and hosted 15 joint presentations for various City departments as well as new employee orientations for the benefit of 1,034 attendees.
- Processed 2,045 benefit applications, including retirements, the DROP, survivor benefits, refunds, and lump-sum payments.
- Participated in the Fall Financial Retirement Educational Event, an annual event co-sponsored by the System that helps City of Houston employees better plan for their financial futures.

The System maintained a disciplined approach of putting the safety of participants and staff first in order to solidly conduct operations during the pandemic. While benefit counselors have always appreciated the opportunity to meet with members and retirees in person, remote working has been key to the efficient processing and payment of benefits during this time, and to helping ensure the safety and well-being of all members of the HMEPS community.

## **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. The current strategic asset allocation policy has been in place since October 2017.

The target allocation to Global Equity is 32.5%. The target allocation to Fixed Income is 10%, while Real Estate is 12.5%, Private Credit is 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%. During fiscal year 2020, 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 three private equity partnerships, two private real estate partnerships, two private credit partnerships and two private real asset (inflation-linked asset class) partnerships.

The System's investment portfolio closed its 2020 fiscal year at \$2.9 billion. The total investment return for the fiscal year was -0.9%. The System's investment performance was 5.1%, 5.9% and 8.3% for the past three-, five- and ten-year periods. The best performing asset classes for fiscal year 2020 were Fixed Income (+4.3%) and Private Credit (+4.0%).

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

## **BOARD GOVERNANCE**

During FY 2020, the Board's membership did not change. Appointed Board members serve three-year terms. Elected Board members serve staggered four-year terms, with elections for two active members and one retiree occurring every even-numbered year. The next Board election will occur in 2022.

## **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, 2019. This was the 26th 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.

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.

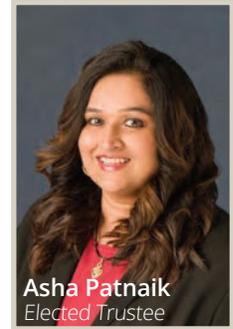
Sincerely,

A handwritten signature in black ink, appearing to read "Sherry Mose". The signature is fluid and cursive, with the first name being more prominent.

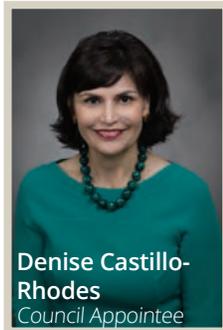
Sherry Mose  
Chairman

A handwritten signature in black ink, appearing to read "David L. Long". The signature is fluid and cursive, with the last name being more prominent.

David L. Long  
Executive Director



# BOARD OF TRUSTEES



## 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
- Member Services

## OPERATIONS

- Accounting
- Financial Reporting
- Records
- Technology Support

For more information on investment professionals who provide services to HMEPS, refer to the *Other Supplemental Information* beginning on page 59 and the *Schedule of Fees and Commissions Paid* table on page 70.

**CERTIFICATE OF ACHIEVEMENT FOR EXCELLENCE IN FINANCIAL REPORTING**

The Government Finance Officers Association (GFOA) of the United States and Canada awarded a “Certificate of Achievement for Excellence in Financial Reporting” to Houston Municipal Employees Pension System for its comprehensive annual financial report for the fiscal year ended June 30, 2019. This was the 26th consecutive year that HMEPS 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.

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**PROFESSIONAL CONSULTANTS  
(FY 2020)**

**ACTUARY**

Gabriel, Roeder, Smith & Company

**AUDITOR**

Weaver and Tidwell, L.L.P.

**BOARD MEDICAL ADVISOR**

Charles Schuhmacher, M.D.

**COMMUNICATION SERVICES**

KLM Public Affairs, LLC

**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.  
DLA Piper L.L.P.  
Jackson Walker, L.L.P.  
Locke Lord L.L.P.

**MASTER CUSTODIAN/TRUSTEE**

State Street Bank and Trust Company

**OTHER POSTEMPLOYMENT BENEFITS**

US Bank  
HighMark Capital Management  
Public Agency Retirement Services

**INVESTMENT MANAGERS  
(FY 2020)**

**ABSOLUTE RETURN**

Anchorage Capital Group LLC  
Angelo, Gordon & Co.  
Brigade Capital Management  
Davidson Kempner Capital  
Management, LLC  
Graham Capital Management L.P.  
Highland Capital Management  
MKP Capital Management, LLC  
Sculptor Capital Management Group  
Samlyn Capital, LLC  
Scopia PX LLC

**FIXED INCOME**

AB Institutional Investments  
BlackRock, Inc.  
DDJ Capital Management, L.L.C.  
GMO LLC  
Loomis, Sayles & Co.  
Pugh Capital Management  
Smith Graham & Co.  
Whippoowill Associates, Inc.

**INFLATION-LINKED**

BlackRock, Inc.  
Cohen & Steers Capital Management  
LLC  
EnCap Investments LP  
Enervest, Ltd  
Global Forest Partners, L.P.  
NGP Energy Capital  
Oaktree Capital Management  
Quantum Energy Partners  
Riverstone Holdings  
Salient Partners LLC  
Tailwater Capital LLC  
Taurus Funds Management Pty Ltd  
Tillridge Global Agribusiness Partners  
Tortoise Capital Advisors L.L.C

**GLOBAL EQUITY**

Ariel Investments  
Ballie Gifford & Co  
BlackRock, Inc.  
DePrince, Race & Zollo, Inc.  
Globeflex Capital  
Invesco  
Neumeier Investment Counsel, L.L.C.  
State Street Global Advisors  
T. Rowe Price Associates

**PRIVATE CREDIT**

Angelo, Gordon & Co  
DRC Capital  
Mesa West Capital  
Orbimed Healthcare Fund  
Management  
Summit Capital

**PRIVATE EQUITY**

Adams Street Partners  
Anchorage Capital Group LLC  
Brera Capital Partners, L.L.C.  
Brockway Moran & Partners, Inc.  
Carrick Capital Management LLC  
Centerbridge Capital Partners  
Clearlake Capital Partners  
TrueBridge Capital Partners  
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 Crossover Ventures  
The Capstreet Group  
The Carlyle Group  
The Jordan Company, L.P.  
Valor Equity Partners  
Vista Equity Partners  
Wayzata Investment Partners, LLC

**REAL ESTATE**

Aetos Capital Real Estate LP  
Aermont Capital  
Angelo, Gordon & Co.  
Artemis Real Estate Partners  
Crow Holdings Capital  
Fortress Investment Group, L.L.C.  
GEM Realty Capital  
IC Berkeley Partners  
Kildare Partners  
Lone Star U.S. Acquisitions, L.L.C.  
Long Wharf Real Estate Partners  
Morgan Stanley Asset Management,  
Inc.  
Orion Capital Managers, LLP  
Pennybacker Capital  
Prime Storage Group  
Rockpoint Group  
State Street Global Advisors  
Starwood Capital Group Global LP