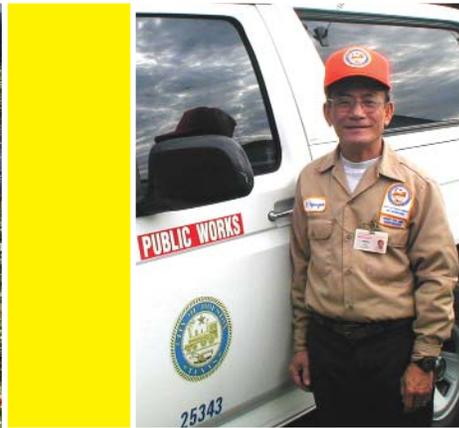


Houston Municipal Employees Pension System

2008 Report to Participants



65 Years
of Service



*Sound History
Solid Future*

65 years
HMEPS

Celebrating 65 Years of Service



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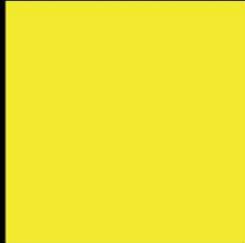
Note to Participants

We prepared this report for our participants, to serve as a summary of the primary investment, benefit and financial information you care about. All the information in this report is derived from our Comprehensive Annual Financial Report (CAFR) and is consistent with Generally Accepted Accounting Principals (GAAP). All financial information is as of June 30, 2008. (The full CAFR is available on our website at www.hmeps.org/publications.html.)

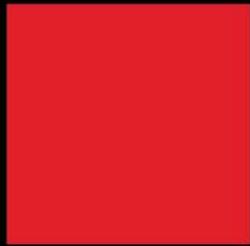
HMEPS



*Sound
History*



*Solid
Future*



A LETTER FROM THE CHAIRMAN

Sound History *Solid Future*

January 31, 2009

Dear Plan Participants:

In 1943, HMEPS was created to provide the hard-working employees of the City of Houston a pension



plan they could count on when it was time to retire or if they became disabled.

Over the years HMEPS has established an extraordinary record of achievements based on sound investment principles and plain, old-fashioned hard work. Now,

sixty-five years later, HMEPS is honored to continue this tradition of excellence.

Our Board of Trustees and dedicated staff work tirelessly to enhance the stability of the system, as well as the services we provide to our members. As you know, this past year was a turbulent one for the financial markets. And while it appears 2009 will continue to exhibit tough market conditions, I want you know

that we're meeting our obligations today, and we will continue to meet them tomorrow and beyond.

In our continual efforts to provide better communications and to keep you aware of the status of the System, we have developed a condensed version of our Comprehensive Annual Financial Report (CAFR). You hold in your hands our 2008 Report to Participants which we hope you find informative.

In the years ahead, I look forward to continuing to serve all our participants. Thank you for your support.

Sincerely yours,

A handwritten signature in blue ink, which appears to read "Sherry Mose". The signature is fluid and cursive.

Sherry Mose



Service, Commitment, Dedication

At the heart of HMEPS is the hard work and dedication of everyone who serves it, beginning with the Board of Trustees. 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, to ensure the accuracy and reliability of the accounting system and to 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.

The majority of the Board's work is conducted at the Board level and within six committees, each of which addresses a specific aspect of the System's operations.

- The **Audit Committee** reviews and monitors the HMEPS audit process and oversees the reporting of financial information for HMEPS.
- The **Budget and Oversight Committee** reviews and monitors operational and adminis-

trative expenditures of HMEPS and the HMEPS actuarial process.

- The **Disability Committee** reviews the submitted medical reports and other relevant information for each disability claim and makes recommendations to the Board as to whether the claim should be approved or denied, or whether another action would be appropriate.
- The **External Affairs Committee** deals with matters concerning state and federal legislative issues that affect HMEPS.
- The **Investment Committee** reviews investment strategies and has the authority to change HMEPS' asset allocation, tactical asset allocation, managers or any other aspect of HMEPS' operations relating to investments. The Investment Committee is a committee of the entire Board.
- The **Personnel and Procedures Committee** deals with matters concerning HMEPS' employees, changes in policies in the working of HMEPS, and constructing the procedures for HMEPS' adherence to laws that apply to HMEPS.

Board of Trustees*

Elected and Appointed Trustees

Sherry Mose, *Chairman*
Mark V. Mancuso, *Vice Chairman*
Lonnie Vara, *Secretary*
Terrence Ardis
George Bravenec
Lenard Polk
Barbara Chelette, *Appointed*

City Appointed Trustees

Richard Badger

Gilbert Garcia

Craig T. Mason

Art Morales

David L. Long, *Executive Director*



Sherry Mose
Chairman



Mark V. Mancuso
Vice Chairman



Lonnie Vara
Secretary



Terrence Ardis
Elected Trustee



George Bravenec
Elected Trustee



Lenard Polk
Elected Trustee



Barbara Chelette
Appointed Trustee



Richard Badger
Council Appointee



Gilbert Garcia
Controller Appointee



Art Morales
Council Appointee



Craig T. Mason
Mayoral Appointee



David L. Long
Executive Director

*As of January 31, 2009

35 Years of Service to the Fund

Fred Holmes entered into public service in 1964 – years before many City of Houston employees had even started high school. In the 43 years that followed, Holmes dedicated his career to the public, the employees who serve them and, of course, the development and growth of HMEPS.

Holmes began his public service with the City of Houston, working as an employee in the Civil Service-Human Resources Department from 1964-1991. He was elected in 1972 to serve as an employee Trustee on the HMEPS Board of Trustees. Upon his retirement as a City employee in 1991, Holmes continued his service on the Board as a retiree Trustee. During his many years with the Fund, he served in the capacity of Secretary, Vice Chairman, and as Chairman, the latter a position he held for 14 years.

Holmes oversaw the increase in HMEPS' total membership from 8,729 to its current 25,760 participants

and helped grow the System's total assets from \$36 million to more than \$2.3 billion. Holmes put his heart and soul into the fund and for that we express our appreciation. Without him the System would not be where it is today.

Even in the most difficult of times Holmes would be the first to step up to take on the workload and make the tough decisions, always while sharing his wonderful sense of humor. He could be depended on in whatever capacity he served - whether it was guiding investments or meeting new retirees.

Holmes served HMEPS for 35 years and will always be remembered for his service to HMEPS and his dedication to ensuring its soundness for future members.



***Sound
History***



Discovery Green, Houston's Downtown, Eco-friendly Park

THE STAFF

Trust, Integrity, Dependability

For 65 years the staff of HMEPS has been serving the active and non-active members of the System, dedicated to making sure their needs are met in a timely and efficient manner. They also never lose sight of the fact that our participants are the reason they come to work every day.

The individuals who make up the pension system's staff are talented professionals who are experts in their respective fields. HMEPS has five general areas of organization:

- Administrative Services
- Information Systems
- Investment Services
- Legal Services
- Communications Services

The **Administrative Services** division is responsible for serving the needs of our participants on a daily basis. The many tasks at hand include benefits counseling, accounting, financial reporting, internal controls, financial counseling and more.

The **Information Services** division is responsible for the technology that is so crucial to serving HMEPS' participants. Every participants record, specific participants' documents, computer/server maintenance and more are the responsibility of this division.

The **Investment Services** division develops and implements investment strategies that maximize returns while minimizing risks, both short-term and long-term. The Board of Trustees then incorporates these strategies into their final decisions regarding HMEPS investments.



The **Legal Services** division works with all the divisions of the System, as well as the Board, to ensure we are providing the best service possible to our members in compliance with federal, state and local laws.

The **Communications Services** division is responsible for serving HMEPS' membership through one-on-one, print and electronic communications.

Major Current and Future Initiatives

Member Services

Customer service is a critical element of the pension system's goals and is the driving force behind many of our service improvements. During Fiscal Year 2008



HMEPS increased site visits to various City departments. The System collaborated with the City's deferred compensation staff and others to successfully facilitate the third annual "Financial Fitness" Expo. The System also added a new financial counselor position to meet with and assist participants with benefit options, retirement and general financial planning and to develop and maintain a participant education program.

The System processed more than 96,000 payments totaling more than \$169 million, annually, in monthly retirements and lump-sum payments.



Technology

These efforts could not be attained without the effective management of HMEPS technology. The Administration Information System (AIS), HMEPS' proprietary system for participant data, continues to undergo upgrades including the further development of linking the benefits administration system to the imaging system to provide additional ease and efficiency to the process of servicing participants.

Investments

The HMEPS Board, staff and professional consultants continue to closely monitor the HMEPS investment portfolio. In Fall 2008, the HMEPS Board reviewed and approved the current strategic asset allocation to help assure monies are allocated in a manner that allows the system to continue to meet its long-term investment goals.



BENEFITS OVERVIEW

Honor and Service

The System is a defined benefit pension plan 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, elected City Officials, and the full time employees of the System. As of July 1, 2007, there were 25,760 participants in HMEPS. Included in this figure are active members, inactive participants, service retirees, disabled retirees and beneficiaries and spouses.

The System includes a contributory group (Group A) and two noncontributory groups (Group B and Group D) and provides for service, disability and death benefits for eligible participants. Participants newly hired on or after January 1, 2008 automatically become members of Group D pursuant to the Fourth Amendment to the Meet and Confer Agreement dated June 27, 2007.

MEMBERSHIP DATA

	Number	Number Vested	Average Salary or Annual Benefit	Average Age	Average Service
Active Members	12,376	7,374	\$36,274	45.2	9.3
Inactive Participants		2,922	\$6,470/\$2,491 (nonvested)		
Service retirees	6,017		\$20,815	65.9	
Disabled retirees	446		\$8,296	61.3	
Beneficiaries and spouses	1,508		\$9,293	67.1	





SCHEDULE OF ANNUITANTS BY TYPE

Schedule of Annuitants by Type	July 1, 2007			July 1, 2006		
	Number	Benefits (\$000)	Average Benefit	Number	Benefits (\$000)	Average Benefit
Retirees receiving benefits	5,847	\$119,287	\$20,401	5,592	\$108,217	\$19,352
Retired on disability	452	3,658	8,093	483	3,762	7,788
Survivors and beneficiaries	1,481	12,743	8,604	1,448	11,232	7,757
Total retirees, survivors and beneficiaries	7,780	135,688	17,441	7,523	123,211	16,378
Former participants eligible but not yet receiving benefits	2,786	16,531	5,934	2,659	14,228	5,351
Total Eligible for Benefits	10,566	\$152,219	\$14,406	10,182	\$137,439	\$13,500

HISTORICAL ACTIVE PARTICIPANT DATA*

Valuation Date	Number of Participants	Annual Payroll (\$000)	Average Salary (\$)	% Salary Increase
July 1, 1996	14,067	367,610	26,133	(0.8)
July 1, 1998 ¹	13,764	394,919	28,692	9.8
July 1, 1999 ¹	13,286	396,617	29,852	4.0
July 1, 2000 ¹	13,126	421,591	32,119	7.6
July 1, 2001 ¹	12,928	413,021	31,948	(0.5)
July 1, 2002	12,527	399,794	31,915	(0.1)
July 1, 2003	12,120	390,314	32,204	0.9
July 1, 2004	11,856	366,190	30,886	(4.1)
July 1, 2005	11,974	404,565 ²	33,787 ²	9.4
July 1, 2006	12,145	422,496	34,788	3.0
July 1, 2007	12,376	448,925	36,274	4.3

* There was no actuarial valuation in FY1997

¹ 1998, 1999, 2000 and 2001 does not include DROP participants

² Beginning with 2005, a change in methodology now annualizes payroll for new entrants. If the methodology had not been changed, the covered payroll for 2005 would have been \$376,208,345 and the average payroll would have been \$31,419

FINANCIALS

Financial Highlights

Each year the System coordinates an annual audit during which an external firm reviews the System's financial statements and confirms that the state-

SUMMARY COMPARATIVE STATEMENT OF PLAN NET ASSETS

ASSETS	FY 2008	FY 2007
Cash and equivalents	\$ 956	3,148
Investments	1,886,044	2,021,243
Receivables on asset sales	52,292	14,714
Other receivables	77,482	59,207
Note receivable - City of Houston	300,000	300,000
Collateral on securities lending	141,334	132,467
Furniture, fixtures and equipment, net	419	419
Total Assets	2,458,527	2,531,198
LIABILITIES		
Payable on asset purchases	47,975	45,727
Accrued liabilities	7,185	8,407
Collateral on securities lending	141,334	132,467
Total liabilities	196,494	186,601
Plan Net Assets	\$ 2,262,033	2,344,597

SUMMARY COMPARATIVE STATEMENT OF CHANGES IN PLAN NET ASSETS

	FY 2008	FY 2007
Additions		
Contributions	\$ 94,447	91,231
Investments and interest income, net	73	365,105
Other income	634	1,185
Total Additions	95,154	457,521
Deductions		
Benefits paid	169,482	157,716
Contribution refunds	1,760	1,398
Administration and professional fees	6,476	6,106
Total deductions	177,718	165,220
Net (decrease) increase in plan net assets	(82,564)	292,301
Plan net assets, prior year	2,344,597	2,052,296
Plan net assets, current year	\$ 2,262,033	2,344,597

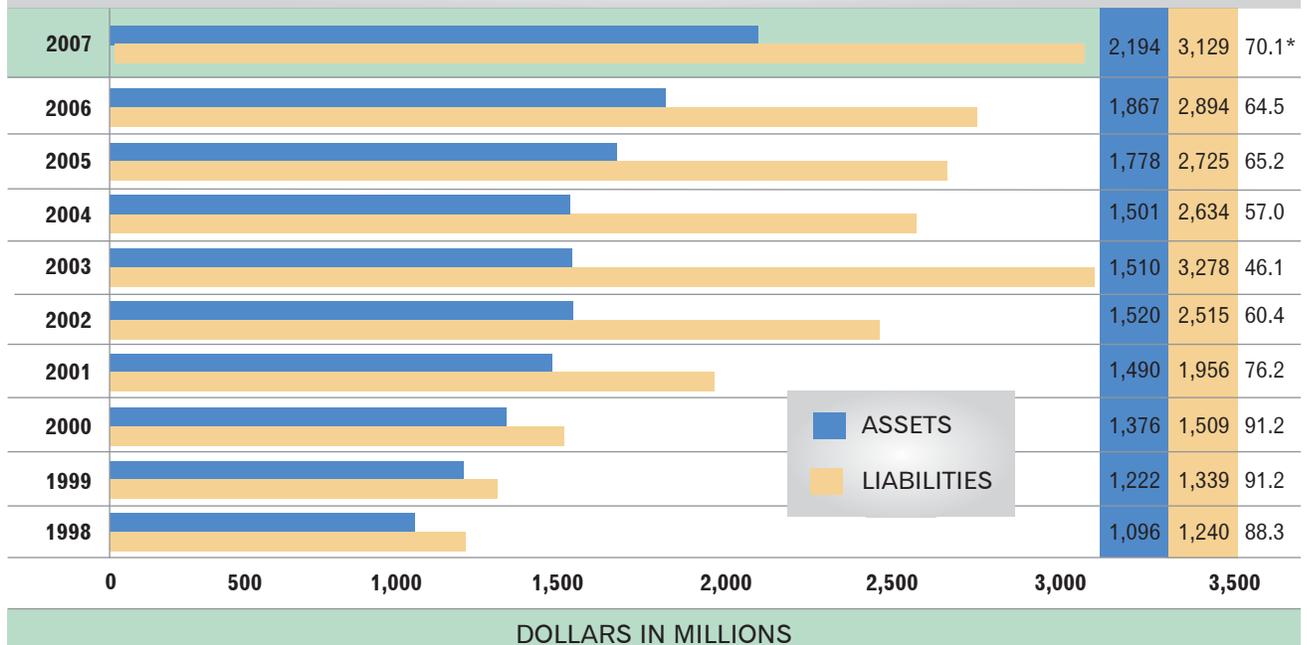
ments are free of material misstatement. This outside opinion considers internal control over financial reporting. The System coordinates the production of the Comprehensive Annual Financial Report (CAFR), which is made possible through considerable teamwork by all departments.

The System's CAFR is also submitted to the Government Finance Officers Association (GFOA), which oversees the certification program for a governmental entity's CAFR. For the 14th consecutive year, the System has received the Certificate of Achievement for Excellence in Financial Reporting for its work on the CAFR. This award speaks to the thorough nature of the System's financial reporting skills.

Fiscal Year 2008 Financial Highlights

This fiscal year, ending June 30, 2008, the System earned \$95 million compared to \$457 million in the last fiscal year. This income was derived through the collection of member and City of Houston contributions and through returns on investments and the City note. Because of the market downturn during Fiscal Year 2008, the investment activity posted a loss of \$29 million. The System posted interest income on the City of Houston note receivable of \$29 million (see note description). The City and participant contributions account for 99 percent of our total additions compared to 20 percent in prior years. This increased percentage is attributable to the market decline.

ACTUARIAL SUMMARY



* The funding ratio reflects the System's actuarial assets value relative to its actuarial accrued liability. This chart indicates a 10-year history of the plan for each year that a valuation was prepared.

As always, a large majority of the Fund's expenditures - nearly \$169 million, or 95 percent - was paid out in the form of benefits to our participants and beneficiaries.

Contributions from members and the City of Houston covered 55 percent of the benefits paid, with our investment income from current and prior years funding the remaining 45 percent. Another major expenditure is disbursed in the form of fees necessary to maintain our investments, which are managed externally by professional money management firms. Remaining expenses involve the day-to-day operations including servicing our participants and maintaining our state-of-the-art information system. It is the System's duty and privilege to add to the valuable services offered for participants and their families. This duty guides the allocation of all available resources.

City Pension Obligation Note

As part of the Meet and Confer Agreement and to improve the System's long-term funding outlook, on November 10, 2004, the City issued the System a \$300 million pension obligation note (the Note), secured in part by a deed of trust on the Convention Center Hotel adjacent to the George R. Brown Convention Center.

Subsequent to 2008 year-end, the City refinanced the Note, which cleared the way for HMEPS to receive approximately \$381 million in cash through the City's prepayment of the Note and related deferred and accrued interest. The transaction was completed on January 8, 2009. Prepayment was in the amount of approximately \$381 million, which adds to the System's investment portfolio and benefits both the City and HMEPS.

Results-Driven Performance

During Fiscal Year 2008, the downturn in the markets experienced in the first six months of 2008 offset the prior gains the Fund experienced in the last six months of 2007. The System posted an investment return of 0.5% for the fiscal year. The System's allocation to private market investments, namely real estate and private equity, and its exposure to energy and fixed income investments provided positive returns for the year, which were partially offset by its investments in US and non-US equities. Clearly the diversification of the System's investment portfolio enabled the System to produce a positive return in an environment when most of its peers were negative. The median return for public funds was -4.9% for the year, according to the Wilshire Public Fund Universe.

Proper funding and healthy long-term investment returns are essential to the financial soundness of the System. An integral part of the overall investment policy is the strategic asset allocation policy. This

policy is designed to provide an optimal mix of asset class investments which can best meet future pension obligations while minimizing the effects that market volatility has on the portfolio. This approach emphasizes strong diversification among a range of investments, each of which offers the opportunity of long-term returns. These investments include allocations to public markets (money markets, bond and global stocks) as well as private markets (real estate, private equity and venture capital).

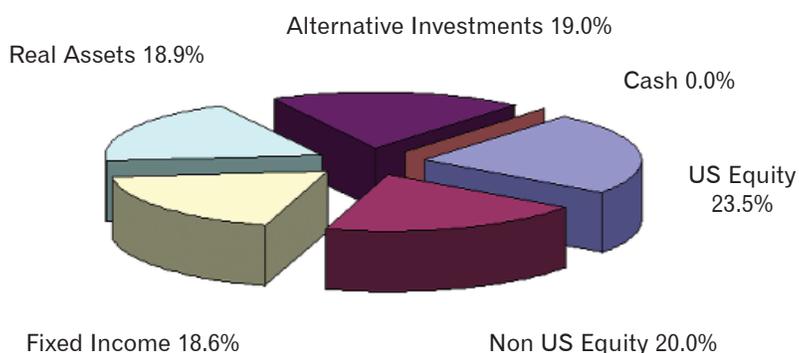
Instead of claiming to be able to "time the market" which has always been a proven ineffective method, the System continues to maintain a level of asset allocation with an opportunistic eye. Subsequent to year-end, the HMEPS Board reviewed and approved an updated asset allocation to help assure monies are allocated in a manner that allows the System to continue to meet its long-term investment goals.

The System's investment performance was 0.5%, 12.1% and 13.7% for the past one-, three- and five-year periods. These results are materially above the

System's policy benchmark over the same periods. Relative to its peer group the System continues to post attractive investment returns.

As of June 30, 2008, HMEPS ranks in the top 4th and 2nd percentiles, respectively, for the trailing one- and three-year periods, and is the top performing fund over the trailing five- and ten-year periods.

SYSTEM ASSET ALLOCATION



COMPARISON OF INVESTMENT RETURNS - YEARS ENDED JUNE 30

(Calculated based on a time-weighted rate of return based on the market rate of return)

	2008	2007	2006	2005	2004	3-Yrs.	5-Yrs.	10-Yrs.
Total Fund								
Actuarial Rate	8.5	8.5	8.5	8.5	8.5	8.5	8.5	8.5
HMEPS Total Fund	0.47	18.64	18.11	13.85	18.64	12.08	13.72	8.37
Median of Wilshire Public Fund Universe	-4.92	17.75	11.14	10.23	16.62	7.36	9.99	6.31
HMEPS Domestic Equity	16.79	19.36	11.14	7.94	21.95	3.35	7.76	4.48
Dow Jones Wilshire 5000 Index	-12.53	20.45	9.92	8.23	21.24	5.01	8.73	3.59
HMEPS International Equity	-5.42	29.54	30.14	13.24	34.44	16.83	19.41	8.27
MSCI ACW Free ex US Index	-6.20	30.14	28.40	16.95	32.50	16.16	19.42	7.74
HMEPS Fixed Income	1.95	9.56	2.62	9.17	3.99	4.66	5.41	5.41
Lehman Aggregate Index	7.13	6.12	-0.81	6.81	0.32	4.08	3.86	5.69
HMEPS Real Assets	18.18	20.10	36.39	30.03	15.92	24.63	23.89	16.92
NCREIF Index	9.20	17.24	18.67	18.02	10.83	14.96	14.72	12.23
HMEPS Alternative Investments	11.86	25.37	22.46	19.96	13.32	19.76	18.48	9.45
S&P500 Index	-13.13	20.60	8.63	6.31	19.10	4.41	7.58	2.89



THE HISTORY OF HMEPS

1943 to 2008 - 65 Years of Service

City of Houston officials in 1934 began setting aside funds with a special goal in mind - creating a retirement system to serve its hard-working employees. Nine years later, they had



accumulated \$281,000 that they used to create the Municipal Pension System. The Texas Legislature signed off on the plan, making the system official on May 3, 1943.

Sixty-five years of service later, the System

remains true to the original vision of providing a pension to its members. But there have been a few changes along the way, as well as plenty of growth in assets and membership.

The Municipal Pension System consisted of a seven-member Board of Trustees made up of the city manager, city treasurer, two city employees who were members of the System and three taxpaying Houston voters. Membership included 108 retirees who received average monthly pensions of \$44.98 and 1,067 active members who made monthly contributions of \$2.00.

By 1950, Houston was the nation's 14th largest city - behind Milwaukee - with a population of 596,163. As the city continued to expand, officials knew they needed a solid workforce to fuel the growth and so they promised new hires a pension. The offer attracted many citizens to local government work, spurring a dramatic increase in the pension system.

Membership in the mid-1950s reached 4,548 and assets grew to \$3,966,825. An employee retiring in 1956 with 28 years of service was entitled to a pension benefit of \$100 per month. The monthly contribution by employees rose to \$7. Also during that time, employees became eligible for Social Security benefits.

As a new decade began in 1960, the System's assets surpassed the \$10 million mark for the first time to total \$10,596,901. Membership stood at 5,376 and active members were contributing \$10 a month to help fund the System's positive trend.

More change came in 1981, when bills were introduced in the Texas Legislature to establish a noncontributory pension group for employees, Group B.

The pension system continued its upward trek in the early 1980s, with membership topping 14,856, including 12,252

active members and 2,604 retired members, beneficiaries and inactive vested members. During this time, Houston became the nation's 4th largest city. The System's market value surpassed yet another milestone, the \$100 million mark, to equal \$108.5 million.

In 1987 the U.S. stock market suffered a severe decline and budgets in most of the nation's cities, including Houston, were adversely affected.

Despite the economic turmoil of the 1980s, the System's market value continued to grow. The 1989 fund was \$546.3 million - a 400 percent increase from 1980. That same year, the System published the first issue of the *Pension Press* newsletter.

In 1992, Roderick J. Newman was elected as the first African American to serve on the HMEPS Board. In 1993, the Board hired its first executive director and administrative staff and the name was changed to the Houston Municipal Employees Pension System, HMEPS.

HMEPS thrived and its market value climbed to \$1.17 billion in 1997, another major first for the pension system. Also, that year the Deferred Retirement Option Plan (DROP) was instituted.

In 2004, HMEPS and the City entered into its first Meet and Confer Agreement to make certain changes to the pension plan. In subsequent years, there have been four amendments to the original Meet and Confer Agreement. The Meet and Confer Agreement also established a new noncontributory group - Group D.

HMEPS continued to expand services to its membership in 2006 by participating in the City's first Financial Fitness Expo and introducing AccessHMEPS, an online service for DROP participants.

After serving the System for 35 years in different capacities, Fred Holmes stepped down from the HMEPS Board in 2008. Rod Newman was elected Chairman, the first African American elected to the post since the creation of the fund in 1943. In September, Sherry Mose became the first female elected to the office of Chairman.

As of June 30, 2008 the System had more than 25,700 participants and total assets of \$2.2 billion. HMEPS is honored to continue the commitment set forth so many decades ago for the valued employees of the City of Houston.

ACKNOWLEDGEMENTS

The Houston Municipal Employees Pension System would like to thank the following for their efforts in providing photographs and assistance for this publication:

- Dave Schafer and the staff of the City of Houston Human Resources Department.
- The Houston Public Library.
- The City of Houston employees whose photographs were used in the report.
- www.VisitHoustonTexas.com.



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