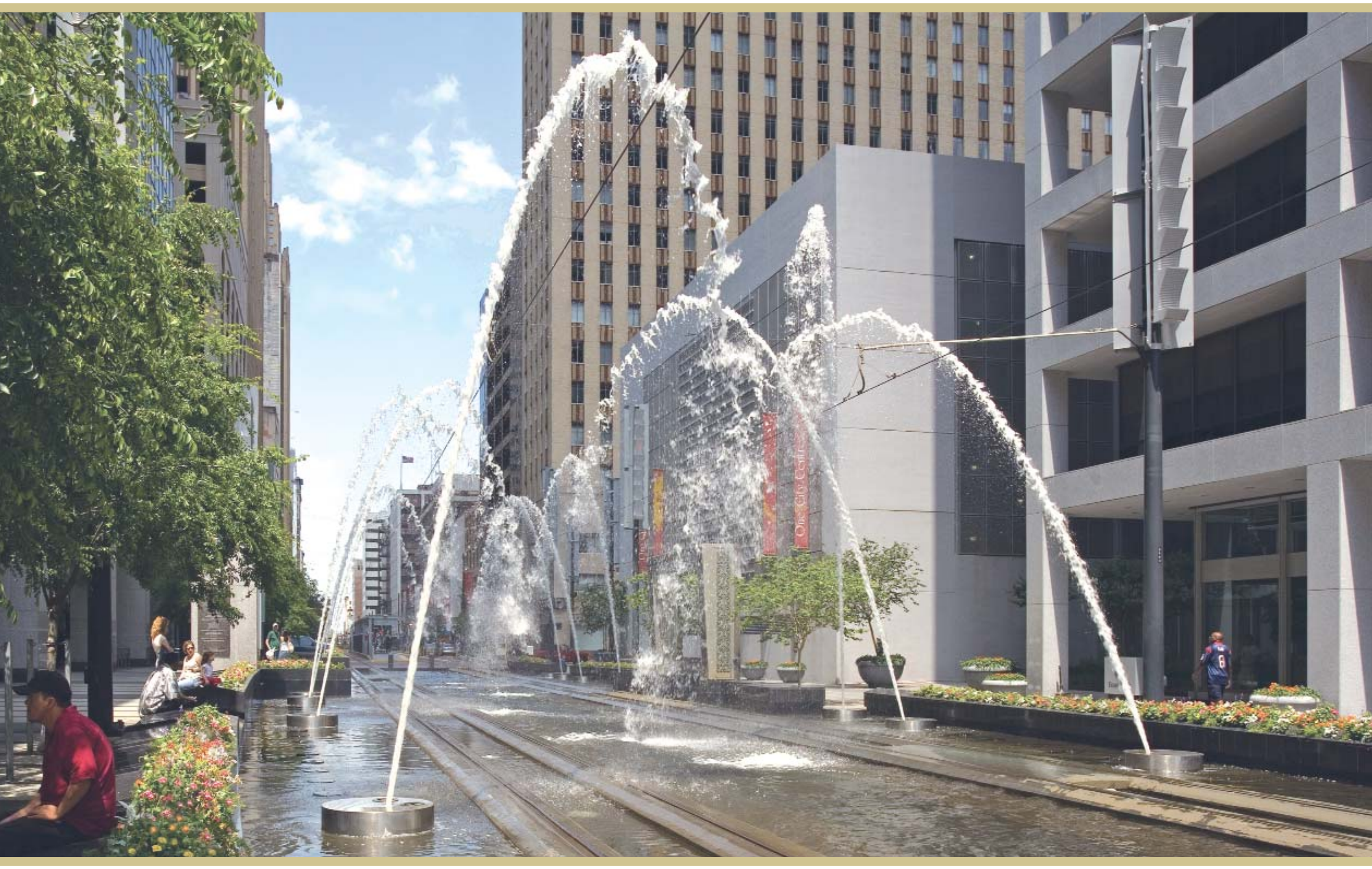
Houston Municipal Employees Pension System



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

A Component Unit of the City of Houston, Texas

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

COMPREHENSIVE ANNUAL FINANCIAL REPORT
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

A COMPONENT UNIT OF THE CITY OF HOUSTON, TEXAS

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

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM
1111 BAGBY, SUITE 2450, HOUSTON, TEXAS 77002-2555
713-595-0100
www.hmeps.org

HOUSTON
MUNICIPAL
EMPLOYEES
PENSION SYSTEM

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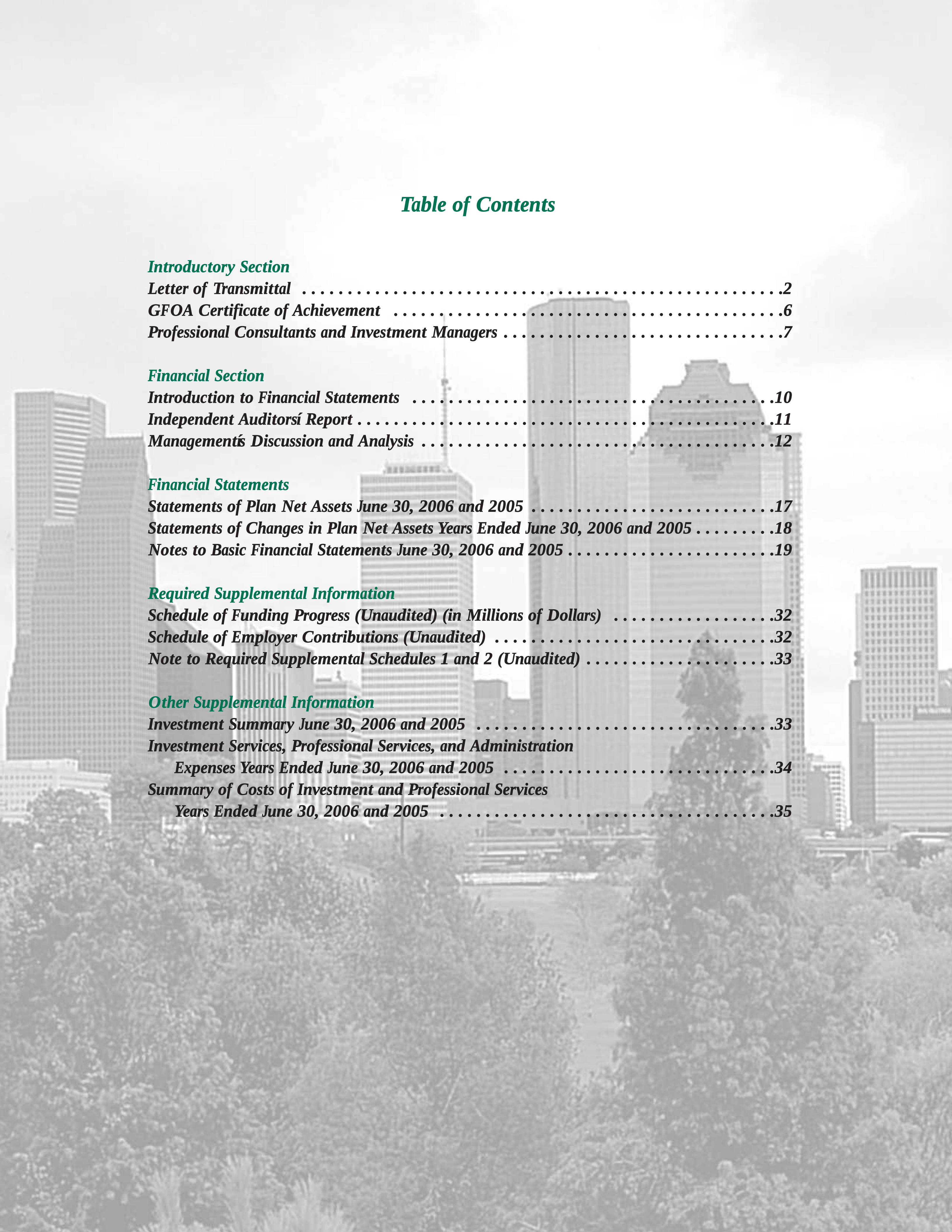
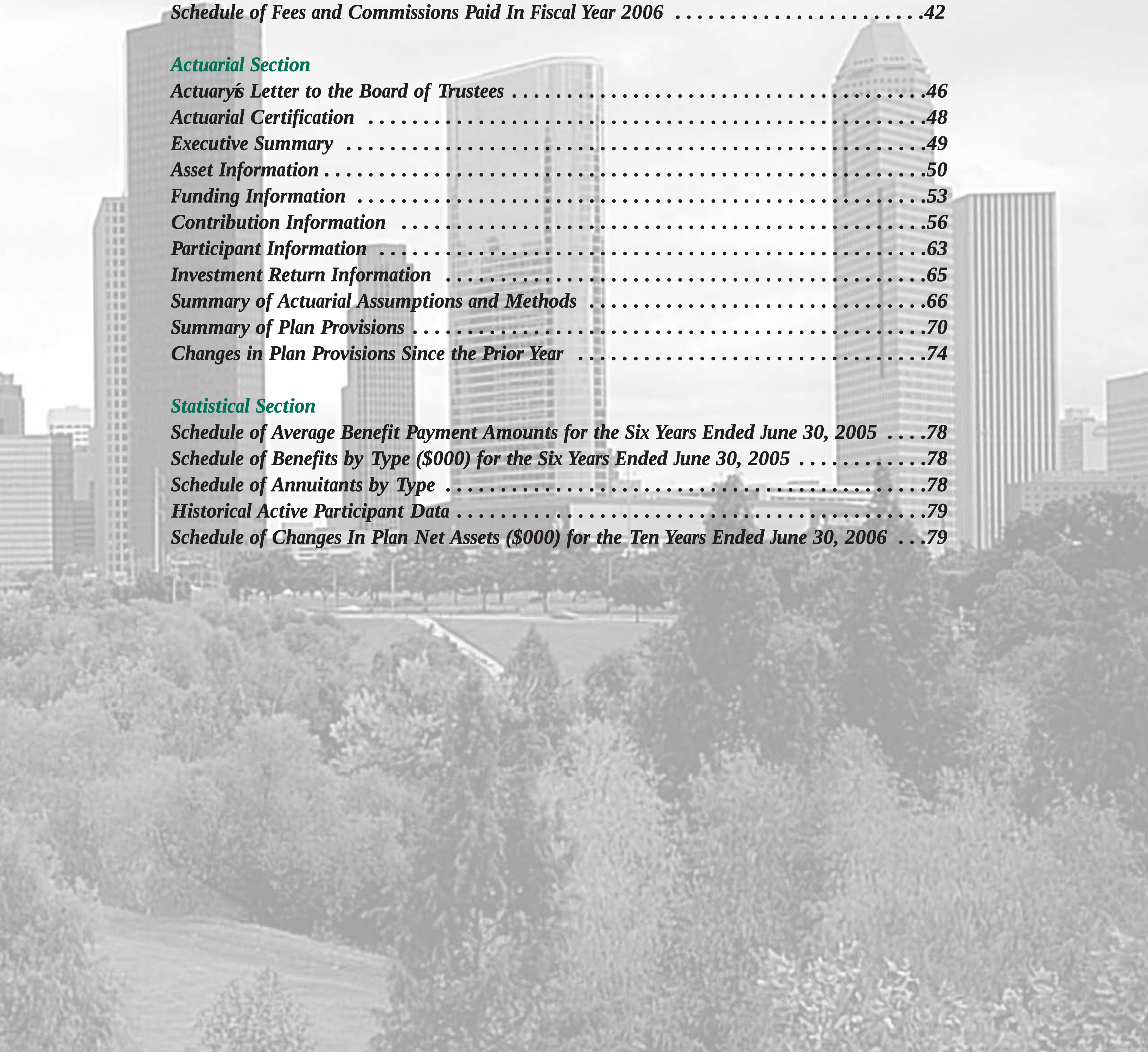


Investment Section

Actuarial Section

Statistical Section



Organizational Overview (as of June 30, 2006)*

Board of Trustees

Elected and Appointed Trustees

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

City Appointed Trustees

Richard Badger
Gilbert Garcia
Alfred Jackson
Craig T. Mason

David L. Long, *Executive Director*

Administrative Organization

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

Executive Director

Chief Investment Officer
Investment Managers' Services
Performance Measurement
Market Research

Benefit Administration
Benefit Administration Services
Member Services

Information Systems

General Counsel

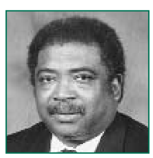
Communications

Accounting

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


Fred Holmes
Chairman

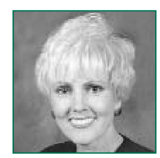

Ray Kennedy
Vice Chairman


Roderick J.
Newman
Secretary


Sophia Chang
Elected Trustee


Sherry Mose
Elected Trustee


Lee Pipes
Elected Trustee


Barbara
Chelette
Appointed
Trustee


Gilbert Garcia
Controller
Appointee


Alfred Jackson
Council
Appointee


Richard Badger
Council
Appointee


Craig T. Mason
Mayoral
Appointee


David L. Long
Executive Director

INTRODUCTORY SECTION

LETTER OF TRANSMITTAL

GFOA CERTIFICATE OF ACHIEVEMENT

PROFESSIONAL CONSULTANTS AND INVESTMENT MANAGERS

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

November 16, 2006

Judy Gray Johnson
Director of Finance and Administration
City of Houston, Texas
P.O. Box 1562
Houston, Texas 77251

Dear Ms. Johnson:

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the Houston Municipal Employees Pension System (the System), a Component Unit of the City of Houston, Texas (the City) for the fiscal year ended June 30, 2006 (2006). The accuracy, fairness of presentation and completeness of this report are the responsibility of the Board of Trustees (the Board) of the System. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of the operations of the System. The System's basic financial statements will be included in the annual financial report of the City.

Report Contents

The CAFR consists of five sections: (i) the introductory section, which contains this transmittal letter and other general information about the structure and activities of the System; (ii) the financial section, which contains the independent auditors' report and the basic financial statements, including notes to the basic financial statements and supplemental schedules, and management's discussion and analysis (MD&A); (iii) the investment section, which includes reports on the investment objectives and activities of the System during 2006; (iv) the actuarial section, which contains information about the actuarial valuation of the System as of July 1, 2005, the funding objectives of the System and the progress being made toward achieving those objectives; and (v) the statistical section, which contains statistical and other significant data intended to provide a user of this CAFR additional information regarding the System and its participants.

Accounting System and Internal Controls

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

The System's independent auditors have audited the financial statements and issued an unqualified opinion as of June 30, 2006 and 2005. The purpose of the audit is to give reasonable assurance to users of those financial statements, the Board, and participants of the System, that the financial statements present fairly, in all material respects, information regarding the System's net assets held in trust for pension benefits and in conformity with accounting principles generally accepted in the United States of America.

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

Financial Information

The MD&A that immediately follows the independent auditors' report provides condensed financial information and activities of the current and prior fiscal years of the System. It provides a narrative introduction, overview, and analysis of the basic financial statements. The MD&A complements this letter of transmittal and should be read in conjunction with it.

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

The investment activity for the year provided a total rate of return on the portfolio of 18.1% during the current fiscal year. A summary of asset allocation and rates of return can be found in the Investment Section of this CAFR.

Plan History and Profile

The System was created in 1943 under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, Article 6243g, Vernon's Annotated Revised Texas Civil Statutes, and reenacted and continued under HB1573, 77th Texas Legislature, as Article 6243h, Vernon's Annotated Revised Texas Civil Statutes (the Statute). The System is a cost-sharing, multiple-employer, defined benefit pension plan and includes a contributory group (Group A) and a noncontributory group (Group B). The System provides service retirement, disability retirement and death benefits for eligible participants which covers all municipal employees, except police officers and fire fighters (other than certain police officers in the System as authorized by the Statute), employed full-time by the City, elected City officials, and the full-time employees of the System (collectively referred to as "participants"). System plan net assets are used to pay benefits for eligible participants of Group A and Group B. The System is administered by an eleven-member Board of Trustees. The Trustees include four elected trustees who are members of the System, two elected trustees who are retirees of the System, a trustee appointed by the elected trustees, the mayor's appointee, the controller's appointee, and two city council appointees.

Budget

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

Funding Status

The funded ratio, the ratio of the actuarial value of assets (AVA) to the actuarial accrued liability (AAL), is a standard measure of a plan's funded status. In the absence of benefit improvements, a plan's funded ratio should increase over time, until it reaches 100%. As of July 1, 2005 HMEPS' AVA and AAL were $1.78 billion and $2.72 billion, respectively, resulting in a funded ratio of 65.2%. This 8.2% increase in the funding status of HMEPS from the previous year's 57% is primarily due to the $300 million note contributed by the City in November 2004, continued strong investment performance and further recognition of prior years' investment performance over the last several years. A historical perspective of HMEPS' funding levels is presented in the Schedule of Funding Progress in the Required Supplementary Information in the Financial Section of this report.

General Economic Conditions

U.S. Economy

Over the first six months of 2006, the U.S. economy continued to grow at a consistent pace. Real gross domestic product (GDP) increased 1.6% in the third quarter after increasing 2.6% in the second quarter (according to the U.S. Department of Commerce's Bureau of Economic Analysis). The strong pace evident over the beginning of the year was boosted by several factors, including spending for hurricane relief (mentioned in last year's report) and the effects of favorable weather on homebuilding. Over the course of the year the pace changed as money directed towards hurricane relief and homebuilding lessened. Consumer spending, which had been strong in the beginning of the year, was restrained by increasing energy costs in the spring. High gas prices over the summer also affected consumer spending. Outside of the household sector, the second quarter marked increased demand for U.S. exports and businesses' fixed investments remained on an upward trend. Since spring, the jobless rate has remained relatively steady.

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

As we approach 2007, the U.S. economy appears to be entering into a period where the rate of increase in real GDP is moving from its longer-run capacity into a more moderate and sustainable rate. Changes in monetary policy since 2004, intended to keep inflation low and promote economic expansion, are one element in this transition. Current U.S. economic activity has experienced moderation but household and business spending appear favorable. The world economy (discussed below) continues to support demand for U.S. exports, which will in turn improve the economic situation in the U.S. There are considerable uncertainties facing the U.S. economy in 2007 including indications of a slowing down in consumer spending and hiring, the demand for and supply of oil, and fear of terrorism here and abroad, to name a few.

Global Economy

Although the global economy has slowed since the record pace posted in 2004, growth remains robust, according to the World Bank. Growth, according to a United Nations report, was expected to continue to grow at about 3 percent for the year. As in the U.S., rising energy prices have pushed up inflation in many countries this year, but pressure on core inflation has, in general, continued to be moderate.

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

Major Current and Future Initiatives

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

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

Certificate of Achievement for Excellence in Financial Reporting

The Government Finance Officers Association (GFOA) of the United States and Canada awarded its “Certificate of Achievement for Excellence in Financial Reporting” to the System for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2005. The Certificate of Achievement is the highest form of recognition in the area of governmental accounting and financial reporting, and its attainment represents a significant accomplishment by a governmental entity and its management. The award and a detailed description thereof are displayed on page 6 in the Introductory Section of this CAFR.

Acknowledgement

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

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

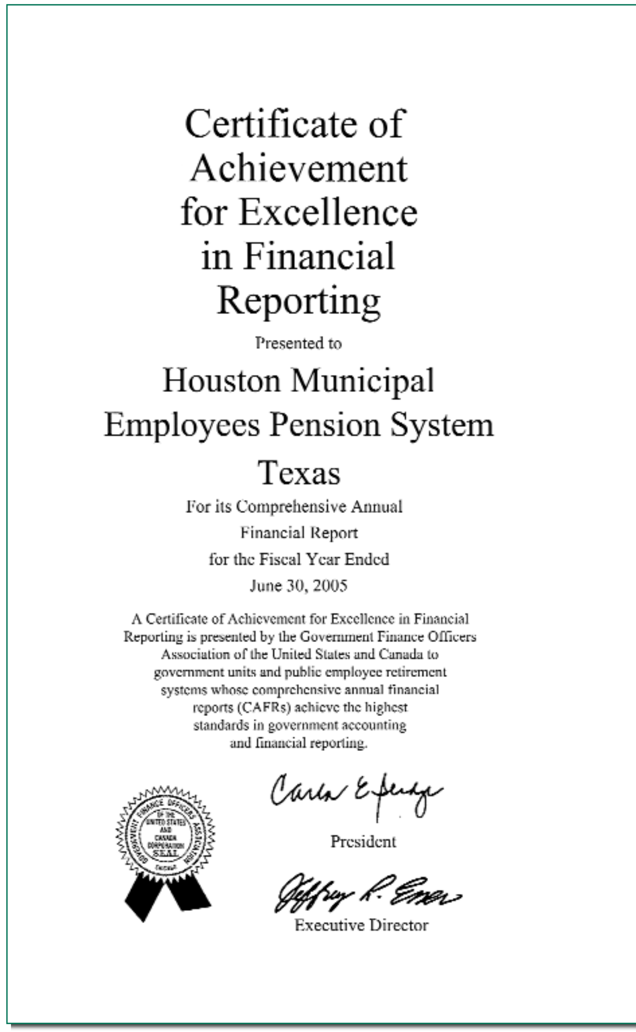
Sincerely,

Fred Holmes	David L. Long
Chairman	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, 2005. 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 12 consecutive years (fiscal years ended June 30, 1994 through 2005). 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, 2005

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

President

Executive Director

Consultants (Fiscal Year 2006)

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

Board Medical Advisor
Charles Schuhmacher, M.D.

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

Master Custodian/Trustee
State Street Bank and Trust Co.

Actuary
Gabriel, Roeder, Smith & Company

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

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

Governmental Representation
HillCo Partners, Inc.

Database Services
Pension Benefits Information

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

Investment Managers (Fiscal Year 2006)

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

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

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

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

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

FINANCIAL SECTION

The Audited Financial Statements and the accompanying Independent Auditors' Report included in this CAFR were approved by the System's Board of Trustees (the Board) in its meeting of September 26, 2006.

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, 2006 and June 30, 2005 and the results of its operation for the years then ended. The financial statements are presented in conformity with accounting and reporting standards of the Governmental Accounting Standards Board (GASB).

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

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

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

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

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

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

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

Member of the American Institute of Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

Board of Trustees
Houston Municipal Employees Pension System:

We have audited the accompanying statements of plan net assets of the Houston Municipal Employees Pension System (the System) as of June 30, 2006 and 2005, and the related statements of changes in plan net assets for the years then ended. These basic financial statements and the schedules referred to below are the responsibility of the System's management. Our responsibility is to express an opinion on these basic financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the basic financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall basic financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the financial status of the System as of June 30, 2006 and 2005, and the changes in its financial status for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Management's discussion and analysis (MD&A) and the required supplemental information (schedules 1 and 2) are not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the MD&A and required supplemental information. However, we did not audit the information and express no opinion on it.

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

September 19, 2006

Mir Fox & Rodriguez

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

Management's Discussion and Analysis (Unaudited)

The Board of Trustees (the Board) of the Houston Municipal Employees Pension System (the System) is pleased to provide this overview and analysis of the financial performance and activities of the System for the fiscal years ended June 30, 2006 and 2005. 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, 2006 and 2005 indicate the net assets available to pay future payments and give a snapshot at a particular point in time. The Statements of Changes in Plan Net Assets for the fiscal years ended June 30, 2006 and 2005 provide a view of the fiscal year's additions to and deductions from the System.

Notes to Basic Financial Statements

The Notes are an integral part of the Basic Financial Statements and provide additional background information that is essential for a complete understanding of the data provided in the System's financial statements. The Notes to the Basic Financial Statements can be found on pages 19 to 31 of this report.

Supplemental Information

The required supplemental information consists of:

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

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

The other supplemental information consists of:

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

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

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

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

- The System received $21,888 and $23,488 during fiscal year 2006 and 2005, respectively, in employee contributions from about 8,000 Group A active participants. For fiscal year 2006 and the period January 1, 2005 through June 30, 2005, the contributions represent 5% of the employee's qualifying base salary. For the period July 1, 2004 through December 31, 2004, the contributions represent 4% of the employee's qualifying base salary. Total employee contributions decreased by $1,600 or 7% in fiscal year 2006 compared to fiscal year 2005. This decline is attributable to a 78% decline in service purchase contributions and transfers from the Section 457 deferred compensation plan totaling $1,270 and $5,741 for fiscal years 2006 and 2005, respectively.

  The City of Houston's (the City) contributions during fiscal years 2006 and 2005 represent the budgeted contributions and the net proceeds received through the issuance of pension obligation bonds as set forth in the Meet and Confer

COMPARATIVE FINANCIAL STATEMENTS

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

Assets	June 30, 2006	June 30, 2005	June 30, 2004
Cash and equivalents	$ 2,718	875	2,691
Proceeds due on asset sales	8,326	54,781	7,496
Receivables	45,767	31,161	18,310
Note receivable - City of Houston	300,000	300,000	
Investments	1,741,434	1,486,295	1,438,005
Collateral on securities lending	93,012	95,636	109,440
Furniture, fixtures and equipment, net	702	828	796
Total assets	2,191,959	1,969,576	1,576,738
Liabilities			
Amounts due on asset purchases	36,009	34,247	45,570
Accrued liabilities	10,642	14,842	3,003
Collateral on securities lending	93,012	95,636	109,440
Total liabilities	139,663	144,725	158,013
Plan net assets	$ 2,052,296	1,824,851	1,418,725

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

Additions	Fiscal Year 2006	Fiscal Year 2005	Fiscal Year 2004
Contributions	$ 88,856	386,735	83,497
Investment and interest income, net	299,331	200,782	227,360
Other income	385	888	726
Total additions	388,572	588,405	311,583
Deductions			
Benefits paid	154,311	175,480	153,202
Contribution refunds	1,037	992	635
Administration expenses and professional fees	5,779	5,807	5,211
Total deductions	161,127	182,279	159,048
Net increase in plan net assets	227,445	406,126	152,535
Plan net assets, prior year	1,824,851	1,418,725	1,266,190
Plan net assets, current year	$ 2,052,296	1,824,851	1,418,725

Agreement between the System and the City dated September 15, 2004. During fiscal year 2006, the System received cash contributions from the City of $66,968. For fiscal year 2005, the System received cash contributions from the City of $63,247 and recognized a $300 million contribution in the form of a note receivable issued by the City on November 10, 2004 (see note 4).

- The net investment and interest income of the System was $299,331 during fiscal year 2006 compared to $200,782 during fiscal year 2005, which is an increase of $98,549 or 49% mainly as a result of an increase in unrealized gain on investments. The investment and interest income of the System consists of:

	Fiscal Year 2006	Fiscal Year 2005	Change
Interest	$ 35,197*	27,464*	7,733
Dividends	9,128	9,891	(763)
Earnings from limited partnerships and real estate trusts	25,592	45,069	(19,477)
Realized gain on investments	120,955	91,474	29,481
Change in unrealized gain on investments	114,123	32,528	81,595
Net proceeds from lending securities	419	352	67
Less cost of investment services	(6,083)	(5,996)	(87)
Net investment and interest income	$ 299,331	200,782	98,549

**The interest income for fiscal years 2006 and 2005 includes accrued interest on the $300 million note from the City (see note 4).*

- Earnings from limited partnerships and real estate trusts decreased by 43% from $45,069 to $25,592 with a corresponding increase in realized gain on investments of 43%. This is a reflection of the System's policy of adjusting the carrying value of limited partnerships and real estate trusts during their holding period based on the general partner's direction. Since the total investment gains associated with these holdings consist of realized gains and unrealized appreciation, as the unrealized appreciation increases, the actual earnings and realized gain typically decreases.
- Benefit payments dropped 12% to $154,311 during fiscal year 2006 compared to $175,480 during fiscal year 2005. Normal retirement pension benefits amounted to $113,122 (10% increase from fiscal year 2005) which accounted for 73% of the total benefit payments for fiscal year 2006. There were 8,305 participants who received benefits for the fiscal year ended 2006 compared to 8,048 participants in 2005. These numbers represent an increase of 3% and 8% for the fiscal years 2006 and 2005, respectively.
- Distributions to DROP (Deferred Retirement Option Plan) participants amounted to $23,174 or 15% of the total benefit payments during fiscal year 2006 compared to 32% of the total during fiscal year 2005. The amount of DROP distributions decreased by 59% in fiscal year 2006. The number of DROP participants dropped to 394 in 2006 compared to 414 in 2005 or a 5% drop.
- Benefit payments exceeded total employee plus employer cash contributions by $65,455 during fiscal year 2006 and by $88,745 during fiscal year 2005.
- Costs of administering the benefit programs of the System, including professional fees, slightly decreased to $5,779 for fiscal year 2006 from $5,807 for fiscal year 2005, for over 23,000 participants.
- Net assets increased to $2,052,000, an increase of $227,445 during fiscal year 2006 compared to an increase of $406,126 in 2005. Fiscal years 2006 and 2005 recognized the $300 million note from the City.

The System capitalizes expenditures for furniture, fixtures and equipment in accordance with Governmental Accounting Standards Board Statement No. 34, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments, as amended. Furniture, fixtures and equipment, net of accumulated depreciation, as of fiscal year end 2006 and 2005 is $702 and $828, respectively.

PERFORMANCE OF INVESTMENT CLASSES

	Investment Return		
	FY 2006	3-Years	5-Years
System's Total Portfolio	18.1%	16.9%	9.0%
Policy Benchmark	13.1%	14.0%	7.4%
Median Public Fund (Wilshire Public Fund Universe)	10.9%	12.6%	7.1%
US Equities	11.1%	13.5%	5.7%
Dow Jones Wilshire 5000 Index	9.9%	13.0%	4.0%
International Equities	30.1%	25.6%	10.9%
MSCI All Country World ex US Index	28.4%	25.8%	11.9%
Fixed Income	2.6%	5.2%	6.3%
Lehman Aggregate Index	-0.8%	2.1%	5.0%
Merrill Lynch High Yield Master II Index	4.7%	8.4%	8.3%
Real Assets	36.4%	27.2%	18.0%
NCREIF Property Index	18.7%	15.8%	12.0%
Alternatives	22.5%	18.5%	5.5%
S&P 500 Index + 3.0%	11.6%	14.2%	5.5%
Cash	4.0%	2.4%	3.4%
91- Day T-Bill	3.9%	2.3%	2.2%

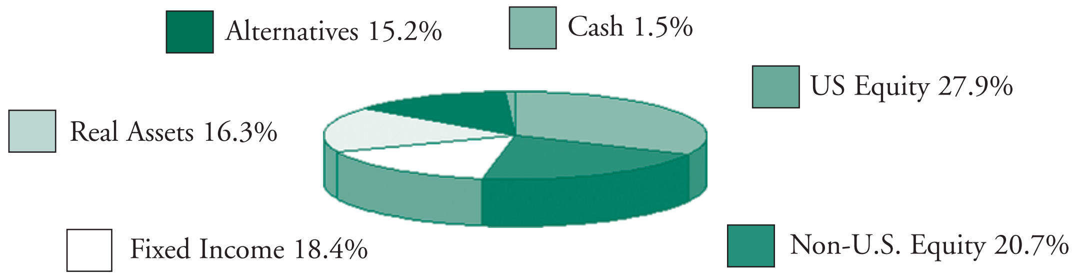
Total investments (excluding the note receivable from the City) were $1.74 billion at the close of fiscal year 2006 and $1.49 billion in 2005 providing an investment return of 18.1% during the current fiscal year.

The System's performance, including the total fund, each asset class and their corresponding benchmarks, for fiscal year 2006 and the trailing three and five-year periods ending June 30 are listed above.

The System's investment performance was 18.1%, 16.9% and 9.0% for the past one, three and five-year periods. These results are consistently above the System's policy benchmark, and also well above the median fund in a universe of the System's public fund peers. The System ranks in the top 1st, 1st and 4th percentiles respectively, for the one, three and five-year periods ending June 30, 2006. The best performing asset classes for the fiscal year 2006 were real assets (+36.4%) and international equities (+30.1%), while real assets (30.0%) and alternative investments (20.0%) were the top two performing asset classes for fiscal year 2005. The benefits of a well-diversified asset allocation are evidenced by the System's ability to perform very competitively in both years where different asset classes drove overall returns. For the past three and five year periods, real assets, which include public and private real estate and natural resource investments, was the System's best performing asset class, providing 27.2% and 18.0% per annum. The System's target allocation of 15% to real assets helped enable it to perform well in an environment where a more traditional asset allocation (60% / 40% mix of S&P 500 Index / Lehman Aggregate Bond Index) would have returned 4.8%, 7.6% and 4.0% over the trailing one, three and five-year periods, which is significantly below the System's actuarial rate of 8.5%, and the System's actual results.

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

SYSTEM ASSET ALLOCATION



The System's securities lending program obtains additional income by lending securities to broker-dealers and banks. During the years ended June 30, 2006 and 2005, 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, 2006, the System had no credit risk exposure to borrowers.

The System's investments in limited partnerships and real estate trusts are included in the tables appearing in note 6. In connection with those investments, the System has remaining commitments as of June 30, 2006 and 2005 of approximately $287 million and $295 million, respectively, pursuant to terms of the respective limited partnerships and real estate trusts.

CONTACTING THE SYSTEM'S FINANCIAL MANAGEMENT

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

	2006	2005
Assets		
Investments, at fair value:		
Government securities		
(cost: $57,792,081 in 2006 and $62,134,178 in 2005)	$ 57,378,912	62,840,296
Corporate bonds		
(cost: $72,032,761 in 2006 and $68,409,051 in 2005)	75,568,208	73,687,436
Capital stocks		
(cost: $438,954,393 in 2006 and $415,043,746 in 2005)	509,384,428	458,701,513
Commingled funds		
(cost: $439,126,450 in 2006 and $348,600,875 in 2005)	548,133,295	420,920,132
Limited partnerships, real estate trusts, and loans and mortgages		
(cost $380,797,625 in 2006 and $320,660,441 in 2005)	484,670,457	372,737,677
Short-term investment funds (valued at cost)	66,298,270	97,408,425
Total investments	1,741,433,570	1,486,295,479
Cash and cash equivalents	2,718,000	874,937
Proceeds due on asset sales	8,326,514	54,780,732
Receivables on foreign exchanges	7,147,170	11,172,093
Contribution receivable - City of Houston		1,005,078
Note receivable - City of Houston	300,000,000	300,000,000
Accrued interest on note receivable - City of Houston	36,182,428	16,362,500
Other receivables	2,437,319	2,621,140
Collateral on securities lending arrangements, at fair value	93,011,816	95,635,714
Furniture, fixtures and equipment, net	702,351	828,304
Total assets	2,191,959,168	1,969,575,977
Liabilities		
Amounts due on asset purchases	36,008,845	34,247,079
Payables on foreign exchanges	7,139,418	11,185,158
Accrued liabilities	3,401,995	3,636,160
Options written	101,081	20,365
Collateral on securities lending arrangements, at fair value	93,011,816	95,635,714
Total liabilities	139,663,155	144,724,476
Plan net assets held in trust for pension benefits	$ 2,052,296,013	1,824,851,501

(A schedule of funding progress for the plan is presented on page 32.)

See accompanying notes to basic financial statements.

	2006	2005
Additions to plan net assets:		
Contributions:		
City of Houston	$ 66,967,596	363,246,727
Participants	21,888,215	23,487,896
Total contributions	88,855,811	386,734,623
Investment income:		
Interest on bonds and deposits	8,632,556	11,101,154
Dividends	9,127,963	9,891,196
Earnings from limited partnerships and real estate trusts	25,592,404	45,069,632
Net appreciation on investments	235,077,959	124,001,689
Total investment income	278,430,882	190,063,671
Proceeds from lending securities	4,859,543	2,694,595
Less costs of securities lending	(4,440,517)	(2,342,722)
Net proceeds from lending securities	419,026	351,873
Less costs of investment services	(6,083,426)	(5,996,174)
Total investment income, net	272,766,482	184,419,370
Interest income - City of Houston note receivable	26,564,784	16,362,500
Other income	385,247	887,582
Total additions to plan net assets	388,572,324	588,404,075
Deductions from plan net assets:		
Benefits paid to participants	154,311,129	175,479,966
Contribution refunds to participants	1,037,337	992,141
Professional services	707,467	1,088,411
Administration expenses	5,071,879	4,717,623
Total deductions from plan net assets	161,127,812	182,278,141
Net increase in plan net assets	227,444,512	406,125,934
Plan net assets held in trust for pension benefits:		
Beginning of year	1,824,851,501	1,418,725,567
End of year	$ 2,052,296,013	1,824,851,501

See accompanying notes to basic financial statements.

1. DESCRIPTION OF PLAN

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

Participation

Participants hired 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) participated in Group C. Effective January 1, 2005, the Executive Officials of the City and the Executive Director of the System automatically became Group A members pursuant to the First Amendment to Meet and Confer Agreement, dated December 21, 2004.

At July 1, 2005, the System's participants consisted of the following:

Retirees and beneficiaries currently receiving benefits	7,523
Former employees - vested but not yet receiving benefits	2,659
Former employees - non-vested	1,234
Vested active participants	7,705
Non-vested active participants	4,269
Total participants	23,390

As of September 15, 2004 and until December 31, 2005, a participant who was eligible to convert previous Group B service to Group A could make a one-time irrevocable election to convert the Group B service to Group A by paying to the System the actuarially determined cost of the converted service, as determined by the System's actuary and approved by the Board, plus interest. Participants may no longer elect to convert previous Group B service to Group A.

Contributions

For fiscal year 2006 and the period January 1, 2005 through June 30, 2005, covered active Group A participants were required to contribute 5% of their qualifying base salary to the System. For the period July 1, 2004 through December 31, 2004, covered active Group A and Group C participants were required to contribute 4% of their qualifying base salary to the System.

The System's Pension Statute provides that the employer contribution to the System be based on a percentage contribution rate multiplied by the combined eligible salaries paid to participants of Group A and Group B. The percentage contribution rate is based on the results of actuarial valuations made at least every three years, calculated on the basis of an acceptable reserve funding method approved by the Board. Notwithstanding any other provision, the City's minimum percentage contribution rate may not be less than the greater of two times the contribution rate of Group A participants, or 10%. However, under the terms of the Meet and Confer Agreement between the Board and the City, dated September 15, 2004, the City agreed to provide funding to the System as follows for the fiscal years 2005, 2006 and 2007, comprised of budgeted contributions and net proceeds of pension obligation bonds as follows (on a cash basis):

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

Retirement Eligibility

Effective January 1, 2005 a participant who terminates employment with the City or the System is eligible for a normal retirement pension beginning on the member's effective retirement date after the date the member completes at least five years of credited service and attains either:

(i) 62 years of age, or

(ii) a combination of years of age and years of credited service, including parts of years, the sum of which equals the number 75, provided the participant is at least 50 years of age, or

(iii) completed at least 5 years of total credited service and attained any combination of age and credited service that when added together equal 70 or more, provided that the member, prior to January 1, 2005, completed at least 5 years of credited service and attained a combination of age and credited service that when added together equal 68 or more.

Pension Benefits

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

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

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

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.

Survivor Benefits

Survivor 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 survivor benefits unless death was caused by a service-connected incident as defined by the Pension Statute.

In order to qualify for survivor 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 than thirty calendar days, may elect to participate in the Deferred Retirement Option Plan (DROP). The DROP provides that a monthly amount (monthly DROP credit) will be credited to a notional account (DROP Account). Interest is credited to the DROP Account at a rate approved by the Board, compounded at an interval approved by the Board. Beginning January 1, 2005 and continuing for the duration of the 2004 Meet and Confer Agreement, the DROP interest rate will be equal to half the return on the System's investment for the prior fiscal year, with a minimum rate of 2.5% and a maximum rate of 7.5%, compounding currently at daily intervals. The first day of DROP participation is the DROP Entry Date. The day a participant's fully executed DROP election is accepted by the System is the DROP Election Date. Normal pension benefits cease to accrue on DROP Entry Date.

Effective September 1, 1999, the DROP Entry Date may precede DROP Election Date. However, effective January 1, 2005, a participant's election to participate in DROP cannot establish a DROP entry date that occurs prior to the date of the System's receipt of the member's request to participate in DROP. The monthly DROP credit is based on the participant's years of credited service and average monthly salary as of DROP Entry Date, and benefit accrual rates in effect on DROP Election Date.

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

Refunds of Participant Contributions

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

Basis of Accounting

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

Reporting Entity

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

Investment Valuation and Income Recognition

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

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

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

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

Furniture, Fixtures and Equipment

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

Use of Estimates

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

Income Tax Status

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

Costs of Administering the System

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

3. CONTRIBUTIONS AND FUNDING STATUS

Group B participants do not contribute to the System. All other active participants are required to contribute to the System amounts as set forth in the Pension Statute. As of June 30, 2006 and 2005, the participant contribution rate was 5% of a participant's qualifying base salary.

Under the System's Pension Statute, the City's contribution rate shall not be less than the greater of 10% of all participant salaries or two times the rate contributed by Group A participants. The City is required to contribute amounts to the System to provide funding on an actuarial reserve basis for normal cost plus the level of percentages of payroll payments based on its amortization period for the unfunded actuarial liability. However, under the terms of the Meet and Confer Agreement between the System's Board and the City, dated September 15, 2004, the City agreed to provide funding to the System as follows for fiscal years 2005, 2006 and 2007, comprised of budgeted contributions and net proceeds of pension obligation bonds as follows (on a cash basis):

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

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

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

The actuarially determined Annual Required Contribution (ARC) for fiscal year 2006 as determined in the July 1, 2005 actuarial valuation resulted in an ARC of 29.43% of covered payroll. The July 1, 2005 actuarial valuation used the following significant assumptions:

Investment rate of return	8.5%, net of expenses
Salary increases	Graded rates based on years of service
Payroll growth factor	3.0% per year
General inflation rate	3.0% per year
Actuarial cost method	Entry age normal cost method
Life expectancy	1994 Uninsured Pensioners Mortality Tables
DROP participation rate	90% at first eligibility

Although the City and participants have contributed the amounts as required under the Pension Statute and the Meet and Confer Agreement, the actual contributions made by the City have been less than the ARC for fiscal years 2006 and 2005.

The funded ratio is a standard measure of a plan's funded status representing the ratio of the actuarial value of assets to the actuarial accrued liability. The funded ratio as of July 1, 2005 is 65% which includes the $300 million note contributed by the City. The City is responsible for funding the deficiency, if any, between the amount available to pay the System's benefits and the amount required to pay such benefits.

Historical trend information is provided as required supplementary information on page 32. This historical information is intended to demonstrate the progress the System has made in accumulating sufficient assets to pay benefits when due and the related actuarial assumptions used in determining the actuarially determined amounts.

4. NOTE RECEIVABLE - CITY OF HOUSTON

As part of the Meet and Confer Agreement and to improve the System's long-term funding outlook, on November 10, 2004, the City issued the System a $300 million pension obligation note (the Note), secured in part by a deed of trust on the Convention Center Hotel adjacent to the George R. Brown Convention Center (the Hotel). The Note will mature on December 1, 2033.

For the initial period through March 31, 2005, the Note had an interest rate of 8.5%. Thereafter, the interest rate adjusts annually effective as of April 1 of each year to be the greater of 8.5% or the sum of the U.S. Treasury bond yield on the prior March 31 for the maturity date closest to December 1, 2033 plus 3.2% less a reduction for adjustments beginning in 2015 to reflect market reductions, if any, in yield spreads to maturity for comparable instruments.

Interest is payable beginning on October 1, 2005 and each October 1 thereafter. Payment of interest may be deferred provided that the aggregate balance of the deferred interest on the Note at any time shall not exceed the sum of $150 million plus, beginning after the 2014 true-up appraisal of the Hotel, 75% of the amount by which the most recent appraised value of the Hotel exceeds $300 million. All deferred interest will be due no later than December 1, 2033 and will bear interest from date of deferral until time of payment at the interest rate determined for the Note, compounded annually. The total interest receivable related to this Note as of June 30, 2006 and 2005 is $36,182,428 and $16,362,500, respectively. The System recognized interest income in connection with this Note of $26,564,784 and $16,362,500 for fiscal year 2006 and 2005, respectively.

5. DEFERRED COMPENSATION PLAN

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

6. INVESTMENTS

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

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

	2006	2005
Government securities	$ 57,378,912	62,840,296
Corporate bonds	75,568,208	73,687,436
Capital stocks	509,384,428	458,701,513
Commingled funds	548,133,295	420,920,132
Limited partnerships, real estate trust, and loans and mortgages	484,670,457	372,737,677
Short-term investment funds (cost)	66,298,270	97,408,425
	$ 1,741,433,570	1,486,295,479

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

In holding all System assets, the Custodian shall act with the same care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in like capacity and familiar with matters of this type would use in the conduct of an enterprise with a like character and with like aims. Further, the Custodian shall hold, manage and administer the System's assets for the exclusive purpose of providing the benefits to the members and the qualified survivors of the System.

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

Custodial Credit Risk

For an investment, custodial credit is the risk that, in the event of the failure of the counterparty, the System will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the System, and are held by either the counterparty or the counterparty's trust department or agent but not in the System's name. At June 30, 2006, the System's investments that were not subject to custodial credit risk were the investments in U.S. government securities and corporate bonds as they are registered in the name of the System and held in possession of the Custodian.

Concentration of Credit Risk

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

Representative guidelines by type of investment are as follows:

U.S. equity managers

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

International equity managers

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

d. Currency options may be entered into in lieu of or in conjunction with forward sales of currencies. The same effective limitations specified in (a) through (c) above will apply to currency options.

Fixed income managers

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

Global opportunistic fixed income/high yield managers

1. No more than 5% at cost and 10% at market value of a manager's portfolio shall be invested in the securities of any single issuer, with the exception of the U.S. government and its agencies.

There is no security issued by a single issuer that is being held with market value over 5% of the System's plan net assets as of June 30, 2006 and June 30, 2005.

Interest Rate Risk

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

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of the investment. Duration is a measure of a debt investment's exposure to fair value changes arising from changes in interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price. The greater the duration of a bond, or a portfolio of bonds, the greater its price volatility will be in response to a change in interest rates and vice-versa. Duration is the measure of a bond price's sensitivity to a 100-basis point change in interest rates. The duration of the System's debt securities is managed by the active managers.

At June 30, 2006, the following table shows the System's investments by type, amount and the effective duration rate calculated using the software Wilshire Axiom.

	Effective Duration	Domestic	International	Fair Value
Collateralized mortgage obligations	4.47	$ 6,972,535		6,972,535
Convertible bonds	3.92	7,775,221	659,750	8,434,971
Corporate bonds	6.93	43,968,363		43,968,363
Corporate bonds (International)	6.49		7,128,537	7,128,537
GNMA/FNMA/FHLMC	4.48	28,435,087		28,435,087
Government issues (United States)	4.64	22,757,628		22,757,628
Government issues (International)	17.10		6,259,983	6,259,983
Misc. receivable (auto/credit card)	0.50	1,004,797		1,004,797
Options-futures		9,919		9,919
Other asset backed	3.59	7,561,716	413,584	7,975,300
	5.77	$ 118,485,266	14,461,854	132,947,120

Credit Risk

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

1. All issues purchased must be of investment grade quality Baa (Moody's) or BBB (S&P) unless expressly authorized by the Board, in which case a minimum B rating shall apply, with a maximum limit of non-investment grade credits of 20% at market.
2. For global opportunistic fixed income/high yield securities, more than 50% of a manager's portfolio at market shall be invested in non-investment grade fixed income securities, i.e. those with ratings of BA1 (Moody's), BB+ (Standard & Poor's), or lower, or unrated bonds, including but not limited to corporate bonds, convertible bonds, and preferred stocks.

The quality ratings of investments in fixed income securities as described by nationally recognized statistical rating organizations at June 30, 2006 are as follows:

Quality Rating	Fair Value	Percentage of Holdings
AAA	$ 10,953,789	8.25%
AA	168,175	0.13%
AA+	1,181,175	0.89%
AA-	86,546	0.07%
A	2,651,316	1.99%
A-	1,640,274	1.23%
A+	1,275,286	0.96%
BBB	4,521,472	3.40%
BBB-	3,486,107	2.62%
BBB+	3,538,950	2.66%
BB	7,945,772	5.98%
BB+	3,049,331	2.29%
BB-	2,661,395	2.00%
B	12,407,513	9.33%
B+	6,483,468	4.88%
B-	5,396,333	4.06%
Below B-	3,992,585	3.00%
Not rated	10,304,999	7.75%
Total credit risk debt securities	81,744,486	61.49%
U.S. government fixed income securities*	51,202,634	38.51%
Total fixed income securities	$ 132,947,120	100.00%

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

Foreign Currency Risk

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

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. Each investment manager, through the purchase of units in a commingled investment trust fund or international equity mutual fund, establishes investments in international equities. The System has an indirect exposure to foreign currency fluctuation as of June 30, 2006 as follows:

	Fair Value	Percentage of Holdings
Australian Dollar	$ 2,219,197	1.1%
Canadian Dollar	4,173,949	2.1%
Euro Currency	86,523,675	42.6%
Hong Kong Dollar	1,560,602	0.8%
Hungarian Forint	458,526	0.2%
Indonesian Rupiah	1,131,502	0.6%
Japanese Yen	36,668,832	18.1%
Mexican Peso	1,685,071	0.8%
New Zealand Dollar	997,127	0.5%
Norwegian Krone	5,926,395	2.9%
Pound Sterling	27,060,066	13.4%
Singapore Dollar	5,231,372	2.6%
South Korean Won	3,468,460	1.7%
Swedish Krona	4,268,573	2.1%
Swiss Franc	19,443,400	9.6%
Taiwan Dollar	1,816,147	0.9%
Total securities subject to foreign currency risk	$ 202,632,894	100%

Schedule 5 on page 35 lists the System's investment and professional service providers.

7. CASH AND CASH EQUIVALENTS

For cash deposits and cash equivalents, custodial credit risk is the risk that in the event of a bank failure, the System's deposits may not be returned to it. The System's deposits are held by the Custodian. As of June 30, 2006 and 2005, the System had fair value bank balances of $2,826,252 and $929,909 respectively, that are in demand deposit accounts subject to coverage by Federal deposit insurance but not collateralized. The System does not have a deposit policy for custodial credit risk; however, the System's credit risk exposure is mitigated by the financial strength of the banking institution in which the deposits are held.

8. SECURITIES LENDING

State statutes allow the System to participate in securities lending transactions and the Board has authorized its Custodian to lend the System's securities to broker-dealers and banks pursuant to a form of loan agreement. During the years ended June 30, 2006 and 2005, the System's Custodian lent, at the direction of the Board, the System's securities and received cash, securities issued or guaranteed by the United States government, and irrevocable bank letters of credit as collateral. The Custodian does not have the ability to pledge or sell securities delivered for collateral, absent a borrower's default. Borrowers were required to deliver collateral for each loan equal to: (i) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; and (ii) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities.

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

During the years ended June 30, 2006 and 2005, 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, 2006 and 2005, such investment pool had an average duration of 58 and 40 days, respectively, and an average expected weighted maturity of 480 and 410 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, 2006, the System had no credit risk exposure to borrowers. The collateral held and the fair value of securities on loan as of June 30, 2006, was $94,575,802 and $92,621,030, respectively, and $96,629,097 and $92,807,489 respectively, as of June 30, 2005.

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

	2006	2005
U.S. government securities	$ 15,896,294	27,699,150
Domestic equity	34,491,583	34,267,743
Domestic fixed income	11,039,256	10,089,776
International equity	31,193,897	20,750,820
	$ 92,621,030	92,807,489

9. 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.

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

Forward Foreign Exchange Contracts

A currency forward is a contractual agreement between two parties to pay or receive specific amounts of foreign currency at a future date in exchange for another currency at an agreed upon exchange rate. Forward commitments are not standardized and carry credit risk due to the possible nonperformance by one of the counterparties. The maximum potential loss is the aggregate face value in U.S. dollars at the time the contract was opened; however, the likelihood of such loss is remote. No such losses occurred during fiscal years 2006 and 2005. 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.

10. FURNITURE, FIXTURES AND EQUIPMENT

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

	2006	2005
Office furniture and equipment	$ 458,489	420,973
Computer equipment	1,028,760	805,509
Leasehold improvements	398,232	398,232
	1,885,481	1,624,714
Less accumulated depreciation and amortization	(1,183,130)	(796,410)
	$ 702,351	828,304

11. 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, 2006 and 2005, aggregate contributions from these eligible participants of the System were approximately $68,326,000 and $80,713,000, respectively.

The System's investments in limited partnerships and real estate trusts are included in the table appearing in note 6. In connection with those investments, the System has remaining commitments as of June 30, 2006 and 2005 of approximately $287,000,000 and $295,000,000 respectively, pursuant to terms of the respective limited partnerships and real estate trusts.

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

Year Ending June 30,	
2007	$ 455,400
2008	455,400
2009	455,400
2010	455,400
2011	455,400
	$ 2,277,000

Additional amounts are assessed for use of common areas, utilities and maintenance. Total rental expense, including these assessments, amounted to approximately $498,600 and $504,800 during the years ended June 30, 2006 and 2005, respectively.

12. RISKS AND UNCERTAINTIES

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

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

SCHEDULE 1 - REQUIRED SUPPLEMENTAL INFORMATION

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

Actuarial Valuation Date	(1) Actuarial Value of Assets (AVA)	(2) Actuarial Accrued Liability (AAL)	(3) Unfunded (UAAL)	(4) Funded Ratio (1):(2)	(5) Covered Payroll	(6) UAAL as a Percentage of Covered Payroll
07/01/96	$ 857.3	1,042.5	185.2	82%	367.6	50%
07/01/98	1,095.6	1,240.1	144.5	88%	397.7	36%
07/01/99	1,222.2	1,339.9	117.7	91%	407.7	29%
07/01/00	1,376.0	1,509.4	133.4	91%	432.6	31%
07/01/01	1,490.2	1,955.8	465.6	76%	418.0	111%
07/01/02	1,519.7	2,515.2	995.5	60%	399.8	249%
07/01/03	1,510.3	3,278.2	1,767.9	46%	390.3	453%
07/01/04	1,501.2	2,633.8	1,132.6	57%	366.2	309%
07/01/05	1,777.6	2,725.2	947.6	65%	404.6	234%

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	07/01/01	71.9	56.5%
06/30/04	07/01/02	123.9	46.0%
06/30/05	07/01/03	102.9	61.0% **
06/30/06	07/01/05	119.1	56.2%

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

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

See accompanying independent auditors' report.

See accompanying note to required supplemental schedules.

NOTE TO REQUIRED SUPPLEMENTAL SCHEDULES 1 and 2 (UNAUDITED)

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

Valuation date	July 1, 2005
Actuarial cost method	Entry Age Normal
Amortization method	Level percentage, open
Amortization period	Rolling 30 year period ending June 30, 2035
Asset valuation method	5-year smoothed market
Actuarial assumptions:	
Investment rate of return	8.5%, net of expenses
Salary increases	Graded rates based on years of service
Payroll growth factor	3.0% per year
General inflation rate	3.0% per year
DROP participation rate	90% at first eligibility
DROP interest credit	4.25% per year
Mortality rates	Based on 1994 Uninsured Pensioners Mortality Table (healthy participants); 1965 Railroad Retirement Board Disabled Life Table (disabled participants)

See accompanying independent auditors' report.

SCHEDULE 3

INVESTMENT SUMMARY JUNE 30, 2006 and 2005

	June 30, 2006			June 30, 2005		
	Cost	Fair Value	Unrealized Appreciation (Depreciation)	Cost	Fair Value	Unrealized Appreciation (Depreciation)
Fixed income:						
Government securities	$ 57,792,081	57,378,912	(413,169)	62,134,178	62,840,296	706,118
Corporate bonds	72,032,761	75,568,208	3,535,447	68,409,051	73,687,436	5,278,385
Total fixed income	129,824,842	132,947,120	3,122,278	130,543,229	136,527,732	5,984,503
Capital stocks	438,954,393	509,384,428	70,430,035	415,043,746	458,701,513	43,657,767
Commingled funds	439,126,450	548,133,295	109,006,845	348,600,875	420,920,132	72,319,257
Limited partnerships, real estate trusts and loans and mortgages	380,797,625	484,670,457	103,872,832	320,660,441	372,737,677	52,077,236
Short-term investment funds	66,298,270	66,298,270		97,408,425	97,408,425	
Total investments	$ 1,455,001,580	1,741,433,570	286,431,990	1,312,256,716	1,486,295,479	174,038,763

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, 2006 AND 2005

	2006	2005
Investment services:		
Custodial services	$ 420,028	360,922
Money management services	5,198,143	5,186,252
Consulting services	465,255	449,000
Total investment services	$ 6,083,426	5,996,174
Professional services:		
Actuarial services	50,492	174,347
Auditing and consulting services	101,850	57,558
Legal services	447,285	711,271
Other professional services	107,840	145,235
Total professional services	$ 707,467	1,088,411
Administration expenses:		
Office costs	505,851	510,577
Insurance costs	134,120	140,495
Costs of staff and benefits	3,393,490	3,057,962
Costs of equipment and supplies	487,616	560,874
Depreciation and amortization	386,720	305,687
Costs of education and research	164,082	142,028
Total administration expenses	$ 5,071,879	4,717,623

See accompanying independent auditors' report.

SCHEDULE 5

SUMMARY OF COSTS OF INVESTMENT AND PROFESSIONAL SERVICES
YEARS ENDED JUNE 30, 2006 AND 2005

Service Provider	Service Provided	2006	2005
Investment services:			
Barclays Global Investors, N.A.	Money management	$ 1,130,558	538,782
Axiom Int'l Investors, L.L.C.	Money management	922,556	721,432
Brandes Investment Partners, LLC	Money management	600,207	577,930
DePrince, Race and Zollo, Inc.	Money management	456,848	398,312
Neumeier Investment Counsel, L.L.C.	Money management	390,472	389,436
Legg Mason Capital Management, Inc.	Money management	385,683	372,559
Adams Street Partners	Money management	342,964	344,248
Loomis, Sayles and Company, L.P.	Money management	281,660	246,100
DDJ Capital Management, LLC	Money management	184,753	
Kopp Investment Advisors	Money management	121,709	114,672
Western Asset Management	Money management	101,792	258,104
Smith Graham & Company	Money management	68,747	86,018
Frank Russell Securities	Money management	66,969	40,439
Global Forest Partners, L.P.	Money management	47,771	46,180
Golden Tree Asset Management, L.P.	Money management	35,460	245,191
Oechsle International Advisors	Money management	32,211	389,000
L&B Realty Advisors, Inc.	Money management	27,783	37,389
Brown Capital Management	Money management		218,656
TT International Investment Management	Money management		205,086
Putnam Advisory Company, Inc.	Money management		(73,760)
Alliance Capital Management, L.P.	Money management		17,108
MDL Capital Management	Money management		13,370
State Street Bank and Trust Company	Custodial services	420,028	360,922
Willshire Associates, Incorporated	Consulting services	284,005	274,000
Pension Consulting Alliance	Consulting services	181,250	175,000
Total investment services		6,083,426	5,996,174
Professional services:			
Locke, Liddell and Sapp, L.L.P.	Legal services	288,237	323,297
Baker and Botts, L.L.P.	Legal services	152,584	313,851
Mercy*Carter*Tidwell, LLP	Legal services	5,669	
Schlanger, Mills, Mayer & Silver	Legal services	795	44,185
E. Troy Blakeney, Jr., P.C.	Legal services		26,207
Hinton Sussman Bailey & Davidson, L.L.P.	Legal services		3,731
Mir·Fox & Rodriguez, P.C.	Auditing and professional services	49,407	53,555
HillCo Partners, LLC	Professional services	107,840	93,971
Vollmer	Professional services		51,264
Werness Inc.	Consulting services	21,938	
Gray Associates	Consulting services	17,826	
Ennis, Knupp & Assoc., Inc.	Consulting services	8,499	
Pension Benefits Information	Consulting services	4,180	4,003
Gabriel, Roeder, Smith & Co.	Actuarial services	50,492	174,347
Total professional services		707,467	1,088,411
Total costs of investment and professional services		$ 6,790,893	7,084,585

See accompanying independent auditors' report.

INVESTMENT SECTION

DISCUSSION OF INVESTMENT POLICIES AND ACTIVITIES
SCHEDULE OF TOP INVESTMENTS ($000) AS OF JUNE 30, 2006
PERFORMANCE BY FISCAL YEAR LAST TEN YEARS
COMPARISON OF INVESTMENT RETURNS - YEARS ENDED JUNE 30
SCHEDULE OF FEES AND COMMISSIONS

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

General

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

Investment Policies

Strategic Asset Allocation Policy and Maintenance

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

Manager Structure Considerations

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

Investment Manager Guidelines and Evaluation

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

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

Manager Evaluation

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

TABLE 1

	Allocation		Investment Performance		
Asset Class	Target	Actual	3 Yrs.	5 Yrs.	10 Yrs.
Domestic Equity	30.0 %	27.9 %	13.5 %	5.7 %	9.0 %
Dow Jones Wilshire 5000 Index			13.0	4.0	8.5
S&P 500 Index			11.2	2.5	8.3
International Equity	20.0	20.7 %	25.6	10.9	8.4
MSCI All Country Free Ex-US Index			25.8	11.9	n/a
MSCI EAFE Index			23.9	10.0	6.4
Fixed Income	20.0	18.4 %	5.2	6.3	6.3
Lehman Aggregate Index			2.1	5.0	6.2
Merrill Lynch High Yield Master II Index			8.4	8.3	6.6
Real Assets	15.0	16.3 %	27.2	18.0	13.9
NCREIF Index			15.8	12.0	12.4
Alternative Investments	15.0	15.2 %	18.5	5.5	2.9
S&P 500 Index + 3.0%			14.2	5.5	11.3
Cash	0.0	1.5 %			
Total Portfolio			16.9	9.0	9.1
Policy Benchmark			14.0	7.4	8.9

Performance Evaluation

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

Investment results were calculated using a time-weighted rate of return based on the market rate of return.

Proxy Voting

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

Investment Activities

During the period covered by this CAFR, investment strategies were employed that are long-term in perspective and designed to work within predefined ranges among asset classes to produce returns that, over market cycles, will exceed the investment return assumption adopted by the Board for actuarial purposes. Diversification provides safeguards against unanticipated market volatility of one or more asset classes. The Chief Investment Officer, Doug Wynkoop, has provided a summary in the above table (Table 1) of the portfolio's actual allocation compared to the targeted allocation.

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

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

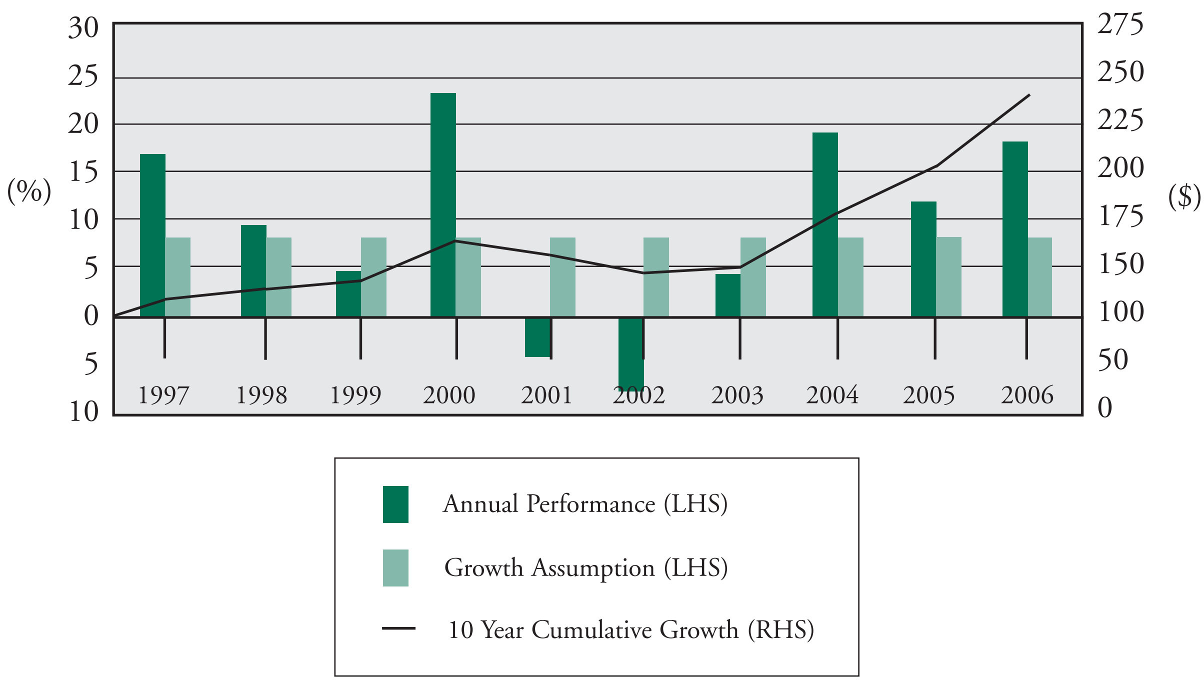
The Investment Section was written by HMEPS' Chief Investment Officer, Doug Wynkoop, and Financial Analyst, Greg Brunt.

*SCHEDULE OF TOP INVESTMENTS ($000) AS OF JUNE 30, 2006**

Name of Investment	Fair Value of Investment	Percent of Portfolio
Barclays Alpha Tilts (Enhanced S&P 500 Index)	$ 138,116,853.53	8.0%
Barclays US Bond Index (Lehman Aggregate Index)	$ 132,086,583.09	7.7%
Barclays Alpha Tilts International (Enhanced MSCI ACW x US Index)	$ 130,987,401.68	7.6%
Blackrock Energy and Natural Resources Fund	$ 64,969,117.74	3.8%
Russell Alternative Strategy Fund	$ 48,612,807.06	2.8%
Pension Obligation Note		
City of Houston Pension Obligation Note	$ 336,182,428.38	

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

PERFORMANCE BY FISCAL YEAR LAST TEN YEARS



COMPARISON OF INVESTMENT RETURNS - YEARS ENDED JUNE 30

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

Period ending 06-30	HMEPS Total Fund	Median of Wilshire Public Fund Universe	HMEPS Domestic Equity	Dow Jones 5000 Index	S&P 500 Index	HMEPS Int'l Equity	MSCI ACW Free ex US Index	MSCI EAFE Index	HMEPS Fixed Income	Lehman Aggregate Index	Merrill Lynch High Yield Master III Index	HMEPS Real Assets	NCREIF Index	HMEPS Alternative Investments	S&P500 Index
1997	16.91%	20.38%	27.73%	29.33%	34.67%	18.39%	n/a	12.84%	12.31%	8.15%	14.58%	5.82%	10.81%	-20.39%	34.67%
1998	9.16%	18.40%	18.91%	28.87%	30.13%	4.22%	n/a	6.08%	8.58%	10.54%	11.81%	3.19%	17.43%	-5.37%	30.13%
1999	3.42%	9.99%	7.87%	19.57%	22.79%	1.60%	n/a	7.60%	0.52%	3.14%	0.89%	6.18%	12.80%	-9.95%	22.79%
2000	22.92%	9.81%	12.14%	9.52%	7.27%	44.02%	n/a	17.17%	8.54%	4.56%	-1.04%	9.73%	11.62%	77.46%	7.27%
2001	-4.08%	-4.84%	-2.00%	-15.33%	-14.81%	-26.31%	n/a	-23.61%	2.30%	11.23%	-1.01%	26.08%	11.57%	-15.95%	-14.81%
2002	-6.97%	-5.85%	-12.78%	-16.62%	-17.96%	-12.10%	-8.16%	-9.50%	2.34%	8.64%	-4.38%	5.24%	5.51%	-18.58%	-17.96%
2003	3.55%	4.14%	3.18%	1.27%	0.25%	-3.76%	-4.19%	-6.45%	13.99%	10.41%	22.24%	5.84%	7.64%	-3.40%	0.25%
2004	18.64%	16.62%	21.95%	21.24%	19.10%	34.44%	32.50%	32.38%	3.99%	0.32%	10.05%	15.92%	10.83%	13.32%	19.10%
2005	13.85%	10.23%	7.94%	8.23%	6.31%	13.24%	16.95%	13.64%	9.17%	6.81%	10.62%	30.03%	18.02%	19.96%	6.31%
2006	18.11%	11.14%	11.14%	9.92%	8.63%	30.14%	28.40%	26.54%	2.62%	-0.81%	4.71%	36.39%	18.67%	22.46%	8.63%
3 Yrs.	16.85%	12.61%	13.52%	12.98%	11.21%	25.60%	25.78%	23.94%	5.22%	2.05%	8.43%	27.15%	15.79%	18.51%	11.21%
5 Yrs.	8.97%	7.21%	5.66%	4.02%	2.50%	10.88%	11.85%	10.02%	6.32%	4.98%	8.30%	18.02%	12.01%	5.54%	2.50%
10 Yrs.	9.11%	8.84%	9.02%	8.45%	8.32%	8.35%	n/a	6.39%	6.34%	6.22%	6.55%	13.90%	12.41%	2.85%	8.32%

SCHEDULE OF FEES AND COMMISSIONS PAID IN FISCAL YEAR 2006

	Commissions	Shares	cents/share
UBS AG	159,465	7,169,342	2.22
Citigroup	89,840	3,793,301	2.37
Cantor Fitzgerald	82,514	1,676,050	4.92
Bear Stearns	76,261	2,100,009	3.63
Lehman Brothers	73,110	6,344,501	1.15
Donaldson*	68,225	1,180,600	5.78
Merrill Lynch, Pierece, Fenner & Smith	62,726	2,136,721	2.94
Warburg Dillon Read Securities	60,693	5,839,209	1.04
Credit Suisse First Boston	41,879	4,992,448	0.84
Goldman Sachs	25,424	1,878,753	1.35
Instinet	24,102	614,894	3.92
Deutsche Bank	20,533	613,825	3.35
Charles Schwab	20,042	539,500	3.71
Lynch Jones and Ryan*	19,397	470,849	4.12
Prudential Equity Group	18,130	381,400	4.75
Enskilda Securities	16,902	454,737	3.72
Jefferies	16,171	478,201	3.38
Sterne, Agee & Leach	15,623	347,600	4.49
National Financial Services	14,815	472,677	3.13
Carnegie	14,627	2,555,300	0.57
Capital Institutional Services*	14,544	343,250	4.24
Morgan Stanley	14,301	880,755	1.62
Moors & Cabot	14,293	284,943	5.02
Pershing	13,287	475,039	2.80
Lombard, Odier and CIE	13,257	132,895	9.98
McDonald	13,009	259,484	5.01
Cazenove	12,886	1,621,400	0.79
J.P. Morgan	12,279	1,414,961	0.87
KBC Finance	10,017	353,144	2.84
Neubergerand Berman	9,579	438,711	2.18
ABG Securities	9,471	410,963	2.30
Wien Securities	9,183	251,800	3.65
Dresdner Kleinworth Wasserstein	8,798	765,393	1.15
BNY Brokerage	8,641	175,800	4.91
Banc/America Securities	8,434	226,000	3.73
Brookview Capital	8,327	197,100	4.22
Kepler Equities	7,851	83,055	9.45
Credit Lyonnais Securities	7,767	1,037,698	0.75
Southwest Securities	7,175	207,500	3.46
Keefe Bruyette & Woods	6,888	142,000	4.85
CIBC World Markets	6,433	174,650	3.68
Nomura Securities International	6,396	146,991	4.35
Macquaries Securities	6,008	589,000	1.02
ABN Amro	5,060	119,443	4.24
Raymond James	5,057	195,800	2.58

(continued on following page)

	Commissions	Shares	cents/share
Canaccord Adams	4,938	108,750	4.54
Davy Stockbrokers	4,856	124,300	3.91
First Albany Capital	4,375	87,500	5.00
Daewoo Securities	4,355	50,754	8.58
Societe Generale Bank and Trust	4,305	135,490	3.18
GMP Securities	4,142	99,700	4.15
Piper Jaffray	4,102	112,850	3.63
Midwest Research Securities	4,097	97,400	4.21
Kempen	3,843	44,000	8.73
Merriman Curhan Ford	3,825	191,250	2.00
Friedman Billings & Ramsey	3,805	74,000	5.14
Scotia Capital	3,752	91,700	4.09
Dongwon Securities	3,702	67,932	5.45
Mizuho Securities USA	3,666	102,982	3.56
Credit Agricole Indosuez Cheuvreux	3,561	24,770	14.38
Oddo Finance	3,539	31,443	11.25
Concorde Ertekpapir Ugynokseg	3,346	21,500	15.56
Oppenheim, Sal., Jr & Koeln	3,312	21,178	15.64
Goodbody Stockbrokers	3,252	78,200	4.16
Morgan Keegan	2,993	97,250	3.08
Harris Nesbitt	2,988	78,200	3.82
Nesbitt Burns	2,939	107,272	2.74
Julius Baer Brokerage	2,935	48,460	6.06
RBC Capital Markets	2,815	91,530	3.08
Securities, Inc.	2,767	18,500	14.96
Svenska Handelsbanken	2,584	89,000	2.90
Adams Harkness & Hill	2,550	67,500	3.78
KB Securities	2,495	37,500	6.65
Weeden	2,309	54,600	4.23
Auerbach Grayson	2,293	65,500	3.50
Baypoint Trading	2,269	60,900	3.73
Goldsmith & Harris (through Bear Stearns)	2,165	43,300	5.00
Rabobank Netherland	2,145	27,100	7.92
Korea Investment & Securities	2,125	43,830	4.85
Ixis Securities	2,074	6,150	33.72
Others	55,937	2,448,564	2.28
TOTAL	1,330,571	59,918,547	2.22

* Gross commissions reported for brokers in directed brokerage program.

ACTUARIAL SECTION

Gabriel, Roeder, Smith & Company

February 7, 2006

Board of Trustees

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

Dear Members of the Board:

Subject: Actuarial Valuation as of July 1, 2005

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

Under the HMEPS statute, the employer contribution rate is determined actuarially, based on the Board's funding policy and HMEPS' governing law. The contribution rate determined by a given actuarial valuation and implemented by the Board becomes effective twelve months after the valuation date, i.e., the rates determined by this July 1, 2005 actuarial valuation would normally be used by the Board when determining the employer contribution rate for the year beginning July 1, 2006 and ending June 30, 2007.

However, under the terms of the "Meet and Confer" agreement between the Board and the City of Houston, the employer contribution amounts for FY2006 and FY2007 have already been set at $69 million and $72 million respectively. The calculated contribution rate from this valuation will not be contributed.

Also, as part of the "Meet and Confer" agreement, a pension obligation note (collateral for the note is provided by the City's interest in a City-owned hotel) of $300 million was contributed by the City to the pension trust as of November 2004. This contribution is reflected in this valuation as a contribution and is included in the market value and actuarial value of assets throughout the report.

Benefit Provisions

The benefit provisions reflected in this valuation are those which were in effect on July 1, 2005, and reflect the changes made as a part of the "Meet and Confer" agreement. The agreement between the City and the Board changed the benefit provisions substantially, effective January 1, 2005. The changes are discussed in the Benefit Provisions subsection of the Discussion section of the July 1, 2004 report.

The benefit provisions have not changed since the prior valuation other than the prospective elimination of Group C participation effective January 1, 2005. The benefit provisions are summarized in Appendix B.

Assumptions and Methods

Actuarial assumptions and methods are set by the Board of Trustees, based upon recommendations made by the plan's actuary. The assumptions used in this valuation have not been modified since the previous valuation. The assumptions used in the valuation were adopted by the Board based on our recommendations following an Experience Analysis performed for the five year period ending July 1, 2004.

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

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

All assumptions and methods are described in Appendix A.

Financing Objectives and Funding Policy

The amortization period is set by statute. The contribution rate and liabilities are computed using the Entry Age actuarial cost method. The employer contribution rate is the sum of two pieces: the employer normal cost rate and the amortization rate. The normal cost rate is determined as a percent of pay. The employer normal cost is the difference between this and the weighted member contribution rate. The amortization rate is determined as a level percent of pay. It is the amount required to amortize the unfunded actuarial accrued liability over an open period (30 years as of July 1, 2005). The amortization rate is adjusted for the one-year deferral in contribution rates.

Progress Toward Realization of Financing Objectives

The funded ratio (the ratio of the actuarial value of assets to the actuarial accrued liability) is a standard measure of a plan's funded status. In the absence of benefit improvements, it should increase over time, until it reaches 100%. The funded ratio as of July 1, 2005 is 65.2%. This is higher than the 57.0% from the 2004 valuation. The major cause for this increase was the $300 million note contributed by the City to HMEPS.

The calculated employer contribution rate for FY 2007 is 24.10%. This rate is significantly lower than the 29.43% from the 2004 valuation.

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

Data

Member data for retired, active and inactive members was supplied as of July 1, 2005 by the HMEPS staff. We did not audit this data, but we did apply a number of tests to the data, and we concluded that it was reasonable and consistent with the prior year's data. Asset information as of July 1, 2005 was taken from the Comprehensive Annual Financial Report for the Year Ended June 30, 2005.

Certification

We certify that the information presented herein is accurate and fairly portrays the actuarial position of HMEPS as of July 1, 2005.

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

Sincerely,

Gabriel, Roeder, Smith & Company

Joe Newton, FSA, EA, MAAA
Consultant

Lewis Ward
Consultant

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

EXECUTIVE SUMMARY

Item	July 1, 2005	July 1, 2004
Membership		
• Number of:		
- Active members	11,974	11,856
- Retirees and beneficiaries	7,523	6,878
- Inactive members	3,893	3,477
- Total	23,390	22,211
• Annualized Payroll supplied by HMEPS[1]	$ 404,565	$ 366,190
Calculated Contribution rates		
• Member (weighted)[2]	3.98 %	3.79 %
• Employer	24.10 %	29.43 %
Assets		
• Market value	$ 1,824,852	$ 1,418,726
• Actuarial value	1,777,656	1,501,235
• Estimation of return on market value[3]	12.9 %	18.1 %
• Estimation of return on actuarial value	4.1 %	4.2 %
• Employer contribution[4]	$ 363,247	$ 57,308
• Ratio of actuarial value to market value	97.4 %	105.8 %
Actuarial Information		
• Employer normal cost %	8.47 %	8.53 %
• Unamortized actuarial accrued liability (UAAL)	$ 947,616	$ 1,132,582
• Amortization rate	15.63 %	20.90 %
• Funding period	30.0 years	30.0 years
• GASB funded ratio	65.2 %	57.0 %
Projected employer contribution based on calculated rate		
• Fiscal year ending June 30,	2007	2006
• Projected payroll (millions)	$ 432.1	$ 390.5
• Projected employer contribution (millions) (actual contribution rate set by Meet & Confer)	$ 104.2	$ 114.9

Note: Dollar amounts in $000, unless otherwise noted

1 Beginning with the 2005 valuation, a change in methodology now annualizes payroll for new entrants. See page 5 for more information.

2 Employee contribution rate for contributing members is 4% prior to January 1, 2005 and 5% thereafter.

3 Dollar-weighted return. The time-weighted return reported in the Comprehensive Annual Financial Report for fiscal year 2005 was 13.85% and 18.64% for fiscal year 2004.

4 July 1, 2005 contribution information includes $300 million note from the City.

STATEMENT OF PLAN NET ASSETS

	July 1, 2005
A. ASSETS	(1)
1. Current Assets	
a. Cash and short term investments	
1) Cash on hand	$ 875
2) Short term investments	97,408
b. Accounts Receivable	
1) Sale of investments	54,781
2) Other	14,798
c. Total Current Assets	$ 167,862
2. Long Term Investments	
a. US. Government securities	$ 62,840
b. Corporate bonds	73,687
c. Capital stocks	458,702
d. Commingled Funds	420,920
e. LP's, real estate trusts, loans and mortgages	372,738
f. Total long term investments	$ 1,388,887
3. Other Assets	
a. Collateral on securities lending	$ 95,636
b. Furniture, fixtures and equipment, net	828
c. Note Receivable - City of Houston	300,000
d. Accrued interest on note receivable	16,363
e. Total other assets	$ 412,827
4. Total Assets	$ 1,969,576
B. LIABILITIES	
1. Current Liabilities	
a. Amounts due on asset purchases	$ 45,452
b. Accrued liabilities	3,636
c. Collateral on securities lending	95,636
2. Total Liabilities	144,724
3. Net Assets Held in Trust	$ 1,824,852
C. ASSET ALLOCATION FOR CASH & LONG TERM INVESTMENTS	
1. Cash	0.9%
2. Fixed Income	16.0%
3. Real Assets	14.7%
4. Domestic Equities	32.6%
5. International Equities	21.4%
6. Alternative Investments	14.4%
7. Total	100.0%

Note: Dollar amounts in $000

RECONCILIATION OF PLAN NET ASSETS

	Year Ending June 30, 2005 (1)
1. Market value of assets at beginning of year	$ 1,418,725
2. Revenue for the year	
a. Contributions	
i. Member contributions	$ 23,488
ii. Employer contributions	363,247
iii. Total	$ 386,735
b. Net investment income	
i. Interest	$ 11,101
ii. Dividends	9,891
iii. Earnings from LP's and real estate trusts	45,070
iv. Net appreciation (depreciation) on investments	124,002
v. Interest income - City of Houston note receivable	16,363
vi. Net proceeds from lending securities	352
vii. Less investment expenses	(5,996)
viii. Other	888
c. Total revenue	$ 588,405
3. Expenditures for the year	
a. Refunds	$ 992
b. Benefit payments	175,480
c. Administrative and miscellaneous expenses	5,806
d. Total expenditures	$ 182,278
4. Increase in net assets (Item 2c - Item 3d)	$ 406,127
5. Market value of assets at end of year (Item 1 + Item 4)	$ 1,824,852

Note: Dollar amounts in $000

CALCULATION OF EXCESS INVESTMENT INCOME

Item	Year Ending June 30, 2005
(1)	(2)
1. Market value of assets at beginning of year	$ 1,418,725
2. Net external cash flow during the year	210,263
3. Market value of assets at end of year	1,824,852
4. Actual investment income during the year based on market value: (3) - (2) - (1)	$ 195,864
5. Assumed earnings rate	8.50 %
6. Expected earnings for the year on:	
a. Market value of assets at beginning of year:	120,592
b. Net external cash flow:	8,754
c. Total: (a) + (b)	129,346
7. Excess investment income for the year: (4) - (6)	$ 66,518

Note: Dollar amounts in $000

DEVELOPMENT OF ACTUARIAL VALUE OF ASSETS

	July 1, 2005
	(1)
1. Excess (Shortfall) of invested income for current and previous three years	
a. Current year	$ 66,518
b. Current year - 1	118,177
c. Current year - 2	(77,263)
d. Current year - 3	(230,096)
e. Total for four years	$ (122,664)
2. Deferral of excess (shortfall) of invested income	
a. Current year (80%)	53,214
b. Current year - 1 (60%)	70,906
c. Current year - 2 (40%)	(30,905)
d. Current year - 3 (20%)	(46,019)
e. Total deferred for year	$ 47,196
3. Market value of assets at end of year	$ 1,824,852
4. Actuarial value of assets at end of year: (3) - (2e)	$ 1,777,656

Note: Dollar amounts in $000

ACTUARIAL PRESENT VALUE OF FUTURE BENEFITS

	July 1, 2005 (1)
1. Active members	
a. Retirement benefits	$ 1,318,713
b. Deferred termination benefits	84,669
c. Refunds	8,043
d. Death benefits	47,452
e. Disability benefits	25,334
f. Total	$ 1,484,211
2. Members in Pay Status	
a. Service retirements	$ 1,343,473
b. Disability retirements	39,908
c. Beneficiaries	100,283
d. Total	$ 1,483,664
4. Inactive members	
a. Vested terminations	$ 92,498
b. Nonvested terminations	1,183
c. Total	$ 93,681
5. Total actuarial present value of future benefits	$ 3,061,556

Note: Dollar amounts in $000

CALCULATION OF TOTAL ACTUARIAL GAIN OR LOSS

1.	Unfunded actuarial accrued liability (UAAL) as of July 1, 2004	$ 1,132,582
2.	Total normal cost for year	48,353
3.	Contributions during year ending June 30, 2005	(386,735)
4.	Interest on UAAL for one year	96,269
5.	Interest on Item 2 and Item 3 for one-half year	(14,088)
6.	Expected UAAL as of July 1, 2005 (1+2+3+4+5)	$ 876,381
7.	Actual UAAL as of July 1, 2005	$ 947,616
10.	Actuarial gain/(loss) for the period (6 - 7)	$ (71,235)
	SOURCE OF GAINS/(LOSSES)	
11.	Asset gain/(loss) (See Table 13)	$ (70,201)
12.	Assumption changes	-
13.	Total liability gain/(loss) for the period (8 - 9 - 10)	$ (1,034)

Note: Dollar amounts in $000

NEAR TERM OUTLOOK

Valuation as of July 1, (1)	Unfunded Actuarial Accrued Liability (UAAL, in 000s) (2)	Funded Ratio (3)	Calculated Contribution Rate (4)	Funding Period (Years)[2] (5)	Funded Ratio Using MVA (6)	For Fiscal Year Ending June 30, (7)	Covered Compensation (8)	Employer Contributions (9)	Employee Contributions (10)	Benefit Payments and Refunds (11)	Net External Cash Flow (12)
2005	$ 947,616	65.2%	24.10%	30.0	67.0 %	2006	$419,542	$ 69,000[1]	$ 16,712	$ 217,336	$ (131,624)
2006	1,008,541	63.7%	24.61%	30.0	66.3%	2007	431,992	72,000[1]	17,597	166,156	(76,559)
2007	1,026,959	64.5%	23.93%	30.06	6.3%	2008	443,203	109,069	18,415	177,810	(50,326)
2008	995,701	67.0%	23.04%	30.0	67.4%	2009	455,055	108,909	19,252	188,189	(60,028)
2009	989,630	68.4%	22.58%	30.0	68.4%	2010	467,129	107,638	20,104	197,928	(70,187)
2010	999,632	69.2%	22.56%	29.0	69.2%	2011	479,705	108,339	20,989	208,566	(79,238)
2011	1,010,576	70.0%	22.54%	28.0	70.0%	2012	492,383	111,080	21,885	220,241	(87,276)
2012	1,020,467	70.7%	22.52%	27.0	70.7%	2013	505,600	113,973	22,806	232,353	(95,574)
2013	1,029,141	71.5%	22.51%	26.0	71.5%	2014	519,243	116,951	23,743	245,126	(104,432)
2014	1,036,447	72.2%	22.48%	25.0	72.2%	2015	533,497	120,067	24,703	257,982	(113,211)
2015	1,042,211	72.9%	22.46%	24.0	72.9%	2016	548,310	123,281	25,681	271,027	(122,065)

These projections are based on the benefit provisions in effect for the July 1, 2005 actuarial valuation with no expected changes to future accruals. Also, beginning in FY2007, the calculated rates shown above are assumed to be paid beginning the year after the valuation. Any changes to future accruals or failure to contribute the calculated rate will change the results of this projection.

1. The agreement between the City and the HMEPS included a $63 million employer contribution and $300 million note for FY2005, a $69 million employer contribution for FY2006, and a $72 million employer contribution for FY2007.
2. The agreement between the City and the HMEPS included an open 30 year amortization period until the 2009 valuation. Beginning with the 2009 valuation, the amortization period will be 30 years from July 1, 2009.

Note: Dollar amounts in $000. MVA represents Market Value of Assets.

ANALYSIS OF NORMAL COST

	July 1, 2005	July 1, 2004
	(1)	(2)
1. Gross normal cost rate		
a. Retirement benefits	9.06%	8.93%
b. Deferred termination benefits	1.56%	1.57%
c. Refunds	0.68%	0.69%
d. Disability benefits	0.53%	0.51%
e. Death benefits	0.62%	0.62%
f. Total	12.45%	12.32%
2. Less: member contribution rate		
a. Present Value of Employee Contributions	$ 106,452	$ 92,888
b. Present value of future pay	$ 2,675,293	$ 2,453,402
c. Effective member contribution rate (2a/2b)	(3.98%)	(3.79%)
3. Employer normal cost rate (Item 1f - Item 2c)	8.47%	8.53%

Note: Dollar amount in $000

CHANGE IN CALCULATED CONTRIBUTION RATE SINCE THE PRIOR VALUATION

1. Calculated Contribution Rate as of July 1, 2004		29.43%
2. Change in Contribution Rate During Year		
a. Change in Employer Normal Cost	(0.06%)	
b. Assumption changes	0.00%	
c. Recognition of prior asset losses (gains)	1.45%	
d. Actuarial (gain) loss from current year asset performance	(0.23%)	
e. Actuarial (gain) loss from liability sources	(0.01%)	
f. Impact of City contributing less than actual cost of plan[1]	5.08%)	
g. Effect of Payroll growing faster than Payroll Growth Rate	(1.16%)	
h. Effect of resetting amortization period to 30 years	(0.24%)	
i. Total Change		(5.33%)
3. Calculated Rate as of July 1, 2004		24.10%

[1] Reflects impact of $300 million note issued by City to HMEPS

CALCULATION OF ANNUAL REQUIRED CONTRIBUTION RATE

	July 1, 2005 (1)	July 1, 2004 (2)
1. Covered payroll[1]	$ 404,565	$ 366,190
2. Covered payroll adjusted for one-year's pay increase	$ 419,542	$ 379,095
3. Present value of future pay	$ 2,675,293	$ 2,453,402
4. Normal cost rate		
a. Total normal cost rate	12.45%	12.32%
b. Less: member contribution rate (weighted)	(3.98%)	(3.79%)
c. Employer normal cost rate	8.47%	8.53%
5. Actuarial accrued liability for active members		
a. Present value of future benefits for active members	1,484,211	$ 1,586,995
b. Less: present value of future normal costs	(323,625)	(292,750)
c. Service Purchase Receivable[2]	(12,659)	(15,584)
d. Actuarial accrued liability	$ 1,147,927	$ 1,278,661
6. Total actuarial accrued liability for:		
a. Retirees and beneficiaries	$ 1,483,664	$ 1,267,118
b. Inactive participants	93,681	88,039
c. Active members (Item 5d)	1,147,927	1,278,661
d. Total	$ 2,725,272	$ 2,633,817
7. Actuarial value of assets	$ 1,777,656	$ 1,501,235
8. Unfunded actuarial accrued liability (UAAL) (Item 6d - Item 7)	$ 947,616	$ 1,132,582
9. Funding period	30 years	30 years
10. Assumed payroll growth rate	3.00%	3.00%
11. Employer Contribution requirement		
a. UAAL amortization payment as % of pay	15.63%	20.90%
b. Employer normal cost	8.47%	8.53%
c. Contribution requirement (a + b)	24.10%	29.43%

Note: Dollar amounts in $000

[1] Beginning with the 2005 valuation, a change in methodology now annualizes payroll for new entrants.

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

HISTORICAL SOLVENCY TEST

	Aggregated Accrued Liabilities for				by Reported Assets		
Valuation Date	Active Members Contributions	Retirees Beneficiaries and Vested Terminations[1]	Members (City Financed Portion)	Actuarial Value of Assets	(5)/(2)	[(5)-(2)]/(3)	[(5)-(2)-(3)]/(4)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
July 1, 1991	32,606	289,174	366,542	558,144	100.0%	100.0%	64%
July 1, 1992	32,850	317,849	414,600	608,524	100.0%	100.0%	62%
July 1, 1993	32,866	369,561	437,894	606,637	100.0%	100.0%	47%
July 1, 1994	32,410	384,100	470,189	713,696	100.0%	100.0%	63%
July 1, 1995	31,130	420,830	511,752	770,189	100.0%	100.0%	62%
July 1, 1996	45,819	438,486	558,154	857,332	100.0%	100.0%	67%
July 1, 1998	34,781	502,335	703,025	1,095,617	100.0%	100.0%	79%
July 1, 1999	33,985	599,270	706,678	1,222,240	100.0%	100.0%	83%
July 1, 2000	38,292	646,611	824,470	1,376,020	100.0%	100.0%	84%
July 1, 2001	36,449	804,901	1,114,456	1,490,179	100.0%	100.0%	58%
July 1, 2002	35,888	893,568	1,585,733	1,519,717	100.0%	100.0%	37%
July 1, 2003	44,388	1,115,801	2,118,063	1,510,264	100.0%	100.0%	17%
July 1, 2004	62,062	1,355,157	1,216,599	1,501,235	100.0%	100.0%	7%
July 1, 2005	48,150	1,577,345	1,099,777	1,777,656	100.0%	100.0%	14%

Note: Dollar amounts in $000

[1] Column (3) included AAL for DROP participants until 2003, now in Column (4)

SCHEDULE OF FUNDING PROGRESS

Date	Actuarial Value of Assets (AVA)	Actuarial Accrued Liability (AAL)	Unfunded Actuarial Accrued Liability (UAAL) (3) - (2)	Funded Ratio (2)/(3)	Annual Payroll	UAAL as % of Payroll (4)/(6)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
July 1, 1992	$ 608,524	765,299	$ 156,775	79.5%	$ 314,686	49.8%
July 1, 1993	660,637	840,321	179,684	78.6%	340,249	52.8%
July 1, 1994	713,696	886,699	173,003	80.5%	366,561	47.2%
July 1, 1995	770,189	963,712	193,523	79.9%	378,511	51.1%
July 1, 1996	857,332	1,042,459	185,127	82.2%	367,610	50.4%
July 1, 1998	1,095,617	1,240,141	144,524	88.3%	397,698	36.3%
July 1, 1999	1,222,240	1,339,933	117,693	91.2%	407,733	28.9%
July 1, 2000	1,376,020	1,509,373	133,353	91.2%	432,604	30.8%
July 1, 2001	1,490,179	1,955,806	465,627	76.2%	418,234	111.3%
July 1, 2002	1,519,717	2,515,189	995,472	60.4%	399,794	249.0%
July 1, 2003	1,510,264	3,278,251	1,767,987	46.1%	390,314	453.0%
July 1, 2004	1,501,235	2,633,817	1,132,582	57.0%	366,190	309.3%
July 1, 2005	1,777,656	2,725,272	947,616	65.2%	404,565	234.2%

Note: Dollar amounts in $000

HISTORICAL CITY CONTRIBUTIONS

Valuation Date	Calculated Contribution Rate[1]	Time Period for Contribution	Actual Contribution Rate
(1)	(2)	(3)	(4)
July 1, 1987	5.83%	January 1, 1988 through December 31, 1988	5.15%
July 1, 1988	6.27	January 1, 1989 through December 31, 1989	5.15
July 1, 1989	6.88	January 1, 1990 through December 31, 1990	6.27
July 1, 1990	6.23	January 1, 1991 through December 31, 1991	6.27
July 1, 1991	8.77	January 1, 1992 through June 30, 1993	6.27
July 1, 1992	9.11	July 1, 1993 through June 30, 1994	9.11
July 1, 1993	9.30	July 1, 1994 through June 30, 1995	9.30
July 1, 1994	8.80	July 1, 1995 through June 30, 1996	8.80
July 1, 1995	9.20	July 1, 1996 through June 30, 1997	9.20
July 1, 1996	9.10	July 1, 1997 through June 30, 1998	9.10
		July 1, 1998 through June 30, 1999	9.10
July 1, 1998	9.30	July 1, 1999 through June 30, 2000	9.30
July 1, 1999	9.80	July 1, 2000 through June 30, 2001	10.00
July 1, 2000	9.50	July 1, 2001 through June 30, 2002	10.00
July 1, 2001	17.70	July 1, 2002 through June 30, 2003	10.00
July 1, 2002	31.80	July 1, 2003 through June 30, 2004	14.70
July 1, 2003	52.89	July 1, 2004 through June 30, 2005	92.55[2]
July 1, 2004	29.43	July 1, 2005 through June 30, 2006	N/A
July 1, 2005	24.10	July 1, 2006 through June 30, 2007	N/A

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

2 Includes $300 million note.

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

Attained Age	0 No. & Avg. Comp.	1 No. & Avg. Comp.	2 No. & Avg. Comp.	3 No. & Avg. Comp.	4 No. & Avg. Comp.	5-9 No. & Avg. Comp.	10-14 No. & Avg. Comp.	15-19 No. & Avg. Comp.	20-24 No. & Avg. Comp.	25-29 No. & Avg. Comp.	30-34 No. & Avg. Comp.	35 & Over No. & Avg. Comp.	Total No. & Avg. Comp.
Under 25	212	57	36	26	18	2							351
	$22,578	$20,837	$21,756	$22,633	$21,354	$21,169							$22,144
25-29	263	153	83	62	57	55							673
	$26,595	$26,233	$27,894	$25,318	$26,115	$26,378							$26,497
30-34	232	131	82	83	76	138	36						778
	$28,599	$27,815	$29,039	$30,887	$28,504	$29,770	$31,350						$29,083
35-39	229	122	70	79	87	188	142	43	1				961
	$30,947	$28,137	$30,317	$34,075	$29,940	$33,889	$34,825	$33,652	$29,123				$31,978
40-44	203	123	91	83	100	250	208	163	121	5			1,347
	$30,596	$32,190	$29,919	$33,138	$27,978	$32,994	$37,540	$36,503	$34,904	$38,954			$33,308
45-49	164	127	87	70	108	237	269	192	236	106	1		1,597
	$33,663	$33,517	$33,895	$32,338	$28,927	$36,328	$40,154	$40,067	$39,409	$38,659	$40,362		$36,729
50-54	142	97	79	46	63	242	238	213	147	86	29		1,382
	$33,886	$32,959	$38,308	$38,188	$33,647	$37,446	$40,753	$42,276	$42,781	$46,070	$44,433		$39,231
55-59	97	69	51	29	72	192	192	124	113	61	22	6	1,028
	$35,733	$38,268	$34,549	$33,595	$31,296	$37,879	$43,208	$45,205	$45,435	$45,212	$46,737	$76,032	$40,512
60-64	36	27	28	26	32	98	126	62	48	17	12	4	516
	$41,007	$32,303	$39,767	$34,655	$37,329	$37,938	$37,638	$45,510	$41,119	$48,342	$50,908	$35,654	$39,512
65 & Over	9	10	6	7	10	42	39	15	8	4	4	5	159
	$27,227	$37,966	$31,682	$33,575	$45,115	$36,545	$44,934	$42,725	$43,726	$42,719	$41,793	$51,727	$40,098
Total	1,606	916	613	511	623	1,444	1,250	812	674	279	68	15	8,811
	$29,664	$30,113	$31,591	$31,888	$29,831	$34,916	$39,339	$40,841	$40,504	$43,029	$46,106	$57,163	$34,675

Average:	Age:	44.42	Number of participants:	Fully vested:	4,542	Males:	5,005
	Service:	8.34		Not Vested:	4,269	Females:	3,806

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

Attained Age	0 No. & Avg. Comp.	1 No. & Avg. Comp.	2 No. & Avg. Comp.	3 No. & Avg. Comp.	4 No. & Avg. Comp.	5-9 No. & Avg. Comp.	10-14 No. & Avg. Comp.	15-19 No. & Avg. Comp.	20-24 No. & Avg. Comp.	25-29 No. & Avg. Comp.	30-34 No. & Avg. Comp.	35 & Over No. & Avg. Comp.	Total No. & Avg. Comp.
Under 25													
25-29						76	2						78
						$25,645	$32,038						$25,809
30-34						184	60	2					246
						$26,763	$27,720	$35,559					$27,068
35-39						213	224	73	6				516
						$28,344	$30,121	$28,391	$25,601				$29,090
40-44						165	228	147	74	4			618
						$29,577	$32,369	$30,711	$30,003	$32,876			$30,949
45-49						162	225	128	85	22			622
						$30,978	$31,665	$33,798	$31,833	$31,801			$31,953
50-54						128	185	128	57	25	5		528
						$30,461	$32,091	$34,493	$34,301	$34,523	$32,806		$32,639
55-59						80	132	64	46	9	1		332
						$31,967	$34,451	$35,480	$36,625	$40,156	$56,687		$34,573
60-64						37	65	33	25	5	1	1	167
						$29,413	$34,241	$36,432	$36,184	$51,281	$66,174	$23,346	$34,531
65 & Over						9	23	15	8	1			56
						$31,690	$29,069	$34,845	$45,174	$45,224			$33,627
Total						1,054	1,144	590	301	66	7	1	3,163
						$29,069	$31,781	$32,873	$33,174	$35,716	$40,984	$23,346	$31,314

Average:	Age:	45.78	Number of participants:	Fully vested:	3,163	Males:	1,597
	Service:	12.92		Not Vested:	0	Females:	1,566

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

Attained Age	0 No. & Avg. Comp.	1 No. & Avg. Comp.	2 No. & Avg. Comp.	3 No. & Avg. Comp.	4 No. & Avg. Comp.	5-9 No. & Avg. Comp.	10-14 No. & Avg. Comp.	15-19 No. & Avg. Comp.	20-24 No. & Avg. Comp.	25-29 No. & Avg. Comp.	30-34 No. & Avg. Comp.	35 & Over No. & Avg. Comp.	Total No. & Avg. Comp.
Under 25	212	57	36	26	18	2							351
	$22,578	$20,837	$21,756	$22,633	$21,354	$21,169							$22,144
25-29	263	153	83	62	57	131	2						751
	$26,595	$26,233	$27,894	$25,318	$26,115	$25,953	$32,038						$26,426
30-34	232	131	82	83	76	322	96	2					1,024
	$28,599	$27,815	$29,039	$30,887	$28,504	$28,052	$29,081	$35,559					$28,599
35-39	229	122	70	79	87	401	366	116	7				1,477
	$30,947	$28,137	$30,317	$34,075	$29,940	$30,944	$31,946	$30,341	$26,104				$30,969
40-44	203	123	91	83	100	415	436	310	195	9			1,965
	$30,596	$32,190	$29,919	$33,138	$27,978	$31,636	$34,836	$33,756	$33,044	$36,253			$32,566
45-49	164	127	87	70	108	399	494	320	321	128	1		2,219
	$33,663	$33,517	$33,895	$32,338	$28,927	$34,156	$36,288	$37,559	$37,403	$37,480	$40,362		$35,391
50-54	142	97	79	46	63	370	423	341	204	111	34		1,910
	$33,886	$32,959	$38,308	$38,188	$33,647	$35,030	$36,965	$39,354	$40,412	$43,469	$42,723		$37,409
55-59	97	69	51	29	72	272	324	188	159	70	23	6	1,360
	$35,733	$38,268	$34,549	$33,595	$31,296	$36,140	$39,640	$41,895	$42,886	$44,562	$47,170	$76,032	$39,063
60-64	36	27	28	26	32	135	191	95	73	22	13	5	683
	$41,007	$32,303	$39,767	$34,655	$37,329	$35,602	$36,482	$42,357	$39,429	$49,010	$52,082	$33,193	$38,295
65 & Over	9	10	6	7	10	51	62	30	16	5	4	5	215
	$27,227	$37,966	$31,682	$33,575	$45,115	$35,688	$39,049	$38,785	$44,450	$43,220	$41,793	$51,727	$38,413
Total	1,606	916	613	511	623	2,498	2,394	1,402	975	345	75	16	11,974
	$29,664	$30,113	$31,591	$31,888	$29,831	$32,449	$35,727	$37,488	$38,241	$41,630	$45,628	$55,050	$33,787

Average:	Age:	44.78	Number of participants:	Fully vested:	7,705	Males:	6,602
	Service:	9.55		Not Vested:	4,269	Females:	5,372

HISTORICAL ACTIVE PARTICIPANT DATA

Valuation Date	Active Count	Average Age	Average Service	Covered Payroll	Average Salary	Percent Changes
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1988	11,344	N/A	N/A	$ 227,900	$ 20,090	1.9%
1989	11,356	N/A	N/A	$ 235,400	$ 20,729	3.2%
1990	12,037	40.0	N/A	$ 258,556	$ 21,480	3.6%
1991	12,488	40.3	N/A	$ 284,914	$ 22,815	6.2%
1992	12,913	40.5	N/A	$ 314,686	$ 24,370	6.8%
1993	13,112	40.9	N/A	$ 340,249	$ 25,949	6.5%
1994	14,027	40.9	N/A	$ 366,561	$ 26,133	0.7%
1995	14,364	41.3	N/A	$ 378,511	$ 26,351	0.8%
1996	14,067	41.8	N/A	$ 367,610	$ 26,133	(0.8%)
1998 [1]	13,764	42.8	9.8	$ 394,919	$ 28,692	9.8%
1999 [1]	13,286	42.9	9.8	$ 396,617	$ 29,852	4.0%
2000 [1]	13,126	43.7	10.3	$ 421,591	$ 32,119	7.6%
2001 [1]	12,928	43.9	10.3	$ 413,021	$ 31,948	(0.5%)
2002	12,527	44.7	11.0	$ 399,794	$ 31,915	(0.1%)
2003	12,120	45.2	11.2	$ 390,314	$ 32,204	0.9%
2004	11,856	45.1	10.3	$ 366,190	$ 30,886	(4.1%)
2005	11,974	44.8	9.6	$ 404,565[2]	$ 33,787[2]	9.4%

Note: Dollar amounts in $000

[1] Excludes DROP participants

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

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

	Added to Rolls		Removed from Rolls		Rolls-End of Year			
Valuation July 1,	Number	Annual Allowances	Number	Annual Allowances	Number	Annual Allowances	% Increase in Annual Allowances	Average Annual Allowances
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1994	306	$ 2,474	227	$ 1,593	4,268	$ 33,971	4.8%	$ 7,959
1995	393	3,044	220	1,307	4,441	36,482	7.4%	8,215
1996	416	3,119	239	1,438	4,618	38,815	6.4%	8,405
1998	693	5,840	441	3,212	4,870	43,394	11.8%	8,910
1999	432	2,131	303	1,515	4,999	46,732	7.7%	9,348
2000	360	3,412	255	1,380	5,104	49,970	6.9%	9,790
2001	652	8,937	299	1,030	5,457	57,877	15.8%	10,606
2002	777	15,061	306	2,476	5,928	72,256	24.8%	12,189
2003	598	11,497	311	1,873	6,215	84,519	17.0%	13,599
2004	942	25,189	279	2,624	6,878	107,084	26.7%	15,569
2005	861	18,054	216	1,926	7,523	123,212	15.1%	16,378

Note: Dollar amounts in $000

MEMBERSHIP DATA

	July 1, 2005 (1)
1. Active members	
a. Number	11,974
b. Number vested	7,705
c. Total payroll supplied by HMEPS[1]	$ 404,565,000
d. Average salary[1]	33,787
e. Average age	44.8
f. Average service	9.6
2. Inactive members (counts)	
a. Vested	2,659
b. NonVested	1,234
3. Service retirees	
a. Number	5,592
b. Total annual benefits	$ 108,217,394
c. Average annual benefit	19,352
d. Average age	65.9
4. Disabled retirees	
a. Number	483
b. Total annual benefits	$ 3,761,785
c. Average annual benefit	7,788
d. Average age	60.8
5. Beneficiaries and spouses	
a. Number	1,448
b. Total annual benefits	$ 11,232,425
c. Average annual benefit	7,757
d. Average age	68.3

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

ESTIMATION OF DOLLAR-WEIGHTED INVESTMENT RETURN

Item	Market Value[1]	Actuarial Value
(1)	(2)	(3)
1. Assets as of July 1, 2004 (A)	$ 1,418,725	$ 1,501,235
2. Contributions during FY05	386,735	386,735
3. Benefit payments made during FY05	175,480	175,480
4. Refunds of contributions during FY05	992	992
5. Expenses during FY05	5,806	5,806
6. Investment return during FY05	201,670	71,964
7. Assets as of July 1, 2005 (B): (1 + 2 - 3 - 4 - 5 + 6)	1,824,852	1,777,656
8. Approximate rate of return on average invested assets		
a. Net investment income (6 - 5 = I)	195,864	66,158
b. Estimated return based on (2I/(A + B - I))	12.85%	4.12%

Note: Dollar amounts in $000

[1] The time-weighted return reported in the Comprehensive Annual Financial Report for fiscal year 2005 was 13.85%.

INVESTMENT EXPERIENCE GAIN OR LOSS

Item	Valuation as of July 1, 2005	Valuation as of July 1, 2004
(1)	(2)	(3)
1. Actuarial assets, prior valuation	$ 1,501,235	$ 1,510,264
2. Total contributions since prior valuation	$ 386,735	$ 83,497
3. Benefits and refunds since prior valuation	$ (176,472)	$ (153,837)
4. Assumed net investment income at 8.5%		
a. Beginning assets	$ 127,605	$ 128,372
b. Contributions	16,101	3,476
c. Benefits and refunds paid	(7,347)	(6,405)
d. Total	$ 136,359	$ 125,443
5. Expected actuarial assets (Sum of Items 1 through 4)	$ 1,847,857	$ 1,565,367
6. Actual actuarial assets, this valuation	$ 1,777,656	$ 1,501,235
7. Asset gain (loss) since prior valuation (Item 6 - Item 5)	$ (70,201)	$ (64,132)

Note: Dollar amounts in $000

HISTORY OF INVESTMENT RETURNS

For Fiscal Year Ending	Market Value[1]	Actuarial Value
(1)	(2)	(3)
June 30, 2000	22.10%	13.00%
June 30, 2001	(4.56%)	8.97%
June 30, 2002	(7.99%)	3.64%
June 30, 2003	2.34%	1.69%
June 30, 2004	18.10%	4.16%
June 30, 2005	12.85%	4.12%

[1] Dollar-weighted return

Summary of Actuarial Assumptions and Methods

The following methods and assumptions were used in preparing the July 1, 2005, actuarial valuation. These assumptions were adopted by the Board effective for the July 1, 2004 valuation.

1. Valuation Date

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

2. Actuarial Cost Method

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

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

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

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

d. The unfunded accrued liability contributions are determined by subtracting the actuarial value of assets from the actuarial accrued liability and amortizing the result over 30 years from the valuation date.

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

3. Actuarial Value of Assets

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

4. Economic Assumptions

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

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

Years of Service (1)	Service-related Component (2)	Total Annual Rate of Increase Including 3.00% Inflation Component and 0.0% General Increase Rate (3)
0	2.50%	5.50%
1	2.00	5.00
2	1.75	4.75
3	1.25	4.25
4	1.00	4.00
5	1.00	4.00
6	1.00	4.00
7	1.00	4.00
8	0.50	3.50
9	0.50	3.50
10 or more	0.00	3.00

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

5. Demographic Assumptions

a. Retirement Rates

	Expected Retirements per 100 Lives	
Age	Males	Females
(1)	(2)	(3)
50	20	13
51-54	14	13
55	14	15
56	14	15
57	14	15
58	14	15
59	14	15
60	16	16
61	16	18
62	30	30
63	30	25
64	22	25
65	28	25
66-69	22	19
70	100	100

b. DROP Participation

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

c. DROP Entry Date

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

d. DROP Interest Credit

4.25% per year

e. Mortality rates (for active and retired members)

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

Sample rates are shown below:

Expected Deaths per 100 Lives

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

f. Termination Rates and Disability Rates

Termination rates (for causes other than death, disability or retirement):

Termination rates are a function of the member's age and service. Termination rates are not applied after a member becomes eligible for a retirement benefit. Rates at selected ages are shown below.

Probability of Decrement Due to Withdrawal – Male Members

Years of Service

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

Probability of Decrement Due to Withdrawal – Female Members

Years of Service

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

Rates of Decrement Due to Disability

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

Rates of disability are reduced to zero once a member becomes eligible for retirement.

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

6. Other Assumptions

a. Percent married: 70% of employees are assumed to be married. (No beneficiaries other than the spouse assumed)

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

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

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

e. There will be no recoveries once disabled.

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

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

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

7. Participant Data

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

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

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

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

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

8. Group Transfers

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

All Group B members who are assumed to transfer to Group A and all current Group A members with convertible Group B service are assumed not to convert their Group B service to Group A service. The conversion price is determined on an actuarially equivalent basis and therefore it should be non-material to HMEPS.

Summary of Plan Provisions

1. Covered Members

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

Persons who became employees of the City of Houston after September 1, 1981 and prior to September 1, 1999, and elected officials of the City of Houston who assumed office after September 1, 1981 and prior to September 1, 1999, participate in Group B, but may make an irrevocable election to participate in Group A instead.

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

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

2. Monthly Final Average Salary (FAS)

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

3. Credited Service

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

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

4. Normal Retirement

a. Eligibility

Prior to January 1, 2005 (with 68 points as of January 1, 2005):

The earliest of:

age 62 and 5 years of Credited Service5 years of Credited Service and age plus years of Credited Service equal 70 or moreage 65 (Group C only)

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

The earliest of:

age 62 and 5 years of Credited Service5 years of Credited Service and age plus years of Credited Service equal 75 or more with minimum age 50

b. Benefit

Prior to August 1, 2000:

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

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

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

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

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

Group C: Double the rate for Group A

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

Group A: 3.25% of FAS for each of the first 10 years of Credited Service plus 3.50% for Credited Service greater than 10 years but less than 20 years plus 4.25% for FAS for each year of Credited Service greater than 20 years (excludes current DROP participants). Maximum benefit is 90% of FAS for all future retirees.

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

Group C: Double the rate for Group A

All accruals after January 1, 2005:

All accruals under the prior multipliers were frozen as of January 1, 2005 and the following benefit multipliers will apply to service after that date:

Group A: 2.50% of FAS for each of the first 20 years of Credited Service plus 3.25% of FAS for each year Credited Service greater than 20 years. Maximum benefit is 90% of FAS for all future retirees.

Group B: 1.75% of FAS for each of the first 10 years of Credited Service plus 2.00% of FAS for each year of Credited Service from 10 through 20, and 2.50% of FAS for each year of Credited Service over 20. Maximum benefit is 90% of FAS for all future retirees.

5. Vested Pension

a. Eligibility — 5 years of Credited Service.

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

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

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

6. Withdrawal Benefit

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

7. Service-Connected Disability Retirement

a. Eligibility — Any age

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

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

8. Nonservice-Connected Disability Retirement

a. Eligibility — 5 years of Credited Service.

b. Benefit — Accrued normal retirement benefit payable immediately.

9. Pre-retirement Survivor Benefits

A. Service-connected

a. Eligibility — Any age or Credited Service

b. Benefit — Prior to September 1, 1999:

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

On or after September 1, 1999:

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

B. Non service-connected

a. Eligibility — 5 years of Credited Service

b. Benefit — Prior to September 1, 1999:

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

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

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

50% of the benefit a surviving spouse would have received for each dependent subject to 100% of a surviving spouse's benefit for all dependents in the aggregate.

On or after August 1, 2001:

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

10. Postretirement Survivor Benefits

Prior to September 1, 1999:

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

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

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

On or after August 1, 2001:

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

11. Benefit Adjustments

Prior to May 11, 2001:

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

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

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

On or after January 1, 2005:

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

12. Contribution Rates

a. Members — 5% of salary only for the Group A members. None for the Group B members.

b. City — Beginning in 1993, the rate required to fund the Retirement Fund on an actuarial reserve basis. However, effective September 1, 1999, the minimum contribution rate is equal to the greater of 10% of covered payroll or twice the contribution rate a Group A member is required to make by statute. As negotiated in the meet and confer agreement, the city contributions will be $69 million for FY2006 and $72 million for FY2007.

13. Deferred Retirement Option

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

b. Monthly DROP Credit

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

c. Other DROP Credits

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

d. Monthly DROP Credit

Prior to May 11, 2001:

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

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

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

On or after January 1, 2005:

The Monthly DROP Credit for participants who entered the DROP effective on or before January 1 of the then current year will be increased effective February 1 each year by 3.0%, not compounded.

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

e. DROP Account Balance

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

14. DROP Benefit Pay-out

A terminated DROP participant may elect to:

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

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

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

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

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

15. Post DROP Retirement

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

Changes in Plan Provisions Since Prior Year

Several changes to the benefit provisions became effective during the year, however, these changes were reflected in the prior valuation. Please see the Benefit Provisions subsection of the Discussion section of the prior year's report.

STATISTICAL SECTION

SCHEDULE OF AVERAGE BENEFIT PAYMENT AMOUNTS FOR THE TEN YEARS ENDED JUNE 30, 2005

SCHEDULE OF BENEFITS BY TYPE ($000) FOR THE TEN YEARS ENDED JUNE 30, 2005

SCHEDULE OF ANNUITANTS BY TYPE

HISTORICAL ACTIVE PARTICIPANT DATA

SCHEDULE OF CHANGES IN PLAN NET ASSETS ($000) FOR THE TEN YEARS ENDED JUNE 30, 2005

SCHEDULE OF AVERAGE BENEFIT PAYMENT AMOUNTS FOR THE TEN YEARS ENDED JUNE 30, 2005

Year Ended	Number Receiving Benefits	Benefits Paid ($000)	Average Annual Benefit
June 30, 1996	4,618	38,815	8,406
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
June 30, 2003	6,215	84,519	13,599
June 30, 2004	6,878	107,083	15,569
June 30, 2005	7,523	123,211	16,378

*SCHEDULE OF BENEFITS BY TYPE ($000) FOR THE TEN YEARS ENDED JUNE 30, 2005**

Fiscal Year Ended	Normal Retirement Benefits	Disability Retirement Benefits	Survivors' Benefits	Total Benefits
June 30, 1996	31,511	2,777	4,527	38,815
June 30, 1998	34,792	3,062	5,540	43,394
June 30, 1999	37,370	3,320	6,061	46,751
June 30, 2000	39,836	3,490	6,816	50,142
June 30, 2001	46,867	3,555	7,455	57,877
June 30, 2002	59,746	3,638	8,872	72,256
June 30, 2003	71,246	3,715	9,558	84,519
June 30, 2004	92,766	3,832	10,485	107,083
June 30, 2005	108,217	3,762	11,232	123,211

* There was no actuarial valuation done in FY1997.

SCHEDULE OF ANNUITANTS BY TYPE

	June 30, 2005			June 30, 2004		
Schedule of Annuitants by Type	Number	Benefits ($000)	Average Benefit	Number	Benefits ($000)	Average Benefit
Retirees receiving benefits	5,592	108,217	19,352	4,952	92,766	18,733
Retired on disability	483	3,762	7,788	495	3,832	7,742
Survivors and beneficiaries	1,448	11,232	7,757	1,431	10,485	7,327
Total retirees, survivors and beneficiaries	7,523	123,211	16,378	6,878	107,083	15,569
Former participants eligible but not yet receiving benefits	2,659	14,228	5,351	2,434	12,071	4,959
Total Eligible for Benefits	10,182	137,439	13,500	9,312	119,154	12,796

HISTORICAL ACTIVE PARTICIPANT DATA

Valuation Date	Number of Participants	Annual Payroll $(000)	Average Salary ($)	% Salary Increase
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[1]	13,764	394,919	28,692	9.8
July 1, 1999[1]	13,286	396,617	29,852	4.0
July 1, 2000[1]	13,126	421,591	32,119	7.6
July 1, 2001[1]	12,928	413,021	31,948	(0.5)
July 1, 2002	12,527	399,794	31,915	(0.1)
July 1, 2003	12,120	390,314	32,204	0.9
July 1, 2004	11,856	366,190	30,886	(4.1)
July 1, 2005	11,974	404,565[2]	33,787[2]	9.4

[1] Does not include DROP participants

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

SCHEDULE OF CHANGES IN PLAN NET ASSETS ($000) FOR THE TEN YEARS ENDED JUNE 30, 2006

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Additions										
Employer contributions	66,968	363,247*	57,308	40,622	40,758	41,298	38,306			
Member contributions	21,888	23,488	26,189	23,762	13,476	8,532	7,341			
Investment Income	272,766	184,419	227,361	33,931	(108,024)	(65,147)	270,991			
Other Income	26,950	17,250	726	114	286	643	407			
Total additions to plan net assets	388,572	588,404	311,584	98,429	(53,504)	(14,674)	317,045	0	0	0
Deductions										
Benefit payments	154,311	175,480	153,202	98,789	78,318	58,296	50,142			
Refund of contributions	1,037	992	635	475	270	308	337			
Professional service fees	708	1,088	712	366	396	324	263			
Cost of administration	5,072	4,718	4,500	4,299	3,662	2,367	2,143			
Total deductions from plan net assets	161,128	182,278	159,049	103,929	82,646	61,295	52,885	0	0	0
Change in net assets	227,444	406,126	152,535	(-5,500)	(136,150)	(75,969)	264,160	0	0	0

* Includes $300 million pension obligation note.

Acknowledgement

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