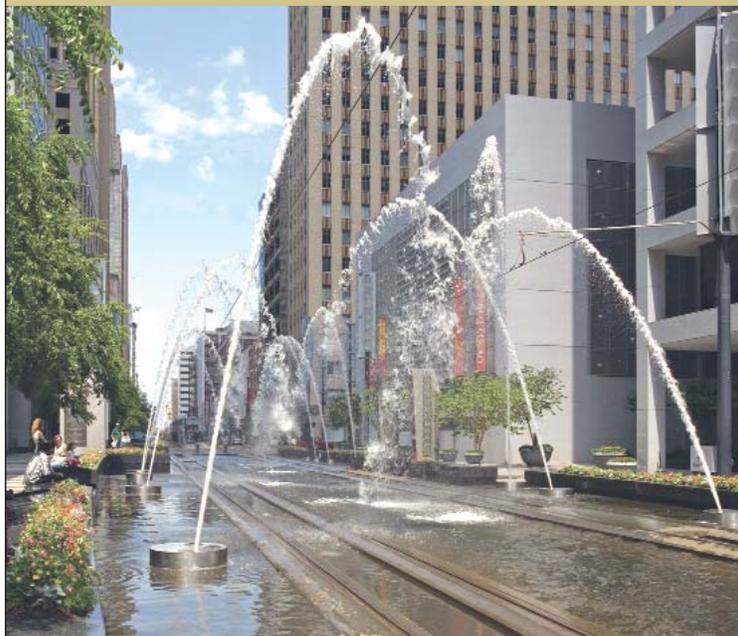
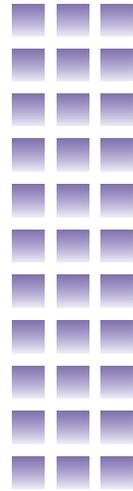
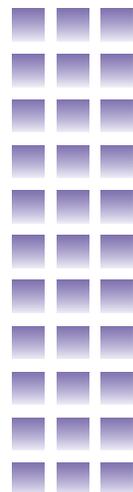


Houston Municipal Employees Pension System



**Summary of the
Comprehensive Annual
Financial Report for the
Year Ended June 30, 2006**



LETTER TO PLAN PARTICIPANTS

April 1, 2007

To Houston Municipal Employees
Pension System Participants

Dear Plan Participants:

This Summary of the Comprehensive Annual Financial Report for the Year Ended June 30, 2006 (Summary) is being presented to the participants of the Houston Municipal Employees Pension System (HMEPS). It provides general information about the operations of HMEPS. Excerpts from the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2006, are included. The CAFR is available for review, in its entirety, in the HMEPS office and online at www.hmeps.org.

During the past year, HMEPS received a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association of the United States and Canada (GFOA) for its CAFR for the year ended June 30, 2005. The Certificate, a prestigious national award recognizing conformance with the highest standards of preparation of state and local government financial reports, has been awarded to HMEPS for the last 12 consecutive years (fiscal years ended June 30, 1994 through 2005). We believe our current CAFR conforms to the highest reporting standards, and we have entered it in the Certificate program.

The Board of Trustees continues its commitment to creating and implementing a pension system with benefits that will meet the long-term financial needs of City of Houston municipal employees and that will help provide a quality life-style for each member after retirement.

Sincerely,



Fred Holmes
Chairman



David L. Long
Executive Director

ORGANIZATIONAL OVERVIEW

ELECTED and APPOINTED TRUSTEES

Fred Holmes, *Chairman*
Ray Kennedy, *Vice Chairman*
Roderick J. Newman, *Secretary*
Shiou-Huey "Sophia" Chang
Sherry Mose
Mark Mancuso
Barbara Chelette, *Appointed*

CITY APPOINTED TRUSTEES

Richard Badger
Gilbert Garcia
Alfred Jackson
Craig T. Mason

David L. Long, Executive Director

PROFESSIONAL CONSULTANTS AND INVESTMENT MANAGERS

Professional Consultants (Fiscal Year 2006)

Auditor

Mir, Fox & Rodriguez, P.C., Certified
Public Accountants

Board Medical Advisor

Charles Schuhmacher, M.D.

Investment Consultants

Wilshire Associates, Inc.
Pension Consulting Alliance, Inc.

Master Custodian/Trustee

State Street Bank and Trust Co.

Actuary

Gabriel, Roeder, Smith & Company

Investment Performance Analysis

Wilshire Associates, Inc.
State Street Bank and Trust Co.

Legal Counsel

Baker Botts, L.L.P.
Cohen, Milstein, Hausfeld & Toll, P.L.L.C.
Locke, Liddell & Sapp, L.L.P.
Schlanger, Mills, Mayer & Silver

Governmental Representation

HillCo Partners, Inc.

Database Services

Pension Benefits Information

Consulting Services

Werness, Inc.
Gray Associates
Ennis, Knupp & Associates, Inc.

Investment Managers (Fiscal Year 2006)

Domestic Equities

Barclays Global Investors, N.A.
Benchmark Plus Partners, L.L.C.
DePrince, Race & Zollo, Inc.
Legg Mason Capital Management
Neumeier Investment Counsel, L.L.C.
Pacific Investment Management Co.
Russell Investment Group

International Equities

Axiom International
Barclays Global Investors, N.A.
Brandes Investment Partners

Fixed Income

Barclays Global Investors, N.A.
DDJ Capital Management, L.L.C.
Highland Capital Management
Loomis, Sayles & Co.
Smith Graham & Co.
Western Asset Management
Whipoorwill Associates, Inc.

Real Assets

Aetos Capital
BlackRock, Inc.
CB Richard Ellis Investors
Crow Holdings
Fortress Investment Group, L.L.C.
Global Forest Partners, L.P.

Goldman, Sachs & Co.
Grove International Partners
L&B Realty Advisors, Inc.
Lone Star U.S. Acquisitions, L.L.C.
Morgan Stanley Asset Management, Inc.
Olympus Real Estate Corp.
Prudential Strategic Investment Corp.
RREEF America L.L.C.

Alternative Investments

Adams Street Partners
Angelo, Gordon & Co.
Brera Capital Partners, L.L.C.
Brockway Moran & Partners, Inc.
Carlyle Group
Goldman, Sachs & Co.
HarbourVest Partners, L.L.C.
J.W. Childs Associates, L.P.
Kopp Investment Advisors
Lexington Partners, Inc.
Matlin Patterson Global Advisors
Oaktree Capital Management
Pacven Walden Management Co., LTD.
Pegasus Investors, L.P.
Pharos Capital Partners, L.L.C.
Platinum Equity Capital Partners
Sun Capital Partners, Inc.
TSG Capital Group, L.L.C.

This Summary has been prepared through the combined efforts of the HMEPS staff under the direction of the Executive Director. The Summary contains excerpts from the HMEPS Comprehensive Annual Financial Report for the Year Ended June 30, 2006 (CAFR), and is intended to provide information to plan participants that may be a basis for a better understanding of HMEPS. Because the CAFR was prepared in 2006, the following excerpts will reflect the information and conditions that applied at that time. In the event of any conflict between this Summary and Article 6243h, Texas Revised Civil Statutes, as amended (the Statute), the Statute will prevail and will supersede this Summary. Nothing contained herein can be construed to convey any right or benefit not otherwise provided by the Statute. This Summary is distributed to participants of HMEPS, and is intended to provide information of interest to them about HMEPS. It is not intended for general circulation, and may not be used as a CAFR.

MANAGEMENT OF PLAN ASSETS

The methods, practices and policies for the management of HMEPS assets are set forth in the Statement of Investment Policies and Objectives (Statement) adopted by the Board. The authority to amend the Statement rests solely with the Board. The Investment Committee, a standing Committee of the whole Board, may from time to time establish a tactical plan of asset allocation among investment types, designed to achieve the earnings objectives established by the Board to meet the needs of HMEPS.

GENERAL ECONOMIC CONDITIONS

U.S. Economy

Over the first six months of 2006, the U.S. economy continued to grow at a consistent pace. Real gross domestic product (GDP) increased 1.6% in the third quarter after increasing 2.6% in the second quarter (according to the U.S. Department of Commerce's Bureau of Economic Analysis). The strong pace evident over the beginning of the year was boosted by several factors, including spending for hurricane relief (mentioned in last year's report) and

the effects of favorable weather on homebuilding. Over the course of the year the pace changed as money directed towards hurricane relief and homebuilding lessened. Consumer spending, which had been strong in the beginning of the year, was restrained by increasing energy costs in the spring. High gas prices over the summer also affected consumer spending. Outside of the household sector, the second quarter marked increased demand for U.S. exports and businesses' fixed investments remained on an upward trend. Since spring, the jobless rate has remained relatively steady.

As of this writing, inflation pressures have been elevated. Higher energy prices not only affected consumer's pocket-books but also had an adverse effect on a broad range of goods and services down the line. One result was an increase in the rate of core consumer price inflation. But strong gains in productivity and labor compensation helped to contain measures of inflation.

Since the beginning of the year, the U.S. economy appears to be entering into a period where the rate of increase in real GDP is moving from its longer-run capacity into a more moderate and sustainable rate. Changes in monetary policy since 2004, intended to keep inflation low and promote economic expansion, are one element in this transition. Current U.S. economic activity has experienced moderation but household and business spending appear favorable. The world economy (discussed below) continues to support demand for U.S. exports, which will in turn improve the economic situation in the U.S. There are considerable uncertainties facing the U.S. economy in the year ahead including indications of a slowing down in consumer spending and hiring, the demand for and supply of oil, and fear of terrorism here and abroad, to name a few.

Global Economy

Although the global economy has slowed since the record pace posted in 2004, growth remains robust, according to the World Bank. Growth, according to a United Nations

report, was expected to continue to grow at about 3 percent for the year. As in the U.S., rising energy prices have pushed up inflation in many countries in 2006, but pressure on core inflation has, in general, continued to be moderate.

The U.S. remains the main force behind the global economy, but India, China and a few other countries are becoming increasingly important on the world stage. The European economy has performed about as expected, with growth reaching 2.1 percent. Japan, as noted in last year's report, has experienced modest growth of about 2 percent. One sector of the world that is experiencing better than average growth is developing countries. On average, they are expanding at a rate of about 5.6 percent.

MAJOR CURRENT AND FUTURE INITIATIVES

Fiscal Year 2006 initiatives emphasized improved information technology. The Administration Information System (AIS), HMEPS' proprietary system for member data, continues to undergo upgrades including the further development of the web-based pension calculator. HMEPS' website also had continual improvements to improve ease-of-use.

During 2006, the HMEPS' benefits division, in conjunction with the communications division, conducted numerous on-site field meetings and pre-retirement seminars. These meetings, which are being continued this year, entail HMEPS staff members going directly to the City's numerous departments and making presentations on various pension subjects including benefits programs, qualifications for retirement, plan changes and answering questions directly from members.

INVESTMENT ACTIVITIES

During the period covered by this CAFR, investment strategies were employed that are long-term in perspective and designed to work within predefined ranges among asset classes to produce returns that, over market

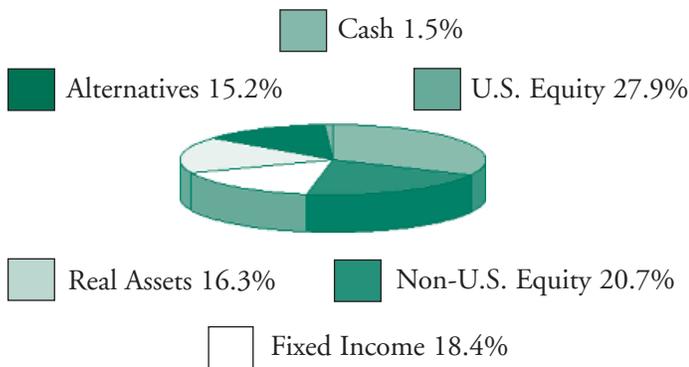
cycles, will exceed the investment return assumption adopted by the Board for actuarial purposes.

Diversification provides safeguards against unanticipated market volatility of one or more asset classes.

To facilitate execution of the strategic investment plan, HMEPS engages the services of a master custodian which utilizes a multi-currency reporting system that reports investments at fair value stated in terms of the base currency, the US dollar. Professional portfolio managers that specialize in a targeted asset class are engaged to perform investment activities within specified guidelines. A nationally recognized institutional investment consulting firm is engaged to provide expert advice to HMEPS in matters pertaining to perceived market conditions and prognosis, portfolio manager selection, and performance measurement and evaluation.

Throughout fiscal year 2006, HMEPS maintained its existing target asset allocation mix of 30% domestic equities, 20% international equities, 20% fixed-income, 15% real assets and 15% alternative investments. However, due to movements in the markets and rebalancing activities directed by staff, HMEPS ended fiscal year 2006 with a slight underweight to domestic equity and fixed income and a slight overweight to international equity, real assets and alternative investments.

SYSTEM ASSET ALLOCATION



FINANCIAL HIGHLIGHTS *(In Thousands of Dollars, Unless Otherwise Noted)*

HMEPS received \$21,888 and \$23,488 during fiscal year 2006 and 2005, respectively, in employee contributions from about 8,000 Group A active participants. For fiscal year 2006 and the period January 1, 2005 through June 30, 2005, the contributions represent 5% of the employee’s qualifying base salary. Total employee contributions decreased by \$1,600 or 7% in fiscal year 2006 compared to fiscal year 2005. This decline is attributable to a 78% decline in service purchase contributions and transfers from the Section 457 deferred compensation plan totaling \$1,270 and \$5,741 for fiscal years 2006 and 2005, respectively.

The City’s contributions during fiscal years 2006 and 2005 represent the budgeted contributions and the net proceeds received through the issuance of pension obligation bonds as set forth in the Meet and Confer Agreement between HMEPS and the City dated September 15, 2004. During fiscal year 2006, HMEPS received cash contributions from the City of \$66,968. For fiscal year 2005, HMEPS received cash contributions from the City of \$63,247 and recognized a \$300 million contribution in the form of a note receivable issued by the City on November 10, 2004.

INVESTMENT PERFORMANCE

Total investments (excluding the note receivable from the City) were \$1.74 billion at the close of fiscal year 2006 and \$1.49 billion in 2005 providing an investment return of 18.1% during the current fiscal year.

HMEPS’s investment performance was 18.1%, 16.9% and 9.0% for the past one, three and five-year periods. These results are consistently above HMEPS’s policy benchmark, and also well above the median fund in a universe of HMEPS’s public fund peers. HMEPS ranks in the top 1st, 1st and 4th percentiles respectively, for the one, three and five-year periods ending June 30, 2006.

The best performing asset classes for the fiscal year 2006 were real assets (+36.4%) and international equities (+30.1%), while real assets (+30.0%) and alternative investments (+20.0%) were the top two performing asset classes for fiscal year 2005. The benefits of a well-diversified asset allocation are evidenced by HMEPS's ability to perform very competitively in both years where different asset classes drove overall returns. For the past three and five year periods, real assets, which include public and private real estate and natural resource investments, was HMEPS's best performing asset class, providing 27.2% and 18.0% per annum. HMEPS's target allocation of 15% to real assets helped enable it to perform well in an environment where a more traditional asset allocation (60% / 40% mix of S&P 500 Index / Lehman Aggregate Bond Index) would have returned 4.8%, 7.6% and 4.0% over the trailing one, three and five-year periods, which is significantly below HMEPS's actuarial rate of 8.5%, and HMEPS's actual results.

FUNDING STATUS

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, a plan's funded ratio should increase over time, until it reaches 100%. As of July 1, 2005 HMEPS' AVA and AAL were \$1.78 billion and \$2.72 billion, respectively, resulting in a funded ratio of 65.2%. This 8.2% increase in the funding status of HMEPS from the previous year's 57% is primarily due to the \$300 million note contributed by the City in November 2004, continued strong investment performance and further recognition of prior years' investment performance over the last several years.

ACCOUNTING SYSTEM AND INTERNAL CONTROLS

The financial statements have been prepared in accordance with generally accepted accounting principles and

presented in accordance with the Governmental Accounting Standards Board (GASB).

The System's independent auditors have audited the financial statements and issued an unqualified opinion as of June 30, 2006 and 2005. 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 assets 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 all of 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, capable personnel, and the organizational structure itself. We believe the System's internal controls are adequate and are working as designed.

STATEMENT OF PLAN NET ASSETS JUNE 30, 2006

STATEMENT OF CHANGES IN PLAN
NET ASSETS JUNE 30, 2006**Assets**

| | |
|--|-------------------------|
| Investments, at fair value: | |
| Government securities | |
| (cost: \$57,792,081) | \$ 57,378,912 |
| Corporate bonds | |
| (cost: \$72,032,761) | 75,568,208 |
| Capital stocks | |
| (cost: \$438,954,393) | 509,384,428 |
| Commingled funds | |
| (cost: \$439,126,450) | 548,133,295 |
| Limited partnerships, real estate trusts, | |
| and loans and mortgages | |
| (cost \$380,797,625) | 484,670,457 |
| Short-term investment funds (valued at cost) | 66,298,270 |
| | <hr/> |
| Total investments | 1,741,433,570 |
| | |
| Cash and cash equivalents | 2,718,000 |
| Proceeds due on asset sales | 8,326,514 |
| Receivables on foreign exchanges | 7,147,170 |
| Contribution receivable - City of Houston | |
| Note receivable - City of Houston | 300,000,000 |
| Accrued interest on note receivable - | |
| City of Houston | 36,182,428 |
| Other receivables | 2,437,319 |
| Collateral on securities lending | |
| arrangements, at fair value | 93,011,816 |
| Furniture, fixtures and equipment, net | 702,351 |
| | <hr/> |
| Total assets | 2,191,959,168 |
| | |
| Liabilities | |
| Amounts due on asset purchases | 36,008,845 |
| Payables on foreign exchanges | 7,139,418 |
| Accrued liabilities | 3,401,995 |
| Options written | 101,081 |
| Collateral on securities lending arrangements, | |
| at fair value | 93,011,816 |
| | <hr/> |
| Total liabilities | 139,663,155 |
| | |
| Plan net assets held in trust for pension benefits | <u>\$ 2,052,296,013</u> |

Additions to plan net assets:

| | |
|---|-------------------------|
| Contributions: | |
| City of Houston | \$ 66,967,596 |
| Participants | 21,888,215 |
| | <hr/> |
| Total contributions | 88,855,811 |
| | |
| Investment income: | |
| Interest on bonds and deposits | 8,632,556 |
| Dividends | 9,127,963 |
| Earnings from limited partnerships | |
| and real estate trusts | 25,592,404 |
| Net appreciation on investments | 235,077,959 |
| | <hr/> |
| Total investment income | 278,430,882 |
| | |
| Proceeds from lending securities | 4,859,543 |
| Less costs of securities lending | (4,440,517) |
| | <hr/> |
| Net proceeds from lending securities | 419,026 |
| | |
| Less costs of investment services | (6,083,426) |
| | <hr/> |
| Total investment income, net | 272,766,482 |
| Interest income - City of Houston note receivable | 26,564,784 |
| Other income | 385,247 |
| | <hr/> |
| Total additions to plan net assets | 388,572,324 |
| | |
| Deductions from plan net assets: | |
| Benefits paid to participants | 154,311,129 |
| Contribution refunds to participants | 1,037,337 |
| Professional services | 707,467 |
| Administration expenses | 5,071,879 |
| | <hr/> |
| Total deductions from plan net assets | 161,127,812 |
| | |
| Net increase in plan net assets | 227,444,512 |
| | |
| Plan net assets held in trust for pension benefits: | |
| Beginning of year | 1,824,851,501 |
| | <hr/> |
| End of year | <u>\$ 2,052,296,013</u> |

Acknowledgement

HMEPS would like to thank the Greater Houston Convention and Visitors Bureau (GHCVB) for their assistance and generosity in the use of the photographs used in this Summary.



