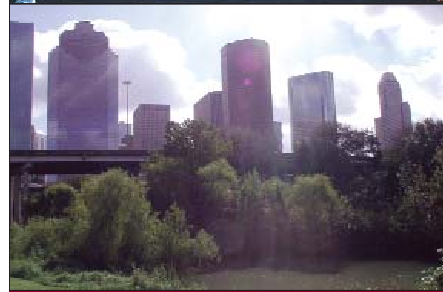
Houston Municipal Employees Pension System

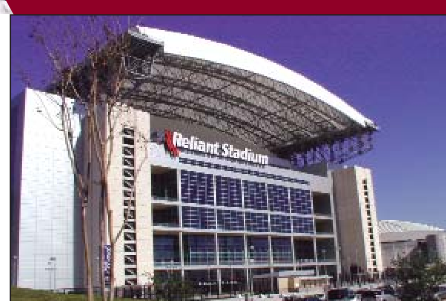


60

Years of Service to City of Houston Municipal Employees

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

A Component Unit of the
City of Houston, Texas



1943-2003

The Houston Municipal Employees Pension System (System) is proud to have served City of Houston municipal employees for 60 years. Created in 1943, HMEPS has grown into an entity that administers the pension plan and benefits for more than 19,000 participants, retirees and their beneficiaries.

This Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2003 pays tribute to the 60 years HMEPS has been in existence. In the pages ahead, you will find photographs of the Houston area during the decade from 1940-1950. HMEPS would like to thank the Houston Metropolitan Research Center, Houston Public Library, for their efforts in researching and providing the photographs. HMEPS hopes you enjoy the varied and interesting views of our great city from the years between 1940-1950 and join us in our appreciation of how far Houston has developed in the past 60 years.

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

COMPREHENSIVE ANNUAL FINANCIAL REPORT
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

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

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

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Events in Houston, 1940 through 1950

1940

Houston ranked twenty-first in the nation with a population of 384,514 - a 31.5 percent increase over 1930. Houston also had registered 170,000 motor vehicles.

World War II affected the Houston economy as ship arrivals fell to 2,809, but freight tonnage remained near the 1939 level with 27,385,589 tons. Five steamship lines discontinued service to Houston, as the war disrupted shipping.

The city possessed a $22,000,000 public school system with 2,250 teachers, 74,000 students, and 115 buildings.

1942

The city manager form of government was instituted with eight council members, a part-time mayor, and the first city manager, John North Edy.

Working on war contracts, the Houston Shipbuilding Corporation expanded its payroll from 6,000 to 20,000. During the war, the company turned out 208 cargo vessels and 14 tankers.

Actuarial Section

Statistical Section

1945

The M.D. Anderson Foundation formed the Texas Medical Center Corporation to oversee the Medical Center's development.

1947

Oscar Holcombe took office as mayor, and the city manager form of municipal government was abandoned in favor of a strong mayor arrangement.

Alley Theatre of Houston gave its first performance under the direction of Nina Vance.

1950

The city's population was 596,163, a jump of 55.5 percent over 1940.

Rice Institute completed the 70,000 seat Rice Stadium.

ORGANIZATIONAL OVERVIEW*

ELECTED TRUSTEES

Fred Holmes, Chairman
Ray Kennedy, Vice Chairman
Barbara Chelette, Secretary
Sherry Mose, Trustee
Roderick J. Newman, Trustee
Lee Pipes, Trustee

TRUSTEES BY DESIGNATION OR APPOINTMENT

Albertino Mays, City Treasurer
Lonnie G. Vara, Mayor's Representative

David L. Long, Executive Director

ADMINISTRATIVE ORGANIZATION

BOARD OF TRUSTEES

Investment Committee
Budget and Oversight Committee
Disability Committee
Legislative Committee
Personnel and Procedures Committee

EXECUTIVE DIRECTOR

Chief Investment Officer
Investment Managers' Services
Performance Measurement
Market Research

Benefit Administration
Benefit Administration
Member Services

Information Systems

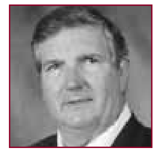
General Counsel

Communications

Accounting

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

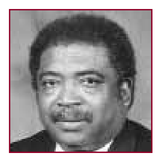
Fred Holmes
Chairman



Ray Kennedy
Vice Chairman

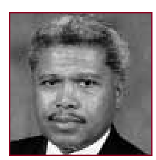
Barbara Chelette
Secretary

Sherry Mose
Elected Trustee



Roderick J. Newman
Elected Trustee

Lee Pipes
Elected Trustee



Albertino Mays
City Treasurer

Lonnie G. Vara
Mayor's Representative

David L. Long
Executive Director

INTRODUCTORY SECTION

LETTER OF TRANSMITTAL

GFOA CERTIFICATE OF ACHIEVEMENT

PROFESSIONAL CONSULTANTS AND INVESTMENT MANAGERS

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

December 1, 2003

Albertino Mays, Treasurer
City of Houston, Texas
P.O. Box 1562
Houston, Texas 77251-1562

Dear Mr. Mays:

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, 2003 (2003), is submitted herewith. The accuracy and completeness of this report are the responsibility of the Board of Trustees of the System. The information provided pertains to the records and accounts of the System and its operation.

The CAFR consists of five sections: (i) the introductory section, which contains this transmittal letter and other general information about the structure and activities of the System; (ii) the financial section, which contains the independent auditors' report and the basic financial statements, including notes to the financial statements and supplemental schedules; (iii) the investment section, which includes reports on the investment objectives and activities of the System during 2003; (iv) the actuarial section, which contains information about the actuarial evaluation of the System as of July 1, 2002, the funding objectives of the System and the progress being made toward achieving those objectives; and (v) the statistical section, which contains statistical and other significant data intended to provide a user of this CAFR additional information about the System.

The System was created in 1943 under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, Article 6243g, Vernon's Annotated Revised Texas Civil Statutes, and reenacted and continued under HB1573, 77th Texas Legislature, as Art. 6243h, Vernon's Annotated Revised Texas Civil Statutes (the Statute). The System is a multi-employer defined benefit pension plan and includes contributory groups (Group A and Group C) and a noncontributory group (Group B). The System provides service retirement, disability retirement and death benefits for eligible participants including the employees of the System and the officers and employees, except police officers and fire fighters, of municipalities in the State of Texas having population of more than 1,500,000. System plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group C. HMEPS is administered by a nine-member Board of Trustees. The Trustees include the Mayor of the City or his designated representative, the City Treasurer, four elected trustees who are active members of HMEPS, two elected trustees who are retirees of HMEPS, and one trustee who is appointed by the elected trustees.

Significant Changes During the Year

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

General Economic Conditions

After experiencing one of the most significant and prolonged capital markets contractions in post-Depression history, the U.S. economy showed signs of improvement in the last year as the recovery started to gain sustainable momentum from a combination of massive fiscal, monetary and stimulative tax policy. Hampering the traditional strong recoveries from recession were a number of factors including a reluctance by businesses to hire new employees and hesitancy by corporations to increase capital expenditures resulting from extremely low capacity utilization. Other factors included technological productivity improvements and synchronized slow worldwide economic growth.

According to the Federal Reserve, household demand has been the major source of real GDP growth since the end of the recession in November 2001. It was driven by a record high of $1.16 trillion of mortgage refinancings this year precipitated by the decline in mortgage rates to their lowest levels in more than three decades. While this demand has helped push the economy along, a lack of job growth will no doubt weigh heavily on future growth. Manufacturing sectors, especially, accounted for 90 percent of the eliminated jobs between February 2001 and July 2003 (according to the Federal Deposit Insurance Corporation), as manufacturing jobs migrated to nations with substantially lower production costs.

Monetary policy, also mentioned in last year's report as a positive influence, has helped consumer spending through the post-recession period. The Growth Tax Relief Reconciliation Act will help to stimulate growth into mid-2004. Lower short-term and mortgage interest rates have also been the result of sound monetary policy to stimulate an economic recovery.

Corporate profits have improved dramatically in many sectors as the fiscal year progressed. The banking industry and residential housing industries appear to be thriving, while outlays on commercial buildings have continued to fall. The technology sector is showing signs of significant improvement as businesses which were in the past reluctant to purchase new software and equipment are now planning on upgrading.

Overall, the US economy is beginning to show strong signs of turning the corner and returning to normalcy. There will be, however, "growing pains" along the way. Optimism should replace pessimism in the year ahead.

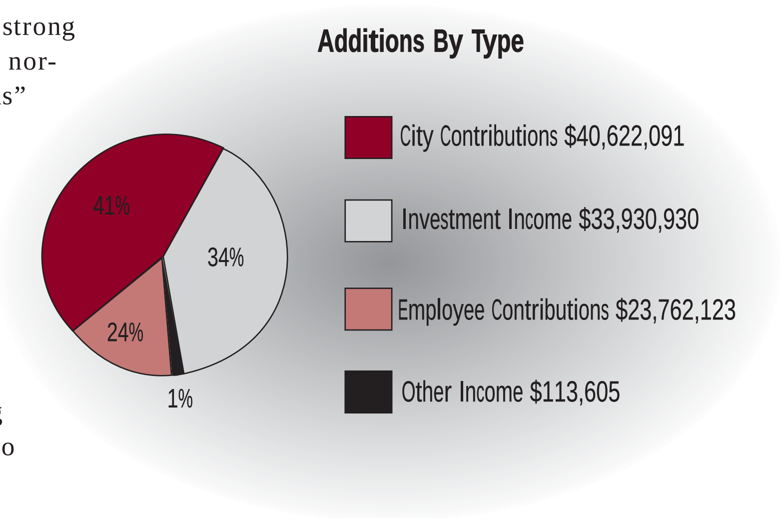
Investment Activities

As discussed in more detail in the Investment Section of the CAFR, investment strategies have been implemented by the System that are long-term in perspective and designed to meet the expectations of working within predefined ranges among asset classes to produce returns, over market cycles, that exceed the investment return assumption adopted by the System for actuarial purposes. Diversification, professional management within stated guidelines, and periodic rebalancing from asset classes to capture gains and reduce risks associated with market movements, are methods that have been adopted by the Board of Trustees to safeguard against loss due to unanticipated market declines. Returns from investing activities for the year ended June 30, 2003 amounted to 3.55% (see page 34 for more information). Annualized time weighted returns for the five fiscal years and 10 fiscal years ended June 30, 2003 were 3.27% and 7.82%, respectively.

The most recent five years have been an exceptional period of volatility. The markets experienced a significant bubble in the late 1990's and a collapse of the bubble from 2000 to 2002 in which the equity markets lost $9 trillion of wealth. This period of extreme volatility provided the most significant stress test of the System's resolve to prudently diversify between several major asset classes and to consistently rebalance where appropriate actions could be taken to enhance returns and reduce overall portfolio risk. The System recorded investment gains of $102 million and $255 million in fiscal years 1999 and 2000, respectively, but recorded losses of $72 million and $100 million in fiscal years 2001 and 2002, respectively. The System began to rebound in fiscal year 2003, gaining $41 million and is up over $100 million thus far in fiscal year 2004.

Financial Highlights

Additions to assets received by the System are used to fund current and future benefits for participants,



their eligible survivors and beneficiaries. The primary sources of additions are contributions from active participants and the City, and investment income. Net investment income after deducting investment fees and costs of lending securities for the years 2003 and 2002 was $33.9 million and $(108.0) million, respectively. City contributions, employee contributions, and other income for 2003 totaled $64.4 million compared to $54.2 million for 2002. The City contribution rate, 10.0% during 2003, is the minimum required actuarially determined rate. City contributions decreased by $136,000 during 2003 over 2002. Participant contributions increased by $10.3 million during 2003 over 2002. The chart, Additions by Type, is a relative representation of 2003 additions by components.

Deductions from assets consist of benefits paid to retired members, their eligible survivors and beneficiaries, refunds of contributions to former members, fees for professional services, and the cost of administering the programs of the System. Total deductions for 2003 were $21.3 million more than for 2002. Benefits and contribution refunds were $20.7 million more, professional services were not significantly different for 2003 over 2002, and administrative costs were $637,000 more. The chart, Deductions by Type, demonstrates the relationship among types of deductions.

The net of additions less deductions for 2003, reported in the financial statements as the net decrease in plan net assets, was $5.5 million. That decrease in plan net assets represents the results of System operations for fiscal year 2003 and represents a decrease of plan net assets held in trust for pension benefits.

Accounting System and Internal Controls

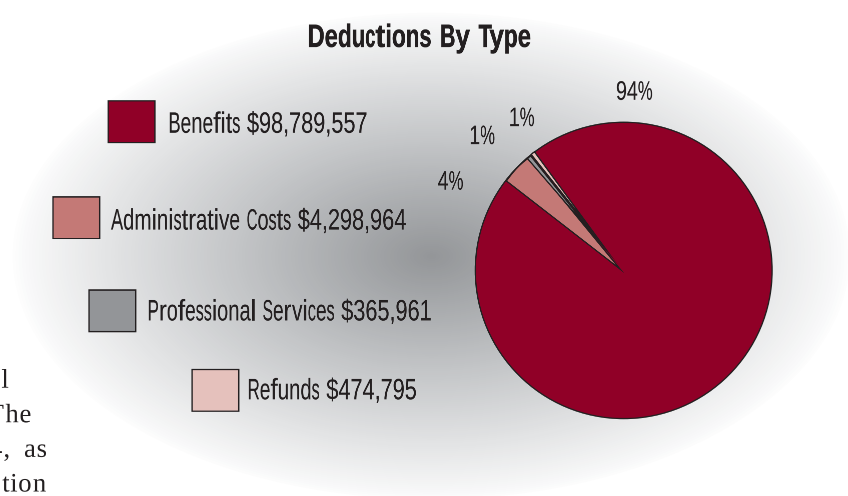
The financial statements and related information included in the financial section of this report are the responsibility of the management of the System. The financial statements have been prepared in accordance with generally accepted accounting principles and presented in accordance with the Governmental Accounting Standards Board (GASB). The System adopted GASB Statement No. 34, as amended, in 2002. As a result of the adoption of GASB Statement No. 34, the Management's Discussion and Analysis has been included as required supplementary information and precedes the financial statements.

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

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

Funding Status

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



Analysis of Funding Progress
(in Millions of Dollars)

*Actuarial Valuation Date	(1) Actuarial Value of Assets	(2) Actuarial Accrued Liability	(3) Unfunded AAL (UAAL)	(4) Funded Ratio (1 ÷ 2)	(5) Annual Covered Payroll	UAAL as a Percentage of ACP (3 ÷ 5)
07/01/98	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 %

*An actuarial evaluation was not performed July 1, 1997. Actuarial calculations are performed a year in arrears and are applied to a future period.

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

The most recent actuarial study was made as of valuation date July 1, 2002. This report was presented to and adopted by the Board on September 11, 2003. The result of this study becomes effective in 2004 for funding purposes but is presented in this CAFR for disclosure purposes.

Acknowledgments

The Government Finance Officers Association (GFOA) awarded its "Certificate of Achievement for Excellence in Financial Reporting" to the System for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2002. The award and a detailed description thereof are displayed on page 6 in the Introductory Section of this CAFR.

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

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

Sincerely,

Fred Holmes
Chairman

David L. Long
Executive Director

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a "Certificate of Achievement for Excellence in Financial Reporting" to Houston Municipal Employees Pension System for its comprehensive annual financial report for the fiscal year ended June 30, 2002. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

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

A Certificate of Achievement is valid for a period of one year only. Houston Municipal Employees Pension System has received a Certificate of Achievement for the last 9 consecutive years (fiscal years ended June 30, 1994 through 2002). 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, 2002

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.

Government Finance Officers Association of the United States and Canada Corporation Seal Chicago

William Patrick Hartz
President

Jeffrey L. Esser
Executive Director

Consultants

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

Board Medical Advisor
Charles Schuhmacher, M.D.

Investment Consultants
Wilshire Associates, Inc.
Pension Consulting Alliance

Investment Performance Analysis
Wilshire Associates, Inc.

Legal Counsel
Baker Botts, L.L.P.
Cohen, Milstein, Hausfeld & Toll, P.L.L.C.
Lawson, Fields, McCue, Lee & Campbell, P.C.
Locke, Liddell & Sapp, L.L.P.

Master Custodian/Trustee
State Street Bank and Trust Co.

Actuary
Towers Perrin

Investment Managers

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

International Equities
- Axiom International
- Brandes International
- Oechsle International
- TT International

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

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

Alternative Investments
- Adams Street Partners
- Barclays Global Investors, N.A.
- Brera Capital Partners, L.L.C.
- Brockway Moran & Partners, Inc.
- Goldman, Sachs & Co.
- HarbourVest Partners, L.L.C.
- J.W. Childs Associates, L.P.
- Kopp Investment Advisors
- Matlin Patterson Global Advisors
- Oaktree Capital Management
- Pacven Walden Management Co., LTD.
- Pegasus Investors, L.P.
- Pharos Capital Partners, L.L.C.
- The Jordan Company
- Triad Ventures, LTD.
- TSG Capital Group, L.L.C.

The Birth of a Thriving City, From a Humble Bayou

In the summer of 1836, shortly after the Battle of San Jacinto, the Allen brothers offered Mrs. Elizabeth Parrott $5,000 for half a league of the John Austin stake along Buffalo Bayou. The widow of John Austin, who was one of the "Old Three Hundred" colonists accompanying Stephen F. Austin, Mrs. Parrott readily accepted. Thus, on August 30, 1836, the Allens purchased some 6,000 acres of land on the southern bank of the tree-lined, murky Buffalo Bayou, naming the site "Houston, in honor of the man who had become the hero of the new republic."

FINANCIAL SECTION

INTRODUCTION TO FINANCIAL STATEMENTS

INDEPENDENT AUDITORS' REPORT

STATEMENTS OF PLAN NET ASSETS JUNE 30, 2003 AND 2002

STATEMENTS OF CHANGES IN PLAN NET ASSETS
YEARS ENDED JUNE 30, 2003 AND 2002

NOTES TO FINANCIAL STATEMENTS JUNE 30, 2003 AND 2002

SUPPLEMENTAL INFORMATION

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, 2003.

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, 2003 and June 30, 2002 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 Held in Trust for Pension Benefits, Notes to the Financial Statements, and Supplemental Schedules.

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

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

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

Supplemental Schedules provide information required by GASB and additional detailed analyses of certain amounts summarized in the financial statements.

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

Member of the American Institute of Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

Board of Trustees
Houston Municipal Employees Pension System:

We have audited the accompanying statements of plan net assets of the Houston Municipal Employees Pension System (the System) as of June 30, 2003 and 2002, and the related statements of changes in plan net assets for the years then ended. These basic financial statements and the schedules referred to below are the responsibility of the System's management. Our responsibility is to express an opinion on these basic financial statements based on our audits.

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

In our opinion, the basic financial statements referred to above present fairly, in all material respects, information regarding the System's net assets held in trust for pension benefits as of June 30, 2003 and 2002, and changes therein for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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

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

Mir Fox & Rodriguez

September 19, 2003

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

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

OVERVIEW OF THE FINANCIAL STATEMENTS

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

System's Basic Financial Statements

There are two basic financial statements presented herewith. The Statements of Plan Net Assets as of June 30, 2003 and 2002 indicate the net assets available to pay future payments and gives a snapshot at a particular point in time. The Statements of Changes in Plan Net Assets for the fiscal years ended June 30, 2003 and 2002 provide a view of the fiscal year's additions and deductions to the System.

Notes to Financial Statements

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

Supplemental Information

The required supplemental information consists of:

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

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

The additional supplemental information consists of:

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

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

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

Comparative Financial Statements

On the following page is a condensed and comparative summary of major classes of Plan Net Assets at fair value.

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

- The System received $23,762 and $13,476 during fiscal year 2003 and 2002, respectively, in employee contributions from over 12,000 participants. During fiscal year 2003 and 2002, the System received $40,622 and $40,758, respectively, in employer contributions from the City of Houston (the City). The City's contribution represents a contribution rate of 10%.
- Employee contributions increased by $10,286 (or 76%) in fiscal year 2003 compared to fiscal year 2002. Of this increase, $5,932 (or 58%) came from the participants' direct rollovers from their Section 457 deferred compensation plan. Employee contributions increased by $4,944 or 58% in fiscal year 2002 compared to fiscal year 2001, primarily due to an increased number of participants in Group A (contributory group).
- The net investment income of the System was $33,930 during the fiscal year 2003 compared to a loss of $108,023 during the fiscal year 2002, which is an increase of $141,953. This increase is a reflection of improved market conditions during fiscal year 2003. During fiscal year 2002, the net investment loss of the System increased 66% from fiscal year 2001 as a result of adverse market conditions.
- Benefit payments grew by 26% or $20,471 during the fiscal year 2003 compared to $78,318

COMPARATIVE FINANCIAL STATEMENTS

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

	Balance June 30, 2003	Balance June 30, 2002	Dollar Change + (-)	Percent Change + (-)
Assets				
Cash and cash equivalents	$ 7,153	2,413	4,740	196 %
Short term investment funds (at cost)	35,532	46,093	(10,561)	(23)
Proceeds due on asset sales	6,290	24,749	(18,459)	(75)
Receivables	21,458	19,425	2,033	10
U.S. government securities	96,536	121,860	(25,324)	(21)
Corporate bonds	89,241	110,302	(21,061)	(19)
Capital stocks	439,387	442,135	(2,748)	(1)
Commingled funds	225,694	212,133	13,561	6
LP's, real estate trusts and loans	400,190	353,212	46,978	13
Collateral on securities lending	84,300	84,928	(628)	(1)
Furniture, fixtures and equipment, net	737	546	191	35
Total assets	1,406,518	1,417,796	(11,278)	(1)
Liabilities				
Amounts due on asset purchases	53,716	58,959	(5,243)	(9)
Accrued liabilities	2,312	2,218	94	4
Collateral on securities lending	84,300	84,928	(628)	(1)
Total liabilities	140,328	146,105	(5,777)	(4)
Plan net assets held in trust for pension benefits	$ 1,266,190	1,271,691	(5,501)	(1)

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

	Fiscal Year 2003	Fiscal Year 2002	Dollar Change + (-)	Percent Change + (-)
Additions				
Contributions:				
City of Houston	$ 40,622	40,758	(136)	(1)%
Participants	23,762	13,476	10,286	76
Investment income:				
Interest	6,868	17,197	(10,329)	(60)
Dividends	7,335	9,552	(2,217)	(23)
Earnings from LP's and real estate trusts	7,690	11,062	(3,372)	(30)
Net appreciation (depreciation) on investments	16,981	(140,619)	157,600	112
Net proceeds from lending securities	376	780	(404)	(52)
Less investment expenses	(5,320)	(5,995)	675	11
Other income	114	286	(172)	(60)
Total additions (reductions)	98,428	(53,503)	151,931	284
Deductions				
Benefits paid	$ 98,789	78,318	20,471	26%
Contribution refunds	475	270	205	76
Professional fees	366	396	(30)	(8)
Administration expenses	4,299	3,662	637	17
Total deductions	103,929	82,646	21,283	26
Net decrease in plan net assets	(5,501)	(136,149)	130,648	96
Plan net assets, prior year	1,271,691	1,407,840	(136,149)	(10)
Plan net assets, current year	$ 1,266,190	1,271,691	(5,501)	(1)

during the fiscal year 2002. Service retirement pension benefits amounted to $64,656 (22% increase from fiscal year 2002) which accounted for 65% of the total benefit payments for fiscal year 2003. There are 6,309 participants receiving benefits for the fiscal year ended 2003 compared to 5,928 participants in 2002. These numbers represent an increase of 6% and 10% for the fiscal years 2003 and 2002, respectively. Fiscal year 2002 benefit payments grew by 34% from fiscal year 2001.

- Benefit payments exceeded total employee plus employer contributions by $34,405 during fiscal year 2003 and by $24,084 during fiscal year 2002.
- Costs of administering the benefit programs of the System were $4,299 and $3,662 for fiscal year 2003 and 2002, respectively, for almost 20,000 participants.
- Net assets decreased by $5,501 during fiscal year 2003 compared to a decrease of $136,149 in 2002. This is a 96% improvement, primarily due to a slight recovery in the world capital market.

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 2003 and 2002 is $737 and $546, respectively.

Total investments were $1.29 billion at the close of fiscal year 2003 and 2002, and the net income on investments was $33.9 million during fiscal year 2003, for a positive net return of approximately 3%. This compares to a net loss of $108 million during 2002, with a negative net return of approximately 8%. The performance of our investment classes are included below based on investment amounts as of June 30, 2003.

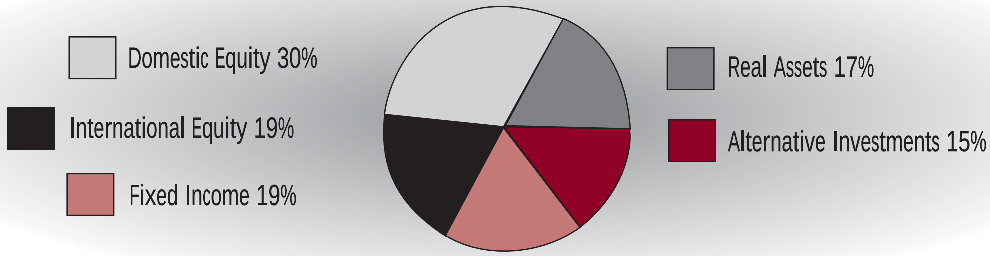
The year ended June 30, 2003 provided a volatile environment for the world's investment community. The year began with a continuation of weak corporate earnings, uncertainty regarding a war with Iraq, fear of terrorism and U.S. short-term interest rates at 40 year lows. This backdrop created a continued worldwide flight to quality, as investors sold equities in favor of high credit fixed-income securities. U.S. equities, as measured by the S&P 500 index, declined by 17.3% in the quarter ended September 2002, the worst performing quarter since the market crash of 1987. Non-U.S. equity market returns, as

PERFORMANCE OF INVESTMENT CLASSES

	Benchmark			System		
Asset Class	Index	Return (%)	Target Allocation (%)	Return (%)	Amount ($)	Allocation (%)
Domestic Equity	Wilshire Target Top 2500	1.01 %	30.0 %	3.18 %	$ 390,130,766	30.3 %
International Equity	MSCI All Country World Free ex US	-4.19 %	20.0 %	-4.12 %	$ 237,436,419	18.5 %
Fixed Income	Lehman Aggregate	10.40 %	20.0 %	13.99 %	$ 243,380,644	18.9 %
Real Assets	NCREIF	7.64 %	15.0 %	5.84 %	$ 222,179,854	17.3 %
Alternative Investments	S&P 500	0.25 %	15.0 %	-3.40 %	$ 193,452,872	15.0 %
Total		3.55 %	100.0 %	3.55 %	$ 1,286,580,555	100.0 %

* Amounts represent fair market values and do not include cash or cash equivalents.

System's Asset Allocation



measured by the MSCI All Country World Free ex-U.S. index, were even worse, with a decline of 19.4%. Aggregate U.S. bonds, as measured by the Lehman Aggregate index, returned 4.6%.

World equity markets began to rebound in October 2002, due in part to improved corporate earnings, strength in retail sales, and an increase in investor confidence. Equity markets strengthened further in March 2003, when U.S. led attacks on Iraq were initiated and world energy prices declined, and again in June 2003, when the Federal Reserve lowered the Fed Funds target rate to 1.0%, its lowest rate in 45 years. In addition, the second tax cut bill in two years lowered personal income tax rates and lowered capital gains taxes to 15%. These changes produced a surge in investor confidence pushing the S&P 500 index up 15.4% for the quarter ended June 30, 2003, its best quarterly gain in nearly 5 years.

Fixed-income and real estate assets provided the only safe haven for the past one and three-year periods. The fixed-income market, as measured by the Lehman Aggregate index, rose 10.4% and 10.1% during these periods, while real estate, as measured by the NCREIF index, climbed 7.6% and 8.2%, respectively.

Throughout fiscal year 2003, the System maintained its existing asset allocation mix of 30% domestic equities, 19% international equities, 19% fixed income, 17% real assets and 15% alternative investments. However, due to movements in the markets and rebalancing activities directed by management, the System maintained a slight underweight to international equities and a slight overweight to real assets.

The System's investment performance was 3.6%, -2.6% and 3.3% for the past one, three and five year periods, respectively. These results are slightly below median relative to a universe of the System's public fund peers, ranking in the 71st percentile for the one year period. The System's results compared better over longer periods ranking in the 50th and 36th percentiles for the trailing three and five-year periods. The System's policy benchmark returned 3.6% and -3.9%, respectively, for the one and three-year periods. The best performing asset class for the past year was fixed income, providing 14.0% per annum, while real assets was the best performer for the past three years, providing 12.0% per annum.

The System's securities lending program obtains additional income by lending securities to broker-dealers and banks. During the years ended June 30, 2003 and 2002, 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, 2003, the System had no credit risk exposure to borrowers.

The System's investments in limited partnerships are included in the tables appearing in note 5 under investments not categorized. In connection with those investments, the System had remaining commitments as of June 30, 2003 and 2002 of approximately $220 million and $299 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, employer, business partners, and taxpayers with a general overview of the System's financial activities. If you have questions about this report or need additional financial information, contact the Accounting Manager of the Houston Municipal Employees Pension System at 1111 Bagby, Suite 2450, Houston, Texas 77002.

	2003	2002
Assets:		
Investments, at fair value:		
United States government securities		
(cost: $95,418,619 in 2003 and $122,388,783 in 2002)	$ 96,536,268	121,859,607
Corporate bonds		
(cost: $82,693,717 in 2003 and $123,447,124 in 2002)	89,240,844	110,302,312
Capital stocks		
(cost: $414,628,215 in 2003 and $456,935,751 in 2002)	439,387,265	442,135,030
Commingled funds		
(cost: $196,302,866 in 2003 and $204,148,431 in 2002)	225,693,863	212,132,654
Limited partnerships, real estate trusts, and loans and mortgages		
(cost $412,404,129 in 2003 and $360,526,672 in 2002)	400,190,471	353,211,833
Short-term investment funds (valued at cost)	35,531,844	46,093,354
Total investments	1,286,580,555	1,285,734,790
Cash and cash equivalents	7,153,389	2,412,976
Proceeds due on asset sales	6,290,351	24,748,818
Receivables on foreign exchanges	16,753,201	12,990,583
Contribution receivable - City of Houston	1,839,988	1,703,872
Other receivables	2,863,411	4,730,091
Collateral on securities lending arrangements, at fair value	84,300,279	84,928,716
Furniture, fixtures and equipment, net	737,414	546,375
Total assets	1,406,518,588	1,417,796,221
Liabilities:		
Amounts due on asset purchases	36,798,635	45,765,126
Payables on foreign exchanges	16,766,897	12,990,583
Accrued liabilities	2,311,903	2,217,701
Options written	150,575	203,228
Collateral on securities lending arrangements, at fair value	84,300,279	84,928,716
Total liabilities	140,328,289	146,105,354
Plan net assets held in trust for pension benefits	$ 1,266,190,299	1,271,690,867

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

See accompanying notes to the basic financial statements.

	2003	2002
Additions to Plan Net Assets:		
Contributions:		
City of Houston	$ 40,622,051	40,757,900
Participants	23,762,123	13,475,642
Total contributions	64,384,174	54,233,542
Investment income:		
Interest on bonds and deposits	6,868,504	17,196,858
Dividends	7,335,018	9,552,358
Earnings from limited partnerships and real estate trusts	7,690,010	11,062,189
Net appreciation (depreciation) on investments	16,981,165	(140,618,885)
Total investment income (loss)	38,874,697	(102,807,480)
Proceeds from lending securities	1,501,543	3,545,117
Less costs of securities lending	(1,124,872)	(2,765,594)
Net proceeds from lending securities	376,671	779,523
Less costs of investment services	(5,320,438)	(5,995,628)
Total investment income (loss), net	33,930,930	(108,023,585)
Other income	113,605	286,059
Total additions (reductions) to plan net assets	98,428,709	(53,503,984)
Deductions from Plan Net Assets:		
Benefits paid to participants	98,789,557	78,317,974
Contribution refunds to participants	474,795	269,692
Professional services	365,961	395,541
Administration expenses	4,298,964	3,662,432
Total deductions from plan net assets	103,929,277	82,645,639
Net decrease in plan net assets	(5,500,568)	(136,149,623)
Plan net assets held in trust for pension benefits:		
Beginning of year	1,271,690,867	1,407,840,490
End of year	$ 1,266,190,299	1,271,690,867

See accompanying notes to the basic financial statements.

1. Description of Plan

The Houston Municipal Employees Pension System (the System) was created under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, 1943 (Article 6243g, Vernon's Texas Civil Statutes) and reenacted and continued under HB1573, 77th Texas Legislature, Article 6243h, Vernon's Texas Civil Statutes (the Pension Statute). The System is a multi-employer defined benefit pension plan and includes contributory groups (Group A and Group C) and a noncontributory group (Group B). The System provides for service, disability and death benefits for eligible participants including all municipal employees, except police officers and firefighters, 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"). System plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group C. The System is a local governmental plan and therefore is not subject to the Employee Retirement Income Security Act of 1974. The System is governed by a Board of Trustees (the Board) and can only be terminated or amended by an act of Legislature of the State of Texas or agreement between the City and the Board pursuant to the Pension Statute.

Participation

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

At July 1, 2002, the System's participants consisted of the following:

Retirees and beneficiaries currently receiving benefits	5,928
Former employees entitled to benefits but not yet receiving them	1,136
Vested active participants	8,975
Non-vested active participants	3,552
Total participants	19,591

Contributions

During the years ended June 30, 2003 and 2002, covered active Group A and Group C participants were required to contribute 4% of their qualifying gross salary to the System. Participants are also eligible to roll over certain qualified plan amounts and make additional contributions to purchase credited service.

The City funds the System based on a percentage contribution rate multiplied by the combined eligible salaries paid to participants of Group A, Group B and Group C. The percentage contribution rate is based on the results of actuarial valuations 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%. Based on the actuarial valuation as of July 1, 2002, presented to and adopted by the Board on September 11, 2003, the actuarially determined City contribution rates were 17.7% and 10% for the fiscal years 2003 and 2002, respectively. For funding purposes, the 17.7% rate becomes effective in fiscal year 2004. The City's actual percentage contribution rate was 10% for each of the years ended June 30, 2003 and 2002. Effective July 1, 2003, the City's actual contribution rate increased to 14.7%.

Retirement Eligibility

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

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

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

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

Pension Benefits

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

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

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

Disability Benefits

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

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

Death Benefits

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

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

Deferred Retirement Option Plan

A participant who is eligible to retire, except that he or she has not retired and remains a full-time employee of the City, or the System, or has been separated from service for not more that thirty (30) calendar days, may elect to participate in the Deferred Retirement Option Plan (DROP). The DROP provides that a monthly amount (monthly DROP credit) plus a participant's employee contributions, if any, attributable to the participant's salary earned during the period of DROP participation will be credited to a notional account (DROP Account). Interest at a rate equal to the average of the annual percent returns on the System's investments for the then most recent five complete fiscal years established effective January 1 each year will accrue, compounded daily, on the DROP account balance. The first day of DROP participation is the DROP Entry Date. The day a participant's fully executed DROP election is accepted by the System is the DROP Election Date. Normal pension benefits cease to accrue on DROP Entry Date.

Prior to September 1, 1999, the DROP Entry Date was established as the date a participant applied to the System for DROP election, and the monthly DROP credit was based on a participant's credit service, average monthly salary, and the benefit accrual rates in effect on DROP Entry Date. After September 1, 1999, the DROP Entry Date may precede DROP Election Date, and the monthly DROP credit is based on the participant's years of credited service and average monthly salary as of DROP Entry Date, and benefit accrual rates in effect on DROP Election Date.

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

Refunds of Participant Contributions

Group A or Group C participants who terminate employment prior to retirement for reasons other than death, or disability, may request a refund of their accumulated employee contributions, without interest, in lieu of a pension.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying basic financial statements are presented in accordance with the 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 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 the employer pays compensation to the participant. 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.

Investments

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.

Cash and Cash Equivalent Securities

The System's cash balances are classified in three categories of credit risk:

(1) insured or collateralized with securities held by the System or by its agent in the System's name,

(2) collateralized with securities held by the pledging financial institution's trust department or agent in the System's name,

(3) uncollateralized, including any bank balance that is collateralized with securities held by the pledging institution or by its agent or trust department but not in the System's name.

As of June 30, 2003 and 2002, the System had bank balances of $7,228,131 and $5,506,470, respectively, that meet the criteria of Category (1) held in demand deposits. The book balances, reflected in the financial statements, of those deposits are $7,153,389 and $2,412,976, respectively.

Furniture, Fixtures and Equipment

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

Use of Estimates

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

Income Tax Status

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

Costs of Administering the System

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

Reclassifications

Certain amounts in 2002 have been reclassified to conform to current year presentation.

3. Funding Status and Progress

Participants of Group A and Group C are required to contribute to the System amounts set forth in the Pension Statute. In addition, the City is required to contribute amounts to the System which provide funding, on an actuarial reserve basis, stated as a percentage of covered payroll, for normal cost plus the level of percentages of payroll payments required to amortize the unfunded accrued liability over 40 years from January 1, 1983. The City's contribution rate is based on actuarial valuations of the System's assets and liabilities, and shall be not less than the greater of 10% of all member salaries or 2 times the rate contributed by Group A participants.

The City's percentage contribution rate for the year ended June 30, 2003 was based on the preceding actuarial report adopted by the Board as of the July 1, 2000 actuarial valuation, which used the following significant assumptions:

Actuarial Assumptions

Investment yield rate	8.5%
Salary increases	5.5%
Payroll growth factor	5.0%
General inflation rate	4.5%
Funding method	Entry age normal cost method
Life expectancy	1994 Group Annuity Mortality Table

The actuarially determined contribution requirements as determined in the July 1, 2000 valuation and the contributions actually made for the year ended June 30, 2003 are as follows:

Contributions Required and Contributions Made

	(in millions)	Percentage of covered payroll
Actuarially determined normal cost	$ 30.5	7.5 %
Amortization of unfunded actuarial accrued liability	8.1	2.0 %
Additional statutory requirement	2.0	.5%
Employer contributions actually made	40.6	10.0 %
Participant contributions made	23.8	4.0 %

The latest actuarial report on the System, which was approved and accepted by the Board on September 11, 2003, is based on the market value of System net assets and participant data as of July 1, 2002. The significant actuarial assumptions adopted as of July 1, 2002, and used in that actuarial valuation are as follows:

Actuarial Assumptions – July 1, 2002 Data

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

Historical trend information is provided as required supplementary information on pages 26 to 27. This historical information is intended to demonstrate the progress the System has made in accumulating sufficient assets to pay benefits when due and the related actuarial assumptions used in determining the actuarially determined amounts.

4. Deferred Compensation Plan

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

5. Investments

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

The fair values of the System's investments at June 30, 2003 and June 30, 2002 are presented in the following tables. Investments are listed by category of credit risk. Investments not subject to credit risk classification are listed but not categorized.

The System's investments as of June 30, 2003 of $92,104,573 in BGI Alpha TILTS Fund exceeds 5% of the System's net assets as of June 30, 2003. The System's investment as of June 30, 2002 of $90,014,335 in BGI Alpha TILTS Fund exceeds 5% of the System's net assets as of June 30, 2002. All investments that exceed 5% of the System's total investments as of June 30, 2003 and 2002 are included in the amounts invested in commingled funds. Schedule 5 on page 29 lists the System's investment and professional service providers.

Investment securities, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the statement of plan net assets.

INVESTMENTS AS OF JUNE 30, 2003

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

INVESTMENTS AS OF JUNE 30, 2002

	Category			
	1	3	Not Categorized	Totals
U.S. government securities	$ 121,859,607			121,859,607
Corporate bonds	110,302,312			110,302,312
Capital stocks		442,135,030		442,135,030
Commingled funds			212,132,654	212,132,654
Limited partnerships, real estate trusts, and loans and mortgages			353,211,833	353,211,833
Short-term investment funds			46,093,354	46,093,354
Total investments	232,161,919	442,135,030	611,437,841	1,285,734,790
Investments made with securities lending cash collateral:				
U.S. government securities		29,739,087		29,739,087
Domestic equity		15,517,975		15,517,975
Domestic fixed income		5,024,850		5,024,850
International equity		34,646,804		34,646,804
Total investments made with securities lending cash collateral	-	84,928,716	-	84,928,716
Total	$ 232,161,919	527,063,746	611,437,841	1,370,663,506

6. Financial Instruments With Off-Balance Sheet Risk

Covered Call Options

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

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

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

Forward Foreign Exchange Contracts

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

Mortgage-Backed Securities

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

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

7. Securities Lending

State statutes do not prohibit the System from participating 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, 2003 and 2002, the System's custodian lent, at the direction of the Board, the System's securities and received cash, securities issued or guaranteed by the United States government, and irrevocable bank letters of credit as collateral. The custodian does not have the ability to pledge or sell securities delivered for collateral, absent a borrowers default. Borrowers were required to deliver collateral for each loan equal to: (i) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; and (ii) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities.

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

During the years ended June 30, 2003 and 2002, 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, 2003 and 2002, such investment pool had an average duration of 64 and 69 days, respectively, and an average weighted maturity of 252 and 144 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, 2003, the System had no credit risk exposure to borrowers. The collateral held and the fair value of securities on loan as of June 30, 2003, was $89,415,420 and $86,744,755, respectively, and $92,757,102 and $90,601,736, respectively, as of June 30, 2002.

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

Fair Value of Underlying Securities Lent As of June 30

	2003	2002
U.S. government securities	$ 41,259,341	36,810,259
Domestic equity	20,702,036	14,866,461
Domestic fixed income	5,906,065	4,852,491
International equity	18,877,313	34,072,525
	$ 86,744,755	90,601,736

8. Furniture, Fixtures and Equipment

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

	2003	2002
Office furniture and equipment	$ 349,911	221,833
Computer equipment	253,113	111,190
Leasehold improvements	398,232	345,995
	1,001,256	679,018
Less accumulated depreciation amortization	(263,842)	(132,643)
	$ 737,414	546,375

9. Commitments

As described in note 1, certain participants of the System are eligible to receive, upon request, a refund of their accumulated Group A and/or Group C contributions, without interest, upon termination of employment with the City, or System, prior to being eligible for pension benefits. At June 30, 2003 and 2002, aggregate contributions from these eligible participants of the System were approximately $59,175,000 and $46,893,000, respectively.

The System's investments in limited partnerships are included in the tables appearing in note 5 under investments not categorized. In connection with those investments, the System has remaining commitments as of June 30, 2003 and 2002 of approximately $219,639,580 and $298,738,000, respectively, pursuant to terms of the respective limited partnerships.

The System leases office facilities and parking spaces under an operating lease expiring in 2011.

Future minimum lease obligations required under such lease are as follows:

Future Minimum Lease Obligations

Year Ending June 30	
2004	$ 290,640
2005	329,700
2006	329,700
2007	455,400
2008	455,400
Thereafter	1,366,200
	$ 3,227,040

Additional amounts are assessed for use of common areas, utilities and maintenance. Total rental expense, including these assessments, amounted to approximately $500,800 and $384,800 during the years ended June 30, 2003 and 2002, respectively.

SCHEDULE 1 - REQUIRED SUPPLEMENTAL INFORMATION

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

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

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

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

SCHEDULE 2 - REQUIRED SUPPLEMENTAL INFORMATION

SCHEDULE OF EMPLOYER CONTRIBUTIONS (UNAUDITED)

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

* The required contributions are calculated based on actuarially determined contribution rates. Actuarial calculations are performed a year in arrears and are applied to a future period. The actuarially determined rates used in this schedule for fiscal years 2002 and 2003 are based on the actuarial valuation presented to and adopted by the Board on September 11, 2003, and become effective in 2004 for funding purposes but are presented here for disclosure purposes.

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

NOTE TO REQUIRED SUPPLEMENTAL SCHEDULES 1 and 2 (UNAUDITED)

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

Valuation date	July 1, 2002
Actuarial cost method	Entry age
Amortization method	Level percentage, closed
Remaining amortization period	20 years
Asset valuation method	5-year smoothed market
Actuarial assumptions:	
Investment rate of return	8.5%, net of expenses
Salary increases	Constant annual rate of 4.5%
Payroll growth factor	4.5% per year
General inflation rate	4.0% per year
DROP participation rate	100%
DROP entry date	Upon eligibility

See accompanying independent auditors' report.

SCHEDULE 3

INVESTMENT SUMMARY JUNE 30, 2003 and 2002

	June 30, 2003			June 30, 2002		
Type of Investment	Cost	Fair Value	Unrealized Appreciation (Depreciation)	Cost	Fair Value	Unrealized Appreciation (Depreciation)
Fixed income:						
U.S. government securities	$ 95,418,619	96,536,268	1,117,649	122,388,783	121,859,607	(529,176)
Corporate bonds	82,693,717	89,240,844	6,547,127	123,447,124	110,302,312	(13,144,812)
Total fixed income	178,112,336	185,777,112	7,664,776	245,835,907	232,161,919	(13,673,988)
Capital stocks	414,628,215	439,387,265	24,759,050	456,935,751	442,135,030	(14,800,721)
Commingled funds	196,302,866	225,693,863	29,390,997	204,148,431	212,132,654	7,984,223
Limited partnerships, real estate trusts and loans and mortgages	412,404,129	400,190,471	(12,213,658)	360,526,672	353,211,833	(7,314,839)
Short-term investment funds	35,531,844	35,531,844		46,093,354	46,093,354	
Total investments	$ 1,236,979,390	1,286,580,555	49,601,165	1,313,540,115	1,285,734,790	(27,805,325)

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

See accompanying independent auditors' report.

SCHEDULE 4

INVESTMENT SERVICES, PROFESSIONAL SERVICES, AND ADMINISTRATION EXPENSES
YEARS ENDED JUNE 30, 2003 AND 2002

	2003	2002
Investment services:		
Custodial services	$ 190,402	190,593
Money management services	4,718,371	5,383,535
Consulting services	411,665	421,500
Total investment services	$ 5,320,438	5,995,628
Professional services:		
Actuarial services	117,750	117,050
Auditing and consulting services	45,703	54,299
Legal services	202,508	224,192
Total professional services	$ 365,961	395,541
Administration expenses:		
Office costs	505,034	419,951
Insurance costs	136,819	109,340
Costs of staff and benefits	2,719,729	2,417,370
Costs of equipment and supplies	733,572	527,559
Costs of education and research	203,810	188,212
Total administration expenses	$ 4,298,964	3,662,432

See accompanying independent auditors' report.

SCHEDULE 5

SUMMARY OF COSTS OF INVESTMENT AND PROFESSIONAL SERVICES
YEARS ENDED JUNE 30, 2003 AND 2002

Service Provider	Service Provided	2003	2002
DePrince, Race and Zollo, Inc.	Money Management	$ 442,726	511,168
Bank of America	Money Management	11,314	13,730
Taplin, Canida and Habacht	Money Management	61,576	148,785
PM Realty Advisors	Money Management	48,000	59,339
Oechsle International Advisors	Money Management	674,951	681,731
Kopp Investment Advisors	Money Management	147,814	199,023
Barclays Global Investors, N.A.	Money Management	288,361	312,223
Loomis, Sayles and Company, L.P.	Money Management	216,747	373,271
Neumeier Investment Counsel, L.L.C.	Money Management	303,664	364,632
Putnam Investments	Money Management	174,689	269,881
UBS Timber Investors	Money Management	76,984	41,622
UBS Global Asset Management	Money Management	519,378	344,689
Alliance Capital Management, L.P.	Money Management	147,222	256,995
TT International Investment Management	Money Management	335,818	447,804
Brown Capital Management	Money Management	179,484	218,536
Legg Mason Capital Management, Inc.	Money Management	266,633	276,526
L&B Realty Advisors	Money Management	93,934	76,468
Smith Graham & Company	Money Management	87,667	90,609
Western Asset Management	Money Management	116,376	255,456
MDL Capital Management	Money Management	103,377	98,977
Axiom International Investors, L.L.C.	Money Management	421,656	342,070
State Street Bank and Trust Company	Custodial Services	190,402	190,593
Wilshire Associates, Inc.	Consulting Services	254,000	244,000
Pension Consulting Alliance	Consulting Services	157,665	177,500
Total investment services		5,320,438	5,995,628
Baker and Botts, L.L.P.	Legal Services	79,650	83,886
Locke, Liddell and Sapp, L.L.P.	Legal Services	116,474	123,398
Lawson, Fields, McCue, Lee & Campbell, P.C.	Legal Services	6,384	16,908
Mir-Fox & Rodriguez, P.C.	Auditing Services	44,098	28,550
Pension Benefits Information	Auditing Services	1,605	2,249
Lloyd Brown Search Consultants	Consulting Services		23,500
Towers Perrin, Inc.	Actuarial Services	117,750	117,050
Total professional services		365,961	395,541
Total costs of investment and professional services		$ 5,686,399	6,391,169

See accompanying independent auditors' report.

A Bustling Main Street For Over A Century

If you were to travel back in time to 1945, Main Street would appear as a bustling, thriving thoroughfare. Dating back to its construction around 1860, however, its first businesses were only two and three story buildings. Post-World War II Main Street was approximately 24 miles long and contained buildings such as the Rice Hotel, which boasted more than 16 floors. Recently, the addition of a rail system and numerous shops and restaurants has helped infuse energy back into this main thoroughfare.

INVESTMENT SECTION

DISCUSSION OF INVESTMENT POLICIES AND ACTIVITIES
SCHEDULE OF TOP INVESTMENTS ($000) AS OF JUNE 30, 2002
COMPARISON OF INVESTMENT RETURNS – YEARS ENDED JUNE 30
PERFORMANCE BY FISCAL YEAR LAST TEN YEARS
SUMMARY OF INVESTMENTS BY TYPE AS OF JUNE 30, 2003
SCHEDULE OF FEES AND COMMISSIONS

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

General

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

Investment Policies

Strategic Asset Allocation Policy and Maintenance

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

Manager Structure Considerations

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

Investment Manager Guidelines and Evaluation

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

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

Manager Evaluation

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

Performance Evaluation

The Board reviews System investment performance on a periodic basis to evaluate conformity to the goals and objectives established in the strategic plan. The Board recognizes that financial markets from time to time may not support attainment of those goals and objectives. During such times, progress toward conformity is evaluated by comparing performance to a percentage equal to the weighted aver-

Asset Class	Allocation Target	Allocation Actual*	Investment Performance 3 Yrs.	Investment Performance 5 Yrs.
U.S. Equities	30.0 %	30.8 %	-4.10 %	1.30 %
Wilshire Top 2500 Index			-10.73	-1.26
International Equities	20.0	18.6	-14.58	-1.82
MSCI EAFE Index			-13.52	-4.00
Fixed Income	20.0	17.6	6.07	5.42
Lehman Aggregate Index			10.08	7.54
Real Assets	15.0	17.5	11.99	10.35
NCREIF Index			8.20	9.79
Alternative Investments	15.0	15.4	-12.89	1.10
S&P 500 Index			-11.20	-1.61
Cash	0.0	0.2		
Total Portfolio	100.0	100.0	-2.60	3.27
Policy Benchmark			-3.87	2.40

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

age of the performances of indexes and peer groups comparable in class and weight to the styles in the System's investment portfolio.

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

Proxy Voting

The Board authorizes each investment manager to vote all proxies relating to shares of securities under management, and requires each Investment Manager to provide a written proxy voting policy statement. Each manager is expected to promptly vote all proxies and related actions in a manner consistent with the long-term interests of the System and its participants and beneficiaries. Each investment manager is required to keep detailed records of all voting of proxies and related actions and to comply with all related regulatory obligations. The System's management staff periodically review each investment manager's policies and actions in respect to proxy voting.

Investment Activities

During the period covered by this CAFR, investment strategies were employed that are long-term in perspective and designed to work within predefined ranges among asset classes to produce returns that, over market cycles, will exceed the investment return assumption adopted by the Board for actuarial purposes. Diversification provides safeguards against unanticipated market volatility of one or more asset classes. The Chief Investment Officer, Neal Wallach, has provided a summary in the above table of the portfolio's actual allocation compared to the targeted allocation.

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

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

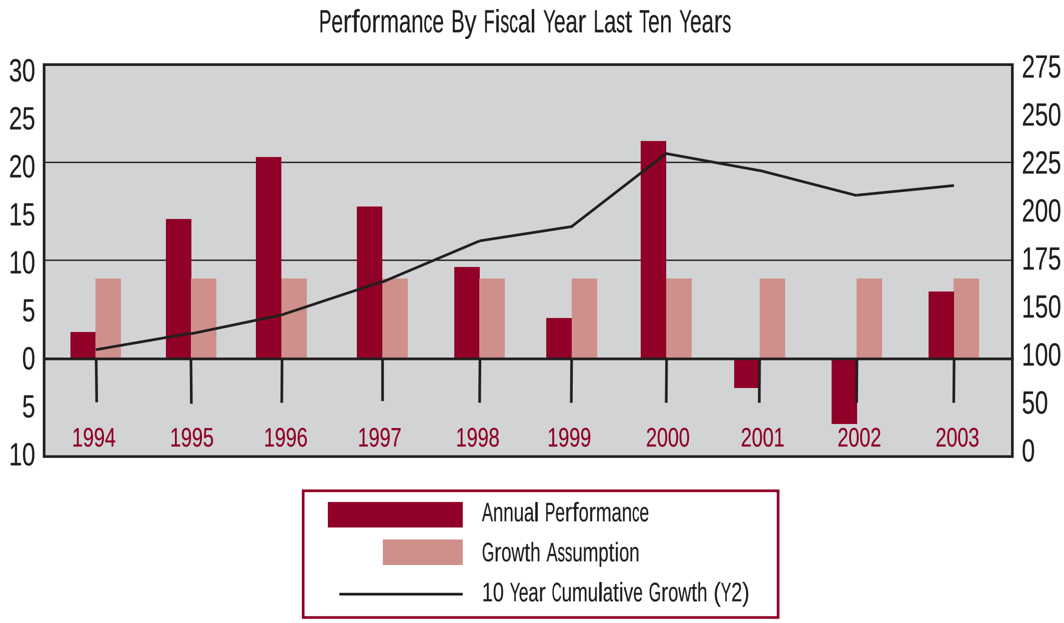
The Investment Section was written by HMEPS's Chief Investment Officer, Neal Wallach; Investment Manager, Douglas Wynkoop; and Financial Analyst, Greg Brunt.

SCHEDULE OF TOP INVESTMENTS ($000) AS OF JUNE 30, 2003

Name of Investment	Fair Value of Investment	Percent of Portfolio
Barclays Alpha Tilts (Enhanced S&P 500 Index)	$ 92,105	7.3 %
Brandes International Value Fund	60,865	4.8
PIMCO Stocks Plus (Enhanced S&P 500 Index)	58,580	4.6
Barclays US Equity Index (S&P 500 Index)	42,166	3.3
Barclays US Bond Index (Lehman Aggregate Index)	32,843	2.6

COMPARISON OF INVESTMENT RETURNS - YEARS ENDED JUNE 30

Period Ending 6-30	HMEPS Total Fund	Median of Wilshire Public Fund Universe	HMEPS Domestic Equity	Wilshire Target Top 2500 Index	S&P 500 Index	HMEPS Int'l. Equity	MSCI ACWI Free ex US Index	MSCI EAFE Index	HMEPS Fixed Income	Lehman Aggregate Index
1994	2.04 %	1.91 %	-1.55 %	1.18 %	1.41 %	17.65 %	n/a	16.99 %	-2.56 %	-1.31 %
1995	14.47	16.30	25.59	25.03	26.07	3.87	n/a	1.66	12.78	12.55
1996	21.27	16.76	33.18	26.03	25.99	17.10	n/a	13.28	8.13	5.01
1997	16.91	20.38	17.22	30.10	34.70	18.39	n/a	12.84	12.31	8.16
1998	9.16	18.40	19.28	30.06	30.17	4.22	n/a	6.09	8.58	10.54
1999	3.42	12.10	7.87	20.22	22.74	1.60	n/a	7.59	0.52	3.13
2000	22.92	9.81	12.14	9.74	7.27	44.02	n/a	17.18	8.54	4.56
2001	-4.08	-5.15	-2.00	-14.95	-14.82	-26.31	n/a	-23.61	2.30	11.23
2002	-6.97	-5.87	-12.79	-17.20	-17.99	-12.10	-8.45 %	-9.49	2.34	8.63
2003	3.55	4.10	3.18	1.00	0.25	-3.76	-4.59	-6.46	13.98	10.40
3 Yrs.	-2.60	-2.78	-4.10	-10.73	-11.20	-14.58	n/a	-13.52	6.07	10.08
5 Yrs.	3.27	2.80	1.30	-1.26	-1.61	-1.82	n/a	-4.00	5.42	7.54
10 Yrs.	7.82	8.53	9.40	9.74	10.04	4.88	n/a	2.78	6.55	7.21



Performance By Fiscal Year Last Ten Years
30
25
20
15
10
5
0
5
10
275
250
225
200
175
150
100
50
0
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Annual Performance
Growth Assumption
10 Year Cumulative Growth (Y2)

SCHEDULE OF FEES & COMMISSIONS PAID IN FISCAL YEAR 2003

	Commissions	Shares	cents/share
Lehman Bros	$ 200,787	14,977,970	1.3
Merrill Lynch	187,278	15,184,068	1.2
UBS Paine Webber Bunting Warburg	110,737	5,398,617	2.1
CSFB	103,211	7,964,219	1.3
Capital Institutional Svcs	88,885	1,888,195	4.7
Salomon Smith Barney/Citigroup	86,121	9,095,835	0.9
Donaldson and Co	81,030	1,345,441	6.0
Lynch Jones Ryan	79,205	1,937,750	4.1
JP Morgan / Chase Manhattan	78,837	5,884,257	1.3
Goldman Sachs	62,481	35,625,833	0.2
Cantor Fitzgerald	61,806	1,738,886	3.6
Deutsche Bank / Morgan Grenfell	56,870	2,467,859	2.3
Morgan Stanley	54,173	8,325,099	0.7
HSBC	51,872	18,375,371	0.3
Dresdner Kleinwort Benson Wasserstein	48,711	2,201,494	2.2
ABN Amro	31,701	1,577,327	2.0
State Street / SSB	29,751	2,681,305	1.1
Bear Stearns	29,380	742,313	4.0
Charles Schwab	27,240	986,044	2.8
Nomura	21,471	1,807,566	1.2
Cazenove	21,283	1,565,718	1.4
Friedman Billings	20,418	514,180	4.0
BNP	20,384	1,242,611	1.6
Instinet	19,582	874,636	2.2
Prudential Securities	19,389	398,616	4.9
Daiwa	18,013	550,750	3.3
Bank Julius Baer	14,716	359,884	4.1
Carnegie (Fondkomission)	14,578	387,281	3.8
Griffiths McBurney	13,356	1,175,169	1.1
BMO Nesbitt Burns	13,137	987,700	1.3
LG Securities	13,067	43,965	29.7
Banc of America	11,873	1,090,964	1.1
Auerbach Grayson	10,713	217,198	4.9
Scotia Capital McLeod	10,303	604,770	1.7
SG Cowen	9,783	845,323	1.2
Brockhouse and Cooper	9,477	621,898	1.5
Gerard Klauer Mattison	9,140	193,600	4.7
BNY/Goodbody	8,706	269,810	3.2
Abel Noser	8,580	171,600	5.0
ABG Sundal Collier	8,432	359,459	2.3
Investec Ernst Henderson Crossthwaite	8,421	445,791	1.9
Fox Pitt Kelton	8,398	413,454	2.0
Collins Stewart	8,186	440,249	1.9
ING Baring	7,785	474,533	1.6
Lombard Odier	7,772	62,180	12.5

	Commissions	Shares	cents/share
KBC Bank	7,600	239,500	3.2
Euromobiliare	7,298	338,900	2.2
CIBC Wood Gundy	6,405	143,490	4.5
Credit Lyonnais	6,256	605,016	1.0
Thomason Institutional	6,243	124,850	5.0
Mizuho	5,956	210,238	2.8
Pershing / DLJ	5,357	195,612	2.7
JB Were	5,342	518,900	1.0
Pereire TOD Ltd	5,246	214,516	2.4
Sanford C. Bernstein	5,032	110,898	4.5
RBC Dain Rauscher	4,997	213,230	2.3
Baird, Robert W.	4,860	389,200	1.2
Enskilda Securities	4,802	98,571	4.9
Macquari	4,558	656,200	0.7
Needham and Co	4,500	90,000	5.0
William Blair	4,465	139,100	3.2
Credit Agricole Indosuez Cheuvreux	4,185	71,826	5.8
Goodmorning	3,924	12,790	30.7
Wit Soundview	3,871	117,420	3.3
First Union	3,842	80,741	4.8
Pictet and Cie	3,487	29,355	11.9
Keefe Bruyette Woods	3,459	57,700	6.0
Standard and Poors	3,454	66,800	5.2
Legg Mason	3,438	110,200	3.1
Jefferies Co	3,040	116,052	2.6
Soundview Financial	3,000	100,000	3.0
US Bancorp Piper Jaffray	2,994	67,875	4.4
Thomas Weisel	2,874	62,405	4.6
Wedbush Morgan	2,750	55,000	5.0
Exane	2,610	103,171	2.5
West LB Panmure	2,545	85,824	3.0
MainFirst Bank	2,261	26,265	8.6
Weeden	2,250	75,000	3.0
Beta Capital	2,201	121,230	1.8
Vicker Ballas	2,184	773,100	0.3
Wachovia	2,140	49,000	4.4
DBS Vickers	2,118	453,700	0.5
Jardine Fleming	2,064	2,200	93.8
Davy Stockbrokers	2,013	101,375	2.0
Others	$47,976	6,230,882	0.8
Total	$ 2,010,637	167,774,920	1.2

The Coliseum, Predecessor to the Astrodome

In 1936 a small wooden hall called the Sam Houston Hall, originally built for a Democratic National Convention, was razed to make way for the Sam Houston Coliseum and Music Hall. The new arena was modern (by those days standards) and a crowd totalling 9,200 was considered a "sell out." The Coliseum hosted such memorable events as the Shrine Circus, the Houston Fat Stock Show and Rodeo, and in later years, the Beatles and other rock'n'roll bands.

ACTUARIAL SECTION

Towers Perrin

November 4, 2003

Board of Trustees
Houston Municipal Employees Pension System

Dear Board Members:

We certify that the information contained in this July 1, 2002 Actuarial Report for the Houston Municipal Employees Pension System ("the System") has been prepared in accordance with generally accepted actuarial principles and practices. This report describes the results of an actuarial valuation of the System. The System has retained Towers Perrin to perform this actuarial valuation to determine the funding status as of July 1, 2002 and the associated actuarially determined employer contribution rate. To the best of our knowledge, the information is accurate and fairly presents the actuarial position of the System as of July 1, 2002.

The consulting actuary for this report is a member of the Society of Actuaries and other professional actuarial organizations and meets their "General Qualification Standard for Prescribed Statements of Actuarial Opinions" relating to pension plans.

In preparing the actuarial results, we have relied on information provided by the Board of Trustees regarding plan provisions, plan participants, plan assets and other matters. While the scope of our engagement did not call for us to perform an audit or independent verification of this information, we have reviewed this information for reasonableness but we have not audited it. The accuracy of the results presented in this report depends on the accuracy and completeness of the underlying information. Historical information for the years prior to 1993 was prepared by the prior actuaries and was therefore not subject to our actuarial review.

Considerations in Preparing Actuarial Valuations

Frequency

Actuarial valuations are prepared and adopted by the Board at least every three years. The most recent such prior actuarial valuation adopted by the Board was prepared as of July 1, 2000.

Financing Objective of the System and Progress Toward its Realization

Contribution rates are established that, over time, are expected to remain level as a percentage of payroll. The contribution rate has been determined to provide for normal cost plus the level percentage of payroll required to amortize the unfunded actuarial accrued liability (or surplus) over 40 years from January 1, 1983.

Note that the summary of accrued and unfunded accrued liabilities in Section II of the report illustrates the progress toward realizing this financing objective.

Disclosure of Pension Information

Effective for fiscal years beginning July 1, 1996, the Board of Trustees has implemented the requirements of Governmental Accounting Standards Board (GASB) Statement No. 25. The information required to be disclosed by GASB No. 25 in the notes to the System's financial statements is shown in Sections II and III of the report.

Data

In preparing the July 1, 2002, actuarial valuation, we relied on data provided by the Board. As part of this valuation, we tested the data for reasonableness. We did not, however, subject this data to any auditing procedures as indicated above.

Actuarial Methods and Assumptions

These methods and assumptions – described in Section VI of the report – were selected by the Board of Trustees. The Board has sole authority to determine the actuarial assumptions. Changes in actuarial methods and assumptions since the prior valuation are described also in Section VI. In our opinion, the actuarial assumptions used are appropriate for the purposes of the valuation and, in the aggregate, are reasonably related to the experience of the System as of the valuation date.

The funding determination portion of the actuarial valuation has been conducted in accordance with principles of practice prescribed by the Actuarial Standards Board and the requirements of the Texas Government Code. Section 802.101 of the Texas Government Code requires the use of actuarial "assumptions and methods that are reasonable in the aggregate, considering the experience of the program and reasonable expectations, and that, in combination, offer the actuary's best estimate of anticipated experience under the program."

We believe that the assumptions and methods used for funding purposes meet the parameters set for the disclosures presented in the financial section by Government Accounting Standards Board (GASB) Statement No. 25.

Plan Provisions

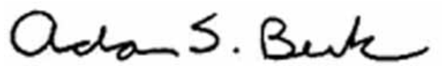
The plan provisions used in the actuarial valuation are described in Section VI of the report. Changes in the plan provisions since the prior valuation are described in Section VI.

Towers Perrin understands that an experience study of the System is contemplated prior to completion of the July 1, 2003 actuarial valuation. The experience study would examine actual experience in relation to all of the actuarial assumptions for the purpose of assisting the Board in re-evaluating the reasonableness of the assumptions. In particular, the study would examine the experience of members changing Service Group elections from Group B to Group A and retroactively changing service elections to Group A through a purchase election. Currently, members are assumed to remain in their current Group election. In the event the experience study and reasonable expectations indicate that future service election changes are to be expected, we will recommend changes to the actuarial assumptions and, as appropriate, to the actuarially determined City contribution rate.

Results shown in this report are reasonable actuarial results. However, a different set of results could also be considered reasonable actuarial results, since the Actuarial Standards of Practice describe a "best-estimate range" for each assumption, rather than a single best-estimate value. Thus, reasonable results differing from those presented in this report could have been developed by selecting different points within the best-estimate ranges for various assumptions.

We are available to answer any questions on the information contained in the report, or to provide any additional information you may need.

Sincerely,



Adam Berk, A.S.A., C.F.A., E. A., M.A.A.A.

Actuarial Certification

This report describes the results of an actuarial valuation of the Houston Municipal Employees Pension System. The Houston Municipal Employees Pension System retained Towers Perrin to perform this actuarial valuation for the purposes of determining the funding status and employer contributions for the plan year July 1, 2002 through June 30, 2003.

The consulting actuary is a member of the Society of Actuaries and other professional actuarial organizations and meets their "General Qualification Standard for Prescribed Statements of Actuarial Opinions" relating to pension plans.

In preparing the actuarial results, we have relied upon information provided by the Board of Trustees regarding plan provisions, plan participants, plan assets, and other matters. While the scope of our engagement did not call for us to perform an audit or independent verification of this information, we have reviewed this information for reasonableness but have not audited it. The accuracy of the results presented in this report is dependent upon the accuracy and completeness of the underlying information. Historical information for years prior to 1986 was prepared by the prior actuaries and was not subjected to our actuarial review.

The actuarial methods and assumptions used in this valuation were selected by the Board of Trustees. The Board has sole authority to determine the actuarial assumptions. In our opinion, the actuarial assumptions used are appropriate for purposes of this valuation and, in the aggregate, are reasonably related to the experience of the Fund as of the valuation date.

Towers Perrin understands that an experience study of the System is contemplated prior to completion of the July 1, 2003 actuarial valuation. An experience study will examine actual experience in relation to all of the actuarial assumptions for the purpose of assisting the Board in re-evaluating the reasonableness of the assumptions. In particular, a study will examine the experience of members changing Service Group elections from Group B to Group A and retroactively changing service elections to Group A through a purchase election. Currently, members are assumed to remain in their current Group election. In the event an experience study and reasonable expectations indicate that future service election changes are to be expected, we will recommend changes to the actuarial assumptions and, as appropriate, to the actuarially determined City contribution rate.

The funding determination portion of this actuarial valuation has been conducted in accordance with principles of practice prescribed by the Actuarial Standards Board and the requirements of the Texas Government Code. Section 802.101 of the Texas Government Code requires the use of actuarial "assumptions and methods that are reasonable in the aggregate, considering the experience of the program and reasonable expectations, and that, in combination, offer the actuary's best estimate of anticipated experience under the program."

The results shown in this report are reasonable actuarial results. However, a different set of results could also be considered reasonable actuarial results, since the Actuarial Standards of Practice describe a "best-estimate range" for each assumption, rather than a single best-estimate value. Thus, reasonable results differing from those presented in this report could have been developed by selecting different points within the best-estimate ranges for various assumptions.

The information contained in this report was prepared for the internal use of the Houston Municipal Employees Pension System and its auditors in connection with our actuarial valuation of the pension plan. It is not intended nor necessarily suitable for other purposes and may not be relied on by third parties.

Towers Perrin

Adam Berk, A.S.A., C.F.A., E. A., M.A.A.A.

September, 2003

SUMMARY OF KEY RESULTS ($000)

City Contribution Rate	July 1, 2002	July 1, 2001
Normal Cost (City Portion)	12.3 %	10.0 %
Amortization of Unfunded Actuarial Accrued Liability	19.5	7.7
Preliminary Actuarially Determined City Contribution Rate	31.8 %	17.7 %
Additional Statutory Requirement	0.0	0.0
Final Actuarially Determined City Contribution Rate	31.8 %	17.7 %
Summary of Assets		
Market Value	$ 1,271,691	$ 1,407,516
Actuarial Value	1,519,717	1,490,179
Summary of Liabilities		
Actuarial Accrued Liability	$ 2,515,189	$ 1,955,806
Actuarial Value of Assets	(1,519,717)	(1,490,179)
Unfunded Actuarial Accrued Liability (UAAL)	$ 995,472	$ 465,627
Summary of Data		
Number of Participants Included in the Valuation		
• Active participants	12,527 *	12,928
• DROP participants	N/A	281
• Vested terminated participants	1,136	1,226
• Retirees and beneficiaries	5,928	5,457
• Total	19,591	19,892
Annual Base Pay Reported for the Prior Year	$ 399,794	$ 418,234
Expected Covered Payroll (for Amortization of UAAL and Projection of Assets and Liabilities)	$ 365,000 **	$ 418,234

* Includes 277 DROP participants included in the July 1, 2002 actuarial valuation as active participants.

** Budgeted payroll for fiscal year ending June 30, 2003 reported by the Houston Municipal Employees Pension System.

SUMMARY OF ASSETS AS OF JULY 1, 2002 ($000)

	Market Value	
Investment Category	Amount	Percent
Cash and Cash Equivalents	$ 2,413	0.2 %
Fixed Income Investments		
Government bonds	121,860	9.6
Corporate bonds	110,302	8.7
Short-term interest-bearing deposits	46,093	3.6
Total	$ 278,255	21.9
Equity Investments		
Capital stock	442,135	34.7
Commingled funds	212,133	16.7
Total	$ 654, 268	51.4
Other Investments		
Limited partnerships and real estate investment trusts	$ 353,212	27.8
Furniture, fixtures and equipment	546	0.0
Total	353,758	27.8
Other Assets (Liabilities)		
Miscellaneous receivables	44,174	3.5
Miscellaneous payables	(60,973)	(4.8)
Written options	(204)	0.0
Net	$ (17,003)	(1.3)
Total	$ 1,271,691	100.0 %

CHANGE IN ASSETS SINCE THE PRIOR VALUATION ($000)

Market Value as of July 1, 2001	$ 1,407,516
Contributions and Disbursements	
City contributions	40,758
Employee contributions	13,476
Benefit payments	(78,318)
Contributions refunds	(270)
Miscellaneous	0
Net	$ (24,354)
Net Investment Return	
Interest	17,197
Dividends	9,552
Earnings from limited partnerships and real estate investment trust	11,062
Net (depreciation)/appreciation on investments	(140,619)
Net proceeds from lending securities	780
Other income	286
Investment services expense	(5,995)
Administrative expenses	(3,734)
Net	$ (111,471)
Market Value as of June 30, 2002	$ 1,271,691
Approximate Annual Rate of Return (Net of Expenses)*	(8.0) %

* Calculated using a dollar-weighted rate of return assuming all contributions and disbursements are made uniformly throughout the year.

DEVELOPMENT OF ACTUARIAL VALUE OF ASSETS ($000)

Actuarial Investment Gain (Loss) for the Year	
Market Value of Assets as of July 1, 2001	$ 1,407,516
City Contributions	40,758
Employee Contributions	13,476
Benefit Payments and Contribution Refunds	(78,588)
Miscellaneous Contributions and Disbursements	0
Expected Interest at 8.5%	118,625
Expected Market Value of Assets as of June 30, 2002	$ 1,501,787
Actual Market Value of Assets as of June 30, 2002	1,271,691
Actuarial Investment Gain (Loss)	$ (230,096)

SCHEDULE OF ACTUARIAL INVESTMENT GAINS (LOSSES) ($000)

Plan Year Ended	Initial Actuarial Gain (Loss)	Five-Year Amortization	Unrecognized Gain (Loss) as of July 1, 2002*
June 30, 2002	$ (230,096)	$ (46,019)	$ (184,077)
June 30, 2001	(193,278)	(38,656)	(115,967)
June 30, 2000	$ 165,524	$ 33,105	$ 66,210
June 30, 1999	(70,960)	(14,192)	(14,192)
			$ (248,026)

* Deferred for recognition in future years.

ACTUARIAL VALUE OF ASSETS

Market Value as of July 1, 2002	$ 1,271,691
(Gain) Loss to be Recognized in Future Years	248,026
Actuarial Value as of July 1, 2002	$ 1,519,717

UNFUNDED ACTUARIAL ACCRUED LIABILITY ($000)

	July 1, 2002	July 1, 2001
Actuarial Present Value of Future Benefits		
- Active participants	$ 2,069,709	$ 1,528,322
- DROP participants	N/A*	119,205
- Vested terminated participants	32,979	33,327
- Retirees and beneficiaries	860,589	652,369
- Total	$ 2,963,277	$ 2,333,223
Actuarial Present Value of Future Employee Contributions	(71,251)	(57,111)
Actuarial Present Value of Future Normal Costs (City Portion)	(376,837)	(320,306)
Actuarial Accrued Liability	$ 2,515,189	$ 1,955,806
Actuarial Value of Assets	(1,519,717)	(1,490,179)
Unfunded Actuarial Accrued Liability (UAAL)	$ 995,472	$ 465,627

* DROP participants are included in the July 1, 2002 actuarial valuation as active participants.

CHANGE IN UNFUNDED ACTUARIAL ACCRUED LIABILITY SINCE THE PRIOR VALUATION ($000)

Unfunded Actuarial Accrued Liability as of July 1, 2001	$ 465,627
Change in Actuarial Assumptions and Methods	268,858
Expected Change due to Normal Operation	
- Normal cost (City portion)	42,000
- City actuarially determined contribution	(72,141)
- Interest	38,323
- Recognition of prior asset losses (gains)	18,713
- Net change	$ 26,895
- Expected Change due to City Funding Less than Actuarial Rate:	32,690
Change due to Actuarial Experience	
- Actuarial (gain) loss from asset sources	53,046
- Actuarial (gain) loss from liability sources	148,356
- Net change	$ 201,402
Change in Plan Provisions	0
Unfunded Actuarial Accrued Liability as of July 1, 2002	$ 995,472

HISTORICAL UNFUNDED ACTUARIAL ACCRUED LIABILITY ($000)

Valuation Date	Actuarial Accrued Liability (AAL)	Actuarial Value of Assets (AVA)	AVA as a Percentage of AAL	Unfunded AAL	Covered Payroll	UAAL as a Percentage of Covered Payroll
July 1, 1991	$ 688,322	$ 558,144	81%	$ 130,178	$ 284,914	46%
July 1, 1992	765,299	608,524	80	156,775	314,686	50
July 1, 1993	840,321	660,637	79	179,684	340,249	53
July 1, 1994	886,699	713,696	80	173,003	366,561	47
July 1, 1995	963,712	770,189	80	193,523	378,511	51
July 1, 1996	1,042,459	857,332	82	185,127	367,610	50
July 1, 1998	1,240,141	1,095,617	88	144,524	397,698	36
July 1, 1999	1,339,933	1,222,240	91	117,693	407,733	29
July 1, 2000	1,509,373	1,376,020	91	133,353	432,604	31
July 1, 2001	1,955,806	1,490,179	76	465,627	418,234	111
July 1, 2002	2,515,189	1,519,717	60	995,472	399,794	249

HISTORICAL SOLVENCY TEST ($000)

		Actuarial Accrued Liability for:			Portion of Actuarial Accrued Liability Covered by Assets		
Valuation Date	Employee Contributions (1)	Retirees, Beneficiaries, Vested Terminated and DROP Participants (2)	Active Participants (City-Financed Portion) (3)	Actuarial Value of Assets	(1)	(2)	(3)
July 1, 1991	$ 32,606	$ 289,174	$ 366,542	$ 558,144	100%	100%	64%
July 1, 1992	32,850	317,849	414,600	608,524	100	100	62
July 1, 1993	32,866	369,561	437,894	660,637	100	100	59
July 1, 1994	32,410	384,100	470,189	713,696	100	100	63
July 1, 1995	31,130	420,830	511,752	770,189	100	100	62
July 1, 1996	45,819	438,486	558,154	857,332	100	100	67
July 1, 1998	34,781	502,335	703,025	1,095,617	100	100	79
July 1, 1999	33,985	599,270	706,678	1,222,240	100	100	83
July 1, 2000	38,292	646,611	824,470	1,376,020	100	100	84
July 1, 2001	36,449	804,901	1,114,456	1,490,179	100	100	58
July 1, 2002	35,888	893,568	1,585,733	1,519,717	100	100	37

ACTUARIALLY DETERMINED CITY CONTRIBUTION RATE

	July 1, 2002 through June 30, 2003	July 1, 2001 through June 30, 2002
City Normal Cost Rate	12.3 %	10.0 %
Rate to Amortize Unfunded Actuarial Accrued Liability Over 40 Years from January 1, 1983	19.5	7.7
Actuarially Determined City Contribution Rate	31.8 %	17.7 %
Additional Statutory Requirement	0.0	0.0
Actuarially Determined City Contribution Rate plus Additional Statutory Requirement	31.8 %	17.7 %

CHANGE IN CITY CONTRIBUTION RATE SINCE THE PRIOR VALUATION

Actuarially Determined City Contribution Rate as of July 1, 2001	17.7 %
Change in the Actuarially Determined City Contribution Rate	
- Change in actuarial assumptions and methods	5.7
- Recognition of prior asset losses (gains)	0.3
- Effect of City contribution less than actuarial rate	0.6
- Actuarial (gain) loss from asset sources	0.9
- Actuarial (gain) loss from liability sources	6.6
- Change in plan provisions	0.0
Actuarially Determined City Contribution Rate as of July 1, 2002	31.8 %

HISTORICAL CITY CONTRIBUTIONS AS A PERCENTAGE OF COVERED PAYROLL

Actuarially Calculated City Contribution Rate		Actual City Contribution Rate	
Valuation Date	Rate	Period	Rate
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	9.30	July 1, 1998 through June 30, 1999	9.10
July 1, 1999	9.80 *	July 1, 1999 through June 30, 2000	9.30
July 1, 2000	9.50	July 1, 2000 through June 30, 2001	10.0
July 1, 2001	17.70	July 1, 2001 through June 30, 2002	10.0
July 1, 2002	31.80	July 1, 2002 through June 30, 2003	10.0

*Average for the year.

Note: Since January 1, 1983, the actual City contribution rate has been based on results of actuarial valuations prepared at least every three years.

PROJECTION OF ESTIMATED ASSETS AND LIABILITIES ($000)

Year Beginning July1	Annual Covered Payroll	Actuarially Determined Rate (1)	City Contribution Rate	City Contribution	Employee Contributions	Benefit Payments	Net Cash Flow	Market Value of Assets at Beginning of Year	Unfunded Actuarial Liability at Beginning of Year
2002	$ 365,000	17.7 %	10.0 %	$ 36,500	$ 8,178	$ 95,856	$ (51,178)	$ 1,271,691	$ 995,472
2003	375,000	31.8	14.7	55,125	8,402	103,266	(39,739)	1,326,475	1,175,680
2004	391,875	35.5	35.5	139,116	8,780	113,865	34,031	1,397,832	1,333,305
2005	409,509	38.3	38.3	156,842	9,175	127,018	38,999	1,552,094	1,447,724
2006	427,937	40.5	40.5	173,315	9,588	142,535	40,368	1,724,644	1,509,810
2007	447,194	41.7	41.7	186,480	10,019	151,494	45,005	1,913,287	1,512,446
2008	467,318	41.8	41.8	195,339	10,470	167,966	37,843	2,122,796	1,504,059
2009	488,348	41.8	41.8	204,129	10,941	186,026	29,044	2,342,652	1,488,311
2010	510,323	41.8	41.8	213,315	11,433	202,567	22,181	2,572,031	1,464,762
2011	533,288	41.7	41.7	222,381	11,948	226,120	8,209	2,813,758	1,432,460

(1) Based on actuarially determined rate from the prior year's valuation.

The projection is based on the economic and demographic assumptions summarized in Section VI, including an 8.5% investment return beginning as of July 1, 2002. The total covered payroll is assumed to be $365 million for fiscal year 2003 and $375 million for fiscal year 2004, increasing by 4.5% per year thereafter. As actual economic (such as the actual investment return from July 1, 2002 through June 30, 2003) and demographic experience vary, the results will change.

The projection assumes the Assumptions and Methods and the Plan Provisions as summarized in Section VI do not change throughout the projection period.

This projection is incomplete without the accompanying report.

SUMMARY OF ACTIVE PARTICIPANTS AS OF JULY 1, 2002

Contributory Plan

Age Last Birthday		Completed Years of Service								
		0-4	5-9	10-14	15-19	20-24	25-29	30-34	Over 34	Total
15-19	Number	21								21
	Tot Earnings	428,833								428,833
	Avg Earnings	20,421								20,421
20-24	Number	273	2							275
	Tot Earnings	5,804,489	38,641							5,843,130
	Avg Earnings	21,262	19,320							21,248
25-29	Number	412	33							445
	Tot Earnings	9,843,906	896,184							10,740,090
	Avg Earnings	23,893	27,157							24,135
30-34	Number	394	105	42	2					543
	Tot Earnings	10,410,365	3,080,063	1,274,027	58,214					14,822,669
	Avg Earnings	26,422	29,334	30,334	29,107					27,298
35-39	Number	383	154	119	62	13				731
	Tot Earnings	10,099,134	4,902,965	4,135,079	2,035,317	398,225				21,570,721
	Avg Earnings	26,368	31,837	34,749	32,828	30,633				29,509
40-44	Number	374	191	178	153	251	18			1,165
	Tot Earnings	10,189,646	6,769,518	6,767,524	5,487,350	8,370,446	688,170			38,272,654
	Avg Earnings	27,245	35,443	38,020	35,865	33,348	38,232			32,852
45-49	Number	293	153	180	135	332	123	2		1,218
	Tot Earnings	8,579,875	5,519,785	7,013,863	5,427,577	12,130,069	4,635,825	111,665		43,418,658
	Avg Earnings	29,283	36,077	38,966	40,204	36,536	37,690	55,832		35,648
50-54	Number	223	165	134	150	203	149	59	1	1,084
	Tot Earnings	7,222,349	5,922,422	5,763,670	6,238,761	7,518,372	5,975,515	2,261,695	34,291	40,937,074
	Avg Earnings	32,387	35,893	43,012	41,592	37,036	40,104	38,334	34,291	37,765
55-59	Number	153	123	101	114	140	85	41	12	769
	Tot Earnings	4,937,168	4,895,823	4,012,241	4,839,273	5,564,146	3,261,673	1,600,546	505,498	29,616,366
	Avg Earnings	32,269	39,803	39,725	42,450	39,744	38,373	39,038	42,125	38,513
60-64	Number	71	61	51	49	57	19	27	10	345
	Tot Earnings	2,406,392	2,166,219	2,320,193	2,148,020	2,225,517	744,858	1,024,111	420,768	13,456,078
	Avg Earnings	33,893	35,512	45,494	43,837	39,044	39,203	37,930	42,077	39,003
Over64	Number	17	23	32	6	17	16	4	8	123
	Tot Earnings	568,146	680,197	1,396,246	292,195	616,432	622,369	145,397	285,611	4,606,594
	Avg Earnings	33,420	29,574	43,633	48,699	36,261	38,898	36,349	35,701	37,452
Total	Number	2,614	1,010	837	671	1,013	410	133	31	6,719
	Tot Earnings	70,490,303	34,871,818	32,682,843	26,526,707	36,823,206	15,928,409	5,143,413	1,246,169	223,712,867
	Avg Earnings	26,966	34,527	39,048	39,533	36,351	38,850	38,672	40,199	33,296

Average Age = 45.0 Average Service = 11.0

SUMMARY OF ACTIVE PARTICIPANTS AS OF JULY 1, 2002 (cont.)

Noncontributory Plan

Age Last Birthday		Completed Years of Service 0-4	5-9	10-14	15-19	20-24	25-29	30-34	Over 34	Total
15-19	Number									
	Tot Earnings									
	Avg Earnings									
20-24	Number	53	13							66
	Tot Earnings	1,107,819	307,751							1,415,571
	Avg Earnings	20,902	23,673							21,448
25-29	Number	157	148	2						307
	Tot Earnings	3,529,462	3,720,849	57,216						7,307,527
	Avg Earnings	22,481	25,141	28,608						23,803
30-34	Number	179	371	154	1					705
	Tot Earnings	4,621,858	10,003,759	4,051,094	43,708					18,720,420
	Avg Earnings	25,820	26,964	26,306	43,708					26,554
35-39	Number	154	347	338	87	18				944
	Tot Earnings	4,000,612	10,079,471	9,790,577	2,466,266	550,475				26,887,400
	Avg Earnings	25,978	29,047	28,966	28,348	30,582				28,482
40-44	Number	139	318	308	172	125				1,062
	Tot Earnings	3,859,612	9,435,194	9,841,246	5,243,768	3,923,870				32,303,692
	Avg Earnings	27,767	29,670	31,952	30,487	31,391				30,418
45-49	Number	127	315	265	168	132	35			1,042
	Tot Earnings	3,750,780	9,634,296	9,017,232	5,582,001	4,333,015	1,271,920			33,589,244
	Avg Earnings	29,534	30,585	34,027	33,226	32,826	36,341			32,235
50-54	Number	67	253	215	154	80	36	10		815
	Tot Earnings	2,037,378	8,144,952	7,154,306	5,428,073	2,716,931	1,227,058	324,845		27,033,542
	Avg Earnings	30,409	32,193	33,276	35,247	33,962	34,085	32,484		33,170
55-59	Number	45	165	160	103	50	26	8	2	559
	Tot Earnings	1,363,979	5,299,209	5,181,696	3,737,149	1,804,367	967,650	221,191	57,598	18,632,840
	Avg Earnings	30,311	32,116	32,386	36,283	36,087	37,217	27,649	28,799	33,332
60-64	Number	13	65	68	41	17	4	4		212
	Tot Earnings	372,001	2,039,472	2,240,180	1,295,116	724,762	144,578	132,915		6,949,023
	Avg Earnings	28,615	31,376	32,944	31,588	42,633	36,144	33,229		32,778
Over 64	Number	4	28	27	19	10	6	2		96
	Tot Earnings	138,850	855,051	851,607	741,848	362,939	183,418	108,078		3,241,792
	Avg Earnings	34,713	30,538	31,541	39,045	36,294	30,570	54,039		33,769
Total	Number	938	2,023	1,537	745	432	107	24	2	5,808
	Tot Earnings	24,782,352	59,520,004	48,185,155	24,537,928	14,416,360	3,794,624	787,029	57,598	176,081,051
	Avg Earnings	26,420	29,422	31,350	32,937	33,371	35,464	32,793	28,799	30,317

Average Age = 44.4 Average Service = 11.1

SUMMARY OF ACTIVE PARTICIPANTS AS OF JULY 1, 2002 (cont.)

Total

Age Last Birthday		Completed Years of Service 0-4	5-9	10-14	15-19	20-24	25-29	30-34	Over 34	Total
15-19	Number	21								21
	Tot Earnings	428,833								428,833
	Avg Earnings	20,421								20,421
20-24	Number	326	15							341
	Tot Earnings	6,912,309	346,392							7,258,701
	Avg Earnings	21,203	23,093							21,287
25-29	Number	569	181	2						752
	Tot Earnings	13,373,368	4,617,033	57,216						18,047,617
	Avg Earnings	23,503	25,508	28,608						23,999
30-34	Number	573	476	196	3					1,248
	Tot Earnings	15,032,224	13,083,822	5,325,121	101,922					33,543,089
	Avg Earnings	26,234	27,487	27,169	33,974					26,877
35-39	Number	537	501	457	149	31				1,675
	Tot Earnings	14,099,746	14,982,437	13,925,655	4,501,583	948,700				48,458,121
	Avg Earnings	26,257	29,905	30,472	30,212	30,603				28,930
40-44	Number	513	509	486	325	376	18			2,227
	Tot Earnings	14,049,258	16,204,712	16,608,770	10,731,118	12,294,316	688,170			70,576,346
	Avg Earnings	27,386	31,836	34,174	33,019	32,698	38,232			31,691
45-49	Number	420	468	445	303	464	158	2		2,260
	Tot Earnings	12,330,654	15,154,081	16,031,095	11,009,578	16,463,084	5,907,745	111,665		77,007,902
	Avg Earnings	29,359	32,381	36,025	36,335	35,481	37,391	55,832		34,074
50-54	Number	290	418	349	304	283	185	69	1	1,899
	Tot Earnings	9,259,726	14,067,375	12,917,976	11,666,834	10,235,302	7,202,572	2,586,539	34,291	67,970,616
	Avg Earnings	31,930	33,654	37,014	38,378	36,167	38,933	37,486	34,291	35,793
55-59	Number	198	288	261	217	190	111	49	14	1,328
	Tot Earnings	6,301,147	10,195,031	9,193,937	8,576,422	7,368,513	4,229,323	1,821,737	563,096	48,249,206
	Avg Earnings	31,824	35,399	35,226	39,523	38,782	38,102	37,178	40,221	36,332
60-64	Number	84	126	119	90	74	23	31	10	557
	Tot Earnings	2,778,393	4,205,691	4,560,374	3,443,135	2,950,279	889,435	1,157,026	420,768	20,405,101
	Avg Earnings	33,076	33,378	38,322	38,257	39,869	38,671	37,323	42,077	36,634
Over 64	Number	21	51	59	25	27	22	6	8	219
	Tot Earnings	706,996	1,535,249	2,247,853	1,034,042	979,371	805,787	253,475	285,611	7,848,386
	Avg Earnings	33,666	30,103	38,099	41,362	36,273	36,627	42,246	35,701	35,837
Total	Number	3,552	3,033	2,374	1,416	1,445	517	157	33	12,527
	Tot Earnings	95,272,655	94,391,822	80,867,997	51,064,635	51,239,565	19,723,033	5,930,442	1,303,767	399,793,917
	Avg Earnings	26,822	31,122	34,064	36,063	35,460	38,149	37,774	39,508	31,915

Average Age = 44.7 Average Service = 11.0

HISTORICAL ACTIVE PARTICIPANT DATA

Valuation Data	Number of Participants	Average Age	Annual Payroll ($000)	Average Annual Salary	Annual Percentage Increase In Average Salary
January 1, 1982	12,338	N/A	$ 207,100	$ 16,906	15.1 %
July 1, 1984	12,407	N/A	227,000	18,429	3.5
July 1, 1986	11,459	N/A	234,300	20,342	5.1
July 1, 1987	12,149	N/A	239,500	19,832	(2.5)
July 1, 1988	11,344	N/A	227,900	19,934	0.5
July 1, 1989	11,356	N/A	235,400	20,771	4.2
July 1, 1990	12,037	40.0	258,556	21,480	3.4
July 1, 1991	12,488	40.3	284,914	22,815	6.2
July 1, 1992	12,913	40.5	314,686	24,370	6.8
July 1, 1993	13,112	40.9	340,249	25,949	6.5
July 1, 1994	14,027	40.9	366,561	26,133	0.7
July 1, 1995	14,364	41.3	378,511	26,351	0.8
July 1, 1996	14,067	41.8	367,610	26,133	(0.8)
July 1, 1998 *	13,764	42.8	394,919 *	28,692 *	9.8
July 1, 1999 *	13,286	42.9	396,617 *	29,852 *	4.0
July 1, 2000 *	13,126	43.7	421,591 *	32,119 *	7.6
July 1, 2001 *	12,928	43.9	413,021 *	31,948 *	(0.5)
July 1, 2002	12,527	44.7	399,794	31,915	(0.1)

* Excludes DROP participants.

SUMMARY OF INACTIVE PARTICIPANTS AS OF JULY 1, 2002

	Number	Annual Benefits ($000)	Average Annual Benefit
Retirees	4,002	59,746	14,929
Beneficiaries	1,422	8,872	6,239
Disabled Participants	504	3,638	7,217
Deferred Vesteds	1,136	5,947	5,235
Total	7,064	$ 78,203	$ 11,071

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

	Added to Rolls		Removed from Rolls		Rolls at the End of the Year		
Period Ended	Number	Annual Benefits ($000)	Number	Annual Benefits ($000)	Number	Annual Benefits	Average Annual Benefits
June 30, 1993	473	$ 3,714	309	$ 1,534	4,189	$ 32,419	$ 7,739
June 30, 1994	306	2,474	227	1,593	4,268	33,971	7,959
June 30, 1995	393	3,044	220	1,307	4,441	36,482	8,215
June 30, 1996	416	3,119	239	1,438	4,618	38,815	8,405
June 30, 1998	693	5,840	441	3,212	4,870	43,394	8,910
June 30, 1999	432	2,131	303	1,515	4,999	46,732	9,348
June 30, 2000	360	3,412	255	1,380	5,104	49,970	9,755
June 30, 2001	652	8,937	299	1,030	5,457	57,877	10,606
June 30, 2002	777	15,061	306	2,476	5,928	72,256	12,189

SUMMARY OF ACTUARIAL METHODS AND ASSUMPTIONS

The following methods and assumptions were adopted for the July 1, 2002 actuarial valuation.

Actuarial Methods

Actuarial Value of Assets	Gains and losses in the Market Value of Assets, based on the difference between the actual rate of return and the assumed rate of return are recognized in the Actuarial Value of Assets over five years.
Actuarial Cost Method	Entry Age Method with liabilities allocated from date of entry to age 70. The Unfunded Actuarial Accrued Liability, including the effects of actuarial gains and losses, is amortized as a level percentage of payroll ending December 31, 2022. The contribution is increased for interest for one-half of a year to reflect timing of payments.

Economic Assumptions

Investment Return	8.5% per year, net of expenses
Individual Pay Increase Rate	4.5% per year
Payroll Growth Rate	4.5% per year
General Inflation Rate	4.0% per year

DEMOGRAPHIC ASSUMPTIONS

Retirement Rate

Age	Rate
<55	5%
56-59	5
60	10
61	10
62	25
63	10
64	10
65	40
66-69	10
70+	100

DROP Participation	100% of eligible members assumed to elect DROP
DROP Entry Date	Earliest date the member is eligible to participate in the DROP
DROP Interest Credit	8.5% per year

Mortality Rates

• Active participants and nondisabled retirees	1994 Group Annuity Mortality Table (see associated table for sample rates).
• Disabled retirees	1987 Commissioners Group Disabled Mortality Table (see associated table for sample rates).
Disability Rates	Graduated rates (see associated table for sample rates).
Percentage of Service-Connected Deaths and Disabilities	10%
Termination Rates	Graduated rates (see associated table for sample rates).
Rehire Rates	Each year 2% of the nonvested terminations are assumed to be rehired in the future.
Group Membership	Members are assumed to remain in their current membership groups for future and past service.

Form of Payment	100% joint and survivor annuity.
Marital Status at Benefit Eligibility	
• Percentage married	60%. (No beneficiaries other than the spouse assumed).
• Age difference	Husbands assumed to be three years older than wives.
Reported Pay	Pay reported by the City for the 12 months prior to the valuation date
Valuation Pay	Reported Pay projected with one year of assumed pay increases.

Missing Data Assumptions*

Current Age:	
• Active participants	Contributory Plan - 44.9
	Noncontributory Plan - 43.1
• Retirees and spouses	65
• Deferred vested participants	40
Service for Active Participants	Contributory Plan - 12.3
	Noncontributory Plan - 9.3
Pay	Contributory Plan - $35,789
	Noncontributory Plan - $32,850

Sample Rates Per 100 Participants

	Nondisabled Mortality (GAM94)		Disabled Mortality (Ultimate)	Termination		Disability
Age	Male	Female	All	First 3 Years	After 3 Years	All
20	0.05	0.03	2.82	36.20	21.20	0.05
25	0.07	0.03	2.82	30.80	15.80	0.05
30	0.08	0.04	2.82	26.60	11.60	0.05
35	0.09	0.05	2.82	23.40	8.40	0.06
40	0.11	0.07	2.82	21.20	6.20	0.09
45	0.16	0.10	2.82	19.20	4.20	0.18
50	0.26	0.14	2.82	17.60	2.60	0.40
55	0.44	0.23	2.82	0.00	0.00	0.85
60	0.80	0.44	3.14	0.00	0.00	1.74

* HMEPS staff members were not included in the valuation.

Changes in Methods and Assumptions Since the Prior Valuation

The actuarial methods and assumptions used in this valuation are the same as those used in the prior valuation except the assumed DROP participation rate was changed from 50% to 100% and the assumed DROP Entry Date was changed from five years prior to the assumed retirement date to the earliest date the member is eligible to participate in the DROP.

Summary of Plan Provisions

Covered Members	Any person who is a participant of Group A, under the original act. Persons who become employees of the City of Houston after September 1, 1981, and elected officials of the City of Houston who assumed office after September 1, 1981, participate in Group B, but may make an irrevocable election to participate in Group A instead. Persons who become employees of the City and persons who are elected as City officials after September 1, 1999 become members of Group A. Certain persons who are or become Director of a City Department, Chief Financial Executive, or Executive Director of the Pension System on or after September 1, 1999 may participate in Group C.
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.
Credited Service	All services and work performed by an employee, including prior service. For members of Group A and Group C, all services and work performed after September 1, 1943 must have been accompanied by corresponding contributions to the Pension System by the employee or legally authorized repayments must have been made. Credited service for participants in Group C means the number of eligible service after the executive official's effective date of participation in Group C. A Group C member receives two times the number of actual Credited Service in Group C solely for the purpose of fulfilling the eligibility requirements in Group C.
Normal Retirement	
• Eligibility	<u>On or after August 1, 2000:</u> 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)
• Benefit	<u>On or after May 11, 2001:</u> Group A: 3.25% of FAS for each of the first 10 years of Credited Service plus 3.50% for Credited Service greater than 10 years but less than 20 years plus 4.25% for FAS for each year of Credited Service greater than 20 years (excludes current DROP participants). Maximum benefit is 90% of FAS for all future retirees. Minimum monthly benefit is greater of $8 times years of Credited Service or $100. Group B: 1.75% of FAS for each of the first 10 years of Credited Service plus 2.00% of FAS for each year of Credited Service from 10 through 20, and 2.75% of FAS for each year of Credited Service over 20. Maximum benefit is 90% of FAS for all future retirees. Group C: Double the rate for Group A

Vested Pension

• Eligibility	5 years of Credited Service. Immediate for Group C.
• Benefit	Group A and Group C: Either the accrued normal retirement benefit with payments beginning at the normal retirement eligibility date or a refund of contributions, if any, without interest. Group B: Accrued normal retirement benefit payable at the normal retirement eligibility date. If the actuarial present value of a pension is less than $10,000, a terminated participant who is not eligible to begin receiving a pension may request an early lump sum distribution of the pension. Such early lump sum distribution is irrevocable. Credited Service associated therewith can be reinstated after reemployment and pursuant to rules of the plan.
Withdrawal Benefit	If a nonvested member withdraws from service with less than 5 years, a refund of the member's contributions is made without interest, upon request.

Service-Connected Disability Retirement

• Eligibility	Any age or Credited Service.
• Benefit	Group A: Accrued normal retirement benefit, but not less than 20% of final monthly salary at time of disability plus 1% of final monthly salary per year of Credited Service, to a maximum of 40% of final monthly salary. Group B: Accrued normal retirement benefit, but not less than 20% of final monthly salary at time of disability. Group C: Double Group A benefit

Nonservice-Connected Disability Retirement

• Eligibility	5 years of Credited Service.
• Benefit	Accrued normal retirement benefit payable immediately.

Preretirement Survivor Benefits

Service-connected

• Eligibility	Any age or Credited Service.
• Benefit	On or after September 1, 1999: If there is a surviving spouse, 100% of FAS payable to the spouse. 10% of FAS is payable to each qualifying dependent to a maximum of 20% for all dependents. Surviving spouses benefit will be reduced by the amount of dependent benefits. If no surviving spouse, dependent benefits are 50% of the amount a surviving spouse would have received for each dependent to a maximum of 100% for all dependents in the aggregate.

Nonservice-connected

• Eligibility	5 years of Credited Service.
• Benefit	On or after August 1, 2001: If there is a surviving spouse, 100% of accrued normal retirement benefit payable to the spouse and 10% of accrued normal retirement benefit to each qualifying dependent to a maximum of 20% for all dependents in the aggregate. The surviving spouse's benefit will be reduced by dependent benefits, if any. If there is no surviving

	spouse, each dependent will receive 50% of the benefit of a surviving spouse would have received subject to a maximum of 100% of a surviving spouse's benefit for all dependents in the aggregate.
Postretirement Survivor Benefits	On or after August 1, 2001: If there is a surviving spouse, 100% of the retirement benefit if the deceased retiree was receiving at the time of death payable to the spouse and 10% of that retirement benefit payable to each qualifying dependent to a maximum of 20% for all dependents. The surviving spouse's benefit will be reduced by dependent benefits, if any. If there is no surviving spouse, each dependent will receive 50% of the benefit a surviving spouse would have received subject to 100% of a surviving spouse's benefit for all dependents in the aggregate.
Contribution Rates	
• Members	4% of salary only for the Group A and Group C members. None for the Group B members.
• City	Beginning in 1993, the rate required to fund the Retirement Fund on an actuarial reserve basis. However, effective September 1, 1999, the minimum contribution rate is equal to the greater of 10% and twice the contribution rate of a Group A members is required to make by statute.
Deferred Retirement Option Program (DROP)	
• 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.
• Monthly DROP Credit	Accrued normal retirement benefit as of the effective date of DROP participation. The Monthly DROP Credit is credited to a notional account (DROP Account) on the last business day each month.
• Other DROP Credits	A participant's biweekly employee contributions, if any, are credited to the DROP Account on the day they are paid to the Pension System by the City. In addition, interest is credited to the DROP Account at the beginning of each day based on the DROP Account balance at the end of the previous day. The annual interest rate effective beginning January 1 each year is the arithmetical average of the System's annual investment return percentage for the then most recent 5 fiscal years. Minimum interest rate is the investment yield assumption for actuarial purposes adopted by the Pension Board as of interest calculation date. The interest rate for interest accrued after a DROP participant's City employment is terminated, if applicable, is reduced 3/4%. Participants who are eligible to retire but who have not retired and who remain in service with the City may participate in the DROP.
• Monthly DROP Credit Adjustments	On or after May 11, 2001: The Monthly DROP Credit for participants who entered the DROP effective on or before January 1 of the then current year will be increased effective February 1 each year 4.0%, not compounded.
• DROP Account Balance (DROP Benefit)	The sum of a participant's Monthly DROP Credits, employee contributions paid after DROP participation began, Monthly DROP Credit Adjustments, and applicable interest.

- DROP Benefit Pay-out

A terminated DROP participant may elect to:

1. Receive the entire DROP Account Balance in lump sum.
2. Receive the DROP Account Balance in periodic payments as approved by the Pension Board.
3. Receive a portion of the DROP Account Balance in lump sum and the remainder in periodic payments as approved by the Pension Board.
4. Defer election of a payout option until a future date.

- Post DROP Retirement Benefit (Final Pension)

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

- Post DROP Retirement Benefit Adjustments

Prior to May 11, 2001:

Each year, effective February 1, retired former DROP participants' monthly retirement pension will be increased 3.5% of their Final Pension, not compounded, for all such former DROP participants and their survivors whose monthly retirement pension was effective on or before January 1 of the then current year.

On or after May 11, 2001:

Each year, effective February 1, retired former DROP participants' monthly retirement pension will be increased 4.0% of their Final Pension, not compounded, for all such former DROP participants and their survivors whose monthly retirement pension was effective on or before January 1 of the then current year.

Back DROP

Effective September 1, 1999, a participant who is eligible to enter the DROP but has not yet elected to do so, has the option to elect into the DROP at any time between the participant's DROP entry date, no earlier than October 1, 1997, or the actual retirement date. A DROP participant who entered the DROP prior to September 1, 1999 may make a one-time irrevocable election before termination of employment, to revoke the DROP election.

Post-termination Survivor Benefits

Same as postretirement survivor benefits in effect at the date of termination. Participants of the Noncontributory Plan whose employment terminated prior to September 1, 1997 may elect to receive a life annuity, 50% joint and survivor annuity, 100% joint and survivor annuity, or a 10-year guaranteed annuity.

Changes in Plan Provisions Since Prior Year

Plan provisions have not changed since the prior year.

Plan Provisions Effective After July 1, 2002

No future plan changes have been recognized.

Hermann Hospital and the Texas Medical Center

In 1942 voters authorized the sale of 131 acres of land adjacent to Hermann Park to the M.D. Anderson Foundation for the Texas Medical Center. The foundation was established in 1936 by Monroe D. Anderson of Anderson, Clayton and Company, international cotton brokers. Anderson was the moving force behind the idea of a major health care center in Houston. The M.D. Anderson foundation is still a major Houston philanthropic force. In 1943, the foundation successfully wooed the Baylor College of Medicine to the city from Dallas, where the college was founded in 1900.

At the end of 1944, the M.D. Anderson Foundation started the construction of the Texas Medical Center on the triangular site bounded by Fannin, Bellaire and the Hermann Hospital and Park. In 1945, it formed the Texas Medical Center Corporation to oversee development. In February 1946, the Texas Medical Center was formally dedicated.

STATISTICAL SECTION

SCHEDULE OF AVERAGE BENEFIT PAYMENT AMOUNTS FOR THE SIX YEARS ENDED JUNE 30, 2002

Year Ended	Number Receiving Benefits	Benefits Paid ($000)	Average Annual Benefit
June 30, 1997	4,740	40,981	8,646
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

SCHEDULE OF BENEFITS BY TYPE ($000) FOR THE SIX YEARS ENDED JUNE 30, 2002*

Fiscal Year Ended	Normal Retirement Benefits	Disability Retirement Benefits	Survivors' Benefits	Total Benefits
June 30, 1997	*	*	*	40,643
June 30, 1998	34,509	3,062	5,540	43,111
June 30, 1999	37,370	3,320	6,061	46,751
June 30, 2000	39,836	3,490	6,816	50,142
June 30, 2001	46,867	3,555	7,455	57,877
June 30, 2002	59,746	3,638	8,872	72,256

* Information not available for year ended June 30, 1997

SCHEDULE OF ANNUITANTS BY TYPE

	June 30, 2001			June 30, 2002		
Schedule of Annuitants by Type	Number	Benefits ($000)	Average Benefit	Number	Benefits ($000)	Average Benefit
Retirees receiving benefits	3,585	46,867	13,073	4,002	59,746	14,929
Retired on disability	512	3,555	6,943	504	3,638	7,217
Survivors and beneficiaries	1,360	7,455	5,482	1,422	8,872	6,239
Total retirees, survivors and beneficiaries	5,457	57,877	10,606	5,928	72,256	12,189
Former participants eligible but not yet receiving benefits	1,226	6,360	5,188	1,136	5,947	5,235
Total Eligible for Benefits	6,683	64,237	9,612	7,064	78,203	11,071

HISTORICAL ACTIVE PARTICIPANT DATA

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

*Does not include DROP participants

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

Year (June 30)	Sponsor Contributions	Member Contributions	Investment Income	Other Income	Total Income
1998	35,343	6,198	94,656	406	136,603
1999	36,030	6,184	32,344	276	74,835
2000	38,306	7,341	270,991	407	317,045
2001	41,298	8,532	(65,147)	643	(14,674)
2002	40,758	13,476	(108,024)	286	(53,504)
2003	40,622	23,762	33,931	114	98,429

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

Year (June 30)	Benefits Paid	Contributions Refunded	Professional Service Fees	Cost of Administration	Total Expenses
1998	43,111	284	142	1,634	45,171
1999	46,751	232	238	2,043	46,264
2000	50,142	337	263	2,143	52,885
2001	58,296	308	324	2,367	61,295
2002	78,318	270	396	3,662	82,646
2003	98,789	475	366	4,299	103,929

Acknowledgments

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