Houston Municipal Employees Pension System

Comprehensive Annual Financial Report for the Year Ended June 30, 2004

A Component Unit of the
City of Houston, Texas

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

COMPREHENSIVE ANNUAL FINANCIAL REPORT
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

A COMPONENT UNIT OF THE CITY OF HOUSTON, TEXAS

PREPARED BY THE PENSION ADMINISTRATION STAFF
DAVID L. LONG, EXECUTIVE DIRECTOR

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM
1111 BAGBY, SUITE 2450, HOUSTON, TEXAS 77002-2555
(713) 759-9275
www.hmeps.org

HOUSTON
MUNICIPAL
EMPLOYEES
PENSION SYSTEM

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ELECTED TRUSTEES

Fred Holmes, Chairman
Ray Kennedy, Vice Chairman
Roderick J. Newman, Secretary
Louis McKinney, Trustee**
Sherry Mose, Trustee
Lee Pipes, Trustee

TRUSTEES BY DESIGNATION OR APPOINTMENT

Barbara Chelette, Trustee
Philip B. Scheps, City Treasurer
Lonnie G. Vara, Mayor's Representative

David L. Long, Executive Director

ADMINISTRATIVE ORGANIZATION

BOARD OF TRUSTEES

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

EXECUTIVE DIRECTOR

Chief Investment Officer
Investment Managers' Services
Performance Measurement
Market Research

Benefit Administration
Benefit Administration Services
Member Services

Information Systems

General Counsel

Communications

Accounting

* Information pertaining to investment-related professionals is located on page 7.

** In August 2004, Sophia Chang was elected to the position previously held by Louis McKinney.

Fred Holmes
Chairman

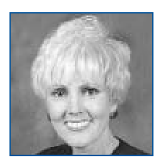
Ray Kennedy
Vice Chairman

Roderick J. Newman
Secretary

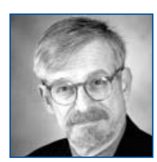
Louis McKinney
Elected Trustee

Sherry Mose
Elected Trustee

Lee Pipes
Elected Trustee



Barbara Chelette
Appointed Trustee



Philip B. Scheps
City Treasurer

Lonnie G. Vara
Mayor's Representative

David L. Long
Executive Director

INTRODUCTORY SECTION

1111 BAGBY
SUITE 2450
HOUSTON, TEXAS 77002-2555
(713) 759-9275
FAX (713) 650-1961

December 1, 2004

Philip B. Scheps, Ph.D.
City of Houston, Texas
P.O. Box 1562
Houston, Texas 77251-1562

Dear Dr. Scheps:

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 year ended June 30, 2004 (2004), is submitted herewith. The accuracy and completeness of this report are the responsibility of the Board of Trustees (the Board) of the System. The information provided pertains to the records and accounts of the System and its operation.

The CAFR consists of five sections: (i) the introductory section, which contains this transmittal letter and other general information about the structure and activities of the System; (ii) the financial section, which contains the independent auditors' report and the basic financial statements, including notes to the basic financial statements and supplemental schedules; and management's discussion and analysis; (iii) the investment section, which includes reports on the investment objectives and activities of the System during 2004; (iv) the actuarial section, which contains information about the actuarial valuation of the System as of July 1, 2003, the funding objectives of the System and the progress being made toward achieving those objectives; and (v) the statistical section, which contains statistical and other significant data intended to provide a user of this CAFR additional information regarding the System and its participants.

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 reenacted and continued under HB1573, 77th Texas Legislature, as Art. 6243h, Vernon's Annotated Revised Texas Civil Statutes (the Statute). The System is a multi-employer defined benefit pension plan and includes contributory groups (Group A and Group C) and a noncontributory group (Group B). The System provides service retirement, disability retirement and death benefits for eligible participants which covers 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"). System plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group C. The System is administered by a nine-member Board of Trustees. The Trustees include the Mayor of the City or his designated representative, the City Treasurer, four elected trustees who are active members of the System, two elected trustees who are retirees of the System, and one trustee who is appointed by the elected trustees.

Significant Changes During the Year

There were no significant changes in the System or its operation that affected the year included in this CAFR.

General Economic Conditions

The year ended June 30, 2004 provided a welcome return of double-digit investment returns for world equity markets. The year began with a dramatic sell-off in the U.S. Treasury market, triggered by remarks by U.S. Federal Reserve Chairman Alan Greenspan, concerning his inflation expectations. During an 11-week period, the yield on the benchmark 10-year treasury bond climbed to 4.6% from 3.7%. This was the most significant sell-off in the U.S. bond market in over 20 years. This sell-off coupled with a continued improvement in world economies drove equity markets, in the U.S. and abroad, which were further supported by a weakening U.S. dollar. The capture of Saddam Hussein, improved labor markets, increased Federal Reserve liquidity, increased business and consumer spending, and continued low inflation pushed world equity markets further. For the quarter ended December 31, 2003, U.S. equities, as measured by the S&P 500 index returned 12.2%, while non-U.S. equities, as measured by the MSCI All Country World ex-U.S. index returned 17.1%. During this same period, the U.S. fixed-income market, as measured by the Lehman Aggregate index returned just 0.3%.

January 2004 brought several events the equity markets viewed favorably, including numerous "90's style" corporate merger announcements (JP Morgan/Bank One, Comcast/Disney, Cingular/AT&T Wireless, et al.). Also, the Japanese economy grew at its highest level in 13 years during the first quarter of 2004. Unfortunately, terrorist attacks in Spain, 18-year high gasoline prices, and a very weak February payroll report, which indicated only 12,000 jobs were created as opposed to the 125,000 that were expected, drove most world equity markets downward. Increased investor demand for U.S. Treasuries rallied the yield on the 10-year note to 3.8% at the end of the first quarter. The return of the Lehman Aggregate for the quarter was 2.7%.

The quarter ended June 2004 witnessed continued offsetting events, including improved corporate earnings and relatively strong payroll reports. These were offset by steep increases in energy prices and a 0.25% rise in the federal funds rate to 1.25%, in late June. For the quarter, the S&P 500 returned 1.7%, while the Lehman Aggregate returned -2.4%.

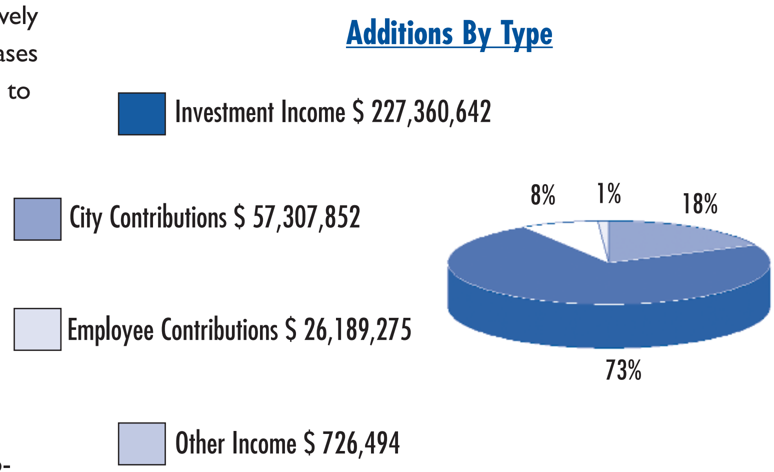
Fixed-income and real estate assets provided the only safe haven for the past three and five-year periods. The fixed-income market, as measured by the Lehman Aggregate index, rose 6.4% and 7.0% during these periods, while real estate, as measured by the NCREIF index, climbed 8.0% and 9.4%, respectively. However, for the one-year period, non-U.S. equity provided the highest returns. The one-year return of the MSCI ACWI x-US index was 32.5%.

Throughout fiscal year 2004, the System maintained its existing target asset allocation mix of 30% domestic equities, 20% international equities, 20% fixed-income, 15% real estate and 15% alternative investments. However, due to movements in the markets and rebalancing activities directed by Staff, the System maintained a slight underweight to fixed income and alternative investments, with a slight overweight to U.S. equities and real estate.

The System's investment performance was 18.6%, 4.6% and 6.2% for the past one, three and five-year periods. These results are above the System's policy benchmark, and also above the median fund in a universe of the System's public fund peers. The System ranks in the 15th, 47th and 4th percentiles, for the one, three and five-year periods ended June 30, 2004. The best performing asset classes for the past year were Non-U.S equity (34.4%) and U.S. equity (21.9%). However, for the past three and five years, real estate was the best performing asset class, providing 8.9% and 12.3% per annum.

Investment Activities

As discussed in more detail in the Investment Section of the CAFR, investment strategies have been implemented by the System that are long-term in perspective and designed to meet the expectations of working within predefined ranges among asset classes to produce returns, over market cycles, that exceed the investment return assumption adopted by the System for actuarial purposes. Diversification, professional management within stated guidelines, and periodic rebalancing from asset classes to capture gains and reduce

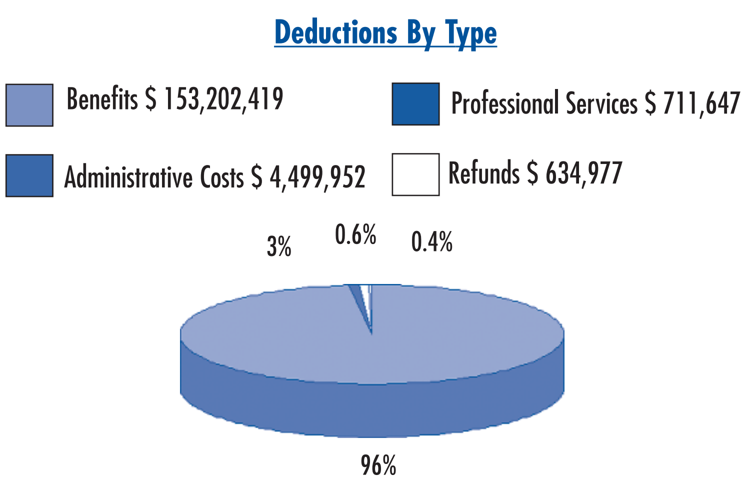


risks associated with market movements are methods that have been adopted by the Board of Trustees to safeguard against loss due to unanticipated market declines.

Financial Highlights

Additions to assets received by the System are used to fund current and future benefits for participants, their eligible survivors and beneficiaries. The primary sources of additions are contributions from active participants and the City, and investment income. Net investment income after deducting investment fees and costs of lending securities for the years 2004 and 2003 was $227.4 million and $33.9 million, respectively. City contributions, employee contributions, and other income for 2004 totaled $83.5 million compared to $64.4 million for 2003. The City contribution rate was 14.7% during 2004, and 10.0% in 2003. City contributions increased by $16.7 million during 2004 over 2003. Participant contributions increased by $2.4 million during 2004 over 2003. The chart, Additions by Type, is a relative representation of 2004 additions by components.

Deductions from assets consist of benefits paid to retired members, their eligible survivors and beneficiaries, refunds of contributions to former members, fees for professional services, and the cost of administering the programs of the System. Total deductions for 2004 were $55.1 million more than for 2003. Benefits and contribution refunds were $54.6 million more, professional services were $345,686 more for 2004 over 2003, and administrative costs were $200,988 more. The chart, Deductions by Type, demonstrates the relationship among types of deductions.



The net of additions less deductions for 2004, reported in the financial statements as the net increase in plan net assets, was $152.5 million. That increase in plan net assets represents the results of System operations for fiscal year 2004 and represents the change from the prior year in the plan net assets held in trust for pension benefits.

Additional financial information and discussion can be found in the Management's Discussion and Analysis report, financial statements, and schedules included in the financial section of this report.

Accounting System and Internal Controls

The financial statements and related information included in the financial section of this report are the responsibility of the management of the System. 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. 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 a proper 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.

Funding Status

Expressing the actuarial value of assets (AVA) as a percentage of the actuarial accrued liability (AAL) provides one indication of the System's funding status on a going-concern basis. Analysis of that percentage over time indicates whether the System is becoming financially stronger or weaker. Generally, the greater that percentage, the stronger

Analysis of Funding Progress
(in Millions of Dollars)

Actuarial Valuation Date	(1) Actuarial Value of Assets	(2) Actuarial Accrued Liability	(3) Unfunded AAL (UAAL)	(4) Funded Ratio (1 ÷ 2)	(5) Annual Covered Payroll	UAAL as a Percentage of ACP (3 ÷ 5)
07/01/99	1,222.2	1,339.9	117.7	91 %	407.7	29 %
07/01/00	1,376.0	1,509.4	133.4	91 %	432.6	31 %
07/01/01	1,490.2	1,955.8	465.6	76 %	418.0	111 %
07/01/02	1,519.7	2,515.2	995.5	60 %	399.8	249 %
07/01/03	1,510.3	3,278.2	1,767.9	46 %	390.3	453 %

Actuarial calculations are performed a year in arrears and are applied to a future period.

the plan. The net of AAL minus AVA is the unfunded actuarial accrued liability (UAAL). Since UAAL and annual covered payroll (ACP) are both affected by inflation, expressing the UAAL as a percentage of ACP approximately adjusts for the effects of inflation and aids analysis of the System's progress toward accumulating sufficient assets to pay benefits when due. Generally, the smaller this percentage, the stronger the system. The analysis (see above) indicates the System's funding progress according to the most recent five actuarial valuations.

In an agreement signed on September 15, 2004, the City of Houston committed to improve the System's long-term funding outlook through changes in the benefit provisions of the System and increasing the System's assets. The provisions of this agreement are fully disclosed in Note 11 of the basic financial statements.

The most recent actuarial study was made as of valuation date July 1, 2003. This report was presented to and adopted by the Board on August 19, 2004. The result of this study becomes effective in 2005 for funding purposes but is presented in this CAFR for disclosure purposes.

Acknowledgments

The Government Finance Officers Association (GFOA) awarded its "Certificate of Achievement for Excellence in Financial Reporting" to the System for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2003. The award and a detailed description thereof are displayed on page 6 in the Introductory Section of this CAFR.

This CAFR was prepared through the combined efforts of the System staff and 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 State Pension Review Board, the GFOA, and other interested parties who may from time to time request it.

Sincerely,

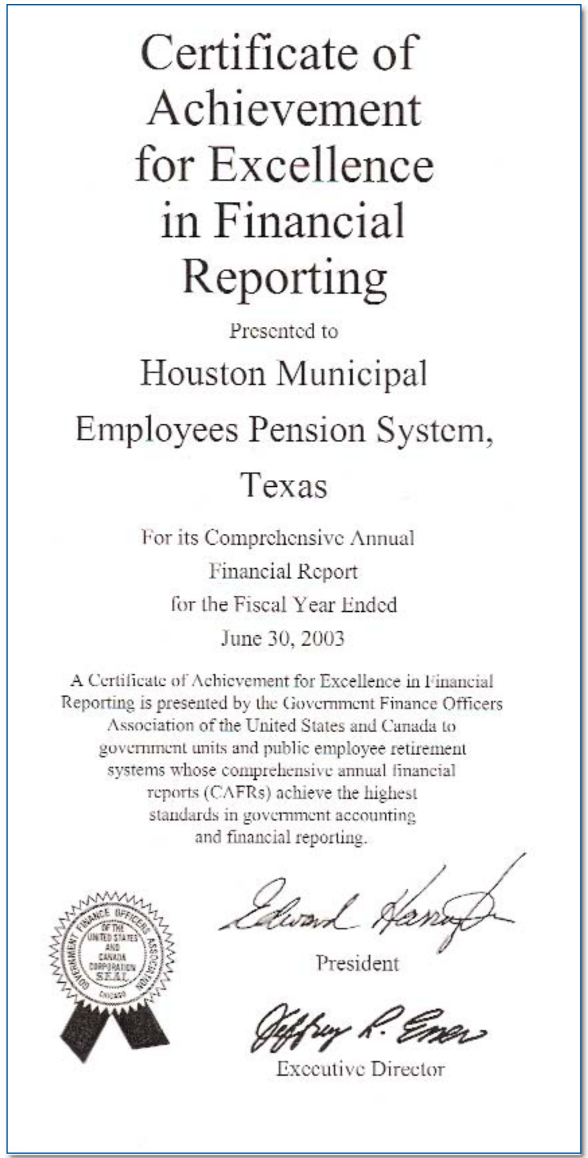
Fred Holmes
Chairman

David L. Long
Executive Director

The Government Finance Officers Association of the United States and Canada (GFOA) 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, 2003. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, the contents of which conform to program standards. Such CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. Houston Municipal Employees Pension System has received a Certificate of Achievement for the last 10 consecutive years (fiscal years ended June 30, 1994 through 2003). We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA for consideration.



Certificate of Achievement for Excellence in Financial Reporting

Presented to

Houston Municipal Employees Pension System, Texas

For its Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2003

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.

President

Executive Director

Consultants (July 1, 2003 – June 30, 2004)

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.

Investment Performance Analysis
Wilshire Associates, Inc.

Legal Counsel
Baker Botts, L.L.P.
Cohen, Milstein, Hausfeld & Toll, P.L.L.C.
E. Troy Blakeney Jr., P.C.
Hinton, Sussman, Bailey & Davidson, L.L.P.
Jenkins & Gilchrest
Lawson, Fields, McCue, Lee & Campbell, P.C.
Locke, Liddell & Sapp, L.L.P.

Master Custodian/Trustee
State Street Bank and Trust Co.

Actuary
Gabriel, Roeder, Smith & Company

Investment Managers (July 1, 2003 – June 30, 2004)

Domestic Equities
Barclays Global Investors, N.A.
Brown Capital Management
DePrince, Race & Zollo, Inc.
Legg Mason Capital Management
Neumeier Investment Counsel
Pacific Investment Management Co.

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

Fixed Income
Barclays Global Investors, N.A.
GoldenTree Asset Management, L.P.
Loomis, Sayles & Co.
MDL Capital Management
Smith Graham & Co.
Western Asset Management

Real Assets
Alliance Bernstein Institutional Investment Management
CB Richard Ellis Investors
CDK Realty Advisors
Crow Holdings
Goldman, Sachs & Co.
Heitman Capital Management
L&B Realty Advisors, Inc.
Lone Star U.S. Acquisitions, L.L.C.
Morgan Stanley Asset Management, Inc.
Olympus Real Estate Corp.
Prudential Investments
Global Forest Partners, L.P.
Soros Private Funds Management, L.L.C.
State Street Research & Management Co.

Alternative Investments
Adams Street Partners
Barclays Global Investors, N.A.
Brera Capital Partners, L.L.C.
Brockway Moran & Partners, Inc.
Goldman, Sachs & Co.
HarbourVest Partners, L.L.C.
J.W. Childs Associates, L.P.
Kopp Investment Advisors
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
The Jordan Company
TSG Capital Group, L.L.C.

FINANCIAL SECTION

The Audited Financial Statements and the accompanying Independent Auditors' Report included in this CAFR were approved by the System's Board of Trustees (the Board) in its meeting of September 28, 2004.

The audit of the System's financial statements was conducted in accordance with generally accepted auditing standards (GAAS). The Independent Auditors' Report is based on that audit, and it is intended to give reasonable assurance to users of the System's financial statements that those financial statements are free of material misstatement when taken as a whole and that they present fairly the financial position and results of operations of the System at the times and for the periods reported. The audit gives reasonable assurance to the Board and members of the System that the System's assets are adequately safeguarded and that its financial transactions are properly authorized and recorded.

The financial statements provide a comprehensive overview of the financial position of the System as of June 30, 2004 and June 30, 2003 and the results of its operation for the years then ended. The financial statements are presented in conformity with accounting and reporting standards of the Governmental Accounting Standards Board (GASB).

The System is responsible for the accuracy of its financial statements and the completeness and fairness of their presentation. The auditors are responsible for issuing an opinion on those financial statements when taken as a whole.

The financial statements consist of Statements of Plan Net Assets, Statements of Changes in Plan Net Assets, Notes to the Basic Financial Statements, and Supplemental Schedules.

The Statements of Plan Net Assets present the financial position of the System as of the end of the fiscal years reported. They are statements of the System's assets, liabilities, and net assets held in trust for pension benefits.

The Statements of Changes in Plan Net Assets include additions to the System's assets and deductions from them and the increase or decrease in plan net assets. Additions consist of contributions, investment income, and other income. Deductions are benefit payments, fees for professional services and costs of administering the programs of the System. The net of additions and deductions represents the change, for the years presented, in net assets held in trust for pension benefits.

Notes to the basic financial statements contain disclosures required by generally accepted accounting principles and GASB reporting standards. Required disclosures include a summary description of the pension plan, significant accounting policies, information about the System's funding status and progress toward achieving its funding objectives, information about the System's investments and investing activities, and information about the System's commitments. Supplemental Schedules provide information required by GASB and additional detailed analyses of certain amounts summarized in the basic financial statements.

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

Member of the American Institute of Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

Board of Trustees
Houston Municipal Employees Pension System:

We have audited the accompanying statements of plan net assets of the Houston Municipal Employees Pension System (the System) as of June 30, 2004 and 2003, and the related statements of changes in plan net assets for the years then ended. These basic financial statements and the schedules referred to below are the responsibility of the System's management. Our responsibility is to express an opinion on these basic financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the basic financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall basic financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the financial status of the System as of June 30, 2004 and 2003, and the changes in its financial status for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Management's discussion and analysis (MD&A) and the required supplemental information (schedules 1 and 2) are not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the MD&A and required supplemental information. However, we did not audit such information and do not express an opinion on it.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The additional supplemental information (schedules 3, 4, and 5) are presented for the purpose of additional analysis and are not a required part of the System's basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

September 20, 2004

Mir Fox & Rodriguez

One Riverway, Suite 1900
Houston, TX 77056
Off. (713) 622-1120
Fax (713) 961-0625

The Board of Trustees (the Board) of the Houston Municipal Employees Pension System (System) is pleased to provide this overview and analysis of the financial performance and activities of the System for the fiscal years ended June 30, 2004 and 2003. We encourage the readers to consider the information presented here in conjunction with the basic financial statements.

OVERVIEW OF THE FINANCIAL STATEMENTS

The discussion and analysis is intended to serve as an introduction to the System's financial statements. The financial section consists of (1) System's Basic Financial Statements, (2) Notes to Basic Financial Statements, and (3) Supplemental Information.

System's Basic Financial Statements

There are two basic financial statements presented herewith. The Statements of Plan Net Assets as of June 30, 2004 and 2003 indicate the net assets available to pay future payments and gives a snapshot at a particular point in time. The Statements of Changes in Plan Net Assets for the fiscal years ended June 30, 2004 and 2003 provide a view of the fiscal year's additions to and deductions from the System.

Notes to Financial Statements

The notes are an integral part of the basic financial statements and provide additional background information that is essential for a complete understanding of the data provided in the System's financial statements. The notes to the basic financial statements can be found on pages 18 to 25 of this report.

Supplemental Information

The required supplemental information consists of:

Schedule 1 – Schedule of Funding Progress – this provides historical trend information that contributes to the understanding of the changes in the funded status of the System over time. These are calculations made by the System's actuary and they provide actuarial information that contributes to the understanding of the changes in the actuarial funding of and the funded status of the System over a number of years. It should be noted though that actuarial information is based upon assumptions about future events, and therefore, the figures presented are estimates.

Schedule 2 – Schedule of Employer Contributions – this provides historical trend information of required annual employer contributions and the contributions actually made in relation to this requirement over time.

The additional supplemental information consists of:

Schedule 3 – Investment Summary – this lists the System's investments by type presented both at cost and fair market value.

Schedule 4 – Investment Services, Professional Services, and Administration Expenses – this provides more information for purposes of more detailed analysis.

Schedule 5 – Summary of Costs of Investment and Professional Services – this provides more information for purposes of more detailed analysis.

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

- The System received $26,189 and $23,762 during fiscal year 2004 and 2003, respectively, in employee contributions from over 12,000 active participants, of which over 8,000 belong to Group A. During the fiscal years 2004 and 2003, the System received $57,308 and $40,622, respectively, in employer contributions from the City of Houston (the City). The City's contribution represents a contribution rate of 14.7% in 2004 and 10% in 2003. On September 15, 2004, an agreement was entered into by the System with the City which provides among other provisions additional funding commitment beginning July 1, 2004 from the City (see note 11). Employee contributions increased by $2,427 or 10% in fiscal year 2004 compared to fiscal year 2003. Forty percent of the employees' contributions came from service purchase and direct rollovers from Section 457 deferred compensation plan amounting to $5,663 and $4,826 for fiscal years 2004 and 2003, respectively.
- The net investment income of the System was $227,360 during fiscal year 2004 compared to $33,931 during fiscal year 2003, which is an increase of $193,429. This increase is a reflection of favorable market conditions as the economy began showing signs of improvement. Interest and dividend income likewise grew by 74% due to a shift from investment grade fixed-income securities to high-yield securities providing higher interest income and value equity accounts providing higher dividend income. Earnings from limited partnerships and real estate trusts increased one and a half times from $7,690 to $19,464 resulting from the maturity of the alternative investment portfolio as distributions start to become due.

COMPARATIVE FINANCIAL STATEMENTS

Below is a condensed and comparative summary of major classes of Plan Net Assets at fair value. *(In Thousands of dollars)*

	Balance June 30, 2004	Balance June 30, 2003	Balance June 30, 2002
Assets			
Cash and short term investments	$ 2,691	7,153	2,413
Proceeds due on asset sales	7,496	6,290	24,749
Receivables	18,310	21,457	19,425
Investments	1,438,005	1,286,581	1,285,735
Collateral on securities lending	109,440	84,300	84,928
Furniture, fixtures and equipment, net	796	737	546
Total assets	$ 1,576,738	1,406,518	1,417,796
Liabilities			
Amounts due on asset purchases	45,570	53,716	58,959
Accrued liabilities	3,003	2,312	2,218
Collateral on securities lending	109,440	84,300	84,928
Total liabilities	158,013	140,328	146,105
Plan net assets held in trust for pension benefits	$ 1,418,725	1,266,190	1,271,691

Below is a comparative summary of Statements of Changes in Plan Net Assets available for pension benefits. *(In Thousands of Dollars)*

	Fiscal Year 2004	Fiscal Year 2003	Fiscal Year 2002
Additions			
Contributions	$ 83,497	64,384	54,234
Investment income (loss), net	227,360	33,931	(107,851)
Other income	726	113	114
Total additions (reductions)	311,583	98,428	(53,503)
Deductions			
Benefits paid	153,202	98,789	78,318
Contribution refunds	635	475	270
Administration expenses and professional fees	5,211	4,665	4,058
Total deductions	159,048	103,929	82,646
Net increase (decrease) in plan net assets	152,535	(5,501)	(136,149)
Plan net assets, prior year	1,266,190	1,271,691	1,407,840
Plan net assets, current year	$ 1,418,725	1,266,190	1,271,691

- Benefit payments grew by 55% to $153,202 during fiscal year 2004 compared to $98,789 during fiscal year 2003. Service retirement pension benefits amounted to $79,316, (23% increase from fiscal year 2003) which accounted for 52% of the total benefit payments for fiscal year 2004. There are 7,436 participants receiving benefits for the fiscal year ended 2004 compared to 6,215 participants in 2003. These numbers represent an increase of 20% and 6% for the fiscal years 2004 and 2003, respectively.
- Distributions to DROP (Deferred Retirement Option Plan) participants amounted to $59,563 or 39% of the total benefit payments. DROP distributions increased 184% in fiscal year 2004 as more DROP participants elected lump-sum distribution or rollover to their IRA accounts. The number of DROP participants increased to 476 in 2004 compared to 259 in 2003 or an 84% increase.
- Benefit payments exceeded total employee plus employer contributions by $69,705 during fiscal year 2004 and by $34,405 during fiscal year 2003.
- Costs of administering the benefit programs of the System, including professional fees, were $5,211 and $4,665 for fiscal years 2004 and 2003, respectively, for over 20,000 participants.
- Net assets increased by $152,535 during fiscal year 2004 compared to a decrease of $5,501 in 2003. This is a 12% improvement, primarily due to recovery in the world equity markets.

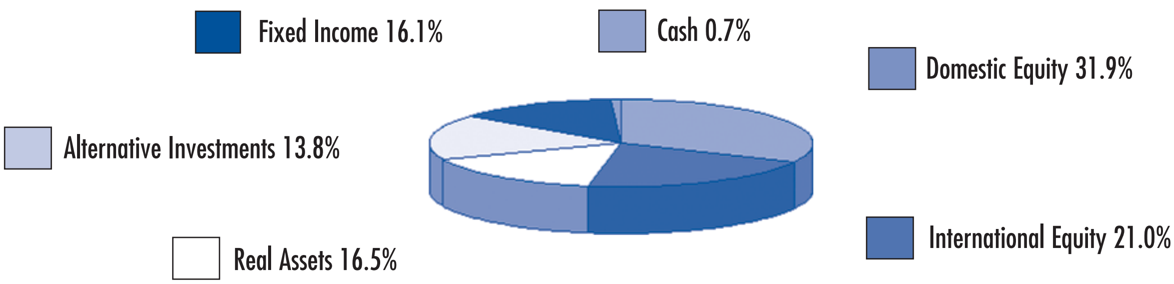
The System capitalizes expenditures for furniture, fixtures and equipment in accordance with Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended. Furniture, fixtures and equipment, net of accumulated depreciation, as of fiscal year end 2004 and 2003 is $796 and $737, respectively.

Total investments were $1.44 billion at the close of fiscal year 2004 and $1.29 billion in 2003, and the net income on investments was $227.4 million during fiscal year 2004, for a positive net return of approximately 16%. This compares to a net investment income of $33.9 million during 2003, with a positive net return of approximately 3%. The performances of our investment classes are as follows based on investment amounts as of June 30, 2004.

PERFORMANCE OF INVESTMENT CLASSES

Periods Ending June 30, 2004		Investment Return	
	FY 2004	3-Years	5-Years
System's Total Portfolio	18.64%	4.55%	6.15%
Policy Benchmark	17.29%	4.24%	2.50%
Median Public Fund (Wilshire Public Fund Universe)	16.73%	4.48%	3.55%
US Equities	21.93%	3.14%	3.82%
Wilshire Target Top 2500 Index	20.60%	0.28%	-1.20%
International Equities	34.45%	4.38%	3.83%
MSCI All Country World Free ex US Index	32.50%	5.25%	0.96%
Fixed Income	3.99%	6.65%	6.14%
Lehman Aggregate Index	0.32%	6.36%	6.95%
Real Estate	15.92%	8.90%	12.31%
NCREIF Index	10.83%	7.97%	9.41%
Alternatives	13.32%	-3.77%	5.86%
S&P 500 Index	20.88%	-0.21%	-1.91%
Cash	1.03%	1.74%	3.37%
91- Day T-Bill	0.96%	1.60%	3.15%

SYSTEM'S ASSET ALLOCATION



Throughout fiscal year 2004, the System maintained its existing target asset allocation mix of 30% domestic equities, 20% international equities, 20% fixed-income, 15% real estate and 15% alternative investments. However, due to movements in the markets and rebalancing activities directed by System staff, the System maintained a slight underweight to fixed income and alternative investments, with a slight overweight to U.S. equities and real estate.

The System's gross investment performance was 18.6%, 4.6% and 6.2% for the past one, three and five-year periods. These results are above the System policy benchmark, and also above the median fund in a universe of the System's public fund peers. The System ranks in the 15th, 47th and 4th percentiles, for the one, three and five-year periods ended June 30, 2004. The best performing asset classes for the past year were Non-U.S equities 34.4% and U.S. equities 21.9%. However, for the past three and five years, real estate was the best performing asset class, providing 8.9% and 12.3% per annum.

The System's securities lending program obtains additional income by lending securities to broker-dealers and banks. During the years ended June 30, 2004 and 2003, the System's custodian lent, at the direction of the Board, the System's securities and received cash, securities issued or guaranteed by the United States government, and irrevocable bank letters of credit as collateral. The Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested together with the cash collateral of other qualified tax-exempt plan lenders, in a collective investment pool. On June 30, 2004, the System had no credit risk exposure to borrowers.

The System's investments in limited partnerships are included in the tables appearing in note 5 under investments not categorized. In connection with those investments, the System has remaining commitments as of June 30, 2004 and 2003 of approximately $214 million and $220 million, respectively, pursuant to terms of the respective limited partnerships.

CONTACTING THE SYSTEM'S FINANCIAL MANAGEMENT

This financial report is designed to provide our participants, business partners, and taxpayers with a general overview of the System's financial activities. If you have questions about this report or need additional financial information, contact the Accounting Manager of the Houston Municipal Employees Pension System at 1111 Bagby, Suite 2450, Houston, Texas 77002.

	2004	2003
Assets:		
Investments, at fair value:		
United States government securities		
(cost: $87,887,717 in 2004 and $95,418,619 in 2003)	$ 88,750,245	96,536,268
Corporate bonds		
(cost: $97,984,474 in 2004 and $82,693,717 in 2003)	100,819,631	89,240,844
Capital stocks		
(cost: $492,382,196 in 2004 and $414,628,215 in 2003)	552,420,134	439,387,265
Commingled funds		
(cost: $228,930,791 in 2004 and $196,302,866 in 2003)	291,693,891	225,693,863
Limited partnerships, real estate trusts, and loans and mortgages		
(cost $335,672,800 in 2004 and $412,404,129 in 2003)	350,343,146	400,190,471
Short-term investment funds (valued at cost)	53,977,861	35,531,844
Total investments	1,438,004,908	1,286,580,555
Cash and cash equivalents	2,690,902	7,153,389
Proceeds due on asset sales	7,495,944	6,290,351
Receivables on foreign exchanges	12,510,828	16,753,201
Contribution receivable - City of Houston	2,430,079	1,839,988
Other receivables	3,369,386	2,863,411
Collateral on securities lending arrangements, at fair value	109,439,773	84,300,279
Furniture, fixtures and equipment, net	796,754	737,414
Total assets	1,576,738,574	1,406,518,588
Liabilities:		
Amounts due on asset purchases	33,039,912	36,798,635
Payables on foreign exchanges	12,512,162	16,766,897
Accrued liabilities	3,002,363	2,311,903
Options written	18,797	150,575
Collateral on securities lending arrangements, at fair value	109,439,773	84,300,279
Total liabilities	158,013,007	140,328,289
Plan net assets held in trust for pension benefits	$ 1,418,725,567	1,266,190,299

(A schedule of funding progress for the plan is presented on page 26)

See accompanying notes to basic financial statements.

	2004	2003
Additions To Plan Net Assets:		
Contributions:		
City of Houston	$ 57,307,852	40,622,051
Participants	26,189,275	23,762,123
Total contributions	83,497,127	64,384,174
Investment income:		
Interest on bonds and deposits	9,513,651	6,868,504
Dividends	15,133,937	7,335,018
Earnings from limited partnerships and real estate trusts	19,463,685	7,690,010
Net appreciation on investments	189,464,813	16,981,165
Total investment income	233,576,086	38,874,697
Proceeds from lending securities	1,121,875	1,501,543
Less costs of securities lending	(769,437)	(1,124,872)
Net proceeds from lending securities	352,438	376,671
Less costs of investment services	(6,567,882)	(5,320,438)
Total investment income, net	227,360,642	33,930,930
Other income	726,494	113,605
Total additions to plan net assets	311,584,263	98,428,709
Deductions From Plan Net Assets:		
Benefits paid to participants	153,202,419	98,789,557
Contribution refunds to participants	634,977	474,795
Professional services	711,647	365,961
Administration expenses	4,499,952	4,298,964
Total deductions from plan net assets	159,048,995	103,929,277
Net increase (decrease) in plan net assets	152,535,268	(5,500,568)
Plan net assets held in trust for pension benefits:		
Beginning of year	1,266,190,299	1,271,690,867
End of year	$ 1,418,725,567	1,266,190,299

See accompanying notes to basic financial statements.

1. DESCRIPTION OF PLAN

The Houston Municipal Employees Pension System (the System) was created under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, 1943 (Article 6243g, Vernon's Texas Civil Statutes) and reenacted and continued under HB1573, 77th Texas Legislature, Article 6243h, Vernon's Texas Civil Statutes (the Pension Statute). The System is a multiple-employer 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 Statute), employed full time by the City of Houston, Texas (the City), elected City Officials, and the full time employees of the System (collectively referred to as "participants"). The System includes contributory groups (Group A and Group C) and a noncontributory group (Group B) and provides for service, disability and death benefits for eligible participants. System plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group C. The System is a local governmental plan and therefore is not subject to the Employee Retirement Income Security Act of 1974. The System is governed by a Board of Trustees (the Board) and can only be terminated or amended by an act of the Legislature of the State of Texas or by an agreement between the City and the Board pursuant to the Pension Statute. On September 15, 2004, an agreement was made between the City and the Board providing certain amendments which are fully discussed in Note 11.

Participation

Participants hired before September 1, 1981 participate in Group A, unless they elected before December 1, 1981 or after May 1, 1996 to transfer to Group B. Participants hired or rehired after September 1, 1981 but before September 1, 1999, may make a one-time irrevocable election to participate in Group A; otherwise, they participate in Group B. Participants hired or rehired on or after September 1, 1999 participate in Group A; except that Executive Officials of the City and the Executive Director of the System (Executive Officials) participate in Group C.

At July 1, 2003, the System's participants consisted of the following:

Retirees and beneficiaries currently receiving benefits	6,215
Former employees - vested but not yet receiving benefits	2,386
Former employees - nonvested	564
Vested active participants	8,818
Non-vested active participants	3,302
Total participants	21,285

Contributions

During the years ended June 30, 2004 and 2003, covered active Group A and Group C participants were required to contribute 4% of their qualifying gross salary to the System. Participants are also eligible to roll over certain qualified plan amounts and make additional contributions to purchase credited service.

The City funds the System based on a percentage contribution rate multiplied by the combined eligible salaries paid to participants of Group A, Group B and Group C. The percentage contribution rate is based on the results of actuarial valuations made at least every three years, calculated on the basis of an acceptable reserve funding method approved by the Board. Notwithstanding any other provision, the City's minimum percentage contribution rate may not be less than the greater of two times the contribution rate of Group A participants or 10%. The City's actual percentage contribution rate was 14.7% and 10% for the years ended June 30, 2004 and 2003, respectively.

Retirement Eligibility

A participant whose employment with the City or the System terminated before August 1, 2000 is eligible to receive a normal monthly pension benefit after at least one of the following combinations of minimum age and service requirements has been met:

(i) attainment of age 50 with 25 years of total credited service,

(ii) attainment of age 55 with 20 years of total credited service,

(iii) attainment of age 60 with 10 years of total credited service,

(iv) attainment of age 62 with 5 years of total credited service, or

(v) attainment of age 65 with any credited service in Group C.

A participant whose employment with the City or the System terminated on or after August 1, 2000 is eligible to receive a normal monthly pension benefit after at least one of the following combinations of minimum age and service requirements has been met:

(i) attainment of age 65 with any credited service in Group C,

(ii) attainment of age 62 with at least 5 years of total credited service, or

(iii) completed at least 5 years of total credited service and attained any combination of age and credited service that when added together equal 70 or more.

Pension Benefits

Pension benefits are based on a participant's average monthly salary, as defined in the Pension Statute, and years of credited service. The maximum pension benefit is 90% of the participant's average monthly salary.

Pension benefits are increased annually by a Cost of Living Adjustment equal to 4% of the original benefit amount, not compounded.

A participant who is eligible to receive a deferred benefit may elect to receive his or her pension benefit in an early lump sum distribution if the actuarial present value of the participant's benefit is less than $10,000 as of the later of September 1, 1995 or the date of termination. Early lump-sum distributions are subject to approval by the Board.

Disability Benefits

Service-connected disability benefits for covered participants are based on the participant's normal accrued benefit, but are not less than 20% of the participant's final monthly salary. There is no minimum credited service requirement to qualify for service-connected disability benefits.

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

Death Benefits

Death benefits are provided for a participant's surviving spouse and/or dependent children. A deceased participant must have had at least five years of credited service at the time of his or her death to qualify for death benefits unless death was caused by a service-connected incident as defined by the Pension Statute.

In order to qualify for death benefits, a surviving spouse must have been married to the deceased participant at the time the participant's employment with the City or System was terminated and at the time of the participant's death. To qualify for benefits, a child must be the natural, or legally adopted, dependent child of the deceased participant at the time of the participant's death and (a) must be under age 21 and never have been married, or (b) have been totally and permanently disabled before age 18 and at the time of the participant's death and never have been married. Dependent benefits are payable to the legal guardian of the dependent(s) unless the dependent is at least 18 years of age.

Deferred Retirement Option Plan (DROP)

A participant who is eligible to retire, except that he or she has not retired and remains a full-time employee of the City, or the System, or has been separated from service for not more that thirty calendar days, may elect to participate in the Deferred Retirement Option Plan (DROP). The DROP provides that a monthly amount (monthly DROP credit) plus a participant's employee contributions, if any, attributable to the participant's salary earned during the period of DROP participation will be credited to a notional account (DROP Account). Interest at a rate equal to the average of the annual percent returns on the System's investments for the then most recent five complete fiscal years established effective January 1 each year will accrue, compounded daily, on the DROP account balance. The first day of DROP participation is the DROP Entry Date. The day a participant's fully executed DROP election is accepted by the System is the DROP Election Date. Normal pension benefits cease to accrue on DROP Entry Date.

Effective September 1, 1999, the DROP Entry Date may precede DROP Election Date, and the monthly DROP credit is based on the participant's years of credited service and average monthly salary as of DROP Entry Date, and benefit accrual rates in effect on DROP Election Date.

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

Refunds of Participant Contributions

Group A or Group C participants who terminate employment prior to retirement for reasons other than death or disability, may request a refund of their accumulated employee contributions, without interest, in lieu of a pension or in the event the participant has fewer than five years of credited service.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

Recent Accounting Pronouncement

The GASB has issued Statement No. 40, *Deposit and Investment Risk Disclosures*, which amends GASB Statement No. 3, *Deposits with Financial Institutions*, *Investments (Including Repurchase Agreements)*, and *Reverse Repurchase Agreements*. GASB Statement No. 40 requires disclosure information related to common risks inherent in deposit and investment transactions. The statement is effective for financial statements for periods beginning after June 15, 2004 and accordingly, will be implemented by the System in fiscal year 2005.

Basis of Accounting

The basis of accounting is the method by which revenues and expenses are recognized in the accounts and reported in the financial statements. The accompanying basic financial statements are presented on the accrual basis of accounting. Under the accrual basis of accounting, revenues, which include investment and other income, are recognized when they are earned and collection is reasonably assured, and expenses are recognized when the liability is incurred. Accrued income, when deemed not collectible, is charged to operations. Participant and employer contributions are recognized as revenues in the period in which they are due pursuant to formal commitments. Benefits and refunds are recognized when due and payable in accordance with the terms of the Pension Statute.

Reporting Entity

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

Investment Valuation and Income Recognition

Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Mortgages are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. The fair value of limited partnerships and real estate trusts is based on independent appraisals or recent financial results. Short-term investments are carried at cost, which approximates fair value. Investments that do not have an established market are reported at estimated fair value.

Purchases and sales of investments and forward foreign exchange contracts are recorded on the trade date. Gains or losses on the forward foreign exchange contracts are recognized when the contract is complete.

Dividend income is recorded on the ex-dividend date. Interest and income from other investments are recorded when earned.

Net appreciation on investments represents realized gains and losses on sales of investments during the year and the change in the fair value of investments between years.

Cash and Cash Equivalent Securities

The System's cash balances are classified in three categories of credit risk: (1) insured or collateralized with securities held by the System or by its agent in the System's name,

(2) collateralized with securities held by the pledging financial institution's trust department or agent in the System's name, (3) uncollateralized, including any bank balance that is collateralized with securities held by the pledging institution or by its agent or trust department but not in the System's name. As of June 30, 2004 and 2003, the System had bank balances of $2,845,275 and $7,228,131, respectively, that meet the criteria of Category (1) held in demand deposits. The book balances, reflected in the basic financial statements, of those deposits are $2,690,902 and $7,153,389, respectively.

Furniture, Fixtures and Equipment

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

Use of Estimates

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

Income Tax Status

The System obtained its latest determination letter on April 23, 2002, in which the Internal Revenue Service stated that the System, as amended on May 11, 2001, is in compliance with the applicable requirements of the Internal Revenue Code. The System's management and Board believe that the System is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code.

Costs of Administering the System

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

3. CONTRIBUTIONS AND FUNDING STATUS

Participants of Group A and Group C are required to contribute to the System amounts set forth in the Pension Statute. For the years ended June 30, 2004 and June 30, 2003, participants of Group A and Group C contributed 4% of their qualifying gross salary.

The City's contribution rate is stated as a percentage of covered payroll and shall be not less than the greater of 10% of all participant salaries or two times the rate contributed by Group A participants. For the years ended June 30, 2004 and June 30, 2003, the City's actual percentage contribution rate was 14.7% and 10%, respectively. The City is required to contribute amounts to the System which provide funding on an actuarial reserve basis for normal cost plus the level of percentages of payroll payments required to amortize the unfunded accrued liability over 40 years from January 1, 1983.

The Annual Required Contribution (ARC) for fiscal year 2004, as determined in the July 1, 2002 actuarial valuation, was 31.8% of covered payroll. The July 1, 2002 actuarial valuation used the following significant assumptions:

Investment yield rate	8.5%
Salary increases	4.5%
Payroll growth factor	4.5%
General inflation rate	4.0%
Funding method	Entry age normal cost method
Life expectancy	1994 Group Annuity Mortality Table
DROP participation rate	100%
DROP entry date	Upon eligibility

Although the City and participants have contributed the amounts required under the Pension Statute, the actual contributions made by the City have been less than the ARC for fiscal year 2004 and 2003.

The funded ratio is a standard measure of a plan's funded status representing the ratio of the actuarial value of assets to the actuarial accrued liability. The funded ratio as of July 1, 2003 is 46.1% This ratio has decreased from 91% as of July 1, 2000, due primarily to benefit enhancements granted in 2001 and lower than anticipated investment performance during the last several years. The City is responsible for funding the deficiency, if any, between the amount available to pay the System's benefits and the amount required to pay such benefits. The System has negotiated a program with the City of Houston to improve the System's long-term funding outlook which includes changes in the benefit provisions of the System and increasing the System's assets (see note 11 for additional information on the City's funding commitment).

Historical trend information is provided as required supplementary information on page 26. This historical information is intended to demonstrate the progress the System has made in accumulating sufficient assets to pay benefits when due and the related actuarial assumptions used in determining the actuarially determined amounts.

4. DEFERRED COMPENSATION PLAN

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

5. INVESTMENTS

Portions of the System's investments are classified as security investments. A security is a transferable financial instrument that evidences ownership or creditorship. The System's security investments have been classified by risk category to indicate the level of risk assumed by the System. There are 3 categories of risk. Category 1 includes securities that are insured or registered, or securities that are held by the System or its agent in the System's name. Category 2 includes securities which are uninsured and unregistered, with securities held by the counterparty's trust department or agent in the System's name. Category 3 includes securities which are uninsured and unregistered, with securities held by the counterparty, or its trust department or agent but not in the System's name.

The fair values of the System's investments at June 30, 2004 and June 30, 2003 are presented in the tables on the following page. Investments are listed by category of credit risk. Investments not subject to credit risk classification are listed but not categorized.

The System's investment as of June 30, 2004 of $108,836,958 in BGI Alpha TILTS Fund exceeds 5% of the System's net assets as of June 30, 2004. The System's investment as of June 30, 2003 of $92,104,573 in BGI Alpha TILTS Fund exceeds 5% of the System's net assets as of June 30, 2003. All investments that exceed 5% of the System's total investments as of June 30, 2004 and 2003 are included in the amounts invested in commingled funds. Schedule 5 on page 29 lists the System's investment and professional service providers.

INVESTMENTS AS OF JUNE 30, 2004

	Category 1	Category 3	Not Categorized	Totals
U.S. government securities	$ 88,750,245			88,750,245
Corporate bonds	100,819,631			100,819,631
Capital stocks		552,420,134		552,420,134
Commingled funds			291,693,891	291,693,891
Limited partnerships, real estate trusts, and loans and mortgages			350,343,146	350,343,146
Short-term investment funds			53,977,861	53,977,861
Total investments	189,569,876	552,420,134	696,014,898	1,438,004,908
Investments made with securities lending cash collateral:				
U.S. government securities		40,505,784		40,505,784
Domestic equity		33,493,327		33,493,327
Domestic fixed income				
International equity		35,440,662		35,440,662
Total investments made with securities lending cash collateral	-	109,439,773	-	109,439,773
Total	$ 189,569,876	661,859,907	696,014,898	1,547,444,681

INVESTMENTS AS OF JUNE 30, 2003

	Category 1	Category 3	Not Categorized	Totals
U.S. government securities	$ 96,536,268			96,536,268
Corporate bonds	89,240,844			89,240,844
Capital stocks		439,387,265		439,387,265
Commingled funds			225,693,863	225,693,863
Limited partnerships, real estate trusts, and loans and mortgages			400,190,471	400,190,471
Short-term investment funds			35,531,844	35,531,844
Total investments	185,777,112	439,387,265	661,416,178	1,286,580,555
Investments made with securities lending cash collateral:				
U.S. government securities		37,027,622		37,027,622
Domestic equity		21,410,549		21,410,549
Domestic fixed income		6,039,618		6,039,618
International equity		19,822,490		19,822,490
Total investments made with securities lending cash collateral	-	84,300,279	-	84,300,279
Total	$ 185,777,112	523,687,544	661,416,178	1,370,880,834

6. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

Covered Call Options

The System writes covered call options as an investment technique to enhance portfolio returns and to reduce portfolio volatilities. When a call option is sold (written), it obligates the System to deliver stock at a set price for a specific period of time. The System receives premium income for options written, and the value of the options are recorded as a liability due to the obligation to deliver stock. The liability is recorded at the current fair value of the options written. Fair value is the amount that the System would pay to terminate the contracts at the reporting date.

If a call option expires, a gain is realized to the extent of the premium received. If a call option is exercised, the premium received is realized as a gain. A gain or loss is also realized on the underlying security to satisfy the delivery obligation. The System may repurchase a call option written at its discretion when it is favorable to do so. When a contract is repurchased, the liability is reduced and the difference between the premium received and the amount paid to close the contract is realized as a gain or loss.

Two of the System's investment managers, Oechsle International Advisors and Western Asset Management, are permitted to use investment options. However, Oechsle International Advisors is not currently active in options. Western Asset Management periodically invests in options as a means to manage their portfolio's duration.

Forward Foreign Exchange Contracts

A currency forward is a contractual agreement between two parties to pay or receive specific amounts of foreign currency at a future date in exchange for another currency at an agreed upon exchange rate. Forward commitments are not standardized and carry credit risk due to the possible nonperformance by one of the counterparties. The maximum potential loss is the aggregate face value in U.S. dollars at the time the contract was opened; however, the likelihood of such loss is remote. No such losses occurred during fiscal years 2004 and 2003. Forwards are usually traded over-the-counter. These transactions are entered into in order to hedge risks from exposure to foreign currency rate fluctuation and to facilitate trade settlement of foreign security transactions. Forwards carry market risk resulting from adverse fluctuations in foreign exchange rates. Recognition of realized gain or loss depends on whether the currency exchange rate has moved favorable or unfavorable to the contract holder upon termination of the contract. Prior to termination of the contract, the System records the unrealized currency translation gain or loss based on the applicable forward exchange rates.

Mortgage-Backed Securities

A mortgage-backed security depends on the underlying pool of mortgage loans to provide the cash flow to make principal and interest payments on the security. A decline in interest rates can result in prepayments, which reduces the fair value of the security. If homeowners pay on mortgages longer than anticipated, the cash flows are greater and the return on investment would be higher than anticipated. A collateralized mortgage obligation (CMO), is a mortgage-backed security that is comprised of classes of bonds created by prioritizing the cash flows of the underlying mortgage pool. This redistributes prepayment risk among the various bond classes in the CMO structure.

The System invests in mortgage-backed securities to enhance fixed-income returns. Mortgage-backed securities are subject to credit risk, in that the borrower may be unable to meet its obligations. These securities are also subject to prepayment risk, which is the risk that a payment may be made in excess or in advance of the regularly scheduled principal payment.

7. SECURITIES LENDING

State Statutes allow the System to participate in securities lending transactions and the Board has authorized its custodian to lend the System's securities to broker-dealers and banks pursuant to a form of loan agreement. During the years ended June 30, 2004 and 2003, the System's custodian lent, at the direction of the Board, the System's securities and received cash, securities issued or guaranteed by the United States government, and irrevocable bank letters of credit as collateral. The custodian does not have the ability to pledge or sell securities delivered for collateral, absent a borrowers default. Borrowers were required to deliver collateral for each loan equal to: (i) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; and (ii) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities.

The Board did not impose any restrictions on the amounts of the loans that the System's custodian made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions. Moreover, there were no losses during the year resulting from a default of the borrowers or the custodian.

During the years ended June 30, 2004 and 2003, the Board and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified tax-exempt plan lenders, in a collective investment pool. As of June 30, 2004 and 2003, such investment pool had an average duration of 52 and 64 days, respectively, and an average weighted maturity of 118 and 252 days, respectively. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. On June 30, 2004, the System had no credit risk exposure to borrowers. The collateral held and the fair value of securities on loan as of June 30, 2004, was $112,913,330 and $109,866,599, respectively, and $89,415,420 and $86,744,755, respectively, as of June 30, 2003.

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

	2004	2003
U.S. government securities	$ 43,329,150	41,259,341
Domestic equity	24,192,115	20,702,036
Domestic fixed income	8,577,755	5,906,065
International equity	33,767,579	18,877,313
	$ 109,866,599	86,744,755

8. FURNITURE, FIXTURES AND EQUIPMENT

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

	2004	2003
Office furniture and equipment	$ 397,426	349,911
Computer equipment	491,819	253,113
Leasehold improvements	398,232	398,232
	1,287,477	1,001,256
Less accumulated depreciation and amortization	(490,723)	(263,842)
	$ 796,754	737,414

9. COMMITMENTS

As described in note 1, certain participants of the System are eligible to receive, upon request, a refund of their accumulated Group A and/or Group C contributions, without interest, upon termination of employment with the City, or System, prior to being eligible for pension benefits. At June 30, 2004 and 2003, aggregate contributions from these eligible participants of the System were approximately $69,329,000 and $59,175,000, respectively.

The System's investments in limited partnerships are included in the tables appearing in note 5 under investments not categorized. In connection with those investments, the System has remaining commitments as of June 30, 2004 and 2003 of approximately $214,500,000 and $219,600,000, respectively, pursuant to terms of the respective limited partnerships.

The System leases office facilities and parking spaces under an operating lease expiring in 2011. Future minimum lease obligations required under such lease are as follows:

Year Ending June 30,	
2005	$ 329,700
2006	329,700
2007	455,400
2008	455,400
2009	455,400
Thereafter	910,800
	$ 2,936,400

Additional amounts are assessed for use of common areas, utilities and maintenance. Total rental expense, including these assessments, amounted to approximately $440,100 and $500,800 during the years ended June 30, 2004 and 2003, respectively.

10. RISKS AND UNCERTAINTIES

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

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

11. SUBSEQUENT EVENTS

To address the projected unfunded actuarial accrued liability of the System, an agreement was entered into between the System's Board and the City pursuant to the statutory authority under the provisions of Article 6243h, Tex. Rev. Civ. Stats. (Agreement). This Agreement is effective September 15, 2004 and provides for the following:

a. For the three year period beginning July 1, 2004, the City shall provide funding to the System as follows:

	Budgeted Contributions	Pension Obligation Bond Proceeds
Fiscal year 2005	$ 33 million	$ 33 million
Fiscal year 2006	36 million	33 million
Fiscal year 2007	39 million	33 million

b. If the System's average investment performance for fiscal years 2005 and 2006 is less than 8.25%, then the City and the System will use their best efforts to amend the funding provisions of the Agreement for fiscal year 2007 or enter into a new agreement on funding to increase the City's contributions to the System.

c. For the five year period beginning July 1, 2004, the period for amortizing the unfunded actuarial liability shall be a rolling 30-year period. Thereafter, the amortization period will be a fixed 30-year period ending June 30, 2039.

d. Effective January 1, 2005, the contribution rate for Group A and Group C participants is 5% of salary for the duration of the Agreement.

e. Pension benefit provisions are changed as follows effective January 1, 2005, unless otherwise noted:

- A change in retirement eligibility to 75 points (age plus years of service) with a minimum age requirement of 50 and a minimum 5 years of credited service. This change does not affect the retirement eligibility of participants who are at least age 62 with at least 5 years of credited service. Participants who have accumulated 68 points as of January 1, 2005, will still be able to retire with 70 points.
- A change in the accrual rates. For Group A, the accrual rate will be 2.5% for years 1-20 and 3.25% for each year over 20. For Group B, the accrual rates will be 1.75% for years 1-10, 2% for years 11-20 and 2.5% for each year over 20. The maximum accrual will remain at 90% and Group C accrual rates remain at twice the accrual rates of Group A.
- A change in guaranteed cost of living adjustments (COLA) from 4% to 3% for current employees, retirees and survivors. For employees starting after December 31, 2004, the COLA will be 2%.
- A change in interest credited to the Deferred Retirement Option Plan (DROP), tying the rate to 50% of the System's previous year market returns with a maximum of 7.5% and a minimum of 2.5%.
- A freeze in the DROP calculation of final average salary used to determine ultimate retirement benefits at the average salary level at the time of DROP entry. For participants currently in or eligible for DROP as of January 1, 2005, that date will be used for salary calculation, or DROP entry date if they elect DROP at a later date.
- Elimination of crediting participant contributions during the DROP period to the member's DROP account.
- Elimination of back DROP.
- As of September 15, 2004, conversions from Group B to Group A will require a conversion payment that is based on the actuarial equivalent.

f. The City will issue the System a $300 million recourse note, secured in part by a deed of trust on the Convention Center Hotel adjacent to the George R. Brown Convention Center (the Hotel), and a $150 million recourse unsecured note (the Notes). It is intended that the Notes will be issued on or about November 1, 2004 and will have the following terms:

- Maturity date of December 1, 2033.
- For the initial period through March 31, 2005, the Notes will bear interest at 8.5%. Thereafter, the interest rate will adjust annually effective as of April 1 of each year to be the greater of 8.5% or the sum of the U.S. Treasury bond yield on the prior March 31 for the maturity date closest to December 1, 2033 plus 3.2% less a reduction for adjustments beginning in 2015 to reflect market reductions, if any, in yield spreads to maturity for comparable instruments.
- Interest will be payable on October 1, 2005 and each October 1 thereafter. Payment of interest may be deferred provided that the aggregate balance of the deferred interest on the Notes at any time shall not exceed the sum of $150 million plus, beginning after the 2014 true-up appraisal of the Hotel, 75% of the amount by which the most recent appraised value of the Hotel exceeds $300 million.
- All deferred interest will be due no later than December 1, 2033 and will bear interest from date of deferral until time of payment at the interest rate determined for the Notes, compounded annually.

The Agreement will remain in full force and effect for a period of five years from January 1, 2005, unless earlier terminated or amended. The Agreement will continue in effect for successive one-year terms unless either the System or the City gives notice to the other party with at least 90 days notice prior to the end of the term that it desires to terminate.

SCHEDULE 1 - REQUIRED SUPPLEMENTAL INFORMATION

SCHEDULE OF FUNDING PROGRESS (UNAUDITED)
(IN MILLIONS OF DOLLARS)

Actuarial Valuation Date	(1) Actuarial Value of Assets (AVA)	(2) Actuarial Accrued Liability (AAL)	(3) Unfunded (UAAL)	(4) Funded Ratio (1):(2)	(5) Covered Payroll	(6) UAAL as a Percentage of Covered Payroll
07/01/96	$ 857.3	1,042.5	185.2	82 %	367.6	50 %
07/01/98	1,095.6	1,240.1	144.5	88 %	397.7	36 %
07/01/99	1,222.2	1,339.9	117.7	91 %	407.7	29 %
07/01/00	1,376.0	1,509.4	133.4	91 %	432.6	31 %
07/01/01	1,490.2	1,955.8	465.6	76 %	418.0	111 %
07/01/02	1,519.7	2,515.2	995.5	60 %	399.8	249 %
07/01/03	1,510.3	3,278.2	1,767.9	46 %	390.3	453%

Analysis of the dollar amounts of the actuarial value of assets, actuarial accrued liability, and unfunded actuarial accrued liability in isolation can be misleading. Expressing the actuarial value of assets as a percentage of the actuarial accrued liability provides one indication of the System's funding status on a going-concern basis. Analysis of this percentage over time indicates whether the plan is becoming financially stronger or weaker. Generally, the greater this percentage, the stronger the plan. Trends in unfunded actuarial accrued liability and covered payroll are both affected by inflation. Expressing the unfunded actuarial accrued liability as a percentage of covered payroll approximately adjusts for the effects of inflation and aids analysis of the System's progress made in accumulating sufficient assets to pay benefits when due. Generally, the smaller this percentage, the stronger the plan.

See accompanying independent auditors' report.
See accompanying note to required supplemental schedules.

SCHEDULE 2 - REQUIRED SUPPLEMENTAL INFORMATION

SCHEDULE OF EMPLOYER CONTRIBUTIONS (UNAUDITED)

Fiscal Year	Actuarial Valuation Date	Annual Required Contributions (in millions)*	Percentage Contributed
06/30/97	07/01/95	$ 34.5	100.0%
06/30/98	07/01/96	35.3	100.0%
06/30/99	07/01/96	36.0	100.0%
06/30/00	07/01/98	38.3	100.0%
06/30/01	07/01/99	41.3	100.0%
06/30/02	07/01/00	40.8	100.0%
06/30/03	07/01/02	71.9	56.5%
06/30/04	07/01/02	123.9	46.0%

* The required contributions are calculated based on actuarially determined contribution rates. Actuarial valuations generally are performed annually. The contribution rate, which is based on a given actuarial valuation and approved by the Board, becomes effective one year after the valuation date.

See accompanying independent auditors' report.
See accompanying note to required supplemental schedules.

NOTE TO REQUIRED SUPPLEMENTAL SCHEDULES 1 and 2 (UNAUDITED)

This information presented in the required supplemental information was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows:

Valuation date	July 1, 2003
Actuarial cost method	Entry age
Amortization method	Level percentage, closed
Remaining amortization period	19 years
Asset valuation method	5-year smoothed market
Actuarial assumptions:	
Investment rate of return	8.5%, net of expenses
Salary increases	Graded rates based on years of service
Payroll growth factor	3.0% per year
General inflation rate	3.0% per year
DROP participation rate	100%
DROP entry date	Most valuable entry date

See accompanying independent auditors' report.

SCHEDULE 3

INVESTMENT SUMMARY JUNE 30, 2004 and 2003

	June 30, 2004			June 30, 2003		
	Cost	Fair Value	Unrealized Appreciation (Depreciation)	Cost	Fair Value	Unrealized Appreciation (Depreciation)
Fixed income:						
U.S. government securities	$ 87,887,717	88,750,245	862,528	95,418,619	96,536,268	1,117,649
Corporate bonds	97,984,474	100,819,631	2,835,157	82,693,717	89,240,844	6,547,127
Total fixed income	185,872,191	189,569,876	3,697,685	178,112,336	185,777,112	7,664,776
Capital stocks	492,382,196	552,420,134	60,037,938	414,628,215	439,387,265	24,759,050
Commingled funds	228,930,791	291,693,891	62,763,100	196,302,866	225,693,863	29,390,997
Limited partnerships, real estate trusts and loans and mortgages	335,672,800	350,343,146	14,670,346	412,404,129	400,190,471	(12,213,658)
Short-term investment funds	53,977,861	53,977,861		35,531,844	35,531,844	
Total investments	$1,296,835,839	1,438,004,908	141,169,069	1,236,979,390	1,286,580,555	49,601,165

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

See accompanying independent auditors' report.

SCHEDULE 4

INVESTMENT SERVICES, PROFESSIONAL SERVICES, AND ADMINISTRATION EXPENSES
YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
Investment services:		
Custodial services	$ 324,969	190,402
Money management services	5,783,913	4,718,371
Consulting services	459,000	411,665
Total investment services	$ 6,567,882	5,320,438
Professional services:		
Actuarial services	201,483	117,750
Auditing and consulting services	37,058	45,703
Legal services	473,106	202,508
Total professional services	$ 711,647	365,961
Administration expenses:		
Office costs	446,489	505,034
Insurance costs	168,815	136,819
Costs of staff and benefits	2,932,346	2,719,729
Costs of equipment and supplies	836,243	733,572
Costs of education and research	116,059	203,810
Total administration expenses	$ 4,499,952	4,298,964

See accompanying independent auditors' report.

SCHEDULE 5

SUMMARY OF COSTS OF INVESTMENT AND PROFESSIONAL SERVICES
YEARS ENDED JUNE 30, 2004 AND 2003

Service Provider	Service Provided	2004	2003
Investment services:			
Axiom Int'l Investors, L.L.C.	Money management	$ 698,557	421,656
DePrince, Race and Zollo, Inc.	Money management	511,117	442,726
Oechsle International Advisors	Money management	494,319	674,951
Adams Street Partners	Money management	431,813	519,378
Neumeier Investment Counsel, L.L.C.	Money management	384,834	303,664
TT International Investment Management	Money management	368,360	335,818
Brandes Investment Partners, LLC	Money management	364,188	
Legg Mason Capital Management, Inc.	Money management	358,519	266,633
Barclays Global Investors, N.A.	Money management	347,276	288,361
Western Asset Management	Money management	320,950	116,376
Brown Capital Management	Money management	252,125	179,484
Kopp Investment Advisors	Money management	213,418	147,814
Putnam Advisory Company, Inc.	Money management	201,317	174,689
Loomis, Sayles and Company, L.P.	Money management	199,269	216,747
Golden Tree Asset Management, L.P.	Money management	193,264	
Alliance Capital Management, L.P.	Money management	137,165	147,222
L&B Realty Advisors, Inc.	Money management	99,686	93,934
MDL Capital Management	Money management	90,582	103,377
Smith Graham & Company	Money management	64,709	87,667
Global Forest Partners, L.P.	Money management	45,000	76,984
Bank of America	Money management	7,445	11,314
Taplin, Canida and Habacht	Money management		61,576
PM Realty Advisors	Money management		48,000
State Street Bank and Trust Company	Custodial services	324,969	190,402
Willshire Associates, Incorporated	Consulting services	264,000	254,000
Pension Consulting Alliance	Consulting services	195,000	157,665
Total investment services		6,567,882	5,320,438
Professional services:			
Baker and Botts, L.L.P.	Legal services	279,820	79,650
Locke, Liddell and Sapp, L.L.P.	Legal services	136,782	116,474
E. Troy Blakeney, Jr., P.C.	Legal services	26,452	
Hinton Sussman Bailey & Davidson, L.L.P.	Legal services	25,608	
Jenkins & Gilchrist	Legal services	3,824	
Lawson & Fields, P.C.	Legal services	620	6,384
Mir·Fox & Rodriguez, P.C.	Auditing services	34,380	44,098
Pension Benefits Information	Consulting services	2,678	1,605
Towers Perrin, Inc.	Actuarial services	159,295	117,750
Gabriel, Roeder, Smith & Co.	Actuarial services	42,188	
Total professional services		711,647	365,961
Total costs of investment and professional services		$ 7,279,529	5,686,399

See accompanying independent auditors' report.

INVESTMENT SECTION

The Board of Trustees (the Board) of the Houston Municipal Employees Pension System (System) has adopted a Statement of Investment Policies and Objectives (Statement) as a framework for the investment of the System's assets. The authority to amend the Statement rests solely with the Board. The Board may delegate to the Investment Committee (Committee) the authority to act on certain matters relating to the System's investments. The Committee is made up of the full Board of Trustees. The following provides an outline of the Statement.

General

The Board recognizes the following investment responsibilities: a) to establish investment policy, guidelines and objectives for the investment of System assets, b) to select independent investment managers to implement management strategies in conformity with stated investment policies and guidelines, and c) to monitor investment activities and progress toward attaining investment objectives.

Investment Policies

Strategic Asset Allocation Policy and Maintenance

The Board periodically undertakes strategic studies to address the appropriateness of asset classes to be considered for inclusion in the allocation plan, and to define the targeted percentage to each asset class to achieve the desired level of diversification. If market conditions cause one or more asset levels to move significantly outside the targeted range for that class, the Board authorizes appropriate actions to re-balance toward desired diversification levels.

Manager Structure Considerations

For major asset classes (Alternative Investments, Fixed Income, International Equities, Real Assets and U.S. Equities) the Board diversifies investments by engaging the services of professional investment portfolio managers with demonstrated skills and expertise in managing portfolios with characteristics comparable to the desired asset class. The managers retained are expected to utilize varied investment approaches that, when combined, will exhibit characteristics that are similar to the asset class proxy utilized in the strategic asset allocation plan. Cash inflows and outflows are directed, within the targeted asset class, to the various managers so that actual characteristics of the portfolio will be consistent with the strategic plan. No investment manager is permitted to have more than 15% of the fair value of the System's assets in a single investment style.

Investment Manager Guidelines and Evaluation

Investment managers are subject to guidelines and objectives incorporated in the investment management agreement entered into by the Board and the respective investment managers. Investment managers are expected to perform their fiduciary duties as prudent people skilled in such matters and, further, are expected to comply with all applicable State and Federal statutes governing the investment of retirement funds. Within the context of the guidelines, investment managers have full discretion with respect to the purchase and sale of individual securities and concentrations of similar securities. Portfolios are to be managed in a manner similar to other portfolios within an organization with similar guidelines and performance objectives.

The Board requires that all investment managers seek best execution for all trades ordered on behalf of the System. Equity managers are encouraged to direct a designated percentage of their brokerage activity to an approved list of brokers. Fixed income managers are encouraged to direct primary trading activity wherever there is an opportunity to recapture a portion of the syndication costs for the System.

Manager Evaluation

Managers of portfolios are evaluated periodically against predetermined benchmarks such as an appropriate market index or a comparable peer group. All managers are required to make formal reports to the Board of their activities and performance according to standards set forth in the Statement. In addition, System personnel and professional consultants engaged by the Board monitor, pursuant to instructions by the Board, managers' performance and conformity with their guidelines and objectives.

Performance Evaluation

The Board reviews System investment performance on a periodic basis to evaluate conformity to the goals and objectives established in the strategic plan. The Board recognizes that financial markets from time to time may not support attainment of those goals and objectives. During such times, progress toward conformity is evaluated by comparing performance to a percentage equal to the weighted average of the performances of indexes and peer groups comparable in class and weight to the styles in the System's investment portfolio.

Investment results were calculated using a time-weighted rate of return based on the market rate of return, which is not materially different from the AIMR Performance Presentation Standards.

Proxy Voting

The Board authorizes each investment manager to vote all proxies relating to shares of securities under management, and requires each Investment Manager to provide a written proxy voting policy statement. Each manager is expected to promptly vote all proxies and related actions in a manner consistent with the long-term interests of the System

Asset Class	Allocation Target	Allocation Actual*	Investment Performance 3 Yrs.	Investment Performance 5 Yrs.	Investment Performance 10 Yrs.
Domestic Equity	30.0 %	31.9 %	3.15 %	3.82 %	11.77 %
Wilshire Top 2500 Index			0.29	-1.20	11.68
International Equities	20.0	21.0	4.38	3.83	6.01
MSCI All Country Free Ex-US Index			5.25	0.96	4.40
Fixed Income	20.0	16.1	6.65	6.14	7.25
Lehman Aggregate Index			6.36	6.95	7.39
Merrill Lynch High Yield Master II Index			8.76	4.73	7.47
Real Assets	15.0	16.5	8.89	12.30	n/a
NCREIF Index			7.97	9.41	10.36
Alternative Investments	15.0	13.8	-3.77	5.86	n/a
S&P 500 Index			-0.70	-2.20	11.83
Cash	0.0	0.7			
Total Portfolio	100.0	100.0	4.55	6.15	9.46
Policy Benchmark			4.27	2.76	n/a

* Actual amounts represent net asset values including cash and cash equivalents.

and its participants and beneficiaries. Each investment manager is required to keep detailed records of all voting of proxies and related actions and to comply with all related regulatory obligations. The System's management staff periodically review each investment manager's policies and actions in respect to proxy voting.

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. The Chief Investment Officer, Neal Wallach, has provided a summary in the above table of the portfolio's actual allocation compared to the targeted allocation.

To facilitate execution of the strategic investment plan, the System 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 the System in matters pertaining to perceived market conditions and prognosis, portfolio manager selection, and performance measurement and evaluation.

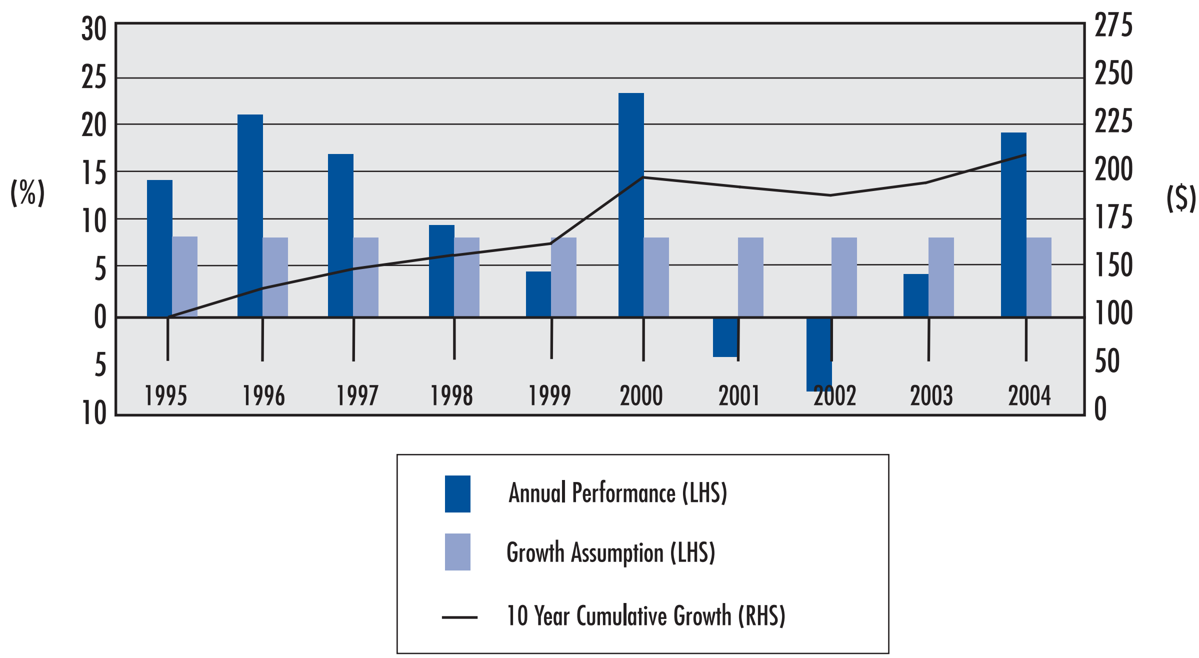
The schedules in this section of this CAFR display information that pertains to the System's investing activities.

The Investment Section was written by HMEPS's Chief Investment Officer, Neal Wallach; Investment Manager, Douglas Wynkoop; and Financial Analyst, Greg Brunt.

SCHEDULE OF TOP INVESTMENTS ($000) AS OF JUNE 30, 2004

Name of Investment	Fair Value of Investment	Percent of Portfolio
Barclays Alpha Tilts (Enhanced S&P 500 Index)	$ 108,836,958	7.7 %
PIMCO Stocks Plus (Enhanced S&P 500 Index)	69,523,126	4.9
Barclays US Equity Index (S&P 500 Index)	42,849,067	3.0
State Street Research Energy and Natural Resources Fund	39,467,718	2.8
Barclays US Bond Index (Lehman Aggregate Index)	32,951,502	2.3

PERFORMANCE BY FISCAL YEAR LAST TEN YEARS



COMPARISON OF INVESTMENT RETURNS - YEARS ENDED JUNE 30

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

Period ending 06-30	HMEPS Total Fund	Median of Wilshire Public Fund Universe	HMEPS Domestic Equity	Wilshire Target Top 2500 Index	S&P 500 Index	HMEPS Int'l Equity	MSCI ACW Free ex US Index	MSCI EAFE Index	HMEPS Fixed Income	Lehman Aggregate Index	HMEPS Real Assets	NCREIF Index	HMEPS Alternative Investments	S&P 500 Index
1995	14.50%	16.37%	25.59%	25.03%	26.07%	3.87%	n/a	1.66%	12.78%	12.55%	n/a	7.80%	n/a	26.07%
1996	21.27%	16.83%	33.18%	26.03%	25.99%	17.10%	n/a	13.28%	8.13%	5.01%	n/a	8.07%	n/a	25.99%
1997	16.91%	20.34%	17.22%	30.10%	34.70%	18.39%	n/a	12.84%	12.31%	8.16%	5.85%	10.81%	n/a	34.70%
1998	9.16%	18.41%	19.28%	30.07%	30.18%	4.22%	n/a	6.09%	8.58%	10.54%	3.19%	17.43%	n/a	30.18%
1999	3.42%	12.05%	7.87%	20.23%	22.74%	1.60%	n/a	7.59%	0.52%	3.13%	6.18%	12.80%	-9.95%	22.74%
2000	22.92%	9.81%	12.14%	9.74%	7.27%	44.02%	n/a	17.18%	8.54%	4.56%	9.73%	11.62%	77.46%	7.27%
2001	-4.08%	-4.95%	-2.00%	-14.94%	-14.82%	-26.31%	n/a	-23.61%	2.30%	11.23%	26.08%	11.57%	-15.95%	-14.82%
2002	-6.97%	-5.85%	-12.78%	-17.20%	-17.98%	-12.10%	-8.47%	-9.49%	2.34%	8.63%	5.24%	5.51%	-18.58%	-17.98%
2003	3.55%	4.14%	3.18%	1.02%	0.25%	-3.76%	-4.60%	-6.45%	13.99%	10.40%	5.84%	7.64%	-3.40%	0.25%
2004	18.64%	16.75%	21.95%	20.62%	19.10%	34.44%	32.04%	32.35%	3.99%	0.33%	15.92%	10.83%	13.32%	19.10%
3 Yrs.	4.55%	4.53%	3.15%	0.29%	-0.70%	4.38%	4.86%	3.87%	6.65%	6.36%	8.89%	7.79%	-3.77%	-0.70%
5 Yrs.	6.15%	3.58%	3.82%	-1.19%	-2.20%	3.83%	n/a	0.06%	6.14%	6.95%	12.30%	9.41%	5.86%	-2.20%
10 Yrs.	9.46%	9.97%	11.53%	11.68%	11.83%	6.01%	n/a	4.05%	7.25%	7.39%	n/a	10.36	n/a	11.83%

SCHEDULE OF FEES AND COMMISSIONS PAID IN FISCAL YEAR 2004

	Commissions	Shares	cents/share
Lehman Bros	$ 262,401	51,510,322	0.5
Merrill Lynch	158,193	13,365,336	1.2
UBS Warburg (SBC Warburg/Warburg Dillon)	149,952	11,975,361	1.3
Cantor Fitzgerald	121,450	5,141,761	2.4
Citigroup/Salomon Bros	107,188	14,367,126	0.7
CSFB	106,077	8,483,452	1.3
Donaldson & Co	104,755	1,746,409	6.0
Goldman Sachs	93,920	10,074,942	0.9
Deustche Bank	80,837	4,385,372	1.8
JP Morgan	80,658	12,946,739	0.6
Morgan Stanley	53,370	2,720,173	2.0
CAPIS	52,035	1,239,581	4.2
Charles Schwab	40,978	979,800	4.2
Dresdner-Kleinwort-Benson-EMM-Wasserstein	39,493	2,533,393	1.6
Bear Stearns	36,913	2,574,967	1.4
Nomura	36,866	7,565,998	0.5
Lynch Jones Ryan	32,682	747,432	4.4
ABN Amro	29,850	1,555,937	1.9
Credit Lyonnais	27,720	2,820,973	1.0
Thomason	25,403	508,050	5.0
Harris Nesbitt Gerard	21,449	539,060	4.0
Mizuho	21,309	697,504	3.1
Julius Baer	20,792	255,941	8.1
KBC	20,130	623,036	3.2
HSBC (James Capel)	19,925	3,122,313	0.6
Instinet	19,071	683,452	2.8
Banque Nationale de Paris	16,090	1,930,495	0.8
Daiwa	15,572	501,362	3.1
Auerbach Grayson	14,879	377,795	3.9
ING Baring	14,789	1,181,562	1.3
Carnegie	13,573	1,078,968	1.3
Pershing	12,607	1,967,465	0.6
Jones and Associates	11,914	274,150	4.3
Hyundai	11,356	35,420	32.1
ABG Securities	10,979	424,176	2.6
Prudential Equity Group	10,885	208,170	5.2
Credit Agricole Indosuez Cheuvreux	10,058	321,282	3.1
Abel Noser	9,558	197,150	4.8
Gerson Lehrman	9,528	184,526	5.2
Macquarie Equities	8,913	444,083	2.0
Lombard Odier	8,769	80,107	10.9
Brockhouse Cooper	8,598	123,127	7.0
Commerzbank	8,389	294,906	2.8
Cazenove	8,031	461,416	1.7
Handelsbanken	7,729	359,903	2.1
LG Secs	7,465	191,130	3.9
Investec Henderson Crossthwaite	7,083	627,414	1.1
Daewoo	6,979	172,760	4.0
Fox Pitt Kelton	6,535	114,453	5.7

	Commissions	Shares	cents/share
State Street Brokerage	6,405	174,550	3.7
Jefferies Company	6,272	172,652	3.6
SG Cowen	6,146	420,961	1.5
Kempen	5,755	691,000	0.8
Samsung	5,618	66,130	8.5
ESN	4,515	67,700	6.7
IBJ	4,498	41,073	11.0
Bank America Montgomery	4,385	84,900	5.2
Legg Mason Wood Walker	4,161	81,600	5.1
Scotia	4,003	145,700	2.7
Griffiths McBurney	3,994	284,300	1.4
Pictet and Cic	3,854	32,778	11.8
Mainfirst	3,783	40,883	9.3
Ssangyong	3,591	24,300	14.8
Standard and Poor's	3,569	66,000	5.4
Pereire Tod Ltd	3,029	138,146	2.2
Collins Stewart	2,967	443,916	0.7
Euromobiliare	2,870	279,300	1.0
Sanford Bernstein	2,839	325,236	0.9
GK Goh	2,780	514,571	0.5
JB Were	2,724	264,705	1.0
William Blair	2,459	54,800	4.5
Baird, Robert W & Co	2,359	50,500	4.7
B Riley	2,345	46,900	5.0
Good Morning	2,315	77,100	3.0
RTX Securities	2,250	75,000	3.0
CIBC Wood Gundy	2,232	6,200	36.0
Moors & Cabot	2,180	43,600	5.0
Keefe Bruyette Woods	2,080	36,200	5.7
Others	53,880	3,125,211	1.7
TOTAL	$ 2,163,55	182,592,162	1.2

ACTUARIAL SECTION

Gabriel, Roeder, Smith & Company

June 15, 2004

Board of Trustees
Houston Municipal Employees Pension System

Dear Members of the Board:

Subject: Actuarial Valuation as of July 1, 2003

This report describes the current actuarial condition of the Houston Municipal Employees Pension System (HMEPS), determines the calculated employer contribution rate, and analyzes changes in this contribution rate. Valuations are prepared annually, as of July 1, the first day of the HMEPS plan year.

Under HMEPS statutes, the Board of Trustees certifies the employer contribution rate. This rate is determined actuarially, based on the Board's funding policy and the System's statutes. The contribution rate determined by a given actuarial valuation and certified by the Board becomes effective twelve months after the valuation date. I.e., the rates determined by this July 1, 2003 actuarial valuation would normally be used by the Board when certifying the employer contribution rate for the year beginning July 1, 2004 and ending June 30, 2005.

Financing Objectives and Funding Policy

The amortization period is set by statute. The contribution rate and liabilities are computed using the Entry Age actuarial cost method. The employer contribution rate is the sum of two pieces: the employer normal cost rate and the amortization rate. The normal cost rate is determined as a percent of pay. The employer normal cost is the difference between this and the weighted member contribution rate. The amortization rate is determined as a level percent of pay. It is the amount required to amortize the unfunded actuarial accrued liability over a closed period (40 years as of January 1, 1983). The amortization rate is not adjusted for the one-year deferral in contribution rates.

Progress Toward Realization of Financing Objectives

The funded ratio (the ratio of the actuarial value of assets to the actuarial accrued liability) is a standard measure of a plan's funded status. In the absence of benefit improvements, it should increase over time, until it reaches 100%. The funded ratio as of July 1, 2003 is 46.1%. It should be noted that the funded ratio has decreased over the last three years, from 91% as of July 1, 2000. The major causes of this decrease were the benefit enhancements granted in 2001 and the substantial asset losses that have occurred over the last several years.

The calculated employer contribution rate has also increased over the last three years. The employer contribution rate calculated as of July 1, 2003 is 52.89%, up from 9.5% as of July 1, 2000.

Benefit Provisions

The benefit provisions reflected in this valuation are those which were in effect on July 1, 2003. There were no material changes adopted since the previous actuarial valuation. The benefit provisions are summarized in Appendix B.

Assumptions and Methods

Actuarial assumptions and methods are set by the Board of Trustees, based upon recommendations made by the plan's actuary. The assumptions used in this valuation have been modified since the previous valuation. The assumptions used in the valuation were based in part on our review of an Experience Analysis performed by Towers Perrin. These assumptions and methods are in full compliance with all parameters established by GASB Statement No. 25.

Changes in the assumptions include:

- increasing retirement decrement rates
- lowering expected salary increases and payroll growth
- assuming 80% of current Group B members transfer to Group A on the valuation date
- assume all Group A members (including future transfers from Group B) with Group B service will convert that service to Group A service and that the applicable transfer price will be paid

- interest credited to DROP accounts will be 9%, up from 8.5% to reflect the minimum crediting rate equal to the valuation expected return on assets
- lowering expected inflation from 4.0% per year to 3.0% per year
- increasing the real rate of return assumption from 4.5% to 5.5%

All assumptions and methods are described in Appendix A.

The information contained in Supplemental Information Schedule 1 and the Notes to Required Supplemental Schedules 1 and 2 contained in the financial section of the Comprehensive Annual Financial Report was prepared by Gabriel, Roeder, Smith & Company. The information contained in Supplemental Information Schedules 2 through 5 was prepared by HMEPS staff.

Data

Member data for retired, active and inactive members was supplied as of July 1, 2003 by the HMEPS staff. We did not audit this data, but we did apply a number of tests to the data, and we concluded that it was reasonable and consistent with the prior year's data. Asset information as of July 1, 2003 was taken from the Comprehensive Annual Financial Report for the Year Ended June 30, 2003.

Certification

We certify that the information presented herein is accurate and fairly portrays the actuarial position of HMEPS as of July 1, 2003.

All of our work conforms with generally accepted actuarial principles and practices, and with the Actuarial Standards of Practice issued by the Actuarial Standards Board. In our opinion, our calculations also comply with the requirements of state law and, where applicable, the Internal Revenue Code, ERISA, and the Statements of the Governmental Accounting Standards Board. The undersigned are independent actuaries and consultants. Mr. Carter and Mr. Newton are Enrolled Actuaries. Mr. Carter is also Member of the American Academy of Actuaries, and all three are experienced in performing valuations for large public retirement systems.

Sincerely,

Gabriel, Roeder, Smith & Company

Joe Newton

Joe Newton, ASA, EA
Consultant

Lewis Ward

Lewis Ward
Consultant

W Michael Carter

W. Michael Carter, FSA, EA, MAAA
Senior Consultant

EXECUTIVE SUMMARY

Item	July 1, 2003	July 1, 2002
Membership		
• Number of:		
- Active members	12,120	12,527
- Retirees and beneficiaries	6,215	5,928
- Inactive members	2,950	1,136
- Total	21,285	19,591
• Annualized Payroll supplied by HMEPS	$ 390,314	$ 399,794
Calculated Contribution rates		
• Member (weighted)*	3.68%	
• Employer	52.89%	31.80%
Assets		
• Market value	$ 1,266,190	$ 1,271,691
• Actuarial value	1,510,264	1,519,717
• Return on market value	2.3%	(8.0%)
• Return on actuarial value	1.7%	3.6%
• Employer contribution	$ 40,622	$ 40,758
• Ratio of actuarial value to market value	119.3%	119.5%
Actuarial Information		
• Employer normal cost %	16.48%	12.30%
• Unamortized actuarial accrued liability (UAAL)	$ 1,767,987	$ 995,472
• Amortization rate	36.41%	19.50%
• Funding period	19.5 years	20.5 years
• GASB funded ratio	46.1%	60.4%
Projected employer contribution based on calculated rate		
• Fiscal year ending June 30,	2005	2004
• Projected payroll (millions)	$ 403.5	$ 375.0
• Projected employer contribution (millions)	$ 213.4	$ 119.3

Note: Dollar amounts in $000, unless otherwise noted
* Employee contribution rate for contributing members is 4%

STATEMENT OF PLAN NET ASSETS

	July 1, 2003
A. ASSETS	(1)
1. Current Assets	
a. Cash and short term investments	
1) Cash on hand	$7,153
2) Short term investments	35,532
b. Accounts Receivable	
1) Sale of investments	6,290
2) Other	21,458
c. Total Current Assets	$ 70,433
2. Long Term Investments	
a. US. Government securities	$ 96,536
b. Corporate bonds	89,241
c. Capital stocks	439,387
d. Commingled Funds	225,694
e. LP's, real estate mortgages	400,190
f. Total long term investments	$ 1,251,048
3. Other Assets	
a.Collateral on securities lending	$ 84,300
b.Furniture, fixtures and equipment, net	737
c.Total other assets	$ 85,037
4. Total Assets	$ 1,406,518
B. LIABILITIES	
1. Current Liabilities	
a. Amounts due on asset purchases	$ 53,716
b. Accrued liabilities	2,312
c.Collateral on securities lending	84,300
2. Total Liabilities	140,328
3. Net Assets Held in Trust	$ 1,266,190
C. ASSET ALLOCATION FOR CASH & LONG TERM INVESTMENTS	
1. Cash	5.3 %
2. Fixed Income	14.1 %
3. Limited Partnerships, RET's, Loans, and Mortgages	30.3 %
4. Equities	33.2 %
5. Commingled Funds	17.1 %
6. Total	100.0 %

RECONCILIATION OF PLAN NET ASSETS

	July 1, 2003
	(1)
1. Market value of assets at beginning of year	$ 1,271,691
2. Revenue for the year	
a. Contributions	
i. Member contributions	$ 23,762
ii. Employer contributions	40,622
iii. Total	$ 64,384
b. Net investment income	
i. Interest	$6,868
ii. Dividends	7,335
iii. Earnings from LP's and real estate trusts	7,690
iv. Net appreciation (depreciation) on investments	16,981
v. Net proceeds from lending securities	376
vi. Less investment expenses	(5,320)
vii. Other	114
c. Total revenue	$ 98,428
3. Expenditures for the year	
a. Refunds	$ 475
b. Benefit payments	98,789
c. Administrative and miscellaneous expenses	4,665
d. Total expenditures	$ 103,929
4. Increase in net assets (Item 2d - Item 3d)	$ (5,501)
5. Market value of assets at end of year (Item 1 + Item 4)	$ 1,266,190

Note: Amounts in $000

CALCULATION OF EXCESS INVESTMENT INCOME

Item	Year Ending June 30, 2003
(1)	(2)
1. Market value of assets at beginning of year	$ 1,271,691
2. Net external cash flow during the year	(34,880)
3. Market value of assets at end of year	1,266,190
4. Actual investment income during the year based on market value: (3) - (2) - (1)	$ 29,379
5. Assumed earnings rate	8.50%
6. Expected earnings for the year	
a. Market value of assets at beginning of year: (5) x (1)	108,094
b. Net external cash flow: (5) x .5 x (2)	(1,452)
c. Total: (a) + (b)	106,642
7. Excess investment income for the year: (4) - (6)	$ (77,263)

Note: Dollar amounts in $000

DEVELOPMENT OF ACTUARIAL VALUE OF ASSETS

	July 1, 2003
	(1)
1. Excess (Shortfall) of invested income for current and previous three years	
a. Current year	$ (77,263)
b. Current year - 1	(230,096)
c. Current year - 2	(193,278)
d. Current year - 3	165,524
e. Total for four years	$ (335,112)
2. Deferral of excess (shortfall) of invested income	
a. Current year (80%)	(61,810)
b. Current year - 1 (60%)	(138,058)
c. Current year - 2 (40%)	(77,311)
d. Current year - 3 (20%)	33,105
e. Total deferred for year	$ (244,074)
3. Market value of assets at end of year	$ 1,266,190
4. Actuarial value of assets at end of year: (3) - (2e)	$ 1,510,264

Note: Amounts in $000.

ACTUARIAL PRESENT VALUE OF FUTURE BENEFITS

	July 1, 2003
	(1)
1. Active members	
a. Retirement benefits	$ 2,558,942
b. Deferred termination benefits	126,488
c. Refunds	18,602
d. Death benefits	73,624
e. Disability benefits	20,055
f. Total	$ 2,797,711
2. Members in Pay Status	
a. Service retirements	$902,202
b. Disability retirements	40,402
c. Beneficiaries	94,153
d. Total	$ 1,036,757
4. Inactive members	
a. Vested terminations 1	$ 78,131
b. Nonvested terminations	913
c. Total	$ 79,044
5. Total actuarial present value of future benefits	$ 3,913,512

Note: Amounts in $000

[1] 1,109 pre-1995 deferred vested members added who were not in July 1, 2002 data

CALCULATION OF TOTAL ACTUARIAL GAIN OR LOSS

1.	Unfunded actuarial accrued liability (UAAL) as of July 1, 2002	$ 995,472
2.	Additions due to Assumption/Methodology Changes	
	a. 80% of Group B transfer at Valuation Date	$ 160,920
	b. All current and future Group A members with Group B service are assumed to convert all service	215,904
	c. All other assumption and methodology changes	73,636
3.	Revised UAAL as of July 1, 2002 (1+2)	$ 1,445,932
4.	Total normal cost for year	78,014
5.	Contributions during year ending June 30, 2003	(64,384)
6.	Interest on UAAL for one year	122,904
7.	Interest on Item 4 and Item 5 for one-half year	567
8.	Expected UAAL as of July 1, 2003 (3+4+5+6+7)	$ 1,583,034
9.	Actual UAAL as of July 1, 2003	$ 1,767,987
10.	Actuarial gain/(loss) for the period (8 – 9)	$ (184,953)
	<u>SOURCE OF GAINS/(LOSSES)</u>	
11.	Asset gain/(loss) (See Table 11)	$ (102,297)
12.	Total liability gain/(loss) for the period (10-11)	$ (82,656)
	<u>Projected UAAL to July 1, 2004 assuming 14.7% Employer Contribution Rate*</u>	
13.	Expected UAAL with no Losses/(Gains)	$ 1,925,757
14.	Recognition of Deferred Asset Losses/(Gains)	$87,685
15.	Projected UAAL at July 1, 2004	$ 2,013,442

* Assumes fund earns 8.5% for FY2004

NEAR TERM OUTLOOK

Valuation as of July 1, (1)	Projected Covered Compensation for Next Year (2)	Unfunded Actuarial Accrued Liability (UAAL, in 000s) (3)	Funded Ratio (4)	Calculated Contribution Rate (5)	Funding Period (Years) (6)	Funded Ratio Using MVA (7)	Employer Contributions (8)	Employee Contributions (9)	Benefit Payments and Refunds (10)
2003	$403,548	$1,767,987	46.1%	52.9%	19.5	38.6%	$59,322	$14,859	$170,742
2004	415,654	2,013,442	41.9%	57.6%	18.5	36.8%	219,872	15,406	141,595
2005	428,124	2,142,664	42.1%	60.4%	17.5	40.0%	246,720	15,964	160,640
2006	440,967	2,209,759	43.9%	62.2%	16.5	43.5%	266,500	16,541	184,738
2007	454,196	2,212,697	47.0%	62.8%	15.5	47.0%	282,360	17,140	205,558
2008	467,822	2,184,558	50.4%	62.9%	14.5	50.4%	293,722	17,756	229,729
2009	481,857	2,144,200	53.8%	63.0%	13.5	53.8%	303,272	18,389	252,418
2010	496,313	2,092,530	57.1%	63.1%	12.5	57.1%	312,837	19,038	277,385
2011	511,202	2,028,648	60.3%	63.1%	11.5	60.3%	322,561	19,703	305,809
2012	526,538	1,951,445	63.4%	63.1%	10.5	63.4%	332,408	20,385	327,451
2013	542,334	1,859,765	66.5%	63.1%	9.5	66.5%	342,381	21,081	354,193

* These projections are based on the benefit provisions in effect for the July 1, 2003 actuarial valuation with no expected changes to future accruals. Also, the calculated rates shown above are assumed to be paid beginning the year after the valuation. Any changes to future accruals or failure to contribute the calculated rate will change the results of this projection.

MVA represents the Market Value of Assets

CHANGE IN CALCULATED CONTRIBUTION RATE SINCE THE PRIOR VALUATION

1. Calculated Contribution Rate as of July 1, 2002		31.80%
2. Revisions to 2002 Rate before Transfer Assumptions		
a. Change in Normal Cost	4.08%	
b. Change in UAAL Amortization	1.82%	
c. Total Change due to Assumptions and Methods		5.90%
3. Transfer Assumption Changes		
a. 80% of Group B members transfer	2.62%	
b. All convertable service converted	4.90%	
c. Total Change due to Transfer Assumptions		7.52%
4. Revised July 1, 2002 Calculated Rate		45.22%
5. Change in Contribution Rate During Year		
a. Change in Normal Cost	0.12%	
b. Recognition of prior asset losses (gains)	1.65%	
c. Actuarial (gain) loss from current year asset performance	0.37%	
d. Actuarial (gain) loss from liability sources	1.65%	
e. Impact of City contributing less than actual cost of plan	2.71%	
f. Effect of Payroll not growing at Payroll Growth Rate	1.17%	
g. Total Change		7.67%
6. Calculated Rate as of July 1, 2003		52.89%
7. Projected Rate for July 1, 2004 Valuation*		
a. Recognition of prior asset losses (gains)	1.79%	
b. Impact of City contributing less than actual cost of plan	2.95%	
		4.74%
8. Projected Calculated Rate as of July 1, 2004		57.63%

* Assumes fund earns 8.5% for FY2004

CALCULATION OF ANNUAL REQUIRED CONTRIBUTION RATE

	July 1, 2003 (1)	July 1, 2002 (2)
1. Covered payroll	$390,314	$399,794
2. Covered payroll adjusted for one-year's pay increase	$403,548	$365,000
3. Present value of future pay	$2,637,853	N/A
4. Normal cost rate		
a. Total normal cost rate	20.16%	N/A
b. Less: member contribution rate (weighted)	(3.68%)	N/A
c. Employer normal cost rate	16.48%	12.30%
5. Actuarial accrued liability for active members		
a. Present value of future benefits for active members	$2,797,711	$2,069,709
b. Less: present value of future normal costs	(635,261)	(448,088)
c. Service Purchase Receivable [1]	(114,406)	N/A
d. Actuarial accrued liability	$2,162,450	$1,621,621
6. Total actuarial accrued liability for:		
a. Retirees and beneficiaries	$1,036,757	$860,589
b. Inactive members	79,044	32,979
c. Active members (Item 5d)	2,162,450	1,621,621
d. Total	$3,278,251	$2,515,189
7. Actuarial value of assets	$1,510,264	$1,519,717
8. Unfunded actuarial accrued liability (UAAL) (Item 6d - Item 7)	$1,767,987	$995,472
9. Funding period	19.5 years	20.5 years
10. Assumed payroll growth rate	3.00%	4.50%
11. Employer Contribution requirement		
a. UAAL amortization payment as % of pay	36.41%	19.50%
b. Employer normal cost	16.48%	12.30%
c. Contribution requirement (a + b)	52.89%	31.80%

[1] Sum of (i) actual current receivable for actives who have entered an agreement and assumed price for converting B service to A service for (ii) 80% of current group B actives and (iii) all Group A members with convertible B service

HISTORICAL SOLVENCY TEST

	Aggregated Accrued Liabilities for					by Reported Assets	
Valuation Date	Active Members Contributions	Beneficiaries and Vested Terminations*	Retirees Members (City Financed Portion)	Actuarial Value of Assets	(5)/(2)	[(5)-(2)]/(3)	[(5)-(2)-(3)]/(4)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
July 1, 1991	32,606	289,174	366,542	558,144	100.0 %	100.0%	64%
July 1, 1992	32,850	317,849	414,600	608,524	100.0 %	100.0%	62%
July 1, 1993	32,866	369,561	437,894	606,637	100.0%	100.0%	47%
July 1, 1994	32,410	384,100	470,189	713,696	100.0%	100.0%	63%
July 1, 1995	31,130	420,830	511,752	770,189	100.0%	100.0%	62%
July 1, 1996	45,819	438,486	558,154	857,332	100.0%	100.0%	67%
July 1, 1998	34,781	502,335	703,025	1,095,617	100.0%	100.0%	79%
July 1, 1999	33,985	599,270	706,678	1,222,240	100.0%	100.0%	83%
July 1, 2000	38,292	646,611	824,470	1,376,020	100.0%	100.0%	84%
July 1, 2001	36,449	804,901	1,114,456	1,490,179	100.0%	100.0%	58%
July 1, 2002	35,888	893,568	1,585,733	1,519,717	100.0%	100.0%	37%
July 1, 2003	44,388	1,115,801	2,118,063	1,510,264	100.0%	100.0%	17%

* Column (3) included AAL for DROP participants until 2003, now in Column (4)

SCHEDULE OF FUNDING PROGRESS

Date	Actuarial Value of Assets (AVA)	Actuarial Accrued Liability (AAL)	Unfunded Actuarial Accrued Liability (UAAL) (3) - (2)	Funded Ratio (2)/(3)	Annual Payroll	UAAL as % of Payroll (4)/(6)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
July 1, 1992	$608,524	765,299	$156,775	79.5%	$314,686	49.8%
July 1, 1993	660,637	840,321	179,684	78.6%	340,249	52.8%
July 1, 1994	713,696	886,699	173,003	80.5%	366,561	47.2%
July 1, 1995	770,189	963,712	193,523	79.9%	378,511	51.1%
July 1, 1996	857,332	1,042,459	185,127	82.2%	367,610	50.4%
July 1, 1998	1,095,617	1,240,141	144,524	88.3%	397,698	36.3%
July 1, 1999	1,222,240	1,339,933	117,693	91.2%	407,733	28.9%
July 1, 2000	1,376,020	1,509,373	133,353	91.2%	432,604	30.8%
July 1, 2001	1,490,179	1,955,806	465,627	76.2%	418,234	111.3%
July 1, 2002	1,519,717	2,515,189	995,472	60.4%	399,794	249.0%
July 1, 2003	1,510,264	3,278,251	1,767,987	46.1%	390,314	453.0%

Note: Dollar amount in 000

HISTORICAL CITY CONTRIBUTIONS

Valuation Date	Calculated Contribution Rate*	Time Period for Contribution	Actual Contribution Rate
(1)	(2)	(3)	(4)
July 1, 1987	5.83 %	January 1, 1988 through December 31, 1988	5.15 %
July 1, 1988	6.27	January 1, 1989 through December 31, 1989	5.15
July 1, 1989	6.88	January 1, 1990 through December 31, 1990	6.27
July 1, 1990	6.23	January 1, 1991 through December 31, 1991	6.27
July 1, 1991	8.77	January 1, 1992 through June 30, 1993	6.27
July 1, 1992	9.11	July 1, 1993 through June 30, 1994	9.11
July 1, 1993	9.30	July 1, 1994 through June 30, 1995	9.30
July 1, 1994	8.80	July 1, 1995 through June 30, 1996	8.80
July 1, 1995	9.20	July 1, 1996 through June 30, 1997	9.20
July 1, 1996	9.10	July 1, 1997 through June 30, 1998	9.10
		July 1, 1998 through June 30, 1999	9.10
July 1, 1998	9.30	July 1, 1999 through June 30, 2000	9.30
July 1, 1999	9.80	July 1, 2000 through June 30, 2001	10.00
July 1, 2000	9.50	July 1, 2001 through June 30, 2002	10.00
July 1, 2001	17.70	July 1, 2002 through June 30, 2003	10.00
July 1, 2002	31.80	July 1, 2003 through June 30, 2004	14.70
July 1, 2003	52.89	July 1, 2004 through June 30, 2005	N/A

* Rate determined by the actuarial valuation is for the fiscal year beginning on the July 1st next following the valuation date.

DISTRIBUTION OF ACTIVE MEMBERS BY AGE AND BY YEARS OF SERVICE CONTRIBUTORY PLAN

Attained Age	0 No. & Avg. Comp.	1 No. & Avg. Comp.	2 No. & Avg. Comp.	3 No. & Avg. Comp.	4 No. & Avg. Comp.	5-9 No. & Avg. Comp.	10-14 No. & Avg. Comp.	15-19 No. & Avg. Comp.	20-24 No. & Avg. Comp.	25-29 No. & Avg. Comp.	30-34 No. & Avg. Comp.	35 & Over No. & Avg. Comp.	Total No. & Avg. Comp.
Under 25	102	69	58	19	4	1							253
	$17,635	$20,589	$19,657	$21,098	$25,012	$25,694							$19,313
25-29	135	91	104	62	16	27							435
	$21,184	$24,560	$26,144	$24,386	$24,602	$24,922							$23,890
30-34	120	99	112	80	39	131	42	1					624
	$22,462	$27,174	$25,541	$27,346	$29,239	$29,701	$27,956	$34,215					$26,720
35-39	84	85	113	69	32	168	136	46	2				735
	$23,439	$30,845	$26,535	$29,097	$29,276	$32,776	$34,858	$32,549	$28,000				$30,386
40-44	104	95	102	84	45	227	223	146	216	4			1,246
	$25,690	$28,312	$25,440	$30,357	$28,742	$34,466	$35,302	$36,002	$33,511	$27,407			$32,183
45-49	75	52	110	73	37	194	235	147	352	116	3		1,394
	$27,839	$26,568	$26,579	$31,014	$32,733	$34,534	$39,965	$37,338	$36,227	$38,031	$52,519		$34,985
50-54	63	45	62	52	30	212	202	149	268	150	48		1,281
	$25,318	$30,013	$27,974	$32,693	$38,888	$37,470	$40,892	$41,322	$35,584	$41,310	$41,856		$37,197
55-59	46	26	50	45	34	173	155	145	168	80	44	15	981
	$27,925	$32,737	$27,764	$33,701	$44,301	$37,539	$40,503	$42,935	$40,380	$46,491	$43,144	$42,135	$39,325
60-64	19	19	23	22	16	97	66	62	69	24	23	10	450
	$33,647	$32,172	$33,206	$30,732	$40,409	$35,261	$40,747	$43,140	$40,483	$46,020	$40,346	$45,395	$38,669
65 & Over	4	6	5	5	6	39	47	15	18	15	9	8	177
	$21,790	$24,261	$39,856	$29,919	$37,976	$36,872	$41,757	$48,936	$38,867	$46,403	$41,629	$44,073	$39,927
Total	752	587	739	511	259	1,269	1,106	711	1,093	389	127	33	7,576
	$23,522	$27,253	$26,147	$29,285	$33,292	$34,606	$38,308	$39,476	$36,468	$41,742	$42,265	$43,592	$33,507

Average: Age: 45.53, Service: 10.96

Number of participants: Fully vested: 4,728, Not Vested: 2,848; Males: 4,218, Females: 3,358

DISTRIBUTION OF ACTIVE MEMBERS BY AGE AND BY YEARS OF SERVICE NONCONTRIBUTORY PLAN

Attained Age	0 No. & Avg. Comp.	1 No. & Avg. Comp.	2 No. & Avg. Comp.	3 No. & Avg. Comp.	4 No. & Avg. Comp.	5-9 No. & Avg. Comp.	10-14 No. & Avg. Comp.	15-19 No. & Avg. Comp.	20-24 No. & Avg. Comp.	25-29 No. & Avg. Comp.	30-34 No. & Avg. Comp.	35 & Over No. & Avg. Comp.	Total No. & Avg. Comp.
Under 25				8	11	5							24
				$25,115	$21,540	$21,272							$22,676
25-29				20	49	106	1						176
				$24,435	$21,931	$23,959	$23,839						$23,448
30-34				22	77	289	103						491
				$28,107	$25,328	$26,722	$27,017						$26,627
35-39			1	11	62	314	302	59					749
			$35,789	$24,656	$24,471	$28,297	$28,924	$28,222					$28,184
40-44				10	53	256	274	131	105	1			830
				$33,499	$26,094	$28,085	$30,705	$29,885	$29,128	$25,211			$29,300
45-49			1	13	46	268	259	132	122	28			869
			$35,789	$23,745	$30,493	$30,287	$31,377	$35,945	$32,173	$36,192			$31,845
50-54				6	34	212	194	104	75	34	7		666
				$23,478	$31,260	$30,893	$31,819	$34,730	$30,404	$35,636	$32,846		$31,921
55-59				5	17	124	142	76	59	17	5	1	446
				$25,552	$33,016	$33,494	$31,123	$35,090	$35,869	$42,538	$26,779	$22,266	$33,462
60-64				4	3	61	75	34	29	6	1		213
				$28,022	$20,710	$29,268	$33,373	$32,220	$34,269	$32,212	$25,667		$31,787
65 & Over					1	19	31	9	14	4	2		80
					$30,913	$31,506	$31,896	$34,239	$33,737	$38,821	$53,630		$33,267
Total			2	99	353	1,654	1,381	545	404	90	15	1	4,544
			$35,789	$26,299	$26,294	$28,807	$30,532	$33,041	$31,797	$36,910	$33,116	$22,266	$30,032

Average: Age: 44.69
Service: 11.68

Number of participants: Fully vested: 4,090
Not Vested: 454

Males:2,283
Females:2,261

DISTRIBUTION OF ACTIVE MEMBERS BY AGE AND BY YEARS OF SERVICE ALL EMPLOYEES

Attained Age	0 No. & Avg. Comp.	1 No. & Avg. Comp.	2 No. & Avg. Comp.	3 No. & Avg. Comp.	4 No. & Avg. Comp.	5-9 No. & Avg. Comp.	10-14 No. & Avg. Comp.	15-19 No. & Avg. Comp.	20-24 No. & Avg. Comp.	25-29 No. & Avg. Comp.	30-34 No. & Avg. Comp.	35 & Over No. & Avg. Comp.	Total No. & Avg. Comp.
Under 25	102	77	58	23	15	6							277
	$17,635	$21,060	$19,657	$21,119	$22,466	$22,009							$19,604
25-29	135	111	104	79	65	133	1						611
	$21,184	$24,538	$26,144	$23,966	$22,589	$24,155	$23,839						$23,763
30-34	120	121	112	100	116	420	145	1					1,115
	$22,462	$27,343	$25,541	$27,344	$26,643	$27,651	$27,289	$34,215					$26,679
35-39	84	96	114	77	94	482	438	105	2				1,484
	$23,439	$30,136	$26,616	$28,202	$26,107	$29,858	$30,766	$30,118	$28,000				$29,275
40-44	104	105	102	92	98	483	497	277	321	5			2,076
	$25,690	$28,806	$25,440	$30,800	$27,310	$31,084	$32,767	$33,109	$32,077	$26,968			$31,031
45-49	75	65	111	81	83	462	494	279	474	144	3		2,263
	$27,839	$26,004	$26,662	$30,323	$31,492	$32,070	$35,462	$36,679	$35,184	$37,673	$52,519		$33,780
50-54	63	51	62	57	64	424	396	253	343	184	55		1,947
	$25,318	$29,244	$27,974	$31,669	$34,836	$34,181	$36,447	$38,612	$34,452	$40,262	$40,709		$35,393
55-59	46	31	50	50	51	297	297	221	227	97	49	16	1,427
	$27,925	$31,578	$27,764	$32,886	$40,539	$35,850	$36,018	$40,237	$39,208	$45,798	$41,474	$40,893	$37,493
60-64	19	23	23	23	19	158	141	96	98	30	24	10	663
	$33,647	$31,450	$33,206	$31,113	$37,298	$32,947	$36,825	$39,273	$38,644	$43,258	$39,735	$45,395	$36,458
65 & Over	4	6	5	5	7	58	78	24	32	19	11	8	257
	$21,790	$24,261	$39,856	$29,919	$36,967	$35,114	$37,838	$43,425	$36,623	$44,807	$43,811	$44,073	$37,854
Total	752	686	741	587	612	2,923	2,487	1,256	1,497	479	142	34	12,120
	$23,522	$27,115	$26,173	$28,772	$29,256	$31,325	$33,990	$36,684	$35,208	$40,834	$41,298	$42,965	$32,204

Average: Age: 45.22
Service: 11.23

Number of participants: Fully vested: 8,818
Not Vested: 3,302
Males: 6,501
Females: 5,619

HISTORICAL ACTIVE PARTICIPANT DATA

Valuation Date	Active Count	Average Age	Average Service	Covered Payroll	Average Salary	Percent Changes
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1988	11,344	N/A	N/A	$227,900	$20,090	1.9%
1989	11,356	N/A	N/A	$235,400	$20,729	3.2%
1990	12,037	40.0	N/A	$258,556	$21,480	3.6%
1991	12,488	40.3	N/A	$284,914	$22,815	6.2%
1992	12,913	40.5	N/A	$314,686	$24,370	6.8%
1993	13,112	40.9	N/A	$340,249	$25,949	6.5%
1994	14,027	40.9	N/A	$366,561	$26,133	0.7%
1995	14,364	41.3	N/A	$378,511	$26,351	0.8%
1996	14,067	41.8	N/A	$367,610	$26,133	-0.8%
1998*	13,764	42.8	9.8	$394,919	$28,692	9.8%
1999*	13,286	42.9	9.8	$396,617	$29,852	4.0%
2000*	13,126	43.7	10.3	$421,591	$32,119	7.6%
2001*	12,928	43.9	10.3	$413,021	$31,948	-0.5%
2002	12,527	44.7	11.0	$399,794	$31,915	-0.1%
2003	12,120	45.2	11.2	$390,314	$32,204	0.9%

* Excludes DROP participants

RETIREES, BENEFICIARIES, AND DISABLED PARTICIPANTS ADDED TO AND REMOVED FROM ROLLS

	Added to Rolls		Removed from Rolls		Rolls-End of Year			
Valuation July 1,	Number	Annual Allowances	Number	Annual Allowances	Number	Annual Allowances	% Increase in Annual Allowances	Average Annual Allowances
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1994	306	$2,474	227	$1,593	4,268	$33,971	4.8%	$7,959
1995	393	3,044	220	1,307	4,441	36,482	7.4%	8,215
1996	416	3,119	239	1,438	4,618	38,815	6.4%	8,405
1998	693	5,840	441	3,212	4,870	43,394	11.8%	8,910
1999	432	2,131	303	1,515	4,999	46,732	7.7%	9,348
2000	360	3,412	255	1,380	5,104	49,970	6.9%	9,790
2001	652	8,937	299	1,030	5,457	57,877	15.8%	10,606
2002	777	15,061	306	2,476	5,928	72,256	24.8%	12,189
2003	598	11,497	311	1,873	6,215	84,519	17.0%	13,599

MEMBERSHIP DATA

	July 1, 2003 (1)
1. Active members	
a. Number	12,120
b. Number vested	8,818
c. Total payroll supplied by HMEPS	$ 390,314,471
d. Average salary	32,204
e. Average age	45.2
f. Average service	11.2
2. Inactive members (Count)	
a. Vested	2,386
b. NonVested	564
3. Service retirees	
a. Number	4,319
b. Total annual benefits	$ 71,246,439
c. Average annual benefit	16,496
d. Average age	67.7
4. Disabled retirees	
a. Number	494
b. Total annual benefits	$ 3,714,827
c. Average annual benefit	7,520
d. Average age	60.1
5. Beneficiaries and spouses	
a. Number	1,402
b. Total annual benefits	$ 9,558,072
c. Average annual benefit	6,817
d. Average age	68.7

ESTIMATION OF INVESTMENT RETURN

Item	Market Value	Actuarial Value
(1)	(2)	(3)
1. Assets as of July 1, 2002 (A)	$ 1,271,691	$ 1,519,717
2. Contributions during FY03	64,384	64,384
3. Benefit payments made during FY03	98,789	98,789
4. Refunds of contributions during FY03	475	475
5. Expenses during FY03	4,665	4,665
6. Investment return during FY03	34,044	30,092
7. Assets as of July 1, 2003 (B): (1 + 2 - 3 - 4 - 5 + 6)	1,266,190	1,510,264
8. Approximate rate of return on average invested assets		
a. Net investment income (6 - 5 = I)	29,379	25,427
b. Estimated return based on (2I/(A + B - I))	2.34 %	1.6 9%

INVESTMENT EXPERIENCE GAIN OR LOSS

Item	Valuation as of July 1, 2003	Valuation as of July 1, 2002
(1)	(2)	(3)
1. Actuarial assets, prior valuation	$ 1,519,717	$ 1,490,179
2. Total contributions since prior valuation	$ 64,384	$ 54,234
3. Benefits and refunds since prior valuation	$ (99,264)	$ (78,588)
4. Assumed net investment income at 8.5%		
a. Beginning assets	$ 129,176	$ 126,665
b. Contributions	2,681	2,128
C. Benefits and refunds paid	(4,133)	(3,083)
d. Total	$ 127,724	$ 125,710
5. Expected actuarial assets (Sum of Items 1 through 4)	$ 1,612,561	$ 1,591,535
6. Actual actuarial assets, this valuation	$ 1,510,264	$ 1,519,717
7. Asset gain (loss) since prior valuation (Item 6 - Item 5)	$ (102,297)	$ (71,818)

Note: Amounts in $000

HISTORY OF INVESTMENT RETURNS

For Fiscal Year Ending	Market Value	Actuarial Value
(1)	(2)	(3)
June 30, 2000	22.10 %	13.00 %
June 30, 2001	-4.56 %	8.97 %
June 30, 2002	-7.99 %	3.64 %
June 30, 2003	2.34 %	1.69 %

Summary of Actuarial Assumptions and Methods

The following methods and assumptions were adopted for the July 1, 2003, actuarial valuation.

1. Valuation Date

The valuation date is July 1st of each plan year. This is the date as of which the actuarial present value of future benefits and the actuarial value of assets are determined.

2. Actuarial Cost Method

The actuarial valuation uses the Entry Age Normal actuarial cost method. Under this method, the employer contribution rate is the sum of (i) the employer normal cost rate, and (ii) a rate that will amortize the unfunded actuarial liability.

a. The valuation is prepared on the projected benefit basis, under which the present value, at the investment return rate assumed to be earned in the future (currently 8.5 percent), of each participant's expected benefit payable at retirement or death is determined, based on his/her age, service, sex and compensation. The calculations take into account the probability of a participant's death or termination of employment prior to becoming eligible for a benefit, as well as the possibility of his/her terminating with a service, disability, or survivor's benefit. Future salary increases are also anticipated. The present value of the expected benefits payable on account of the active participants is added to the present value of the expected future payments to retired participants and beneficiaries to obtain the present value of all expected benefits payable from the Plan on account of the present group of participants and beneficiaries.

b. The employer contributions required to support the benefits of the Plan are determined using a level funding approach, and consist of a normal contribution and an accrued liability contribution.

c. The normal contribution is determined using the "entry age normal" method. Under this method, a calculation is made to determine the average uniform and constant percentage rate of employer contribution which, if applied to the compensation of each new participant during the entire period of his/her anticipated covered service, would be required in addition to the contributions of the participant to meet the cost of all benefits payable on his behalf based on the Group A benefits provisions.

d. The unfunded accrued liability contributions are determined by subtracting the actuarial value of assets from the actuarial accrued liability and amortizing the result over 40 years from January 1, 1983.

The contribution rate determined by this valuation will not be effective until one year later. However, the determination of the rate does not reflect this deferral. It is assumed that there will be no change in the employer normal cost rate due to the deferral, and it is assumed that payments are made uniformly throughout the year.

3. Actuarial Value of Assets

The actuarial value of assets is based on the market value of assets with a five-year phase-in of actual investment return in excess of (less than) expected investment income. Expected investment income is determined using the assumed investment return rate and the market value of assets (adjusted for receipts and disbursements during the year). The returns are computed net of administrative and investment expenses.

4. Economic Assumptions

a. Investment return: 8.50% per year, compounded annually, composed of an assumed 3.00% inflation rate and a 5.50% net real rate of return. This rate represents the assumed return, net of all investment and administrative expenses.

b. Salary increase rate: A service-related component, plus a 3.00% inflation component, plus a general increase, as follows:

Years of Service (1)	Service-related Component (2)	Total Annual Rate of Increase Including 3.00% Inflation Component and 0.0% General Increase Rate (3)
0	2.25 %	5.25 %
1	2.00	5.00
2	1.25	4.25
3	1.00	4.00
4	0.75	3.75
5	0.50	3.50
6	0.50	3.50
7	0.50	3.50
8	0.50	3.50
9	0.50	3.50
10 or more	0.00	3.00

c. Payroll growth rate: In the amortization of the unfunded actuarial accrued liability, payroll is assumed to increase 3.00% per year. This increase rate is solely due to the effect of inflation on salaries, with no allowance for future membership growth.

5. Demographic Assumptions

a. Retirement Rates

	Expected Retirements per 100 Lives	
Age	Males	Females
(1)	(2)	(3)
<55	10	10
55-59	10	10
60	20	20
61	20	20
62	25	25
63	20	20
64	20	20
65	40	40
66-69	10	10
70	100	100

b. DROP Participation

100% of eligible members are assumed to elect DROP. Also, any member who becomes disabled after eligibility for retirement is assumed to select the normal retirement benefit and elect DROP. Beneficiaries of members who die while active are also assumed to elect the DROP benefit if eligible.

c. DROP Entry Date

Active members (not already in DROP) are assumed to take advantage of the Backdrop provision and DROP back to the date calculated to be the most valuable for the member. This attempts to include anti-selection in the valuation. For members who have already entered DROP, the actual DROP entry date supplied in the data is used.

d. DROP Interest Credit

9.0% per year

e. Mortality rates (for active and retired members)

- Healthy males - Based on the 1994 Group Annuity Mortality Tables for males.
- Healthy females - Based on the 1994 Group Annuity Mortality Tables for females.
- Disabled males and females - 1965 Railroad Retirement Board Disable Life Table

Sample rates are shown below:

Expected Deaths per 100 Lives

Age (1)	Healthy Males (2)	Healthy Females (3)	Disabled Males (6)	Disabled Females (7)
25	0.07	0.03	4.41	4.41
30	0.08	0.04	4.41	4.41
35	0.09	0.05	4.41	4.41
40	0.12	0.07	4.41	4.41
45	0.17	0.10	4.44	4.44
50	0.29	0.14	4.53	4.53
55	0.49	0.23	4.78	4.78
60	0.90	0.44	5.33	5.33
65	1.62	0.86	6.11	6.11
70	2.60	1.37	7.47	7.47
75	4.09	2.27	9.55	9.55
80	6.86	3.94	12.98	12.98

f. Termination Rates and Disability Rates

Termination rates (for causes other than death, disability or retirement):
Termination rates are a function of the member's age and service. Termination rates are not applied after a member becomes eligible for a retirement benefit. Rates at selected ages are shown in the following table:

	Expected Decrements per 100 Lives		
Age	Disability	Termination	
	All	First 3Years	After 3Years
(1)	(2)	(3)	(4)
25	0.05	30.5	15.8
30	0.05	26.3	11.6
35	0.06	23.1	8.4
40	0.09	20.9	6.2
45	0.18	18.9	4.2
50	0.40	17.3	2.6
55	0.85	14.7	0.0
60	1.74	14.7	0.0

Service Connected Deaths and Disabilities assumed to be 10% of decrement

6. Other Assumptions

a. Percent married: 60% of employees are assumed to be married. (No beneficiaries other than the spouse assumed)

b. Age difference: Male members are assumed to be three years older than their spouses, and female members are assumed to be three years younger than their spouses.

c. Percent electing annuity on death (when eligible): All of the spouses of vested, married participants are assumed to elect an annuity.

d. Percent electing deferred termination benefit: Vested terminating members are assumed to elect a refund or a deferred benefit, whichever is more valuable at the time of termination.

e. There will be no recoveries once disabled.

f. No surviving spouse will remarry and there will be no children's benefit.

g. Assumed age for commencement of deferred benefits: Members electing to receive a deferred benefit are assumed to commence receipt at the first age at which unreduced benefits are available.

h. Administrative expenses: The assumed investment return rate represents the anticipated net return after payment of all investment and administrative expenses.

7. Participant Data

Participant data was supplied on electronic files. There were separate files for (i) active, (ii) inactive members, and (ii) members and beneficiaries receiving benefits.

The data for an active members included birthdate, sex, date of credited service, salary paid during last fiscal year, hours worked by the employee, and employee contribution account balance. For retired members and beneficiaries, the data included date of birth, sex, amount of monthly benefit, and date of retirement.

All healthy and disabled retirees are assumed to have 100% joint and survivor, prorated by the 60% marriage assumption. All non-children beneficiaries are assumed to have life only benefits and all children beneficiaries' annuities are assumed to stop at age 25.

Salary supplied for the current year was based on the earnings for the year preceding the valuation date. This salary was adjusted by the salary increase rate for one year. For members who worked less than 1900 hours but were not new entrants, the salary was annualized to 1900 hours.

Assumptions were made to correct for missing, bad, or inconsistent data. These had no material impact on the results presented.

8. Group Transfers

20% of current Group B members are assumed to transfer to Group A each year for the next four years, ultimately resulting in 80% of current Group B members transferring to Group A.

All Group B members who are assumed to transfer to Group A and all current Group A members with convertible Group B service are assumed to convert their Group B service to Group A service at the conversion price.

Changes In Assumptions Since the Prior Valuation

The Board adopted new actuarial assumptions for this valuation in connection with the 2002 experience investigation performed by Towers Perrin and independently reviewed by GRS.

These new assumptions include the following changes:

- The inflation assumption was decreased from 4.0% to 3.0%
- The payroll growth rate assumption was decreased from 4.5% to 3.0%
- The salary increase assumption was changed from a flat 4.5% to a set of graded rates based on years of service
- Retirement rates were increased for most ages
- The DROP interest credit rate assumption was increased from 8.5% to 9.0%
- The assumption on when members would enter DROP was changed from first eligibility to the most valuable entry date
- The assumptions on the number of Group B members who would transfer to Group A was increased from 0% to 80%
- The assumption on the number of members with prior Group B service who would convert that service to Group A was increased from 0% to 100%

Summary of Plan Provisions

1. Covered Members

Any person who is a participant of Group A, under the original act.

Persons who become employees of the City of Houston after September 1, 1981, and elected officials of the City of Houston who assumed office after September 1, 1981, participate in Group B, but may make an irrevocable election to participate in Group A instead.

Persons who become employees of the City and persons who are elected as City officials after September 1, 1999 become members of Group A. Certain persons who are or become Director of a City Department, Chief Financial Executive, or Executive Director of the Pension System on or after September 1, 1999 may participate in Group C.

2. Monthly Final Average Salary (FAS)

The sum of the seventy-eight highest biweekly salaries paid to a member during his period of credited service, divided by thirty-six. Salary includes base pay, longevity pay, and any shift differential pay.

3. Credited Service

All services and work performed by an employee, including prior service. For members of Group A and Group C, all services and work performed after September 1, 1943 must have been accompanied by corresponding contributions to the Pension System by the employee or legally authorized repayments must have been made.

Credited service for participants in Group C means the number of years of eligible service after the executive official's effective date of participation in Group C. A Group C member receives two times the number of actual years of Credited Service in Group C solely for the purpose of fulfilling the eligibility requirements in Group C.

4. Normal Retirement

a. Eligibility   Prior to August 1, 2000:

The earliest of:

age 50 and 25 years of Credited Service

age 55 and 20 years of Credited Service

age 60 and 10 years of Credited Service

age 62 and 5 years of Credited Serviceage 65 (Group C only)

On or after August 1, 2000:

The earliest of:

age 62 and 5 years of Credited Service

5 years of Credited Service and age plus years of Credited Service equal 70 or more

age 65 (Group C only)

b. Benefit

Prior to August 1, 2000:

Group A: 2.25% of FAS for each of the first 20 years of Credited Service, plus 2.75% of FAS for each year of Credited Service over 20, to a maximum of 80% of FAS. Minimum monthly benefit is greater of $8 times years of Credited Service or $100.

Group B: 1.50% of FAS for each of first 10 years of Credited Service, plus 1.75% of FAS for each year of Credited Service over 10 through 20, plus 2.00% of FAS for each year of Credited Service over 20, to a maximum of 80% of FAS.

On or after August 1, 2000 and prior to May 11,2001:

Group A: 2.50% of FAS for each of the first 20 years of Credited Service plus 3.25% of FAS for each year Credited Service greater than 20 years. Maximum benefit is 80% of FAS. Minimum monthly benefit is greater of $8 times years of Credited Service or $100.

Group B: 1.75% of FAS for each of the first 10 years of Credited Service plus 2.00% of FAS for each year of Credited Service from 10 through 20, and 2.50% of FAS for each year of Credited Service over 20. Maximum benefit is 80% of FAS for all future retirees.

Group C: Double the rate for Group A

On or after May 11, 2001:

Group A: 3.25% of FAS for each of the first 10 years

of Credited Service plus 3.50% for Credited Service greater than 10 years but less than 20 years plus 4.25% for FAS for each year of Credited Service greater than 20 years (excludes current DROP participants). Maximum benefit is 90% of FAS for all future retirees. Minimum monthly benefit is greater of $8 times years of Credited Service or $100.

Group B: 1.75% of FAS for each of the first 10 years of Credited Service plus 2.00% of FAS for each year of Credited Service from 10 through 20, and 2.75% of FAS for each year of Credited Service over 20. Maximum benefit is 90% of FAS for all future retirees.

Group C: Double the rate for Group A

5. Vested Pension

a. Eligibility — 5 years of Credited Service. Immediate vesting for Group C.

b. Benefit — Group A and Group C: Either the accrued normal retirement benefit with payments beginning at the normal retirement eligibility date or a refund of contributions, if any, without interest.

Group B: Accrued normal retirement benefit payable at the normal retirement eligibility date.

If the actuarial present value of a pension is less than $10,000, a terminated participant who is not eligible to begin receiving a pension may request an early lump sum distribution of the pension. Such early lump sum distribution is irrevocable. Credited Service associated therewith can be reinstated after reemployment and pursuant to the rules of the plan.

6. Withdrawal Benefit

If a nonvested member withdraws from service with less than 5 years, a refund of the member's contributions is made without interest, upon request.

7. Service-Connected Disability Retirement

a. Eligibility — Any age

b. Benefit — Group A: Accrued normal retirement benefit, but not less than 20% of final monthly salary at time of disability plus 1 % of final monthly salary per year of Credited Service, to a maximum of 40% of final monthly salary.

Group B: Accrued normal retirement benefit, but not less than 20% of final monthly salary at time of disability.

Group C: Double Group A benefit

8. Nonservice-Connected Disability Retirement

a. Eligibility — 5 years of Credited Service.

b. Benefit — Accrued normal retirement benefit payable immediately.

9. Preretirement Survivor Benefits

A. Service-connected

a. Eligibility — Any age or Credited Service

b. Benefit — Prior to September 1,1999

If there is a surviving spouse, 80% of FAS payable to the spouse plus 10% of FAS to each qualifying dependent to a maximum of 20% for all dependents. If there is no surviving spouse, dependent benefits are doubled.

On or after September 1, 1999:

If there is a surviving spouse, 100% of FAS payable to the spouse. 10% of FAS is payable to each qualifying dependent to a maximum of 20% for all dependents. Surviving spouses benefit will be reduced by the amount of dependent benefits. If no surviving spouse, dependent benefits are 50% of the amount a surviving spouse would have received for each dependent to a maximum of 100% for all dependents in the aggregate.

B. Non service-connected

a. Eligibility — 5 years of Credited Service

b. Benefit — Prior to September 1, 1999

If there is a surviving spouse, 50% of accrued normal retirement benefit payable to the spouse plus 10% of accrued normal retirement benefit to each qualifying dependent to a maximum of 20% for all dependents. If there is no surviving spouse, dependent benefits are doubled.

On or after September 1, 1999 and prior to

August 1,2001:

If there is a surviving spouse, 85% of accrued normal retirement benefit payable to the spouse plus 10% of accrued normal retirement benefit to each qualifying dependent to a maximum of 20% for all dependents in the aggregate. The surviving spouses benefit will be reduced by the excess, if any, over 100% of the accrued normal retirement benefit. If there is no surviving spouse, dependent benefits are 50% of the benefit a surviving spouse would have received for each dependent subject to 100% of a surviving spouse's benefit for all dependents in the aggregate.

On or after August 1, 2001:

If there is a surviving spouse, 100% of accrued normal retirement benefit payable to the spouse and 10% of accrued normal retirement benefit to each qualifying dependent to a maximum of 20% for all dependents in the aggregate. The surviving spouse's benefit will be reduced by dependent benefits, if any. If there is no surviving spouse, each dependent will receive 50% of the benefit of a surviving spouse would have received subject to a maximum of 100% of a surviving spouse's benefit for all dependents in the aggregate.

10. Postretirement Survivor Benefits

Prior to September 1, 1999:

If there is a surviving spouse, 75% of the retirement benefit the deceased retiree was receiving at the time of death payable to the spouse plus 10% of that retirement benefit payable to each qualifying dependent to a maximum of 20% for all dependents. If there is no surviving spouse, dependent benefits are double.

On or after September 1. 1999 and prior to August 1,2001:

If there is a surviving spouse, 85% of the retirement benefit the deceased retiree was receiving at the time of death payable to the spouse plus 10% of that retirement benefit payable to each qualifying dependent to a maximum of 20% for all dependents. If there is no surviving spouse, dependent benefits are 50% of the benefit a surviving spouse would have received for each dependent subject to 100% of a surviving spouse's benefit for all dependents in the aggregate.

On or after August 1.2001:

If there is a surviving spouse, 100% of the retirement benefit if the deceased retiree was receiving at the time of death payable to the spouse and 10% of that retirement benefit payable to each qualifying dependent to a maximum of 20% for all dependents. The surviving spouse's benefit will be reduced by dependent benefits, if any. If there is no surviving spouse, each dependent will receive 50% of the benefit a surviving spouse would have received subject to 100% of a surviving spouse's benefit for all dependents in the aggregate.

11. Benefit Adjustments

Prior to May 11.2001:

Each year, effective February 1, monthly benefits

will be increased 3.5%, not compounded, for all retirees and survivors whose benefit was effective on or before January 1 of the current year.

On or after May 11.2001:

Each year, effective February 1, monthly benefits will be increased 4.0%, not compounded, for all retirees and survivors whose benefit was effective on or before January 1 of the current year.

12. Contribution Rates

a. Members — 4% of salary only for the Group A and Group C members. None for the Group B members

b. City — Beginning in 1993, the rate required to fund the Retirement Fund on an actuarial reserve basis. However, effective September 1, 1999, the minimum contribution rate is equal to the greater of 10% and twice the contribution rate of a Group A member is required to make by statute.

13. Deferred Retirement Option

a. Eligibility — Participants who are eligible to retire but who have not retired and who remain in service with the City may participate in the DROP

b. Monthly DROP Credit — Accrued normal retirement benefit as of the effective date of DROP participation. The Monthly DROP Credit is credited to a notional account (DROP Account) on the last business day each month.

c. Other DROP Credits — A participant's biweekly employee contributions, if any, are credited to the DROP Account on the day they are paid to the Pension System by the City. In addition, interest is credited to the DROP Account at the beginning of each day based on the DROP Account balance at the end of the previous day. The annual interest rate effective beginning January 1 each year is the arithmetical average of the System's annual investment return percentage for the then most recent 5 fiscal years. Minimum interest rate is the investment yield assumption for actuarial purposes adopted by the Pension Board as of interest calculation date. The interest rate for interest accrued after a DROP participant's City employment is terminated, if applicable, is reduced 3/4%.

d. Monthly DROP Credit

Prior to May 11, 2001

Adjustments – The Monthly DROP Credit for participants who entered the DROP effective on or before January 1 of the then current year will be increased effective February 1 each year 3.5%, not compounded.

On or after May 11,2001:

The Monthly DROP Credit for participants who entered the DROP effective on or before January 1 of the then current year will be increased effective February 1 each year 4.0%, not compounded.

e. DROP Account Balance

The sum of a participant's Monthly DROP (DROP Benefit)Credits, employee contributions paid after DROP participation began, Monthly DROP Credit Adjustments, and applicable interest.

14. DROP Benefit Pay-out

A terminated DROP participant may elect to:

a. Receive the entire DROP Account Balance in lump sum.

b. Receive the DROP Account Balance inperiodic payments as approved by the Pension Board.

c. Receive a portion of the DROP Account lance in lump sum and the remainder in periodic payments as approved by the Pension Board.

d. Defer election of a payout option until a future date.

15. Post DROP Retirement

The Final Pension is the accrued Benefit (Final Pension) percentage as of the effective date of DROP participation times the FAS as of termination from active service. The initial monthly retirement pension is equal to the Final Pension plus the Monthly DROP Credit Adjustments the participant received while in DROP.

Changes in Plan Provisions Since Prior Year

Plan provisions have not changed since the prior year.

STATISTICAL SECTION

SCHEDULE OF AVERAGE BENEFIT PAYMENT AMOUNTS FOR THE SIX YEARS ENDED JUNE 30, 2003

Year Ended	Number Receiving Benefits	Benefits Paid ($000)	Average Annual Benefit
June 30, 1998	4,870	43,394	8,911
June 30, 1999	4,999	46,732	9,348
June 30, 2000	5,104	50,142	9,824
June 30, 2001	5,457	57,877	10,606
June 30, 2002	5,928	72,256	12,189
June 30, 2003	6,215	84,519	13,599

SCHEDULE OF BENEFITS BY TYPE ($000) FOR THE SIX YEARS ENDED JUNE 30, 2003

Fiscal Year Ended	Normal Retirement Benefits	Disability Retirement Benefits	Survivors' Benefits	Total Benefits
June 30, 1998	34,509	3,062	5,540	43,111
June 30, 1999	37,370	3,320	6,061	46,751
June 30, 2000	39,836	3,490	6,816	50,142
June 30, 2001	46,867	3,555	7,455	57,877
June 30, 2002	59,746	3,638	8,872	72,256
June 30, 2003	71,246	3,715	9,558	84,519

SCHEDULE OF ANNUITANTS BY TYPE

	June 30, 2003			June 30, 2002		
Schedule of Annuitants by Type	Number	Benefits ($000)	Average Benefit	Number	Benefits ($000)	Average Benefit
Retirees receiving benefits	4,319	71,246	16,496	4,002	59,746	14,929
Retired on disability	494	3,715	7,520	504	3,638	7,217
Survivors and beneficiaries	1,402	9,558	6,817	1,422	8,872	6,239
Total retirees, survivors and beneficiaries	6,215	84,519	13,599	5,928	72,256	12,189
Former participants eligible but not yet receiving benefits	2,386	11,537	4,835	1,136	5,947	5,235
Total Eligible for Benefits	8,601	64,237	9,612	7,064	78,203	11,071

HISTORICAL ACTIVE PARTICIPANT DATA

Valuation Date	Number of Participants	Annual Payroll $(000)	Average Salary ($)	% Salary Increase
July 1, 1992	12,913	314,686	24,370	6.8
July 1, 1993	13,112	340,249	25,949	6.5
July 1, 1994	14,027	366,561	26,133	0.7
July 1, 1995	14,364	378,511	26,351	0.8
July 1, 1996	14,067	367,610	26,133	(0.8)
July 1, 1998	13,764	394,919	28,692	9.8
July 1, 1999	13,286	396,617	29,852	4.0
July 1, 2000	13,126	421,591	32,119	7.6
June 30, 2001	12,928	413,021 *	31,948 *	(0.5)
June 30, 2002	12,527	399,794	31,915	(0.1)
June 30, 2003	12,120	390,314	32,204	0.9

*Does not include DROP participants

SCHEDULE OF REVENUES BY SOURCE ($000) FOR THE SIX YEARS ENDED JUNE 30, 2004

Year (June 30)	Sponsor Contributions	Member Contributions	Investment Income	Other Income	Total Income
1999	36,030	6,184	32,344	276	74,835
2000	38,306	7,341	270,991	407	317,045
2001	41,298	8,532	(65,147)	643	(14,674)
2002	40,758	13,476	(108,024)	286	(53,504)
2003	40,622	23,762	33,931	114	98,429
2004	57,308	26,189	227,361	726	311,584

SCHEDULE OF EXPENSES BY TYPE ($000) FOR THE SIX YEARS ENDED JUNE 30, 2004

Year (June 30)	Benefits Paid	Contributions Refunded	Professional Service Fees	Cost of Administration	Total Expenses
1999	46,751	232	238	2,043	46,264
2000	50,142	337	263	2,143	52,885
2001	58,296	308	324	2,367	61,295
2002	78,318	270	396	3,662	82,646
2003	98,789	475	366	4,299	103,929
2004	153,202	635	712	4,500	159,049

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