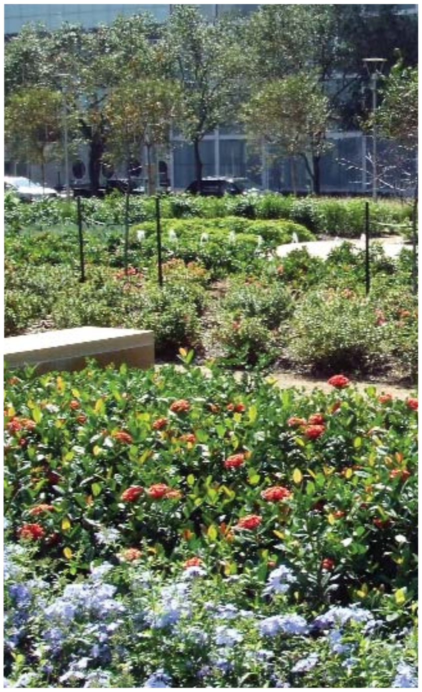
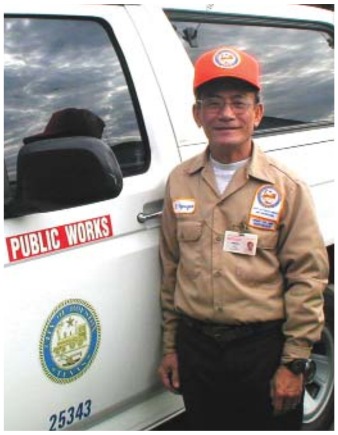
Houston Municipal Employees Pension System

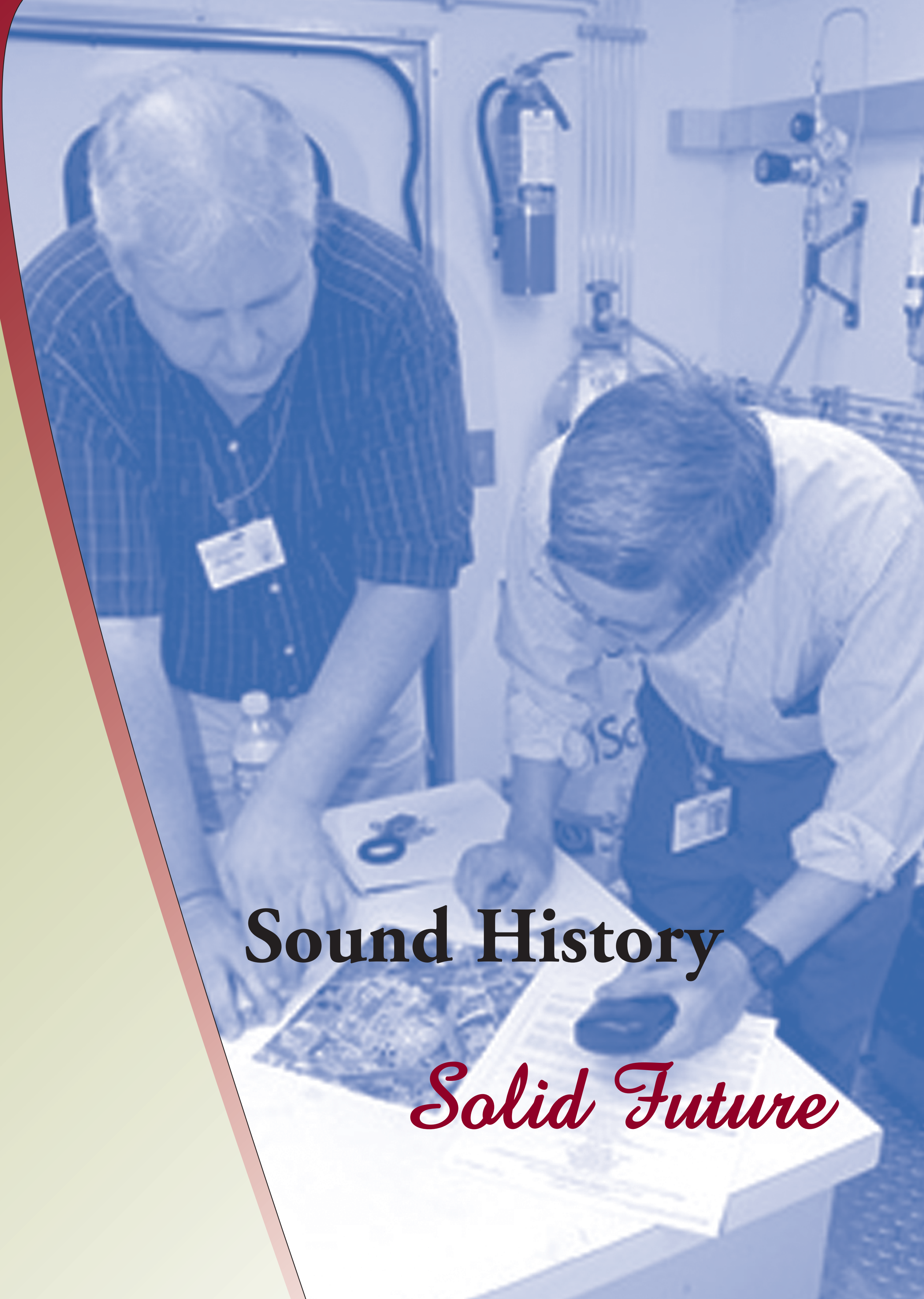
A Component Unit of the City of Houston, Texas

Comprehensive Annual Financial Report for the Year Ended June 30, 2008





65 Years of Service



Sound History

Solid Future

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

A COMPONENT UNIT OF THE CITY OF HOUSTON, TEXAS

COMPREHENSIVE ANNUAL FINANCIAL REPORT
FOR THE YEAR ENDED JUNE 30, 2008

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

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM
1111 BAGBY, SUITE 2450, HOUSTON, TEXAS 77002-2555
713-595-0100
WWW.HMEPS.ORG

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HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

Board of Trustees

Elected and Appointed Trustees

Roderick J. Newman, *Chairman*

Ray Kennedy, *Vice Chairman*

Sherry Mose, *Secretary*

Mark V. Mancuso

Lonnie Vara

Barbara Chelette, *Appointed*

City Appointed Trustees

Richard Badger

Gilbert Garcia

Alfred Jackson

Craig T. Mason

David L. Long,
Executive Director

HOUSTON MUNICIPAL EMPLOYEES
PENSION SYSTEM
1111 BAGBY, SUITE 2450
HOUSTON, TEXAS 77002-2555
713-595-0100
FAX 713-650-1961

November 20, 2008

Michelle Mitchell
Director of Finance
City of Houston, Texas
P.O. Box 1562
Houston, Texas 77251

Dear Ms. Mitchell:

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the Houston Municipal Employees Pension System (the System), a Component Unit of the City of Houston, Texas (the City) for the fiscal year ended June 30, 2008. The accuracy, fairness of presentation and completeness of this report are the responsibility of the Board of Trustees (the Board) of the System. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of the operations of the System. The System's basic financial statements will be included in the annual financial report of the City.

Accounting System and Internal Controls

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

The System's independent auditors have audited the financial statements and issued an unqualified opinion as of June 30, 2008 and 2007. The purpose of the audit is to give reasonable assurance to users of those financial statements, the Board, and participants of the System, that the financial statements present fairly, in all material respects, information regarding the System's net assets held in trust for pension benefits and in conformity with accounting principles generally accepted in the United States of America.

A significant responsibility of the Board is to ensure that the System has in place an adequate system of internal controls. A system of internal controls is an entity's plan of organization and all of its coordinated methods and measures adopted to safeguard its assets, ensure the accuracy and reliability of the accounting system and promote adherence to management policies. These controls include strategic design of the entity's business systems, the appropriate segregation of duties and responsibilities, sound practices in the performance of those duties, capable personnel, and the organizational structure itself. We believe the System's internal controls are adequate and are working as designed.

Financial Information

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

Plan History and Profile

The System was created in 1943 under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, Article 6243g, Vernon's Annotated Revised Texas Civil Statutes, and reenacted and continued under HB1573, 77th Texas Legislature, as Article 6243h, Vernon's Annotated Revised Texas Civil Statutes, as amended (the Statute). The System is a multiple-employer, defined benefit pension plan and includes a contributory group (Group A) and two noncontributory groups (Group B and D). 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"). The System plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group D. The System is administered by an eleven-member Board of Trustees. The Trustees include four elected trustees who are members of the System, two elected trustees who are retirees of the System, a trustee appointed by the elected trustees, the mayor's appointee, the controller's appointee, and two city council appointees.

Budget

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

Funding Status

The funded ratio, the ratio of the actuarial value of assets (AVA) to the actuarial accrued liability (AAL), is a standard measure of a plan's funded status. In the absence of benefit improvements, a plan's funded ratio should increase over time, until it reaches 100%. As of July 1, 2007 HMEPS' AVA and AAL were $2.19 billion and $3.13 billion, respectively, resulting in a funded ratio of 70% which includes the $300 million pension obligation note contributed by the City. This is higher than the funded ratio as of July 1, 2006, which is 64.5%. This increase is the direct result of the 2007 Fourth Amendment to the Meet and Confer Agreement between the City and the System. Prior to the Fourth Amendment, the actuarial value of System assets was determined using techniques that spread the effects of short-term volatility in the market value of investments over a five-year period (20% each year). Under the new agreement, for purposes of the July 1, 2007 actuarial valuation, instead of recognizing 20% of the prior years' deferred investment gains/(losses), all of the deferred investment gains/(losses) for the years prior to 2007 were recognized and 20% of the 2007 excess investment gain was recognized.

A historical perspective of HMEPS' funding levels is presented in the Schedule of Funding Progress in the Required Supplementary Information in the Financial Section of this report.

U.S. Economy

The U.S. economy remained sluggish in the first half of 2008, and steep increases in commodity prices boosted consumer price inflation. The housing market continued to contract, weighing on overall economic activity. Against a backdrop of mounting losses incurred by major financial institutions, financial market conditions further deteriorated sharply toward the end of the first quarter - a development that threatened to severely impair the functioning of the overall financial system and to hinder economic growth. In response, the Federal Reserve undertook a number of significant actions to address liquidity pressures faced by banks and other financial institutions, thereby augmenting the liquidity-enhancing measures implemented in the second half of 2007.

After cutting the target federal funds rate 100 basis points in the second half of 2007, the rate was reduced another 225 basis points over the first four months of 2008. The further easing of policy was seen as consistent with fostering price stability over time, given the Federal Reserve's expectation that a flattening-out of energy prices and increasing economic slack would dampen inflationary pressures. Taken together, these measures fostered some improvement in the functioning of financial markets, but considerable strains persist.

Additional actions taken by the Federal Reserve to improve market functioning and liquidity appeared to have a positive effect, and tensions eased somewhat in the second quarter. Nevertheless, conditions in a broad range of domestic and international financial markets remained strained relative to previous years.

U.S. Markets

The elevated risk spreads, high volatility, and impaired functioning that characterized domestic and international financial markets in the second half of 2007 continued through the first half of 2008 giving clear evidence of a bearish slant on the market.

Overall, share prices dropped about 15 percent from the end of 2007. The declines were led by the financial sector, especially depository institutions and broker-dealers, which fell 37 percent and 41 percent, on average, respectively. The energy and basic materials sectors avoided the downtrend and have changed little on net.

Spillovers from the slumping U.S. housing market were the largest direct source of these pressures, but a generalized flight from riskier assets-particularly structured credit products-and worries about a global economic slowdown also contributed to financial strains.

International Markets

Governments around the globe are recognizing the crisis facing the global economy and are being proactive in combating it with stimulus packages and looser monetary policy. In a globalized economy, with all major central banks acting in unison to combat economic malaise, results should be seen from these efforts in the coming quarters.

Most major equity indexes in the advanced foreign economies stand 12 percent to 25 percent lower in local currency terms compared with the end of 2007. European stock indexes were led lower by the stock prices of financial firms, which declined 34 percent (measured in euros); Japanese financial stocks are down 9 percent on the year. The financial turbulence has had less impact on Latin American stock prices. Equity indexes in Mexico and Brazil were virtually unchanged, on balance, over the first half of 2008. However, Chinese stock prices have tumbled 44 percent since the end of 2007, virtually erasing last year's gains, and other major emerging Asian equity indexes are also down, but to a lesser extent.

Over the first half of 2008, the focus of the major foreign central banks appears to have shifted somewhat from the impact of financial market strains on growth to the effect of higher commodity prices on inflation. After initially lowering official interest rates, the Bank of Canada and the Bank of England have held their target rates steady since April, and the Bank of Japan has kept its policy rate unchanged at 0.5 percent all year.

Investments

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

for the year, according the Wilshire Public Fund Universe.

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

Instead of claiming to be able to time the market, which has always been a proven ineffective method; the System will continue to maintain a level of asset allocation with an opportunistic eye. Subsequent to year-end, the HMEPS board reviewed and approved the 2009 asset allocation study to help assure monies are allocated in a manner that allows the system to continue to meet its long-term investment goals.

The Board manages the investment program of the System in compliance with all applicable Federal and State statutes and regulations concerning the investment of pension assets. The Board has adopted a Statement of Investment Policies and objectives (Investment Policy) to set forth the factors involved in the management of investment assets for the System and that is made part of every investment management agreement. This is discussed in more detail in the investment Section of this CAFR. A summary of asset allocation and rates of return can be found in the Investment Section of this CAFR.

Major Current and Future Initiatives

Member Services

Customer service is a critical element of the System's goals and is the driving force behind many of our service improvements. During Fiscal Year 2008 the System increased site visits to various City departments. The System collaborated with the City's deferred compensation staff and others to successfully facilitate the third annual "Save for Retirement" workshop. The System also added a new financial counselor position to meet with and assist participants with benefit options, retirement and general financial planning and to develop and maintain a participant education program.

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

Technology

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

Investments

During Fiscal Year 2008, the investment group continued to pursue effective oversight and transparency by adding to its team of consultants. The investment group conducted a search for a real estate consultant and hired Courtland Partners, and also conducted a search for a general investment consultant, and rehired Wilshire Associates.

Subsequent Events

City Note

The City requested and was granted a petition by the 345th Judicial Court of Travis County allowing the City to issue refunding bonds. When issued, the bond proceeds are intended to prepay the $300 million pension obligation note (Note) and related deferred interest and to replace that obligation to the System with actual dollars added to the System's investment portfolio. At year-end, the note and deferred interest totaled $369 million. Some of the salient provisions of the Note are included in the Notes to Basic Financial Statements under Note 4.

Board Governance

In September 2008, the Board elected Sherry Mose as the new Board Chairman and Lonnie Vara as its Board Secretary. In October, Lenard Polk was elected Board Vice-Chairman.

Certificate of Achievement for Excellence in Financial Reporting

The Government Finance Officers Association (GFOA) of the United States and Canada 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, 2007. The Certificate of Achievement is the highest form of recognition in the area of governmental accounting and financial reporting, and its attainment represents a significant accomplishment by a governmental entity and its management. The award and a detailed description thereof are displayed on page 8 in the Introductory Section of this CAFR.

Acknowledgement

This CAFR was prepared through the combined efforts of the System staff and was subject to the scrutiny of the Board. It is intended to provide information to its user that may be a basis for a general understanding of the System.

This CAFR is being forwarded to the City of Houston, the Texas State Pension Review Board, the GFOA, and other interested parties who may from time to time request it.

In Closing…

The individuals who initiated the creation of our organization 65 years ago had a vision to provide for the financial security of municipal public employees through retirement. We have grown significantly since that time, and our mission continues to be the same. We know that municipal public sector employees are critical to Houston's economy, and that quality employees are primarily attracted to and retained by the public sector by the security and benefits of a sound pension system. HMEPS is dedicated to serving the municipal employees and retirees who have contributed so impressively to the economy and the city. We look forward to the next 65 years.

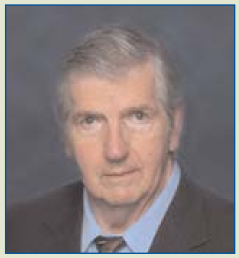
Sincerely,

Sherry Mose
Chairman
Fiscal Year 2009

David L. Long
Executive Director

ORGANIZATIONAL OVERVIEW (AS OF JUNE 30, 2008)*

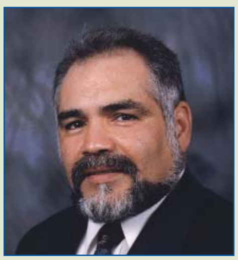
Roderick J.Newman
Chairman



Ray Kennedy
Vice Chairman

Sherry Mose
Secretary

Mark Mancuso
Elected Trustee



Lonnie Vara
Elected Trustee

Barbara Chelette
Appointed Trustee

Richard Badger
Council Appointee

Gilbert Garcia
Controller Appointee

Alfred Jackson
Council Appointee

Craig T. Mason
Mayoral Appointee

Administrative Organization

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

Executive Director

Chief Investment Officer
Investment Managers' Services
Performance Measurement
Market Research

Administrative
Benefit Administration Services
Member Services
Accounting

Information Systems

General Counsel

Communications

Board of Trustees

Elected and Appointed Trustees

Roderick J. Newman, *Chairman*
Ray Kennedy, *Vice Chairman*
Sherry Mose, *Secretary*
Mark Mancuso
Lonnie Vara
Barbara Chelette, *Appointed*

City Appointed Trustees

Richard Badger
Gilbert Garcia
Alfred Jackson
Craig T. Mason

David L. Long, *Executive Director*

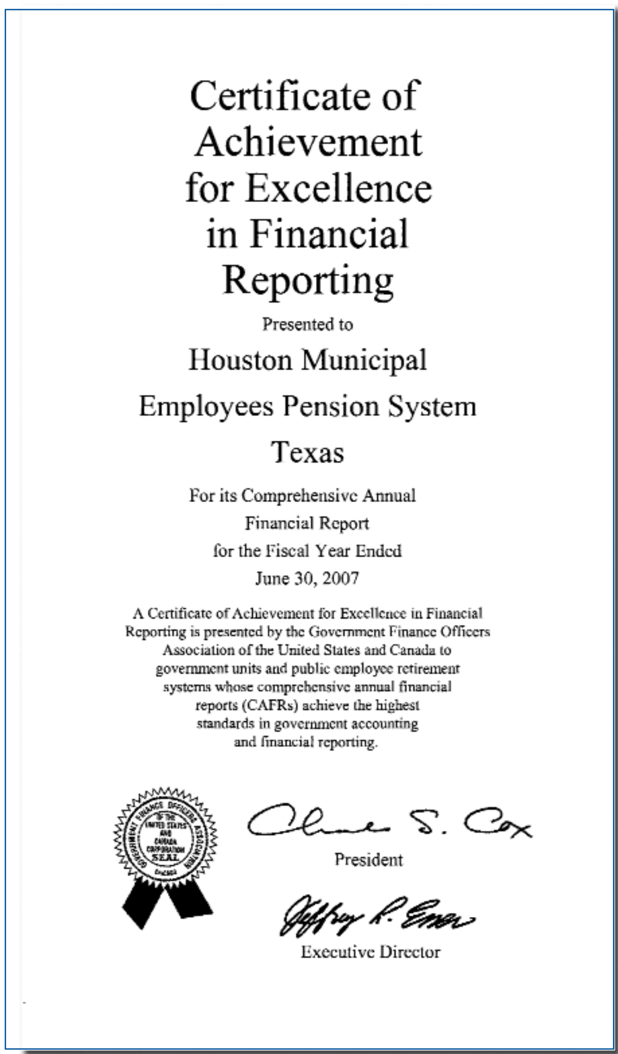
David L. Long
Executive Director

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

The Government Finance Officers Association of the United States and Canada awarded a "Certificate of Achievement for Excellence in Financial Reporting" to Houston Municipal Employees Pension System for its comprehensive annual financial report for the fiscal year ended June 30, 2007. 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. The Houston Municipal Employees Pension System has received a Certificate of Achievement for the last 14 consecutive years (fiscal years ended June 30, 1994 through 2007). 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, 2007

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 (Fiscal Year 2008)

Actuary
Gabriel, Roeder, Smith & Company

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

Board Medical Advisor
Charles Schuhmacher, M.D.

Consulting Services
Ennis, Knupp & Associates, Inc.
TCG Solutions

Database Services
Pension Benefits Information

Governmental Representation
HillCo Partners, Inc.
Locke, Liddell & Sapp, L.L.P

Investment Consultants
Wilshire Associates, Inc.
Pension Consulting Alliance, Inc.
Courtland Partners

Investment Performance Analysis
Wilshire Associates, Inc.
State Street Bank and Trust Co.

Legal Counsel
Baker Botts, L.L.P.
Locke, Lord, Bissell & Lidell, L.L.P.
Purrington, Moody, Weil

Master Custodian/Trustee
State Street Bank and Trust Co.

Investment Managers (Fiscal Year 2008)

Alternative Investments
Adams Street Partners
Angelo, Gordon & Co.
Brera Capital Partners, L.L.C.
Brockway Moran & Partners, Inc.
CVE Kaufman Fellows Endowment
Goldman, Sachs & Co.
HarbourVest Partners, L.L.C.
J.W. Childs Associates, L.P.
Lexington Partners, Inc.
Matlin Patterson Global Advisors
Oaktree Capital Management
Pacven Walden Management Co., LTD.
Pegasus Investors, L.P.
Pharos Capital Partners, L.L.C.
Platinum Equity Capital Partners
Quantum Energy Partners
Sun Capital Partners, Inc.
The Carlyle Group
The Jordan Company, L.P.
TSG Capital Group, L.L.C.
Valor Equity Partners

Domestic Equities
Barclays Global Investors, N.A.
Benchmark Plus Partners, L.L.C.
DePrince, Race & Zollo, Inc.
EARNEST Partners, L.L.C.
Legg Mason Capital Management
Neumeier Investment Counsel, L.L.C.
Profit Investment Management
Russell Investment Group
State Street Global Advisors

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

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

Real Assets
Aetos Capital
BlackRock, Inc.
CB Richard Ellis Investors
Crow Holdings
Fortress Investment Group, L.L.C.
Global Forest Partners, L.P.
Goldman, Sachs & Co.
Grove International Partners
Lone Star U.S. Acquisitions, L.L.C.
Morgan Stanley Asset Management, Inc.
Olympus Real Estate Corp.
Prudential Strategic Investment Corp.
RREEF America L.L.C.
State Street Global Advisors

SECTION 2: FINANCIAL INFORMATION

An Overview

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 25, 2008.

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, 2008 and June 30, 2007 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.

Statements of Plan Net Assets

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. An asset is anything having commercial economic or exchange value. Assets include cash, receivables (interest and dividends earned by the investments of the System and employee member and employer contributions), investment, collateral on securities lending arrangements, and furniture, fixtures and equipment. System liabilities include money reserves for participants who are entitled to benefits and obligations for professional services the system has used - but for which payment has not been made.

Statements of Changes In Plan Net Assets

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 Financial Statements

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 Information

Supplemental Schedules provide information required by the GASB which include the supplementary 10-year trend information. These charts show the progress toward reaching the goal of being totally funded, as well as sources of revenues and types of expenses of the Fund during the fiscal year.

Other supplementary information provides additional information for analysis.

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

Member of the American Institute of Certified Public Accountants

INDEPENDENT AUDITORSí 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, 2008 and 2007, 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements, 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, information regarding the Plan's net assets available for benefits as of June 30, 2008, and changes therein for the year then ended and its financial status as of June 30, 2007, and the changes therein for the year 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, 2 and 3) are not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. 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 the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The other supplemental information (schedules 4, 5, and 6) are presented for purposes 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 audits 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 25, 2008

Mir Fox & Rodriguez

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

Management's Discussion and Analysis (Unaudited)

The Board of Trustees (the Board) of the Houston Municipal Employees Pension System (the 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, 2008 and 2007. 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, 2008 and 2007 indicate the net assets available to pay future payments and give a snapshot at a particular point in time. The Statements of Changes in Plan Net Assets for the fiscal years ended June 30, 2008 and 2007 provide a view of the fiscal year's additions to and deductions from the System.

Notes to Basic 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 22 to 38 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.

Schedule 3 - Schedule of Funding Progress for OPEB- this provides historical trend information that contributes to the understanding of the changes in the funded status of the other postemployment benefits (OPEB) 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 OPEB 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.

The other supplemental information consists of:

Schedule 4 - Investment Summary - this lists the System's investments by type presented both at cost and fair market value.

Schedule 5 - Investment Services, Professional Services, and Administration Expenses - this provides more information for purposes of more detailed analysis.

Schedule 6 - Summary of Costs of Investment and Professional Services - this provides more information for purposes of more detailed analysis.

COMPARATIVE FINANCIAL STATEMENTS

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

Assets	June 30, 2008	June 30, 2007	June 30, 2006
Cash and equivalents	$ 956	3,148	2,718
Investments	1,886,044	2,021,243	1,741,434
Receivables on asset sales	52,292	14,714	8,326
Other receivables	77,482	59,207	45,767
Note receivable - City of Houston	300,000	300,000	300,000
Collateral on securities lending	141,334	132,467	93,012
Furniture, fixtures and equipment, net	419	419	702
Total assets	2,458,527	2,531,198	2,191,959
Liabilities			
Payable on asset purchases	47,975	45,727	36,009
Accrued liabilities	7,185	8,407	10,642
Collateral on securities lending	141,334	132,467	93,012
Total liabilities	196,494	186,601	139,663
Plan net assets	$ 2,262,033	2,344,597	2,052,296

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

Additions	Fiscal Year 2008	Fiscal Year 2007	Fiscal Year 2006
Contributions	$ 94,447	91,231	88,856
Investment and interest income, net	73	365,105	299,331
Other income	634	1,185	385
Total additions	95,154	457,521	388,572
Deductions			
Benefits paid	169,482	157,716	154,311
Contribution refunds	1,760	1,398	1,037
Administration expenses and professional fees	6,476	6,106	5,779
Total deductions	177,718	165,220	161,127
Net (decrease) increase in plan net assets	(82,564)	292,301	227,445
Plan net assets, prior year	2,344,597	2,052,296	1,824,851
Plan net assets, current year	$ 2,262,033	2,344,597	2,052,296

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

- The System received $21,175 and $20,966 during fiscal years 2008 and 2007, respectively, in employee contributions from about 9,900 Group A active participants. For fiscal years 2008 and 2007, the contributions represent 5% of the employee's qualifying base salary. Total employee contributions slightly increased by $209 or 1% in fiscal year 2008 compared to fiscal year 2007.
- The City of Houston's (the City) contributions during fiscal years 2008 and 2007 represent the budgeted contributions and the net proceeds received through the issuance of pension obligation bonds as set forth in the Meet and Confer Agreement between the System and the City dated September 15, 2004 and the fourth Amendment to the agreement dated June 27, 2007. During fiscal years 2008 and 2007, the System received cash contributions from the City of $73,272 and $70,265 (net of contributions to the replacement benefit plan of $1,728 and $1,735 for fiscal years 2008 and 2007, respectively).
- The net investment and interest income of the System was $73 during fiscal year 2008 compared to $365,105 during fiscal year 2007, which is a decrease of $365,032 mainly as a result of depreciation on investments. The investment and interest income of the System consists of:
- Earnings from limited partnerships and real estate trusts decreased from $25,035 to $13,424 with a corresponding decrease in realized gain on investments of 58%. It is the System's policy to adjust the carrying value of limited partnerships and real estate trusts during their holding period based on the general partner's direction. The total investment gains associated with these holdings consist of realized gains and unrealized appreciation and/or (depreciation).
- Benefit payments increased slightly to $169,483 during fiscal year 2008 compared to $157,716 during fiscal year 2007. Normal retirement pension benefits amounted to $126,622 (5% increase from fiscal year 2007), which accounted for 75% of the total benefit payments for fiscal year 2008. There were 8,617 participants that received benefits for the fiscal year ended 2008 compared to 8,452 participants in 2007. These numbers represent a very slight increase in fiscal year 2008 and an increase of 2% for the fiscal year 2007.
- Distributions to DROP (Deferred Retirement Option Plan) participants amounted to $23,139 or 14% of the total benefit payments during fiscal year 2008 compared to 12% of the total during fiscal year 2007. The amount of DROP distributions increased by 23% in fiscal year 2008. The number of DROP participants

	Fiscal Year 2008	Fiscal Year 2007	Change
Interest	42,659*	43,769*	(1,110)
Dividends	14,381	15,276	(895)
Earnings from limited partnerships and real estate trusts	13,424	25,035	(11,611)
Realized gain on investments	56,883	136,358	(79,475)
Change in unrealized gain on investments	(121,759)	150,820	(272,579)
Net proceeds from lending securities	1,025	284	741
Less cost of investment services	(6,540)	(6,437)	(103)
Net investment and interest income	73	365,105	(365,032)

**The interest income for fiscal years 2008 and 2007 includes accrued interest on the $300 million note from the City (see note 4).*

FINANCIAL HIGHLIGHTS *(In Thousands of Dollars, Unless Otherwise Noted) con't*

decreased to 328 in 2008 compared to 373 in 2007 or a 12% decrease.

- Benefit payments exceeded total employee plus employer cash contributions by $75,035 during fiscal year 2008 and by $66,485 during fiscal year 2007.
- Costs of administering the benefit programs of the System, including professional fees, slightly increased to $6,476 for fiscal year 2008 from $6,106 for fiscal year 2007, for over 25,000 participants.
- Net assets were $2,262,033, a decrease of $82,564 during fiscal year 2008 compared to an increase of $292,301 in 2007. Fiscal years 2008 and 2007 reflected the $300 million note receivable from the City.

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 2008 and 2007 is $419, for both years.

The year ended June 30, 2008 provided a challenging environment for investors to earn meaningful investment returns in the world equity and bond markets. Among the most followed markets, emerging market equities, as reflected by the MSCI EMF Index, returned 4.9% and was the sole equity market with positive returns. The US equity market, as defined by the S&P 500 Index was down 13.1%. US growth stocks outperformed US value stocks, -6.4% versus -19.0%, as measured by the Russell 3000 Value and Russell 3000 Growth indices while the US large-cap stocks out-paced the small-caps -12.4% to -16.2% according to the Russell 1000 and Russell 2000 indices.

Government bonds provided the most attractive returns for the year. The US Treasury market, as reflected by the Lehman Treasury Index, returned 10.3%, while Non-US Government bonds, as defined by the Citigroup Non-US Government Bond Index, was up 18.7% for the year.

The System's investment portfolio (excluding the $300 million note from the City) closed its 2008 fiscal year at $1.89 billion, down from $2.02 billion at the beginning of the year. The total investment return for the fiscal year was 0.5%. The System's performance, including the total fund, each asset class and their corresponding benchmark(s), for fiscal year 2008 and the trailing three- and five-year periods are listed below.

The System's investment performance was 0.5%, 12.1% and 13.7% for the past one-, three- and five-year periods. These results are materially above the System's policy benchmark over the same periods. Relative to its peer group the fund continues to post attractive investment returns. As of June 30, 2008, the Fund ranks in the top 4th and 2nd percentiles, respectively, for the trailing one- and three-year periods, and is the top performing fund over the trailing five- and ten-year periods.[1] The best performing asset classes for the fiscal year 2008 were Real Assets (+18.2%) and Alternative Investments (+11.9%), while Non-US Equities (+29.5%) and Alternative Investments (+25.4%) were the top two performing asset classes for fiscal year 2007. The benefits of a well-diversified asset allocation are evidenced by the System's' ability to perform very competitively in both years where different asset classes drove overall returns. For the past three- and five- year periods, Real Assets, which includes public and private real estate and natural resource investments, was the System's best performing asset class, providing 24.6% and 23.9% per annum. The System's target allocation of 15% to real assets helped enable the System to perform well in an environment where a more traditional asset allocation (60% / 40% mix of S&P 500 Index / Lehman Aggregate Bond Index) would have returned -5.3%, 4.4% and 6.2% over the trailing one-, three- and five-year periods.

Throughout fiscal year 2008, the System maintained its existing target asset allocation mix of 30% US Equities, 20% Non-US Equities, 20% Fixed-Income, 15% Real

[1] Wilshire Associates Public Fund Universe.

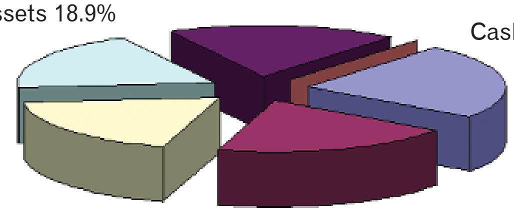
PERFORMANCE OF INVESTMENT CLASSES

Periods Ended June 30, 2008	Investment Return		
	FY 2007	3-Years	5-Years
System's Total Portfolio	0.5%	12.1%	13.7%
Policy Benchmark	-4.9%	8.9%	11.1%
Median Public Fund (Wilshire Public Fund Universe)	-4.8%	7.4%	10.0%
U S Equities	-16.8%	3.4%	7.8%
Dow Jones Wilshire 5000 Index	-12.5%	5.0%	8.7%
International Equities	-5.4%	16.8%	19.4%
MSCI All Country World ex U S Index	-6.2%	16.2%	19.4%
Fixed Income	2.0%	4.7%	5.4%
Lehman Aggregate Index	7.1%	4.1%	3.9%
Merrill Lynch High Yield Master II Index	-2.1%	4.6%	6.9%
Real Estate	18.2%	24.6%	23.9%
NCREIF Property Index	9.2%	15.0%	14.7%
Alternatives	11.9%	19.8%	18.5%
S&P 500 Index + 3.0%	-10.6%	7.3%	10.6%
Cash	4.7%	4.8%	3.6%
91-Day T-Bill	3.6%	4.3%	3.2%

Assets and 15% Alternative Investments. However, due to movements in the markets and rebalancing activities directed by Staff, the System ended fiscal year 2008 with an underweight to Domestic Equity and Fixed Income, and an overweight to Real Assets and Alternative Investments.

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

SYSTEM ASSET ALLOCATION



The System's securities lending program obtains additional income by lending securities to broker-dealers and banks. During the years ended June 30, 2008 and 2007, 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, 2008, the System had no credit risk exposure to borrowers.

The System's investments in limited partnerships are included in the tables appearing in note 7. In connection with those investments, the System has remaining commitments as of June 30, 2008 and 2007 of approximately $234 million and $263 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 Director of Administration of the Houston Municipal Employees Pension System at 1111 Bagby, Suite 2450, Houston, Texas 77002.

	2008	2007
Assets		
Investments, at fair value:		
Short-term investment funds (valued at cost)	$ 50,709,924	91,351,681
Government securities	46,189,118	48,020,004
Corporate bonds	88,482,458	88,502,341
Capital stocks	487,616,910	652,858,988
Commingled funds	537,365,408	588,540,704
Real assets	338,905,427	282,072,691
Alternative Investments	336,774,854	269,897,043
Total investments	$ 1,886,044,099	$ 2,021,243,452
Cash and cash equivalents	956,060	3,148,398
Receivables:		
Receivables on asset sales	52,292,069	14,714,160
Receivables on foreign exchanges	3,095,563	4,156,155
Note receivable - City of Houston	300,000,000	300,000,000
Accrued interest on note receivable - City of Houston	69,893,533	52,343,253
Other receivables	4,492,591	2,707,564
Total receivables	$ 429,773,756	$ 373,921,132
Collateral on securities lending arrangements, at fair value	141,334,443	132,467,071
Furniture, fixtures and equipment, net	418,818	418,576
Total assets	$ 2,458,527,176	$ 2,531,198,629
Liabilities		
Payables on asset purchases	47,974,937	45,727,213
Payables on foreign exchanges	3,077,685	4,158,211
Accrued liabilities	4,001,845	4,203,884
Options written	105,064	44,966
Collateral on securities lending arrangements, at fair value	141,334,443	132,467,071
Total liabilities	196,493,974	186,601,345
Plan net assets held in trust for pension benefits	$ 2,262,033,202	$ 2,344,597,284

(A schedule of funding progress for the plan is presented on page 39.)

See accompanying notes to basic financial statements.

	2008	2007
Additions to plan net assets:		
Contributions:		
City of Houston	$ 73,271,799	$ 70,264,721
Participants	21,175,733	20,966,469
Total contributions	94,447,532	91,231,190
Investment (loss) income:		
Interest on bonds and deposits	13,453,101	15,923,067
Dividends	14,381,110	15,275,523
Earnings from limited partnerships and real estate trusts	13,424,079	25,034,767
Net (depreciation) appreciation on investments	(64,876,697)	287,179,126
Total investment (loss) income	(23,618,407)	343,412,483
Proceeds from lending securities	7,410,879	6,726,695
Less costs of securities lending	(6,385,747)	(6,442,900)
Net proceeds from lending securities	1,025,132	283,795
Less costs of investment services	(6,539,954)	(6,437,145)
Total investment (loss) income, net	(29,133,229)	337,259,133
Interest income - City of Houston note receivable	29,206,117	27,845,681
Other income	633,941	1,185,141
Total additions to plan net assets	95,154,361	457,521,145
Deductions from plan net assets:		
Benefits paid to participants	169,482,632	157,716,433
Contribution refunds to participants	1,760,026	1,397,504
Professional services	637,584	882,886
Administration expenses	5,838,201	5,223,051
Total deductions from plan net assets	177,718,443	165,219,874
Net (decrease) increase in plan net assets	(82,564,082)	292,301,271
Plan net assets held in trust for pension benefits:		
Beginning of year	2,344,597,284	2,052,296,013
End of year	$ 2,262,033,202	$ 2,344,597,284

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), as amended. 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 Pension 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 a contributory group (Group A) and two noncontributory groups (Group B and Group D) and provides for service, disability and death benefits for eligible participants. System plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group D. 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.

Participation

Participants hired on or after January 1, 2008 automatically become members of a new noncontributory group (Group D) pursuant to the Fourth Amendment to the Meet and Confer Agreement dated June 27, 2007.

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 and before January 1, 2008 participate in Group A; except that Executive Officials of the City and the Executive Director of the System (Executive Officials) participated in Group C. Effective January 1, 2005, the Executive Officials of the City and the Executive Director of the System automatically became Group A members pursuant to the First Amendment to Meet and Confer Agreement, dated December 21, 2004.

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

	2007	2006
Retirees and beneficiaries currently receiving benefits	7,971	7,780
Former employees - vested but not yet receiving benefits	2,922	2,786
Former employees - non-vested	2,491	1,849
Vested active participants	7,374	7,524
Non-vested active participants	5,002	4,621
Total participants	25,760	24,560

Participants may no longer elect to convert previous Group B service to Group A after December 31, 2005.

Contributions

For fiscal year 2008 and 2007, covered active Group A participants were required to contribute 5% of their qualifying base salary to the System.

The System's Pension Statute provides that the employer contribution to the System be based on a percentage contribution rate multiplied by the combined eligible salaries paid to participants of all members. 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%.

However, under the terms of the Fourth Amendment to the Meet and Confer Agreement between the Board and the City, dated June 27, 2007, the City agreed to provide funding to the System as follows for the fiscal years 2008, 2009, 2010 and 2011:

	Budgeted Contributions
Fiscal year 2008	$75.0 million
Fiscal year 2009	$78.5 million
Fiscal year 2010	$83.5 million
Fiscal year 2011	$88.5 million

Prior to the current agreement, the original Meet and Confer Agreement between the Board and the City dated September 15, 2004, provided funding to the System for the fiscal years 2005, 2006 and 2007, comprised of budgeted contributions and net proceeds of pension obligation bonds as follows (on a cash basis):

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

Retirement Eligibility

Effective January 1, 2008, new employees participate in a noncontributory group (Group D) with:

- No employee contributions,
- Normal retirement eligibility of age 62 and 5 years of credited service,
- Benefit accrual of 1.8% for the first 25 years of credited service, and 1% thereafter,
- Option to elect an actuarially equivalent benefit with a survivor benefit,
- Option to elect an early reduced retirement benefit, and
- Option to roll over funds from section 457(b) plan to purchase an increased benefit.

A former employee who is rehired as an employee by the City or by the System on or after January 1, 2008 is a member of the group in which the employee participated at the time of the employee's immediately preceding separation from service.

There is no change in benefits for current members and retirees. For those participants employed, effective January 1, 2005, and prior to January 1, 2008 a participant who terminates employment with the City or the System is eligible for a normal retirement pension beginning on the member's effective retirement date after the date the member completes at least five years of credited service and attains either:

(i) 62 years of age, or

(ii) a combination of years of age and years of credited service, including parts of years, the sum of which equals the number 75, provided the participant is at least 50 years of age, 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, provided that the member, prior to January 1, 2005, completed at least 5 years of credited service and attained a combination of age and credited service that when added together equal 68 or more.

Pension Benefits

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

Pension benefits are increased annually by a Cost of Living Adjustment (COLA) equal to 3% of the original benefit amount, not compounded, for all persons receiving a pension or survivor benefit as of January 1 of the year in which the increase is made, provided the person receiving the pension was an employee on or before December 31, 2004, and the person receiving the survivor benefit is an eligible survivor of a person who was an employee on or before December 31, 2004.

Effective January 1, 2005, pension and survivor benefits for all retirees and eligible survivors of Group A and Group B are increased annually by 2%, not compounded, for all persons receiving a pension or survivor benefit as of January 1 of the year in which the increase is made, provided the person receiving the pension was hired or rehired on or after January 1, 2005. Retirees who received a 3% COLA and who are rehired on or after January 1, 2005 will also receive a 3% COLA on the subsequent benefit. Individuals participating in Group D do not have a COLA provision.

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 $20,000 on the date of termination. The Fourth Amendment to the Meet and Confer Agreement established the $20,000 threshold. Prior to this agreement, the maximum amount was $10,000. 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.

Survivor Benefits

Survivor benefits are provided for a member's surviving spouse and/or dependent children. A deceased member must have had at least five years of credited service at the time of his or her death to qualify for survivor benefits unless death was caused by a service-connected incident as defined by the Pension Statute. For a Group D member, death benefits for a death that occurs while actively employed are determined in the same manner as for Group A and Group B. For death that occurs after the Group D member's termination of employment, the payment of a death benefit depends on whether the participant elected an optional annuity. A Group D participant with at least five years of credited service has the option to elect an actuarially equivalent amount under one of three joint annuity options in lieu of a normal benefit with no survivor benefit. If a Group D participant with at least five years of credited service elects a normal benefit, no death or survivor benefit is payable. If a Group D participant with at least five years of credited service makes no optional annuity election, the surviving spouse is eligible to receive an amount equal to the amount that would have been paid if the participant had elected a 50% joint and survivor annuity and named the spouse as the designated beneficiary.

In order to qualify for survivor benefits, if applicable, 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

A Group A or Group B 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 than thirty calendar days, may elect to participate in the Deferred Retirement Option Plan (DROP). The DROP provides that a monthly amount (monthly DROP credit) will be credited to a notional account (DROP Account). Interest is credited to the DROP Account at a rate approved by the Board, compounded at an interval approved by the Board. Beginning January 1, 2005 and continuing for the duration of the 2004 Meet and Confer Agreement, the DROP interest rate will be equal to half the return on the System's investment for the prior fiscal year, with a minimum rate of 2.5% and a maximum rate of 7.5%, compounding currently at daily intervals. 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. However, effective January 1, 2005, a participant's election to participate in DROP cannot establish a DROP entry date that occurs prior to the date of the System's receipt of the member's request to participate in DROP. 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 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, partial distribution, 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.

Group D participants do not participate in DROP.

Refunds of Participant Contributions

Group A 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.

Basis of Accounting

The basis of accounting is the method by which revenues and expenses are recognized in the accounts and reported in the basic 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 depreciation/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.

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.

Compensated Employee Absences

System employees earn paid leave (vacation and sick leave) based on years of service and may accumulate them subject to certain limitations and paid upon termination or resignation from the System. The amount paid is determined based on the departing employee's regular rate of pay at separation. Compensated employee absences (vacation, compensatory time off, annual leave and sick leave) are accrued as an expense and liability in the statement of plan net assets at their most current rate.

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. Accordingly, 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 has been amended since receiving the determination letter. However, 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.

New Accounting Pronouncements

GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*.

This statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. Derivative instruments are often complex financial arrangements used by governments to manage specific risks or to make investments. By entering into these arrangements, governments receive and make payments based on market prices without actually entering into the related financial or commodity transactions. Derivative instruments associated with changing financial and commodity prices result in changing cash flows and fair values that can be used as effective risk management or investment tools. Derivative instruments, however, also can expose governments to significant risks and liabilities. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2009.

GASB Statement No. 50, *Pension Disclosures - an Amendment of GASB Statement No. 25 and No. 27.*

This statement enhances information discussed in notes to financial statements or presented as required supplementary information (RSI) by pension plans and by employers that provide pension benefits. The reporting changes required by this statement amend applicable note disclosure and RSI requirements of Statements No. 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, and No, 27, Accounting for Pensions by Statement and Local Governmental Employers.

In general, the GASB Statement No. 50 requires the financial statements to disclose the funded status of the plan as of the most recent actuarial valuation in the notes to financial statements instead of in the notes to the RSI. It also requires the notes to include a reference linking the funded status disclosure in the notes to financial statements to the required schedule of funding progress in the RSI. The statement is effective for periods beginning after June 15, 2007 and has been adopted with the System's June 30, 2008 financial statements.

GASB Statement No. 47, *Accounting for Termination Benefits*

This statement provides guidance on accounting and financial reporting for termination benefits. These benefits include incentives for voluntary terminations such as early retirement window programs and involuntary termination benefits, such as severance payments and other arrangements that are in substance termination benefits. The implementation of this provision had no material effect on the System's financial statements in 2008 and 2007.

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits Other than Pensions*

This statement establishes the standards for providing employer accounting and financial reporting for other post employment benefits (OPEB). This new pronouncement provides uniform financial reporting standards for plans that provide post-employment benefits such as health care benefits. The statement requires the System to obtain actuarial valuations, and report in its financial statements the funded status and funding progress of these costs. During fiscal year 2008, the System implemented the requirements of GASB Statement No. 45 into note 6 of its financial statements.

3. CONTRIBUTIONS AND FUNDING STATUS

Contributions

Group A active participants are required to contribute to the System amounts as set forth in the Pension Statute. As of June 30, 2008 and 2007, the Group A participant contribution rate was 5% of a participant's qualifying base salary. Group B and Group D participants do not contribute to the System.

Under the System's Pension Statute, the City's contribution rate shall not be less than the greater of 10% of all participant salaries or two times the rate contributed by Group A participants. The City is required to contribute amounts to the System to provide funding on an actuarial reserve basis for normal cost plus the level of percentages of payroll payments based on its amortization period for the unfunded actuarial liability. However, under the terms of the Fourth Amendment to the Meet and Confer Agreement dated June 27, 2007, the City agreed to provide funding to the System for fiscal years to June 30, 2008 through 2011 as follows:

	Budgeted Contributions
Fiscal year 2008	$75.0 million
Fiscal year 2009	$78.5 million
Fiscal year 2010	$83.5 million
Fiscal year 2011	$88.5 million

In addition, as part of the original Meet and Confer Agreement, a pension obligation note (see note 4) of $300 million was recognized as a contribution from the City during fiscal year 2005.

The employer contribution amounts for fiscal years 2008 and 2007 were not set by actuarial valuations but were instead established under the terms of the Meet and Confer Agreement.

Although the City and participants have contributed the amounts as required under the Pension Statute and the Meet and Confer Agreement, the actual contributions made by the City have been less than the Annual Required Contribution (ARC) for fiscal years 2008 and 2007. The actuarially determined Annual Required Contribution (ARC) for fiscal year 2008 was calculated in the July 1, 2006 actuarial valuation at 24.63% of covered payroll as shown in the July 1, 2007 Valuation Report.

Prior to 2008, based on the original Meet and Confer Agreement between the System's Board and the City, dated September 15, 2004, the City agreed to provide funding to the System as follows for fiscal years 2005, 2006 and 2007, comprised of budgeted contributions and net proceeds of pension obligation bonds as follows (on a cash basis):

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

Funding Status

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, 2007 is 70.1%, which includes the $300 million note contributed by the City (see note 4). This is higher than the funded ratio as of July 1, 2006, which is 64.5%. This increase is the direct result of the 2007 Fourth Amendment to the Meet and Confer Agreement. Prior to the Fourth Amendment, the actuarial value of System assets was determined using techniques that spread the effects of short-term volatility in the market value of investments over a five-year period (20% each year). Under the new agreement for purposes of the July 1, 2007 actuarial valuation, instead of recognizing 20% of the prior years' deferred investment gains/(losses) all of the deferred investment gains/(losses) for the years prior to 2007 were recognized and 20% of the 2007 excess investment gain was recognized.

The funded status of the System as of July 1, 2007, the most recent actuarial valuation date, is found on the table at the bottom of the page.

The City is responsible for funding the deficiency, if any between the amounts available to pay the System's benefits and the amount required to pay such benefits.

Actuarial Methods and Assumptions

The July 1, 2007 actuarial valuation used the following significant assumptions:

Investment rate of return	8.5%, net of expenses
Salary increases	Graded rates based on years of service (range from 3 percent to 5.5 percent)
Payroll growth factor	3.0% per year
General inflation rate	3.0% per year
Actuarial cost method	Entry age normal cost method
Life expectancy	Based on 1994 Uninsured Pensioners Mortality Tables (healthy participants)
	Based on 1965 Railroad Retirement Board Disabled Life Table (disabled participants)
DROP participation rate	90% at first eligibility

Funded Status of the System as of July 1, 2007

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
07/01/07	2,193.7	3,128.7	935.0	70%	448.9	208%

Historical trend information is provided as required supplementary information on pages 44. 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. NOTE RECEIVABLE - CITY OF HOUSTON

As part of the Meet and Confer Agreement and to improve the System's long-term funding outlook, on November 10, 2004, the City issued the System a $300 million pension obligation note (the Note), secured in part by a deed of trust on the Convention Center Hotel adjacent to the George R. Brown Convention Center (the Hotel). The Note will mature on December 1, 2033. For the initial period through March 31, 2005, the Note had an interest rate of 8.5%. Thereafter, the interest rate adjusts 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 is payable beginning 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 Note 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 Note, compounded annually.

The total interest receivable related to this Note as of June 30, 2008 and 2007 is $69,893,533 and $52,343,253, respectively. The System recognized interest income in connection with this Note of $29,206,117 and $27,845,681 for fiscal years 2008 and 2007, respectively.

5. 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, Great-West Retirement Services (Great-West), and the cost of administration and funding are borne by the DCP participants. Amounts deferred are held in trust by Great-West 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.

6. POST EMPLOYMENT BENEFITS OTHER THAN PENSION BENEFITS

<u>Plan Description</u>

The System provides health care benefits (i.e. medical, prescription, dental) to retired System employees and their beneficiaries. The System also provides System retirees only with $5,000 of life insurance. A System employee is eligible for retiree health benefits and life insurance if the individual has at least five (5) years of full-time service with the System and meets at least one of the conditions:

- Has retired due to disability.
- Age 62 or greater.
- Total of years of age and years of full-time service are greater than or equal 70.
- Employee is eligible to begin receiving a retirement pension within 5 years after the employee's termination of employment.

The health care benefits are self-funded by the System. The System is fully responsible for the self-funded benefits. An insurance company processes claims and provides other services to the System related to the self-funded benefits. The insurance company does not insure or guarantee the self-funded benefits. The

System's plan includes an excess loss insurance established by the insurance company and the System is insured for the aggregate excess loss of $20,000 maximum amount per covered person.

Funding Policy and Annual OPEB Cost

Contribution requirements of the System's retired employees are established and may be amended by the Board of Trustees. For health care benefits, the eligible retiree contributes 25% of the retiree health insurance premium and the System contributes the remaining 75% of the retiree health care premium. For life insurance, the retiree pays 100% of the cost of the premium.

The System's annual other postemployment benefits (OPEB) cost is calculated based on the annual required contribution of the employer (ARC), an amount actuarially determined in accordance with the parameter of GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and to amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years. The System had its first OPEB actuarial valuation performed as of June 30, 2008 as required by GASB Statement No. 45. The System's annual OPEB cost for the current year is as follows:

Annual required contribution	$ 335,706
Interest on OPEB obligation	-
Adjustment to ARC	-
Annual OPEB cost (expense) (end of year)	335,706
Net estimated employer contributions	(83,679)
Increase in net OPEB obligation	252,027
Net OPEB obligation - as of beginning of the year	-
Net OPEB obligation - as of end of year	$ 252,027

Funded Status and Funding Progress

The funded status of the System's retiree health care plan, under GASB Statement No. 45 as of June 30, 2008 is shown in the table on the following page.

Under the reporting parameters, the System's retiree health care plan is 0% funded with an estimated actuarial accrued liability exceeding actuarial assets by $3,297,680 at June 30, 2008.

Actuarial Methods and Assumptions

The Projected Unit Credit, Level Percent of Payroll actuarial cost method is used to calculate the GASB ARC for the System's retiree health care plan. Using the plan benefits, the present health premiums and a set of actuarial assumptions, the anticipated future payments are projected. The projected unit credit method then provides for a systematic funding for these anticipated payments. The yearly ARC is computed to cover the cost of benefits being earned by covered members as well as to amortize a portion of the unfunded accrued liability. If experience is in accordance with the assumptions used, the ARC will increase at approximately the same rate as active employee payroll, and the ARC as a percentage of payroll will remain basically level on a year to year basis.

Projections of health benefits are based on the plan as understood by the System and include the types of benefits in force at the valuation date and the pattern of sharing benefit costs between the System and the System's employees to that point. Actuarial calculations reflect a long-term perspective and employ methods and assumptions that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets. Significant methods and assumptions were as follows:

Actuarial Methods and Assumptions

Investment rate of return	4.5%, net of expenses
Salary increases	Graded rates based on years of service (range from 3 percent to 5.5 percent)
Payroll growth factor	3.0% per year
General inflation rate	3.0% per year
Actuarial cost method	Projected Unit Credit Cost Method
Amortization method	Level percentage of pay

Funded Status of the System's Retiree Health Care Plan

Actuarial Valuation Date as of June 30	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded (Funded) AAL (UAAL) (b-a)	Funded Ratio (a/b)
2008	-	$3,297,680	$3,297,680	0%

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events in the future. Amounts determined regarding the funded status and the annual required contributions of the System's retiree health care plan are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future. The required schedule of funding progress presented as required supplementary information (See Schedule 3) provides multiyear trend information that shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

7. INVESTMENTS

Portions of the System's investments are classified as security investments. A security is a transferable financial instrument that evidences ownership or creditorship. Investments in commingled funds, limited partnerships, real estate trusts, and loans and mortgages are investments that are evidenced by contracts rather than securities.

The fair values of the System's investments at June 30 are presented by type, as follows:

	2008	2007
Short-term investment funds	$ 50,709,924	91,351,681
Government securities	46,189,118	48,020,004
Corporate bonds	88,482,458	88,502,341
Capital stocks	487,616,910	652,858,988
Commingled funds	537,365,408	588,540,704
Real assets	338,905,427	282,072,691
Alternative Investments	336,774,854	269,897,043
	$ 1,886,044,099	2,021,243,452

The System's Board, in accordance with the power and authority conferred under the Texas Statutes, employed State Street Bank and Trust Company (Custodian) as custodian of the assets of the System, and in said capacity, the Custodian is a fiduciary of the System's assets with respect to its discretionary duties including safekeeping the System's assets. The Custodian has established and maintains a custodial account to hold, or direct its agents to hold, for the account of the System all assets that the Board shall from time to time deposit with the Custodian. All rights, title and interest in and to the System's assets shall at all times be vested in the System's Board.

In holding all System assets, the Custodian shall act with the same care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in like capacity and familiar with matters of this type would use in the conduct of an enterprise with a like character and with like aims.

Further, the Custodian shall hold, manage and administer the System's assets for the exclusive purpose of providing the benefits to the members and the qualified survivors of the System.

The Board shall manage the investment program of the System in compliance with all applicable Federal and state statutes and regulations concerning the investment of pension assets. The Board has adopted a Statement of Investment Policies and Objectives (Investment Policy) to set forth the factors involved in the management of investment assets for the System and which is made part of every investment management agreement.

Custodial Credit Risk

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the System will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the System, and are held by either the counterparty or the counterparty's trust department or agent but not in the System's name. At June 30, 2008, the System's investments that were not subject to custodial credit risk were the investments in U.S. government securities and corporate bonds as they are registered in the name of the System and held in possession of the Custodian.

Concentration of Credit Risk

The allocation of assets among various asset classes is set by the Board. For major asset classes (e.g., U.S. equity, international equity, fixed income, real assets, and alternative investments), the System will further diversify by employing managers with demonstrated skills in complementary areas of expertise. The managers retained will utilize varied investment approaches, but, when combined will exhibit characteristics that are similar, but not identical, to the asset class proxy utilized in the strategic asset allocation plan. The Investment Policy of the System provides that no investment manager shall have more than 15% (at market value) of the System's assets in one investment style offered by the firm, with the exception of passive management.

Representative guidelines by type of investment are as follows:

U.S. equity managers

1. A manager's portfolio shall contain a minimum of twenty-five issues.
2. No more than 5% of the manager's portfolio at market shall be invested in ADR's.
3. No individual holding in a manager's portfolio may constitute more than 5% of the outstanding shares of an issuer.
4. No individual holding may constitute more than 5% of a manager's portfolio at cost or 10% at market.
5. Short sales, purchases on margin, non-negotiable or otherwise restricted securities are prohibited, other than where expressly permitted.
6. While there are no restrictions on cash, a manager must notify the System if the cash position exceeds 10%.

International equity managers

1. Not more than 5% at cost and 10% at market value of a manager's portfolio shall be invested in the securities of any one issuer.
2. Not more than 30% of the assets of a manager's portfolio (at market value) shall be invested in any one country with the exception of Japan.
3. While there are no restrictions on cash, a manager must notify the System if the cash position exceeds 10%.
4. Currency forwards and futures will be limited as follows:
    a. Limits on net forward and future sales of currencies will be addressed in each manager's respective Guidelines and Objectives,
    b. Forward and future exchange contracts of any currencies, other than Yen, Sterling and Euro shall be limited to the manager's underlying equity position in the local market,
    c. Foreign exchange contracts with a maturity exceeding 12 months are prohibited, and
    d. Currency options may be entered into in lieu of or in conjunction with forward sales of currencies. The same effective limitations specified in (a) through (c) above will apply to currency options.

Fixed income managers

1. No more than 10% of a manager's portfolio at market shall be invested in the securities of any single issuer, with the exception of the U.S. government and its agencies.
2. No individual holding in a manager's portfolio shall constitute more than 10% of the market value of an issue.

Global opportunistic fixed income/high yield managers

1. No more than 5% at cost and 10% at market value of

a manager's portfolio shall be invested in the securities of any single issuer, with the exception of the U.S. government and its agencies.

There is no security issued by a single issuer that is being held with market value over 5% of the System's plan net assets as of June 30, 2008 and June 30, 2007.

Interest Rate Risk

The System invests in fixed income securities including, but not limited to, investments representing instruments with an obligated fixed rate of interest including public and private debentures, mortgages, investments in life insurance general accounts and guaranteed investment contracts, with maturities greater than one year, and options/futures. Instruments may have an investment grade or non-investment grade rating. Purchases and sales, investment selection and implementation of investment strategies are delegated to the discretion of the investment manager, subject to compliance with its management agreement and the Investment Policy.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of the investment. This risk is managed within the portfolios using the effective duration or option-adjusted methodology. The System's investment policies require that the portfolio shall maintain a duration within +/- 20% of the Lehman Aggregate Bond index; and maintain a credit quality weighted average of AA-, or equivalent. Duration is a measure of a debt investment's exposure to fair value changes arising from changes in interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price. The greater the duration of a bond, or a portfolio of bonds, the greater its price volatility will be in response to a change in interest rates and vice-versa. Duration is the measure of a bond price's sensitivity to a 100-basis point change in interest rates. The duration of the System's debt securities are managed by the active managers.

Credit Risk

The quality ratings of investments in fixed income securities are set forth in the Investment Policy as follows:

1. All issues purchased must be of investment grade quality Baa (Moody's) or BBB (S&P) unless expressly authorized by the Board, in which case a minimum B rating shall apply, with a maximum limit of non-investment grade credits of 20% at market.

2. For global opportunistic fixed income/high yield securities, more than 50% of a manager's portfolio at market shall be invested in non-investment grade fixed income securities, i.e. those with ratings of BA1 (Moody's), BB+ (Standard & Poor's), or lower, or unrated bonds, including but not limited to corporate bonds, convertible bonds, and preferred stocks. The quality ratings of investments in fixed income securities are shown at the bottom of page 34.

Foreign Currency Risk

International securities investment managers are expected to maintain diversified portfolios by sector and by issuer using the System's Investment Policy.

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. Each investment manager, through the purchase of units in a commingled investment trust fund or international equity mutual fund, establishes investments in international equities. The System has an indirect exposure to foreign currency fluctuation as of June 30, 2008, as follows:

	Fair Value	Percentage
Australian Dollar	$ 4,731,169	2.4%
Brazilian Real	1,997,378	1.0%
Canadian Dollar	22,297,022	11.1%
Danish Krone	3,392,452	1.7%
Euro Currency	51,358,787	25.5%
Hong Kong Dollar	3,449,216	1.7%
Indonesian Rupiah	3,267,993	1.6%
Japanese Yen	46,164,938	23.0%
Malaysian Ringgit	1,113,638	0.6%
Mexican Peso	1,835,140	0.9%
New Taiwan Dollar	1,320,537	0.7%
New Zealand Dollar	1,363,403	0.7%

Continued on page 35.

At June 30, 2008, the table shows the System's investments by type, amount and the effective duration rate calculated using the software Wilshire Axiom.

	Effective Duration	Domestic	International	Fair Value
Collateralized mortgage obligations	6.12	$ 8,567,670		8,567,670
Convertible bonds	9.82	8,317,513		8,317,513
Corporate Bonds	9.84	58,351,072		58,351,072
Corporate Bonds	6.35		7,929,239	7,929,239
GNMA I/FNMA/FHLMC (Sponsored Agencies)	5.01	30,674,118		30,674,118
Government Issues (United States)	6.96	10,090,918		10,090,918
Government Issues (International)	10.93		4,158,775	4,158,775
Zero coupon bond	n/a	1,265,307		1,265,307
Misc. receivable (Auto/Credit card)	0.32	767,569		767,569
Other asset backed	3.46	4,286,261	263,134	4,549,395
	6.55	$ 122,320,428	12,351,148	134,671,576

Quality Ratings

The quality ratings of investments in fixed income securities as described by nationally recognized statistical rating organizations at June 30, 2008 are as follows:

Quality Rating	CMO	Convertible Bonds	Corporate Bonds	Sponsored Agencies	Government Issues (Int'l)	Other	Other Asset Backed	Grand Total Fair Value	Percentage of Holdings
AAA	$ 7,360,076			4,505,827	516,042		818,476	13,200,421	9.80%
AA		320,800	959,781			494,650	393,185	2,168,416	1.61%
AA+	5,075		442,696					447,771	0.33%
AA-			1,794,443					1,794,443	1.33%
A			1,378,737				81,249	1,459,986	1.08%
A-			2,052,072				242,002	2,294,074	1.70%
A+			1,706,097		1,825,804			3,531,901	2.62%
BBB			4,803,802					4,803,802	3.57%
BBB-			4,224,944		1,740,072		450,770	6,415,786	4.76%
BBB+			3,248,326				439,741	3,688,067	2.74%
BB		558,038	4,727,482				650,377	5,935,897	4.41%
BB+			4,672,740		76,858		75,845	4,825,443	3.58%
BB-			4,382,334				302,753	4,685,087	3.48%
B		320,854	9,351,092					9,671,946	7.18%
B+		335,125	6,398,924					6,734,049	5.00%
B-		1,356,563	5,645,942					7,002,505	5.20%
Below C	143,223	1,112,156	7,369,680					8,625,059	6.40%
NA	1,059,297	4,313,978	3,121,219	26,168,291		272,919	1,094,998	36,030,702	26.75%
Subtotal	$ 8,567,671	8,317,514	66,280,311	30,674,118	4,158,776	767,569	4,549,396	123,315,355	91.57%
Total credit risk debt securities								123,315,355	91.57%
US government fixed income securities*								11,356,225	8.43%
Total fixed income securities								134,671,580	100.00%

*Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not have purchase limitations.

	Fair Value	Percentage
Norwegian Krone	6,248,947	3.1%
Pound Sterling	39,562,664	19.7%
Singapore Dollar	516,038	0.3%
South Korean Won	2,146,140	1.1%
Swedish Krona	2,249,315	1.1%
Swiss Franc	8,131,638	4.0%
Total securities subject to foreign currency risk	$ 201,146,415	100.0%

Schedule 6 on page 44 lists the System's investment and professional service providers.

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, 2008 and 2007, 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 borrower's 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, 2008 and 2007, 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, 2008 and 2007, such investment pool had an average duration of 42 and 58 days, respectively, and an average expected weighted maturity of 396 and 533 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, 2008 and 2007, the System had no credit risk exposure to borrowers. The collateral held and the fair value of securities on loan as of June 30, 2008, was $146,227,896 and $141,903,793, respectively, and $135,375,305 and $131,761,764 respectively, as of June 30, 2007.

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

	2008	2007
U.S. government securities	$ 9,849,691	13,476,087
Domestic equity	106,819,700	71,347,541
Domestic fixed income	12,314,032	13,266,087
International equity	12,920,370	33,672,049
	$ 141,903,793	131,761,764

Derivative Investing

The System's investment managers may invest in derivatives if permitted by the guidelines established by the System's Board. Derivatives are generally defined as contracts whose values depend on, or are derived from, the value of an underlying asset, reference rate or index. The investment manager may invest in exchange-traded derivative securities to provide incremental value at the margin and to hedge or reduce risk using Fed funds futures, T-bill futures, 2, 5 and 10-year note futures and options, 30-year bond futures and options, Agency note futures and options and municipal bond futures and options. No more than 5% of the portfolio will be invested in original futures margin and option premiums, exclusive of any in-the-money portion of the premiums. Short options positions will generally be hedged with cash, cash equivalents, current portfolio security holdings, or other options or futures positions.

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.

One of the System's investment managers, Western Asset Management, is permitted to use investment options. Western Asset Management periodically invests in options as a means to manage their portfolio's duration.

At June 30, 2008 and 2007, the Systems' investments had the following option balances at fair market value:

	2008	2007
Options purchased - Calls		$170,244
Options purchased - Puts	6	12
Options written - Calls	(44,609)	(101,262)
Options written - Puts	(60,461)	(24,028)
	$ (105,064)	44,966

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 counter parties. 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 2008 and 2007. 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.

8. CASH AND CASH EQUIVALENTS

For cash deposits and cash equivalents, custodial credit risk is the risk that in the event of a bank failure, the System's deposits may not be returned to it. The System's deposits are held by the Custodian. As of June 30, 2008 and 2007, the System had fair value bank balances of $1,115,272 and $3,317,414, respectively, that are in demand deposit accounts subject to coverage by Federal deposit insurance but not collateralized. The System does not have a deposit policy for custodial credit risk; however, the management believes that the System's credit risk exposure is mitigated by the financial strength of the banking institution in which the deposits are held.

9. FURNITURE, FIXTURES AND EQUIPMENT

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

	2008	2007
Office furniture and equipment	$ 437,945	458,489
Computer equipment	794,303	1,100,255
Leasehold improvements	398,232	398,232
	1,630,480	1,956,976
Less accumulated depreciation and amortization	(1,211,662)	(1,538,400)
	$ 418,818	418,576

10. 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, 2008 and 2007, aggregate contributions from these eligible participants of the System were approximately $88,960,000 and $77,174,000, respectively.

The System's investments in limited partnerships and real estate trusts are included in the table appearing in note 7. In connection with those investments, the System has remaining commitments as of June 30, 2008 and 2007 of approximately $234,000,000 and $271,000,000, respectively, pursuant to terms of the respective limited partnerships and real estate trusts.

The System leases office facilities and parking spaces under an operating lease which was originally made on August 1, 1990 and has been amended to the sixth amendment dated August 30, 2002. The sixth amendment to the lease agreement provides rent abatement on the expansion premises through June 30, 2004 and an annual base rent of $15 per square foot of rentable area up to June 30, 2006, increasing to $21.50 per square foot of rentable area from July 1, 2006 until the end of the lease term on June 30, 2011. The amount of future minimum lease obligations required under this lease are as follows:

Year Ending June 30,	
2009	$ 466,200
2010	466,200
2011	466,200
	$ 1,398,600

Additional amounts are assessed for use of common areas, utilities and maintenance. Total rental expense, including these assessments, amounted to approximately $735,000 and $662,000 during the years ended June 30, 2008 and 2007, respectively.

11. 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 the notes and in Schedules 1, 2 and 3 are 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 basic financial statements.

12. SUBSEQUENT EVENTS

City Note

The City of Houston (the City) pursuant to Chapter 120 of the Texas Government Code (the Expedited Declaratory Judgment Act) petitioned the 345th Judicial Court of Travis County to provide a Declaration Judgment validating the City's authority to issue Pension Obligation Refunding Bonds for the Purpose of refunding the 2004 Note and certain accrued obligations to the System (see note 4). On August 18, 2008, the City's petition was granted allowing the issuances of refunding bonds during fiscal year 2009. The bond proceeds are intended to prepay the City note and related deferred interest and to replace the City obligation to the System with actual dollars added to the System's investment portfolio. As of June 30, 2008 the note and deferred interest total $369 million.

Financial Markets

The recent events relating to deteriorating conditions in credit markets and a potential Federal intervention have continued to adversely affect financial markets and their participants, including the System's investment portfolio. The decline in the System's portfolio is muted due to its diversified asset allocation and investment strategies that are long-term in perspective. Nonetheless, future investment returns on the System's investment portfolio could be adversely impacted in certain asset classes with a prolonged decline in the world's financial markets. The System's board and management continue to monitor the portfolio and take action as deemed appropriate.

SCHEDULE 1 - 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
07/01/98	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 %
07/01/04	1,501.2	2,633.8	1,132.6	57 %	366.2	309 %
07/01/05	1,777.6	2,725.2	947.6	65 %	404.6	234 %
07/01/06	1,867.3	2,894.3	1,027.0	64 %	422.5	243 %
07/01/07	2,193.7	3,128.7	935.0	70 %	448.9	208 %

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 - 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	07/01/01	71.9	56.5 %
06/30/04	07/01/02	123.9	46.0 %
06/30/05	07/01/03	102.9	61.0 %**
06/30/06	07/01/05	119.1	56.2 %
06/30/07	07/01/06	101.8	69.0 %
06/30/08	07/01/07	110.6	66.0 %

* 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.

** Includes only actual cash contributions received. Does not include the $300 million pension obligation note (see note 4).

See accompanying independent auditors' report.

See accompanying note to required supplemental schedules.

NOTES 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, 2007
Actuarial cost method	Entry Age Normal
Amortization method	Level percentage, open
Amortization period	30- year open funding period beginning July 1, 2007
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	90% at first eligibility
DROP interest credit	4.25% per year
Mortality rates	Based on 1994 Uninsured Pensioners Mortality Table (healthy participants); 1965 Railroad Retirement Board Disabled Life Table (disabled participants)

See accompanying independent auditor's report.

SCHEDULE 3 - SCHEDULE OF FUNDING PROGRESS FOR OPEB (UNAUDITED)

Actuarial Valuation Date	Actuarial Value of Assets (a)	(b) Actuarial Accrued Liability (AAL)	(b-a) Unfunded AAL (UAAL)	a/b Funded Ratio	(c) Covered Payroll	((b-a)/c) UAAL as a Percentage of Covered Payroll
June 30, 2008	$0	$3,297,680	$3,297,680	0%	n/a	n/a

NOTE TO REQUIRED SUPPLEMENTAL SCHEDULES 3 (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	June 30, 2008
Actuarial cost method	Projected unit credit
Amortization method	Level percent of payroll
Amortization period	30-Year period
Asset valuation method	Market value of assets
Actuarial assumptions:	
Investment rate of return	4.5%, 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
Health cost trend	Starting at 10% in 2008 and decreasing to 4.5% by 2023

See accompanying independent auditor's report.

See accompanying notes to required supplemental schedules.

SCHEDULE 4- INVESTMENT SUMMARY JUNE 30, 2008 and 2007

	June 30, 2008			June 30, 2007		
	Cost	Fair Value	Unrealized Appreciation (Depreciation)	Cost	Fair Value	Unrealized Appreciation (Depreciation)
Fixed income:						
Government securities	$ 44,620,412	46,189,118	1,568,706	47,177,842	48,020,004	842,162
Corporate bonds	93,654,660	88,482,458	(5,172,202)	84,630,079	88,502,341	3,872,262
Total fixed income	138,275,072	134,671,576	(3,603,496)	131,807,921	136,522,345	4,714,424
Short-term investment funds	50,709,924	50,709,924		91,351,681	91,351,681	
Capital stocks	491,108,221	487,616,910	(3,491,311)	537,602,300	652,858,988	115,256,688
Commingled funds	401,804,751	537,365,408	135,560,657	407,871,324	588,540,704	180,669,380
Real assets	198,531,128	338,905,427	140,374,299	172,655,231	282,072,691	109,417,460
Alternative Investments	296,701,264	336,774,854	40,073,590	244,908,912	269,897,043	24,988,131
Total investments	$ 1,577,130,360	1,886,044,099	308,913,739	1,586,197,369	2,021,243,452	435,046,083

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 5 - INVESTMENT SERVICES, PROFESSIONAL SERVICES, AND ADMINISTRATION EXPENSES YEARS ENDED JUNE 30, 2008 AND 2007

	2008	2007
Investment services:		
Custodial services	$ 371,030	320,967
Money management services	5,660,966	5,617,178
Consulting services	507,958	499,000
Total investment services	$ 6,539,954	6,437,145
Professional services:		
Actuarial services	58,195	80,156
Auditing and consulting services	19,942	88,818
Legal services	527,172	650,060
Other professional services	32,275	63,852
Total professional services	$ 637,584	882,886
Administration expenses:		
Office costs	741,371	668,372
Insurance costs	125,124	141,574
Costs of staff and benefits	3,853,975	3,332,906
Costs of equipment and supplies	747,612	585,587
Depreciation and amortization	225,402	355,270
Costs of education and research	144,717	139,342
Total administration expenses	$ 5,838,201	5,223,051

See accompanying independent auditors' report.

SCHEDULE 6 - SUMMARY OF COSTS OF INVESTMENT AND PROFESSIONAL SERVICES YEARS ENDED JUNE 30, 2008 AND 2007

Service Provider	Service Provided	2008	2007
Investment services:			
Barclays Global Investors, N.A.	Money management	$ 1,261,987	1,261,988
Axiom Int'l Investors, L.L.C.	Money management	1,105,639	907,106
Bloomberg	Money management	5,400	
Brandes Investment Partners, LLC	Money management	630,107	650,427
DePrince, Race and Zollo, Inc.	Money management	458,927	492,235
Earnest Partners, LLC	Money management	160,247	124,732
Profit Investment Management	Money management	52,009	51,763
Neumeier Investment Counsel, L.L.C.	Money management	451,679	421,672
Legg Mason Capital Management, Inc.	Money management	375,675	408,205
UBS Global Asset (formerly Adams Street)	Money management	306,374	329,366
Loomis, Sayles and Company, L.P.	Money management	324,147	316,479
DDJ Capital Management, LLC	Money management	230,724	227,822
Western Asset Management	Money management	101,198	204,585
Smith Graham & Company	Money management	107,773	92,781
Frank Russell Securities	Money management	25,557	78,814
Global Forest Partners, L.P.	Money management	50,920	49,203
State Street Global Advisors	Money management	12,603	
State Street Bank and Trust Company	Custodial services	371,030	320,967
Courtland Partners	Consulting services	102,083	
Wilshire Associates, Incorporated	Consulting services	284,000	284,000
Pension Consulting Alliance	Consulting services	121,875	215,000
Total investment services		6,539,954	6,437,145
Professional services:			
Locke, Liddell and Sapp, L.L.P.	Legal services	322,971	287,363
Baker and Botts, L.L.P.	Legal services	82,870	235,162
Hughes & Luce LLP	Legal services		6,907
Schlanger, Mills, Mayer & Silver	Legal services		628
Purrington, Moody, Weil	Legal services	11,360	
Mir·Fox & Rodriguez, P.C.	Auditing and professional services	16,720	85,858
HillCo Partners, LLC	Professional services	109,971	120,000
TCG Solutions	Professional services		13,600
Groom Law Group	Professional services	300	18,985
CP Paragon Solutions	Professional services	11,125	
Henry, McDonald, James	Consulting services	350	
Pearl, Meyer and Partners	Consulting services	14,000	
Ennis, Knupp & Assoc., Inc.	Consulting services	6,500	31,267
Pension Benefits Information	Consulting services	3,222	2,960
Gabriel, Roeder, Smith & Co.	Actuarial services	58,195	80,156
Total professional services		637,584	882,886
Total costs of investment and professional services		$ 7,177,538	7,320,031

See accompanying independent auditors' report.

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SECTION 3: INVESTMENT INFORMATION

The Board of Trustees (the Board) of the Houston Municipal Employees Pension System (The 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 (The 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 HMEPS 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.

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 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 reviews 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 has provided a summary below the Schedule 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' Chief Investment Officer.

SCHEDULE OF ASSET ALLOCATION

Asset Class	Allocation		Investment Performance		
	Target	Actual	3 Yrs.	5 Yrs.	10 Yrs.
Domestic Equity	30.0 %	23.5 %	3.4 %	7.8 %	4.5 %
Dow Jones Wilshire 5000 Index			5.0	8.7	3.6
S&P 500 Index			4.4	7.6	2.9
International Equity	20.0	20.0	16.8	19.4	8.3
MSCI All Country World Ex-US Index			16.2	19.4	7.7
MSCI EAFE Index			12.8	16.7	5.8
Fixed Income	20.0	18.6	4.7	5.4	5.4
Lehman Aggregate Index			4.1	3.9	5.7
Merrill Lynch High Yield Master II Index			4.6	6.9	4.9
Real Assets	15.0	18.9	24.6	23.9	16.9
NCREIF Index			15.0	14.7	12.2
Alternative Investments	15.0	19.0	19.8	18.5	9.5
S&P 500 Index + 3%			7.4	10.6	5.9
Cash	-	-			
Total Portfolio			12.1	13.7	8.4
Policy Benchmark			8.9	11.1	6.6

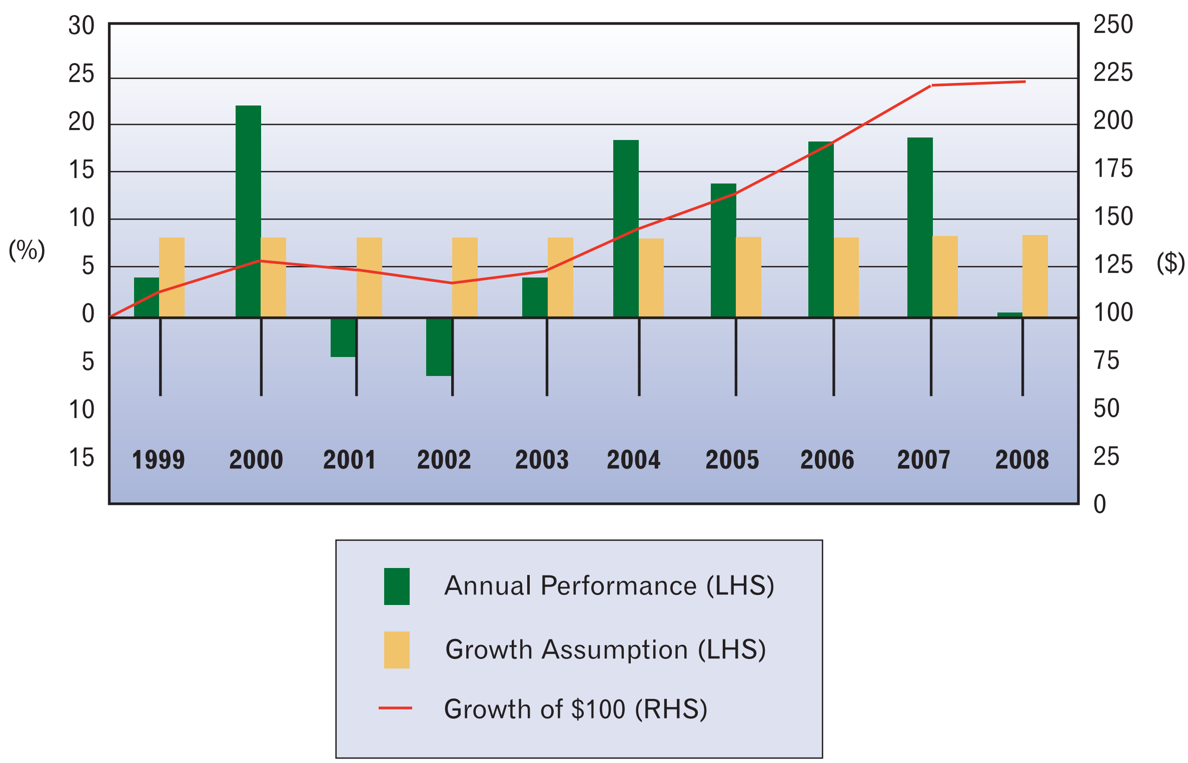
SCHEDULE OF TOP INVESTMENTS AS OF JUNE 30, 2008*

Name of Investment	Fair Value of Investment	Percent of Portfolio
Barclays US Bond Index (Lehman Aggregate Index)	$ 140,654,344	7.4 %
Barclays Alpha Tilts International (Enhanced MSCI ACW x US Index)	137,283,880	7.2 %
Barclays Alpha Tilts (Enhanced S&P 500 Index)	131,586,291	6.9 %
Blackrock Energy and Natural Resources Fund	84,903,248	4.5 %
Barclays Russell 1000 Growth Fund	78,863,833	4.2 %
CB Richard Ellis Strategic Partners U.S. IV, L.P.	36,566,757	1.9 %
DDJ Capital Management High Yield Bond Commingled Pool	35,294,306	1.9 %
RREEF America REIT II, Inc.	34,834,912	1.8 %
Benchmark Plus Institutional Partners Fund	30,000,337	1.6 %
HarbourVest Partners VI-Buyout Partnership Fund L.P.	24,486,122	1.3 %

Pension Obligation Note		
City of Houston Pension Obligation Note	$ 369,893,532	

* A complete list of the System's holdings is available at the System's office by appointment.

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	Dow Jones Wilshire 5000 Index	S&P 500 Index	HMEPS Int'l Equity	MSCI ACW Free ex US Index	MSCI EAFE Index	HMEPS Fixed Income	Lehman Aggregate Index	Merrill Lynch High Yield Master III Index	HMEPS Real Assets	NCREIF Index	HMEPS Alternative Investments	S&P500 Index
1999	3.42%	9.99%	7.87%	19.57%	22.79%	1.60%	9.54%	7.60%	0.52%	3.14%	0.89%	6.18%	12.80%	-9.95%	22.79%
2000	22.92%	9.81%	12.14%	9.52%	7.27%	44.02%	18.12%	17.17%	8.54%	4.56%	-1.04%	9.73%	11.62%	77.46%	7.27%
2001	-4.08%	-4.84%	-2.00%	-15.33%	-14.81%	-26.31%	-23.82%	-23.61%	2.30%	11.23%	-1.01%	26.08%	11.57%	-15.95%	-14.81%
2002	-6.97%	-5.85%	-12.78%	-16.62%	-17.96%	-12.10%	-8.16%	-9.50%	2.34%	8.64%	-4.38%	5.24%	5.51%	-18.58%	-17.96%
2003	3.55%	4.14%	3.18%	1.27%	0.25%	-3.76%	-4.19%	-6.45%	13.99%	10.41%	22.24%	5.84%	7.64%	-3.40%	0.25%
2004	18.64%	16.62%	21.95%	21.24%	19.10%	34.44%	32.50%	32.38%	3.99%	0.32%	10.05%	15.92%	10.83%	13.32%	19.10%
2005	13.85%	10.23%	7.94%	8.23%	6.31%	13.24%	16.95%	13.64%	9.17%	6.81%	10.62%	30.03%	18.02%	19.96%	6.31%
2006	18.11%	11.14%	11.14%	9.92%	8.63%	30.14%	28.40%	26.54%	2.62%	-0.81%	4.71%	36.39%	18.67%	22.46%	8.63%
2007	18.64%	17.75%	19.36%	20.45%	20.60%	29.54%	30.14%	26.99%	9.56%	6.12%	11.72%	20.10%	17.24%	25.37%	20.60%
2008	0.47%	-4.92%	-16.79%	-12.53%	-13.13%	-5.42%	-6.20%	-10.61%	1.95%	7.13%	-2.09%	18.18%	9.20%	11.86%	-13.13%
3 Yrs.	12.08%	7.36%	3.35%	5.01%	4.41%	16.83%	16.16%	12.83%	4.66%	4.08%	4.63%	24.63%	14.96%	19.76%	4.41%
5 Yrs.	13.72%	9.99%	7.76%	8.73%	7.58%	19.41%	19.42%	16.66%	5.41%	3.86%	6.87%	23.89%	14.72%	18.48%	7.58%
10 Yrs.	8.37%	6.31%	4.48%	3.59%	2.89%	8.27%	7.74%	5.83%	5.41%	5.69%	4.88%	16.92%	12.23%	9.45%	2.89%

SCHEDULE OF FEES AND COMMISSIONS PAID IN FISCAL YEAR 2008

Broker Name	Commissions	Shares	cents/share
UBS Warburg	242,650	14,757,685	1.6
Citigroup Global Markets Inc.	105,603	5,408,149	2.0
Cantor Fitzgerald + Co.	83,972	1,767,000	4.8
Capital Institutional Svcs Inc. Equities	61,468	1,550,000	4.0
Merrill Lynch	59,515	2,516,888	2.4
Lehman Brothers Inc.	58,599	11,017,703	0.5
Credit Suisse First Boston	48,270	2,971,026	1.6
J P Morgan Securities Inc.	35,397	2,651,615	1.3
Sterne, Agee & Leach, Inc.	34,548	838,538	4.1
Morgan Stanley Co. Inc.	30,776	1,216,866	2.5
Deutsche Bank Securities Inc.	30,315	1,227,968	2.5
Bear Stearns Securities Corp.	27,885	1,604,603	1.7
Barclays Global Investors	26,934	1,795,575	1.5
Goldman Sachs & Co.	26,102	718,319	3.6
Charles Schwab Co. Inc.	24,351	759,225	3.2
Bank of New York/Lynch Jones Ryan	23,240	580,269	4.0
Credit Lyonnais Securities	18,438	7,030,380	0.3
ABG Securities	17,472	426,965	4.1
ABN Amro Bank Inc.	15,360	3,667,406	0.4
Knight Securities	14,619	862,700	1.7
Instinet	14,532	436,402	3.3
Jefferies & Co. Inc.	14,498	418,475	3.5
Enskilda Securities AB	14,280	613,010	2.3
Cimb-GK Securities Ltd.	13,644	3,539,800	0.4
Macquaries Securities Ltd.	12,299	2,592,633	0.5
Wien Securities Corp.	10,647	356,200	3.0
Societe Generale Bank and Trust	10,459	121,793	8.6
Keefe Bruyette & Woods Inc.	10,168	209,249	4.9
State Street Brokerage Services	9,325	234,901	4.0
Dresdner Kleinworth Wasserstein Sec. LLC	9,311	276,289	3.4
Pershing DLJ S L	7,586	367,500	2.1
Credit Agricole Indosuez Cheuvreux	7,545	95,660	7.9
Cazenove & Co.	6,026	536,100	1.1
Baird, Robert W. & Co. Inc.	5,980	148,022	4.0
Dongwon Securities	5,818	28,323	20.5
Stephens Inc.	5,676	141,900	4.0
Keybanc Capital Markets Inc.	5,675	141,800	4.0
Toronto Dominion Securities	5,375	121,100	4.4
Stifel Nicolaus & Co. Inc	5,331	154,100	3.5
BNP Paribas Securities Corp.	5,233	331,045	1.6
GMP Securities Ltd.	5,206	130,420	4.0
Carnegie BK	4,897	106,790	4.6
HSBC Brokerage	4,811	188,680	2.6
Mizuho Securities USA Inc.	4,667	45,849	10.2
Sidoto & Co. LLC	4,241	101,900	4.2

(continued on following page)

Broker Name	Commissions	Shares	cents/share
ESN NorthAmerica Inc.	3,965	110,316	3.6
ATA Securities Inc. (Istanbul)	3,949	224,700	1.8
Kempen & Co. N.V.	3,937	63,999	6.2
Banco Ianco Itau SA	3,871	82,300	4.7
Kaupthingbank SVverige AB Stockholm	3,718	161,154	2.3
Fortis Bank (Nederland)	3,351	58,400	5.7
Goodmorning Shinhan Securities Co.	3,216	9,072	35.5
Intermonte Sec Sim SPA	3,032	121,900	2.5
Auerbach Grayson and Co. Inc.	2,960	67,500	4.4
Nesbitt Burns	2,858	68,500	4.2
KES Sinarmas Securities PT	2,618	861,500	0.3
First Analysis Securities Corp.	2,612	65,300	4.0
Nomura Securities Int'l Inc.	2,547	42,991	5.9
LiquidNet Inc.	2,521	129,000	2.0
Joh Berenberg Gossler & Co.	2,508	21,811	11.5
Bank J. Vontobel & Co. AG	2,481	13,480	18.4
Raymond James & Assoc. Inc.	2,444	41,760	5.9
Tokyo-Mitsubishi Securities (USA)	2,398	31,545	7.6
Scotia Capital Inc.	2,322	46,300	5.0
Magna Securities Corp.	2,190	62,591	3.5
Banc of America Securities LLC	2,164	54,100	4.0
Banco Portugese De Investimento S.A.	2,066	51,100	4.0
Other	50,591	1,969,239	2.6
Total	1,303,064	79,165,379.00	1.6

* Gross commissions reported for brokers in directed brokerage program.

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SECTION 4: ACTUARIAL INFORMATION

Gabriel, Roeder, Smith and Company

January 31, 2008

Board of Trustees
Houston Municipal Employees Pension System
1111 Bagby, Suite 2450
Houston, TX 77002-2555

Dear Members of the Board:

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 the HMEPS statute, the employer contribution rate is determined actuarially, based on the Board's funding policy and HMEPS' governing law. The contribution rate determined by a given actuarial valuation and implemented by the Board becomes effective twelve months after the valuation date, i.e., the rates determined by this July 1, 2007 actuarial valuation will be used by the Board when determining the employer contribution rate for the year beginning July 1, 2007 and ending June 30, 2008.

Under the 2004 Meet & Confer Agreement between the Board and the City of Houston, a three-year funding schedule was implemented consisting of a $63 million employer contribution and $300 million pension obligation note for FY 2005, a $69 million employer contribution for FY 2006 and a $72 million employer contribution for FY 2007. The funding schedule was developed to substantially increase the funded level of the plan and maintain adequate funding levels over the three-year period ending June 30, 2007.

A Fourth Amendment to the Meet & Confer Agreement between the Board and the City of Houston was adopted in 2007 (2007 Meet & Confer Agreement). As part of this agreement, a four-year funding schedule was implemented consisting of a $75 million employer contribution for FY 2008, a $78.5 million employer contribution for FY 2009, a $83.5 million employer contribution for FY 2010, and a $88.5 million employer contribution for FY 2011.

Therefore, the employer contribution amounts for FY 2007 and FY 2008 were not set by actuarial valuations. The calculated contribution rates from those valuations were not contributed, but were instead $72 million for FY 2007 and $75 million for FY 2008 under the terms of the Meet & Confer.

After reflecting all of the benefit changes in the 2007 Meet & Confer Agreement, the calculated required employer contribution rate for FY2009 is 19.47% of payroll. Using an estimated payroll of $481.8 Million for FY2009 projects an estimated calculated employer contribution for FY2009 of $93.8 Million. This compares to the actual $78.5 million employer contribution that will be paid under the terms of the 2007 Meet & Confer Agreement.

Benefit Provisions

The benefit provisions reflected in this valuation are those which were in effect on July 1, 2007, and also reflect the changes made as a part of the 2007 Meet and Confer agreement. The 2007 agreement between the City and the Board changed the benefit provisions substantially, effective January 1, 2008. The benefits for current employees were not modified, but the benefits for future employees beginning January 1, 2008 will be substantially different. These changes will be more fully detailed in the Benefit Provision portion of the Discussion section of this report.

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 not been modified since the previous valuation. The assumptions used in the valuation were adopted by the Board based on our recommendations following an Experience Analysis performed for the five year period ending July 1, 2004.

The results of the actuarial valuation are dependent on the actuarial assumptions used. Actual results can and almost certainly will differ, as actual experience deviates from the assumptions. Even seemingly minor changes in the assumptions can materially change the liabilities, calculated contribution rates and funding periods. The actuarial calculations are intended to provide information for rational decision making.

The actuarial assumptions and methods used in this report comply with the parameters for disclosure that appear in GASB 25.

All assumptions and methods are described in Appendix A.

Financing Objectives and Funding Policy

The amortization period is set by statute, and was modified under the Meet and Confer. 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 an open period (30 years as of July 1, 2007). The amortization rate is 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, 2007 is 70.1%. This is significantly higher than the 64.5% from the 2006 valuation. This increase is the direct result of the 2007 Meet & Confer Agreement. Under the agreement, instead of recognizing 20% of the prior years' deferred investment gains/(losses) all of the deferred investment gains/(losses) for the years prior to 2007 were recognized and 20% of the 2007 excess investment gain were recognized. This increased the actuarial value of assets by approximately $135 million more than the standard actuarial asset valuation method. This change increased the funded ratio by more than 4%.

The calculated employer contribution rate for FY 2009 is 19.47%. This rate is significantly less than the 24.63% rated calculated in the 2006 valuation. The large decrease is the direct result of the changes in the benefit provisions and the early recognition of the prior years' deferred investment gains/(losses).

Data

Member data for retired, active and inactive members was supplied as of July 1, 2007 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, 2007 was taken from the Comprehensive Annual Financial Report for the Year Ended June 30, 2007.

Plan Experience

As part of each valuation, we examine the System's experience relative to the assumptions. The aggregate results of these analyses are disclosed in Tables 5 & 6. This past fiscal year the System had a total liability loss of approximately $20 million. Relative to the total liabilities of the System we consider this aggregate loss immaterial. Most of the loss can be traced to larger than expected salary increases.

We were asked to determine if an unanticipated actuarial cost occurred in the administration of the Deferred Retirement Option Plan (DROP). It is our opinion that the administration of the (DROP) had no material unanticipated actuarial costs during the prior fiscal year.

Certification

All of the tables contained in this actuarial valuation report and in the actuarial section of the HMEPS CAFR were prepared by Gabriel, Roeder, Smith & Company. We certify that the information presented herein is accurate and fairly portrays the actuarial position of HMEPS as of July 1, 2007.

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 and are also Members of the American Academy of Actuaries. All three of the undersigned are experienced in performing valuations for large public retirement systems.

Sincerely,

Gabriel, Roeder, Smith & Company

Joe Newton, FSA, EA, MAAA
Consultant

Lewis Ward
Consultant

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

Item	July 1, 2007	July 1, 2006
Membership		
• Number of:		
- Active members	12,376	12,145
- Retirees and beneficiaries	7,971	7,780
- Inactive members	5,413	4,635
- Total	25,760	24,560
• Annualized Payroll supplied by HMEPS	$ 448,925	$ 422,496
Calculated Contribution rates		
• Member (weighted)[1]	4.27 %	4.18 %
• Employer	19.47 %	24.63 %
Assets		
• Market value	$ 2,344,597	$ 2,052,296
• Actuarial value	2,193,745	1,867,293
• Estimation of return on market value	17.9 %	16.4 %
• Estimation of return on actuarial value	21.5 %	9.0 %
• Employer contribution	$ 70,265	$ 66,968
• Ratio of actuarial value to market value	93.6%	91.0%
Actuarial Information		
• Employer normal cost %	5.84 %	8.45 %
• Unamortized actuarial accrued liability (UAAL)	$ 934,969	$ 1,027,002
• Amortization rate	13.63 %	16.18 %
• Funding period	30.0 years	30.0 years
• GASB funded ratio	70.1 %	64.5 %
Projected employer contribution based on calculated rate		
• Fiscal year ending June 30,	2009	2008
• Projected payroll (millions)	$ 481.8	$ 445.2
• Projected employer contribution (millions)	$ 93.8	$ 109.6
(actual contribution rate set by Meet & Confer)		

Note: Dollar amounts in $000, unless otherwise noted

[1] Employee contribution rate is 5%. Members hired after January 1, 2008 are noncontributory.

STATEMENT OF PLAN NET ASSETS

	July 1, 2007
A. ASSETS	(1)
1. Current Assets	
a. Cash and short term investments	
1) Cash on hand	$ 3,148
2) Short term investments	91,352
b. Accounts Receivable	
1) Sale of investments	14,714
2) Other	6,864
c. Total Current Assets	$ 116,078
2. Long Term Investments	
a. US. Government securities	$ 48,020
b. Corporate bonds	88,502
c. Capital stocks	652,859
d. Commingled Funds	588,541
e. LP's, real estate trusts, loans and mortgages	551,970
f. Total long term investments	$ 1,929,892
3. Other Assets	
a. Collateral on securities lending	$ 132,467
b. Furniture, fixtures and equipment, net	419
c. Note Receivable - City of Houston	300,000
d. Accrued interest on note receivable	52,343
e. Total other assets	$ 485,229
4. Total Assets	$ 2,531,199
B. LIABILITIES	
1. Current Liabilities	
a. Amounts due on asset purchases	$ 49,930
b. Accrued liabilities	4,204
c. Collateral on securities lending	132,467
2. Total Liabilities	186,601
3. Net Assets Held in Trust	$ 2,344,597
C. ASSET ALLOCATION FOR CASH & LONG TERM INVESTMENTS	
1. Cash	1.0 %
2. Fixed Income	17.3 %
3. Real Assets	15.2 %
4. Domestic Equities	29.7 %
5. International Equities	21.9 %
6. Alternative Investments	14.9 %
7. Total	100.0 %

Note: Dollar amounts in $000

Columns may not add due to rounding $2,045,970

RECONCILIATION OF PLAN NET ASSETS

	Year Ending June 30, 2007
	(1)
1. Market value of assets at beginning of year	$ 2,052,296
2. Revenue for the year	
a. Contributions	
i. Member contributions	$ 20,966
ii. Employer contributions	70,265
iii. Total	$ 91,231
b. Net investment income	
i. Interest	$ 15,923
ii. Dividends	15,275
iii. Earnings from LP's and real estate trusts	25,035
iv. Net appreciation (depreciation) on investments	287,179
v. Interest income - City of Houston note receivable	27,846
vi. Net proceeds from lending securities	284
vii. Less investment expenses	(6,437)
viii. Other	1,185
c. Total revenue	$ 457,521
3. Expenditures for the year	
a. Refunds	$ 1,398
b. Benefit payments	157,716
c. Administrative and miscellaneous expenses	6,106
d. Total expenditures	$ 165,220
4. Increase in net assets (Item 2c - Item 3d)	$ 292,301
5. Market value of assets at end of year (Item 1 + Item 4)	$ 2,344,597

Note: Dollar amounts in $000

CALCULATION OF EXCESS INVESTMENT INCOME

Item	Year Ending June 30, 2007
(1)	(2)
1. Market value of assets at beginning of year	$ 2,052,296
2. Net external cash flow during the year	(67,883)
3. Market value of assets at end of year	2,344,597
4. Actual investment income during the year based on market value: (3) - (2) - (1)	$ 360,184
5. Assumed earnings rate	8.50 %
6. Expected earnings for the year on:	
a. Market value of assets at beginning of year:	174,445
b. Net external cash flow:	(2,826)
c. Total: (a) + (b)	171,619
7. Excess investment income for the year: (4) - (6)	$ 188,565

Note: Dollar amounts in $000

DEVELOPMENT OF ACTUARIAL VALUE OF ASSETS

	July 1, 2007
	(1)
1. Excess (Shortfall) of invested income for current and previous three years	
a. Current year	$ 188,565
b. Current year - 1	141,592
c. Current year - 2	66,518
d. Current year - 3	118,177
e. Current year - 4	(77,263)
f. Total for five years	$ 437,589
2. Deferral of excess (shortfall) of invested income	
a. Current year (80%)	150,852
b. Current year - 1 (60%)[1]	0
c. Current year - 2 (40%)[1]	0
d. Current year - 3 (20%)[1]	0
e. Current year - 4 (0%)	0
f. Total deferred for year	$ 150,852
3. Market value of assets at end of year	$ 2,344,597
4. Actuarial value of assets at end of year: (3) - (2f)	$ 2,193,745

[1]The 2007 Meet & Confer Agreement recognized the deferred gains prior to FY2007.

Note: Dollar amounts in $000

ACTUARIAL PRESENT VALUE OF FUTURE BENEFITS

	July 1, 2007 (1)
1. Active members	
a. Retirement benefits	$ 1,413,633
b. Deferred termination benefits	94,027
c. Refunds	13,501
d. Death benefits	52,992
e. Disability benefits	29,636
f. Total	$ 1,603,789
2. Members in Pay Status	
a. Service retirements	$ 1,529,071
b. Disability retirements	38,518
c. Beneficiaries	121,952
d. Total	$ 1,689,541
4. Inactive members	
a. Vested terminations	$ 132,899
b. Nonvested terminations	2,551
c. Total	$ 135,450
5. Total actuarial present value of future benefits	$ 3,428,780

Note: Dollar amounts in $000

CALCULATION OF TOTAL ACTUARIAL GAIN OR LOSS

1.	Unfunded actuarial accrued liability (UAAL) as of July 1, 2006	$ 1,027,002
2.	Total normal cost for year	55,842
3.	Contributions during year ending June 30, 2007	(91,231)
4.	Interest on UAAL for one year	87,295
5.	Interest on Item 2 and Item 3 for one-half year	(1,473)
6.	Expected UAAL as of July 1, 2007 (1+2+3+4+5)	$ 1,077,435
7.	Actual UAAL as of July 1, 2007	$ 934,969
8.	Actuarial gain/(loss) for the period (6 - 7)	$ 142,466
	SOURCE OF GAINS/(LOSSES)	
9.	Asset gain/(loss) (See Table 13)	$ 103,243
10.	Assumption changes	0
11.	Changes from Meet & Confer	$ 60,002
12.	Total liability gain/(loss) for the period	$ (20,779)
13.	Actuarial gain/(loss) for the period	$ 142,466

Note: Dollar amounts in $000

NEAR TERM OUTLOOK

Valuation as of July 1, (1)	Unfunded Actuarial Accrued Liability (UAAL, in 000s) (2)	Funded Ratio (3)	Calculated Contribution Rate (4)	Funding Period (Years)[2] (5)	Market Value of Fund (in 000s) (6)	For Fiscal Year Ending June 30, (7)	Covered Compensation (8)	Employer Contributions (9)	Employee Contributions (10)	Benefit Payments and Refunds (11)	Net External Cash Flow (12)
2007	$ 934,977	70.1%	19.47%	30.0	$ 2,344,597	2008	$ 465,776	$ 75,000[1]	$ 19,880	$ 183,505	$ (88,625)
2008	908,481	72.0%	18.65%	30.0	2,451,573	2009	481,841	78,500	18,706	198,842	(101,636)
2009	880,307	73.8%	17.91%	30.0	2,554,090	2010	495,158	83,500	17,512	209,342	(108,329)
2010	849,301	75.5%	17.32%	29.0	2,658,348	2011	509,045	88,500	16,363	221,402	(116,539)
2011	815,289	77.2%	16.76%	28.0	2,762,917	2012	522,998	90,592	15,207	234,144	(128,346)
2012	818,848	77.8%	16.78%	27.0	2,864,076	2013	537,464	90,089	14,074	246,821	(142,658)
2013	825,045	78.2%	16.81%	26.0	2,958,925	2014	552,245	92,681	12,973	261,385	(155,731)
2014	830,925	78.6%	16.85%	25.0	3,048,219	2015	567,729	95,456	11,903	274,606	(167,247)
2015	836,348	78.9%	16.89%	24.0	3,133,108	2016	583,893	98,374	10,875	288,077	(178,828)
2016	841,182	79.3%	16.93%	23.0	3,213,150	2017	600,486	101,400	9,884	302,776	(191,492)
2017	845,297	79.5%	16.98%	22.0	3,286,803	2018	617,728	104,591	8,937	304,354	(190,826)

These projections are based on the 2007 Meet and Confer Agreement assuming that the benefit provisions that went into effect January 1, 2008 remain in effect throughout the projection. Also, beginning in FY2012, 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.

1 The agreement between the City and HMEPS includes a $75 million employer contribution for FY 2008, a $78.5 million employer contribution for FY 2009, a $83.5 million employer contribution for FY2010, and a $88.5 million in FY2011.

2 The agreement between the City and HMEPS included an open 30 year amortization period until the 2009 valuation. Beginning with the 2009 valuation, the amortization period will be a closed 30 years from July 1, 2009.

Note: Dollar amounts in $000.

ANALYSIS OF NORMAL COST

	July 1, 2007 (1)	July 1, 2006 (2)
1. Gross normal cost rate		
a. Retirement benefits	4.29%	9.12%
b. Deferred termination benefits	0.63%	1.42%
c. Refunds	0.35%	0.93%
d. Disability benefits	0.27%	0.53%
e. Death benefits	0.30%	0.63%
f. Total	5.84%	12.63%
2. Less: member contribution rate		
a. Present Value of Employee Contributions	NA	$116,146
b. Present value of future pay	NA	$2,775,370
c. Effective member contribution rate (2a/2b)	NA	(4.18%)
3. Employer normal cost rate (Item 1f - Item 2c)	5.84%	8.45%

Note: Dollar amounts in $000

CHANGE IN CALCULATED CONTRIBUTION RATE SINCE THE PRIOR VALUATION

1. Calculated Contribution Rate as of July 1, 2006		24.63%
2. Change in Contribution Rate During Year		
a. Change in Employer Normal Cost	0.00%	
b. Assumption changes	0.00%	
c. Recognition of prior asset losses (gains)	(1.05%)	
d. Actuarial (gain) loss from current year asset performance	(0.60%)	
e. Actuarial (gain) loss from liability sources	0.34%	
f. Impact of City contributing different than expected	(0.01%)	
g. Effect of Payroll growing faster than Payroll Growth Rate	(0.49%)	
h. Effect of resetting amortization period to 30 years	(0.22%)	
i. Total Change		(2.03%)
3. Calculated Rate as of July 1, 2007, before Meet and Confer		22.60%
4. Change from Meet and Confer		
a. Change in Benefits for New Hires	(1.47%)	
b. Advanced Recognition of Deferred Asset Gains	(2.07%)	
c. Specified Contribution Schedule	0.41%	
d. Total Change		(3.13%)
5. Calculated Rate as of July 1, 2007, after Meet and Confer		19.47%

CALCULATION OF ANNUAL REQUIRED CONTRIBUTION RATE

		July 1, 2007 (1)	July 1, 2006 (2)
1.	Covered payroll	$ 448,925	$ 422,496
2.	Covered payroll adjusted for one-year's pay increase	$ 465,776	$ 438,321
3.	Present value of future pay	$ 2,941,394	$2,775,370
4.	Normal cost rate		
	a. Total normal cost rate	5.84%	12.63%
	b. Less: member normal cost	N/A	(4.18%)
	c. Employer normal cost rate	5.84%	8.45%
5.	Actuarial accrued liability for active members		
	a. Present value of future benefits for active members	$ 1,603,789	$ 1,517,742
	b. Less: present value of future employer normal costs	(163,093)	(225,076)
	c. Less: present value of future employee contributions	(125,552)	(116,146)
	d. Service Purchase Receivable [1]	(11,422)	(12,088)
	e. Actuarial accrued liability	$ 1,303,722	$ 1,164,432
6.	Total actuarial accrued liability for:		
	a. Retirees and beneficiaries	$ 1,689,541	$ 1,618,762
	b. Inactive participants	135,450	111,101
	c. Active members (Item 5d)	1,303,722	1,164,432
	d. Total	$ 3,128,713	$ 2,894,294
7.	Actuarial value of assets	$ 2,193,745	$ 1,867,293
8.	Unfunded actuarial accrued liability (UAAL) (Item 6d - Item 7)	$ 934,968	$ 1,027,001
9.	Funding period	30 years	30 years
10.	Assumed payroll growth rate	3.00%	3.00%
11.	Employer Contribution requirement		
	a. UAAL amortization payment as % of pay	13.63%	16.18%
	b. Employer normal cost	5.84%	8.45%
	c. Contribution requirement (a + b)	19.47%	24.63%

Note: Dollar amounts in $000

[1] Includes actual current receivable for actives who have entered into an obligation.

HISTORICAL SOLVENCY TEST

	Aggregated Accrued Liabilities for				by Reported Assets		
Valuation Date	Active Members Contributions	Beneficiaries and Vested Terminations[1]	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%
July 1, 2004	62,062	1,355,157	1,216,599	1,501,235	100.0%	100.0%	7%
July 1, 2005	48,150	1,577,345	1,099,777	1,777,656	100.0%	100.0%	14%
July 1, 2006	58,043	1,729,863	1,106,389	1,867,293	100.0%	100.0%	7%
July 1, 2007	69,544	1,824,992	1,234,178	2,193,745	100.0%	100.0%	24%

Note: Dollar amounts in $000

[1] 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%
July 1, 2004	1,501,235	2,633,817	1,132,582	57.0%	366,190	309.3%
July 1, 2005	1,777,656	2,725,272	947,616	65.2%	404,565	234.2%
July 1, 2006	1,867,293	2,894,295	1,027,002	64.5%	422,496	243.1%
July 1, 2007	2,193,745	3,128,713	934,968	70.1%	448,925	208.3%

Note: Dollar amounts in $000

HISTORICAL CITY CONTRIBUTIONS

Valuation Date	Calculated Contribution Rate[1]	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	92.55[2,3]
July 1, 2004	29.43	July 1, 2005 through June 30, 2006	15.493[3]
July 1, 2005	24.10	July 1, 2006 through June 30, 2007	15.893[3]
July 1, 2006	24.63	July 1, 2007 through June 30, 2008	N/A
July 1, 2007	19.47	July 1, 2008 through June 30, 2009	N/A

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

[2] Includes $300 million note.

[3] As pursuant to the three year funding schedule from the Meet and Confer agreement.

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	144	96	69	12	9	6							336
	$24,218	$23,608	$23,097	$23,888	$26,353	$29,190							$23,948
25-29	285	236	142	65	34	93	3						858
	$28,984	$27,950	$28,579	$28,183	$28,545	$28,912	$34,055						$28,565
30-34	212	170	152	90	45	160	35						864
	$30,357	$30,481	$30,860	$33,378	$34,417	$31,595	$33,878						$31,368
35-39	203	182	169	86	59	241	129	48					1,117
	$30,744	$34,500	$32,500	$31,837	$34,877	$33,862	$38,944	$36,536					$33,793
40-44	213	165	149	98	60	277	186	168	65	6			1,387
	$33,302	$33,201	$35,999	$32,567	$35,894	$36,712	$38,875	$40,157	$38,412	$40,060			$36,167
45-49	165	148	143	91	91	300	236	253	158	142			1,727
	$31,599	$34,758	$36,004	$39,044	$36,206	$35,117	$40,279	$42,625	$42,820	$41,017			$38,083
50-54	128	129	151	89	53	279	235	238	135	123	22		1,582
	$31,966	$35,668	$35,238	$37,703	$40,408	$37,552	$40,221	$46,460	$44,917	$48,616	$51,234		$40,245
55-59	91	83	103	68	50	198	226	169	121	68	22	3	1,202
	$35,746	$38,776	$40,308	$38,300	$36,386	$40,607	$43,063	$46,462	$46,762	$44,202	$52,496	$79,313	$42,203
60-64	42	43	54	38	31	138	132	81	52	35	14	6	666
	$46,603	$41,807	$39,064	$39,489	$37,269	$39,885	$43,230	$45,517	$52,602	$53,015	$56,448	$75,403	$43,921
65 & Over	7	9	11	10	15	46	46	25	14	5	3	3	194
	$44,383	$48,379	$29,952	$35,976	$47,020	$42,380	$41,802	$44,647	$52,506	$46,125	$56,350	$61,376	$43,547
Total	1,501	1,264	1,143	647	447	1,738	1,228	982	545	379	61	12	9,947
	$31,075	$32,499	$33,473	$34,661	$35,982	$36,108	$40,604	$43,785	$44,871	$45,215	$53,138	$72,874	$36,776

Average:	Age:	44.66	Number of participants:	Fully vested:	4,945	Males:	5,615
	Service:	7.99		Not Vested:	5,002	Females:	4,332

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

	0	1	2	3	4	5-9	10-14	15-19	20-24	25-29	30-34	35 & Over	Total
Attained Age	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.	No. & Avg. Comp.
Under 25													
25-29						23	3						26
						$31,198	$31,079						$31,184
30-34						62	51						113
						$28,632	$30,577						$29,510
35-39						102	179	48					329
						$29,728	$32,670	$32,801					$31,777
40-44						77	174	179	36	1			467
						$33,189	$33,572	$33,699	$32,771	$42,663			$33,515
45-49						93	153	144	72	48			510
						$33,170	$34,039	$35,268	$32,288	$33,820			$33,960
50-54						66	168	131	52	30	6		453
						$33,737	$33,421	$38,237	$40,421	$37,791	$38,520		$36,020
55-59						45	117	88	37	13	3		303
						$37,742	$31,726	$34,226	$37,238	$39,591	$43,157		$34,469
60-64						19	61	51	29	9	4	1	174
						$32,326	$37,180	$35,926	$47,210	$46,032	$50,357	$25,326	$38,647
65 & Over						4	25	14	8	3			54
						$33,522	$34,139	$35,385	$47,162	$65,399			$38,082
Total						491	931	655	234	104	13	1	2,429
						$32,258	$33,296	$35,166	$37,310	$37,740	$43,232	$25,326	$34,217

Average:	Age:	47.47	Number of participants:	Fully vested:	2,429	Males:	1,224
	Service:	14.68		Not Vested:		Females:	1,205

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	144	96	69	12	9	6							336
	$24,218	$23,608	$23,097	$23,888	$26,353	$29,190							$23,948
25-29	285	236	142	65	34	116	6						884
	$28,984	$27,950	$28,579	$28,183	$28,545	$29,365	$32,567						$28,642
30-34	212	170	152	90	45	222	86						977
	$30,357	$30,481	$30,860	$33,378	$34,417	$30,768	$31,921						$31,153
35-39	203	182	169	86	59	343	308	96					1,446
	$30,744	$34,500	$32,500	$31,837	$34,877	$32,633	$35,298	$34,668					$33,334
40-44	213	165	149	98	60	354	360	347	101	7			1,854
	$33,302	$33,201	$35,999	$32,567	$35,894	$35,946	$36,312	$36,826	$36,402	$40,431			$35,499
45-49	165	148	143	91	91	393	389	397	230	190			2,237
	$31,599	$34,758	$36,004	$39,044	$36,206	$34,656	$37,825	$39,956	$39,523	$39,199			$37,143
50-54	128	129	151	89	53	345	403	369	187	153	28		2,035
	$31,966	$35,668	$35,238	$37,703	$40,408	$36,822	$37,386	$43,541	$43,667	$46,494	$48,509		$39,305
55-59	91	83	103	68	50	243	343	257	158	81	25	3	1,505
	$35,746	$38,776	$40,308	$38,300	$36,386	$40,077	$39,196	$42,272	$44,531	$43,462	$51,376	$79,313	$40,646
60-64	42	43	54	38	31	157	193	132	81	44	18	7	840
	$46,603	$41,807	$39,064	$39,489	$37,269	$38,970	$41,318	$41,811	$50,672	$51,587	$55,095	$68,249	$42,828
65 & Over	7	9	11	10	15	50	71	39	22	8	3	3	248
	$44,383	$48,379	$29,952	$35,976	$47,020	$41,672	$39,104	$41,322	$50,562	$53,353	$56,350	$61,376	$42,357
Total	1,501	1,264	1,143	647	447	2,229	2,159	1,637	779	483	74	13	12,376
	$31,075	$32,499	$33,473	$34,661	$35,982	$35,260	$37,453	$40,336	$42,600	$43,605	$51,397	$69,216	$36,274

Average:	Age:	45.21	Number of participants:	Fully vested:	7,374	Males:	6,839
	Service:	9.30		Not Vested:	5,002	Females:	5,537

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 [1]	13,764	42.8	9.8	$394,919	$28,692	9.8%
1999 [1]	13,286	42.9	9.8	$396,617	$29,852	4.0%
2000 [1]	13,126	43.7	10.3	$421,591	$32,119	7.6%
2001 [1]	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%
2004	11,856	45.1	10.3	$366,190	$30,886	(4.1%)
2005 [2]	11,974	44.8	9.6	$404,565	$33,787	9.4%
2006	12,145	44.8	9.3	$422,496	$34,788	3.0%
2007	12,376	45.2	9.3	$448,925	$36,274	4.3%

Note: Dollar amounts in $000

1 Excludes DROP participants

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

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
2004	942	25,189	279	2,624	6,878	107,084	26.7%	15,569
2005	861	18,054	216	1,926	7,523	123,212	15.1%	16,378
2006	654	14,722	397	2,246	7,780	135,688	10.1%	17,441
2007	440	10,280	249	3,007	7,971	142,961	16.0%	17,935

Note: Dollar amounts in $000

MEMBERSHIP DATA

	July 1, 2007 (1)
1. Active members	
a. Number	12,376
b. Number vested	7,374
c. Total payroll supplied by HMEPS	$ 448,925,000
d. Average salary	36,274
e. Average age	45.2
f. Average service	9.3
2. Inactive participants (counts)	
a. Vested	2,922
b. Total annual benefits (deferred)	$ 18,906,765
c. Average annual benefit	6,470
d. NonVested	2,491
3. Service retirees	
a. Number	6,017
b. Total annual benefits	$ 125,245,967
c. Average annual benefit	20,815
d. Average age	65.9
4. Disabled retirees	
a. Number	446
b. Total annual benefits	$ 3,700,152
c. Average annual benefit	8,296
d. Average age	61.3
5. Beneficiaries and spouses	
a. Number	1,508
b. Total annual benefits	$ 14,014,497
c. Average annual benefit	9,293
d. Average age	67.1

ESTIMATION OF DOLLAR-WEIGHTED INVESTMENT RETURN

Item	Market Value	Actuarial Value
(1)	(2)	(3)
1. Assets as of July 1, 2006 (A)	$2,052,296	$1,867,293
2. Contributions during FY07 91,231	91,231	
3. Benefit payments made during FY07	157,716	157,716
4. Refunds of contributions during FY07	1,398	1,398
5. Expenses during FY07	6,106	6,106
6. Investment return during FY07	366,290	400,441
7. Assets as of July 1, 2007 (B): (1 + 2 - 3 - 4 - 5 + 6)	2,344,597	2,193,745
8. Approximate rate of return on average invested assets		
a. Net investment income (6 - 5 = I)	360,184	394,335
b. Estimated return based on (2I/(A + B - I))	17.85%	21.51%

Note: Dollar amounts in $000

INVESTMENT EXPERIENCE GAIN OR LOSS

Item	Valuation as of 6/30/2007	Valuation as of 6/30/2006
(1)	(2)	(3)
1. Actuarial assets, prior valuation	$ 1,867,293	$ 1,777,656
2. Total contributions since prior valuation	$ 91,231	$ 88,856
3. Benefits and refunds since prior valuation	$ (159,114)	$ (155,348)
4. Assumed net investment income at 8.5%		
a. Beginning assets	$ 158,720	$ 151,101
b. Contributions	3,798	3,699
c. Benefits and refunds paid	(6,624)	(6,468)
d. Total	$ 155,894	$ 148,332
5. Expected actuarial assets (Sum of Items 1 through 4)	$ 1,955,304	$ 1,859,496
6. Actual actuarial assets, this valuation	$ 2,193,745	$ 1,867,293
7. Early recognition of deferred investment gains	$ 135,198	N/A
8. Asset gain (loss) since prior valuation (Item 6 - Item 5 - Item 7)	$ 103,243	$ 7,797

Note: Dollar amounts in $000

HISTORY OF INVESTMENT RETURNS

For Fiscal Year Ending	Market Value[1]	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%
June 30, 2004	18.10%	4.16%
June 30, 2005	12.85%	4.12%
June 30, 2006	16.41%	8.95%
June 30, 2007	17.85%	21.51%

[1] Dollar-weighted return

Summary of Actuarial Assumptions and Methods

The following methods and assumptions were used in preparing the July 1, 2007, actuarial valuation. These assumptions were adopted by the Board effective for the July 1, 2004 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 benefits provisions for new employees hired on or after January 1, 2008.

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 30 years from the valuation date.

The contribution rate determined by this valuation will not be effective until one year later and the determination of the rate reflects 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:

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 (see table below).

Years of Service (1)	Service-related Component (2)	Total Annual Rate of Increase* (3)
0	2.50 %	5.50 %
1	2.00	5.00
2	1.75	4.75
3	1.25	4.25
4	1.00	4.00
5	1.00	4.00
6	1.00	4.00
7	1.00	4.00
8	0.50	3.50
9	0.50	3.50
10 or more	0.00	3.00

* Including 3.00% Inflation Component and 0.0% General Increase Rate

b. DROP Participation

90% of eligible members are assumed to enter DROP at first eligibility.

c. DROP Entry Date

Active members (not already in DROP) are assumed to take advantage of the DROP and enter when first eligible. For members who have already entered DROP, the actual DROP entry date supplied in the data is used.

d. DROP Interest Credit

4.25% per year

e. Mortality rates (for active and retired members)

- Healthy males – Based on the 1994 Uninsured Pensioners Mortality Tables for males. Rates are set-forward one year.
- Healthy females - Based on the 1994 Uninsured Pensioners Mortality Tables for females. Rates are set-forward one year.
- Disabled males and females – 1965 Railroad Retirement Board Disabled Life Table. Rates are set-back one year for males and 5 years for females.

Sample rates are shown in table below:

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 below.

6. Other Assumptions

a. Percent married: 70% 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.

Retirement Rates

	Expected Retirements per 100 Lives			
	Group A & B Members		Group D Members	
Age	Males	Females	Males	Females
(1)	(2)	(3)	(4)	(5)
50	20	13	5	5
51-54	14	13	5	5
55	14	15	6	6
56	14	15	7	7
57	14	15	8	8
58	14	15	9	9
59	14	15	10	10
60	16	16	12	12
61	16	18	15	15
62	30	30	35	35
63	30	25	25	25
64	22	25	22	25
65	28	25	28	25
66-69	22	19	22	19
70	100	100	100	100

Expected Deaths Per 100 Lives

	Expected Deaths per 100 Lives			
	Healthy	Healthy	Disabled	Disabled
Age	Males	Females	Males	Females
(1)	(2)	(3)	(6)	(7)
25	0.07	0.03	4.41	4.41
30	0.09	0.04	4.41	4.41
35	0.09	0.05	4.41	4.41
40	0.12	0.08	4.41	4.41
45	0.19	0.11	4.43	4.41
50	0.31	0.17	4.50	4.44
55	0.53	0.28	4.72	4.53
60	0.97	0.55	5.21	4.78
65	1.75	1.04	5.92	5.33
70	2.79	1.61	7.14	6.11
75	4.39	2.72	9.06	7.47
80	7.38	4.73	12.16	9.55

Probability of Decrement Due to Withdrawal - Male Members

	Years of Service										
Age	0	1	2	3	4	5	6	7	8	9	10+
20	0.3384	0.2667	0.2137	0.1759	0.1499	0.1290	0.1173	0.1177	0.1264	0.1350	0.1518
30	0.2555	0.2043	0.1644	0.1352	0.1147	0.0995	0.0895	0.0848	0.0839	0.0840	0.0876
40	0.1893	0.1506	0.1197	0.0971	0.0812	0.0703	0.0622	0.0554	0.0494	0.0445	0.0396
50	0.1483	0.1141	0.0873	0.0676	0.0540	0.0451	0.0390	0.0341	0.0297	0.0249	0.0191
60	0.1271	0.0931	0.0677	0.0471	0.0327	0.0239	0.0201	0.0209	0.0246	0.0246	0.0261

Probability of Decrement Due to Withdrawal - Female Members

	Years of Service										
Age	0	1	2	3	4	5	6	7	8	9	10+
20	0.2955	0.2470	0.2142	0.1877	0.1687	0.1515	0.1353	0.1251	0.1235	0.1286	0.1385
30	0.2288	0.1931	0.1638	0.1416	0.1251	0.1121	0.1013	0.0931	0.0875	0.0833	0.0795
40	0.1708	0.1423	0.1167	0.0990	0.0860	0.0769	0.0703	0.0640	0.0567	0.0478	0.0368
50	0.1302	0.1019	0.0824	0.0676	0.0579	0.0514	0.0466	0.0421	0.0367	0.0296	0.0207
60	0.1064	0.0705	0.0634	0.0481	0.0405	0.0348	0.0297	0.0270	0.0268	0.0281	0.0303

Rates of Decrement Due to Disability

Age	Males	Females
20	.00045	.00043
25	.00045	.00043
30	.00045	.00043
35	.00054	.00051
40	.00081	.00077
45	.00162	.00153
50	.00360	.00340
55	.00765	.00723
60	.01566	.01479

Rates of disability are reduced to zero once a member becomes eligible for retirement.
Service Connected Deaths and Disabilities assumed to be 10% of decrement

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.

i. Pay increase timing: Beginning of (fiscal) year. This is equivalent to assuming that reported pays represent amounts paid to members during the year ended on the valuation date.

j. Decrement timing: Decrements of all types are assumed to occur mid-year.

k. Eligibility testing: Eligibility for benefits is determined based upon the age nearest birthday and service nearest whole year on the date the decrement is assumed to occur.

l. Decrement relativity: Decrement rates are used directly from the experience study, without adjustment for multiple decrement table effects.

m. Incidence of Contributions: Contributions are assumed to be received continuously throughout the year based upon the computed percent of payroll shown in this report, and the actual payroll payable at the time contributions are made.

n. Benefit Service: All members are assumed to accrue 1 year of service each year. Exact fractional service is used to determine the amount of benefit payable.

7. Participant Data

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

The data for active members included birth date, sex, date of credited service, salary paid during last fiscal year, hours worked by the employee, and employee contribution amounts.

For retired members and beneficiaries, the data included date of birth, sex, amount of monthly benefit, and date of retirement. Also included was the member's Group and for members participating in DROP, their account balances and monthly DROP income.

All healthy and disabled retirees are assumed to have 100% joint and survivor, prorated by the 70% marriage assumption and reflecting the 3 year spousal age differential. All nonchildren beneficiaries are assumed to have life only benefits and all children beneficiaries' annuities are assumed to stop at age 21.

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.

In fiscal years when a 27th pay period occurs the individual pays for employees who were employed throughout the year will be adjusted by multiplying their reported pay by the ratio of 26/27. In years that have only 26 pay periods no adjustment would be needed.

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

8. Group Transfers

5% of current Group B members are assumed to transfer to Group A each year for the next four years, ultimately resulting in 20% of current Group B members transferring to Group A.

Summary of Plan Provisions

1. <u>Covered Members</u>

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

Persons who became employees of the City of Houston after September 1, 1981 and prior to September 1, 1999, and elected officials of the City of Houston who assumed office after September 1, 1981 and prior to September 1, 1999, 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 and prior to January 1, 2008 become members of Group A. Certain persons who were or became a Director of a City Department, Chief Financial Executive, or Executive Director of HMEPS on or after September 1, 1999 and prior to January 1, 2005 participate in Group C. Effective January 1, 2005, all Group C participation ceased and all Group C participants became Group A participants. Accruals earned by Group C participants prior to January 1, 2005 are retained, but all future accruals are based on the Group A formulas.

All future references to Group C participants in this appendix are intended to reflect this change in the Group C status.

Covered employees newly hired on or after January 1, 2008 will be members of Group D.

A former employee who is rehired on or after January 1, 2008 is a member of the group in which such employee participated at the time of his/her immediately preceding separation from service.

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 former Group C, all services and work performed after September 1, 1943 must have been accompanied by corresponding contributions to HMEPS by the employee or legally authorized repayments must have been made.

Credited service for former 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 former 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 January 1, 2005 (with 68 points as of January 1, 2005):

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)

On or after January 1, 2005 (less than 68 points as of January 1, 2005):

The earliest of:
age 62 and 5 years of Credited Service 5 years of Credited Service, and age plus years of Credited Service equal 75 or more with minimum age 50

For employees newly hired on or after January 1, 2008 (Group D):

Age 62 and 5 years of Credited Service

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 and prior to January 1, 2005:

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 benefits 90% of FAS for all future retirees.

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

All accruals after January 1, 2005:

All accruals under the prior multipliers were frozen as of

January 1, 2005 and the following benefit multipliers will apply to service after that date:

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 90% of FAS for all future retirees.

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 90% of FAS for all future retirees.

Group D: 1.80% of FAS for each of the first 25 years of Credited Service, plus 1.00% of FAS for each year of Credited Service over 25. Maximum benefit is 90% of FAS for all future retirees.

5. <u>Vested Pension</u>

a. Eligibility

5 years of Credited Service.

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 employee contributions, if any, without interest.

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

If the actuarial present value of a pension is less than $20,000, 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. <u>Withdrawal Benefit</u>

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. <u>Service-Connected Disability Retirement</u>

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

8. <u>Non-service-Connected Disability Retirement</u>

a. Eligibility

5 years of Credited Service.

b. Benefit

Accrued normal retirement benefit payable immediately.

9. <u>Pre-retirement Survivor Benefits</u>

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 suviving spouse, dependent benefits are doubled.

<u>On or after September 1, 1999:</u>

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 spouse's 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 and benefits for survivorship and terminated vested Group D members after January 1, 2008:

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 spouse's 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 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. The surviving spouse's benefit will be reduced by dependent benefits, if any. 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 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.

Group D members:

Life only to the retiree. Group D members may elect other options based on actuarial factors.

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 but before January 1, 2005:

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.

On or after January 1, 2005:

Each year, effective February 1, monthly benefits will be increased 3.0%, not compounded, for all retirees and survivors. This will affect all members currently in payment status and members who enter payment status in the future. For members hired on or after January 1, 2005 future increases will be 2.0%, not compounded. However, pre-2005 retirees who are rehired will receive a 3% COLA on their subsequent benefit instead.

Group D Members:

None assumed. COLAs will be granted on an ad hoc basis only.

12. Contribution Rates

a. Members

5% of salary only for the Group A members. None for the Group B or Group D 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% of covered payroll or twice the contribution rate a Group A member is required to make by statute. As negotiated in the meet and confer agreement, the city contributions will be $69 million for FY2006, $72 million for FY2007, $75 million for FY2008, $78.5 million for FY2009, $83.5 million for FY2010, and $88.5 million for FY2011.

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 DROPCredit

An amount equal to the 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 calendar day each month.

c. DROP Credits-Interest

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 and posted monthly on the last calendar day of each month. Effective January 1, 2005, the annual interest rate effective beginning January 1 each year is half of HMEPS' investment return percentage for the prior fiscal year, not less than 2.5% and not greater than 7.5%.

d. DROP Credits-COLA

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 is increased effective February 1 each year by 3.5%, not compounded.

On or after May 11, 2001 but prior to January 1, 2005:

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

On or after January 1, 2005:

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 by 3.0%, not compounded.

The Monthly DROP Credit for participants who were first hired on or after January 1, 2005 who entered the DROP effective on or before January 1 of the then current year will be increased effective February 1 each year by 2.0%, not compounded.

e. DROP Account Balance

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

14. DROP Benefit Pay-out

A terminated DROP participant may elect to:

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

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

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

d. Receive a partial payment of not less than $1,000, no more than once each six months.

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

15. Post DROP Retirement

The Final Pension is the accrued normal retirement benefit as of the effective date of DROP participation, increased with COLAs since DROP entry.

Changes in Plan Provisions Since Prior Year

All members newly hired on or after January 1, 2008 will become members of Group D and will have the benefits as described above for Group D members.

The maximum allowable early lump-sum payment increased from $10,000 to $20,000.

SECTION 5: STATISTICAL INFORMATION

SCHEDULE OF AVERAGE BENEFIT PAYMENT AMOUNTS FOR THE TEN YEARS ENDED JUNE 30, 2007

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
June 30, 2004	6,878	107,083	15,569
June 30, 2005	7,523	123,211	16,378
June 30, 2006	7,780	135,688	17,441
June 30, 2007	7,971	142,961	17,935

SCHEDULE OF BENEFITS BY TYPE ($000) FOR THE TEN YEARS ENDED JUNE 30, 2007

Fiscal Year Ended	Normal Retirement Benefits	Disability Retirement Benefits	Survivors' Benefits	Total Benefits
June 30, 1998	34,792	3,062	5,540	43,394
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
June 30, 2004	92,766	3,832	10,485	107,083
June 30, 2005	108,217	3,762	11,232	123,211
June 30, 2006	119, 287	3,658	12,743	135,688
June 30, 2007	125,246	3,700	14,015	142,961

SCHEDULE OF ANNUITANTS BY TYPE

	June 30, 2008			June 30, 2007		
Schedule of Annuitants by Type	Number	Benefits ($000)	Average Benefit	Number	Benefits ($000)	Average Benefit
Retirees receiving benefits	5,847	119,287	20,401	5,592	108,217	19,352
Retired on disability	452	3,658	8,093	483	3,762	7,788
Survivors and beneficiaries	1,481	12,743	8,604	1,448	11,232	7,757
Total retirees, survivors and beneficiaries	7,780	135,688	17,441	7,523	123,211	16,378
Former participants eligible but not yet receiving benefits	2,786	16,531	5,934	2,659	14,228	5,351
Total Eligible for Benefits	10,566	152,219	14,406	10,182	137,439	13,500

HISTORICAL ACTIVE PARTICIPANT DATA*

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

* There was no actuarial valuation in FY1997

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

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

SCHEDULE OF CHANGES IN PLAN NET ASSETS ($000)

	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999
Additions										
Employer contributions	73,272	70,265	66,968	363,247	57,308	40,622	40,758	41,298	38,306	36,030
Member contributions	21,176	20,966	21,888	23,488	26,189	23,762	13,476	8,532	7,341	6,184
Investment Income	(29,133)	337,259	272,766	184,419	227,361	33,931	(108,024)	(65,147)	270,991	32,344
Other Income	29,839	29,031	26,950	17,250	726	114	286	643	407	276
Total additions to plan net assets	95,154	457,521	388,572	588,404	311,584	98,429	(53,504)	(14,674)	317,045	74,834
Deductions										
Benefit payments	169,483	157,716	154,311	175,480	153,202	98,789	78,318	58,296	50,142	46,751
Refund of contributions	1,760	1,398	1,037	992	635	475	270	308	337	232
Professional service fees	638	883	708	1,088	712	366	396	324	263	238
Cost of administration	5,837	5,223	5,072	4,718	4,500	4,299	3,662	2,367	2,143	2,043
Total deductions from plan net assets	177,718	165,220	161,128	182,278	159,049	103,929	82,646	61,295	52,885	49,264
Change in net assets	(82,564)	292,301	227,444	406,126	152,535	(-5,500)	(136,150)	(75,969)	264,160	25,570
Net Assets as of June 30	2,262,033	2,344,597	2,052,296	1,824,852	1,418,726	1,266,191	1,271,691	1,407,841	1,483,809	1,219,649

2005 employer contributions include $300 million pension obligation note

Acknowledgement

HMEPS would like to thank David Schafer, and the staff at *City Savvy*, for their assistance with several of the photographs used in this Report.

HOUSTON
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