HPOPS
FOR TODAY & TOMORROW

Comprehensive Annual

Financial Report

A Component Unit of

The City of Houston, Texas

July 1, 2004 through

June 30, 2005

HOUSTON POLICE OFFICERS' PENSION SYSTEM
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SECTION ONE

INTRODUCTORY SECTION

HPOPS

FOR TODAY & TOMORROW

December 6, 2005

The Membership
Houston Police Officers' Pension System
Houston, Texas

The Comprehensive Annual Financial Report (CAFR) of the Houston Police Officers' Pension System (the System) for the fiscal year ended June 30, 2005 is submitted herewith. Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, rests with the management of the System. This CAFR is divided into five sections:

- Introductory Section – This section contains the administrative organization, the letter of transmittal and Chairman's report.
- Financial Section – This section contains the report of the Independent Auditor, Management's Discussion and Analysis, the financial statements of the System and certain required supplementary information.
- Investment Section – This section contains a report on investment activity, investment policies, investment results, and various investment schedules.
- Actuarial Section – This section contains the Actuary's Certification Letter and the results of the annual actuarial valuation.
- Statistical Section – This section includes significant data pertaining to the System.

We trust that you will find this CAFR helpful in understanding your retirement system, a system that strives to provide responsible stewardship of assets contributed by the members and the City of Houston.

The System was established in 1947, funded by a $100,000 Treasury note, and offered retiring members a pension of $75 per month. Today, the System has investments of $2.6 billion and offers a variety of pension benefits to members and their beneficiaries. Members have the option to defer their benefits, take a proportionate retirement benefit, or retire under a regular service retirement. Members also may access a disability retirement, either duty or non-duty connected.

Major Initiatives

During the past year, the System completed negotiations with the City regarding pension benefits, and on September 29, 2004, the System and the City entered into an agreement (the New Agreement) that altered the benefit structure of the System and the statutorily required contributions due from the City to the System. The Agreement was designed to protect members' benefits while controlling costs for the City, thus seeking to ensure benefits will be secure now and in the future.

The City adopted a budget for the City of Houston for fiscal year 2005 that failed to appropriate the statutorily mandated 16% of the member's total direct pay, prompting the System to file suit on June 30, 2004. The suit sought to compel the City to adhere to the statutory funding requirements in an agreement with the City dated May 1, 2001, which was subsequently codified in the Governing Statute effective September 1, 2003. The New Agreement the System negotiated with the City addressed this funding issue and the System agreed to nonsuit its lawsuit against the City without prejudice, however, the System has the right to reinstate the lawsuit if the City does not meet its payment obligations under the New Agreement.

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On September 29, 2004 the System and the City entered into the New Agreement altering the benefit structure of the System. The contract has a term beginning on October 9, 2004 extending through June 30, 2017 and thereafter renews for one-year terms through June 30, 2034 unless either party terminates the agreement. The benefits described below include those for members on or before October 9, 2004 as well as benefits for members hired or rehired subsequent to October 9, 2004.

Active members as of October 9, 2004		**Members hired or rehired subsequent to October 9, 2004**
• Monthly DROP and retirement benefits are based on a three-year average of pensionable pay (as re-defined in the New Agreement) subject to certain "grandfather" provisions.		• Monthly retirement benefits are based on a three-year average of pensionable pay (as defined in the New Agreement).
• Increased Employee contribution rate to 9.0%.		• Benefit accrual rate of 2.25% per year of service for the first 20 years of service and 2.0% per year thereafter with a maximum rate of 80%.
• Changed annual cost of living adjustments to equal 80% of CPI with a minimum of 2.4% and a maximum of 8.0%.		• Employee contribution rate of 10.25%.
• The DROP and PROP interest credit will have a floor of 3.0% and a maximum of 7.0%. If the System has a 100% funded ratio then the maximum rate will be 10%.		• Minimum retirement eligibility requirement of age 55 and 10 years of service.
• Supplemental monthly benefit (13th benefit payment) will not be paid unless the System's funded ratio equals or exceeds 120%.		• No DROP benefit.
		• No Supplemental monthly benefit (13th benefit payment).
		• No $5,000 lump sum retirement benefit.
		• No additional disability benefit (education benefit).
		• Partial lump sum option (PLOP).

The investment market is constantly changing, therefore as a part of our on-going due diligence, we periodically take time to reassess our investment strategy to determine the appropriate asset mix, based on productivity and degree of risk. In August 2005, as the result of a nearly year long review, the Board approved a plan to restructure the System's asset allocation to reflect changes in the investment market, so that when our members are eligible for retirement benefits, the funds we have invested will be available to pay those benefits. Further discussion of this restructuring plan can be found in the Investment Section.

The System has continued to place communication with its members as a high priority. The financial planning department has conducted ongoing educational seminars to better prepare members for retirement. In addition, the financial planning department has met with and counseled 490 members and answered over 800 phone calls during the year. Over 300 members attended the System's annual retiree seminar, which hosted speakers who delivered presentation topics ranging from health benefits offered through the City of Houston, benefits accessible through the Social Security Administration as well as providing an opportunity to speak one-on-one with HPOPS' Benefits staff.

Additions to Plan Net Assets

The System relies on the contributions of members and the City of Houston, as well as income generated from investments, to provide funds needed to finance retirement and disability benefits. The New Agreement provides for no increase in the City's contribution for fiscal year 2005 and then increases to 16.0% of member compensation but not less than $53 million for fiscal 2006. Contributions from members have increased in fiscal 2005 mainly due to the increase in the members' rate of pay and an increase in the contribution rate. The System experienced a positive investment return of 13.5% in 2005, which was a decrease from the positive return of 21.6% in 2004. This decrease is primarily due to a weakening in growth in the U.S. equity markets during the second half of the fiscal year. Concerns over increasing oil prices, the rate of economic growth and steady increases in interest rates have combined to hold back stocks for most of calendar 2005.

	$000's		Increase	Increase
	2005	2004	(Decrease)	(Decrease)
Member contributions	$ 28,410	$ 26,393	$ 2,017	8%
Employer contributions	37,125	36,645	480	1%
Net investment gain/(loss)	321,437	437,748	(116,311)	-27%
Total	$ 386,972	$ 500,786	$ (113,814)	-23%

Deductions from Plan Net Assets

The System was created to provide retirement benefits to retired Houston Police officers and their dependents. Although this is still the primary purpose of the System, over the course of nearly 60 years the System has also added survivor benefits and disability benefits. The cost of these programs includes benefit payments and refunds of contributions to terminated employees. The cost of administering the System is also paid from System assets.

	$000's		Increase	Increase
	2005	2004	(Decrease)	(Decrease)
Benefits paid to members	$ 153,861	$ 92,697	$ 61,164	66%
Refunds paid to members	1,198	852	346	41%
Administrative expenses	3,473	2,768	705	25%
Total	$ 158,532	$ 96,317	$ 62,215	65%

Total benefits paid, which include lump sum payments, increased in 2005 as compared to 2004 due mainly to a significant number of new retirees who continued to leave service to take advantage of the April 2004 pay raise which resulted in increased monthly benefits of 15 percent or more for many retiring members. In addition, there was a significant increase in distributions from DROP and PROP lump sum accounts by retiring and retired members due to concerns about the System's funded status. Administrative expenses increased due mainly to the costs for actuarial, legal and lobbying services associated with the litigation with the City of Houston.

Investments

The System invests funds entrusted to it exclusively for the benefit of its members. It avows an investment rule commonly known as the "prudent expert" rule, whereby from a procedural as well as substantive standpoint, it acts with the care, skill, prudence and diligence that a "prudent expert" acting in a similar capacity would act under similar circumstances.

	2005			2004		
		$000's	%		$000's	%
Short-term investments	$	168,342	6%	$	222,763	9%
Fixed income		507,309	19%		423,282	18%
Equity securities		1,692,822	65%		1,556,154	64%
Alternative investments		271,526	10%		217,644	9%
Foreign currency contracts		2,694	0%		1,253	0%
Total	$	2,642,693	100%	$	2,421,096	100%

The Board of Trustees believes that the System's assets should be managed in a way that reflects the uniqueness of the System, and that the System's assets should be diversified over a spectrum of investment vehicles. The determination of the appropriate asset mix is based on capital market assumptions that incorporate historical returns, volatility and the correlation of various asset classes.

The past year has seen the economy show strong growth, however, equity markets have not followed this pattern due to numerous issues including rising oil prices, interest rates and inflation concerns. The System's investment returns grew 10.1% during the first half of the fiscal year due mainly to a post-election rally. The second half of the year saw the Federal Reserve begin slowly raising interest rates, which along with other economic factors had a dampening effect on the public equity markets, limiting the System's second-half investment return to approximately 1.9%. Even in this uncertain environment, HPOPS was able to outperform the financial markets in most areas during our fiscal year. The Board firmly believes that by maintaining a disciplined investment approach and with reasonable diversification, the System will meet its long-term investment goals.

Accounting System and Internal Controls

The financial statements and related information included in the financial section of this report are the responsibility of the Board of Trustees and management of the System. The financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) and presented in accordance with guidance provided by applicable statements issued by the Governmental Accounting Standards Board (GASB). The GASB issued GASB Statement No. 40 in 2003 and the System has adopted the provisions of this statement. The System's independent auditors have audited the financial statements, and their report is included herein.

In developing and evaluating the System's accounting system, the adequacy of internal accounting controls is a primary concern. The System's controls are designed to provide reasonable assurance regarding the safekeeping of assets and the reliability of financial records. These controls include strategic design of the System's business and accounting systems, the appropriate segregation of duties and responsibilities, sound practices in the performance of those duties, capable personnel, and the structure of the organization.

Funding

It is the System's intention to have enough money in reserve to provide members with promised benefits upon their retirement. The System's actuary conducts an annual valuation to determine the adequacy of the current employer contribution rates, to describe the current financial condition of the System, and to analyze changes in the System's condition. An actuarial accrued liability is the liability for service already rendered by former and present employees. An actuarial accrued surplus is the surplus in excess of the System's assets over the actuarial accrued liability. Any liability or surplus is amortized using a 30-year constant level percent of payroll method.

The most recent actuarial valuation shows the funded position of the System at July 1, 2004 decreased from the funding level at July 1, 2003. The actuarial accrued liability increased $464 million and the actuarial value of assets increased $72 million. As a result, the System's Unfunded Actuarial Accrued Liability increased $393 million to $873 million as of July 1, 2004. The increase in the Unfunded Actuarial Accrued Liability is due to a combination of factors including actuarial losses from liability sources, the recognition of prior asset losses and the under funding of the System as more fully described in the footnotes and schedules to the financial statements. Assuming the benefit adjustments outlined in the New Agreement were effective July 1, 2004 the provisions of the New Agreement would have reduced the System's unfunded actuarial accrued liability from $874 million to $699 million.

Professional Services

The Board of Trustees appoints professional consultants to perform services that are considered essential for the operation of the System. The independent auditor's report, issued by BDO Seidman, LLP, is included on page 12 of this report. The actuarial report, certified by Towers Perrin, is included on page 54. Professional service providers engaged by the System are listed in the following table.

Consulting

Abbott Capital Management

Custodian

The Northern Trust Company

Actuarial

Segal Company
Towers Perrin

Auditing

BDO Seidman, LLP
Bickley Prescott & Co.

Legal Service

Gibbs & Bruns, LLP
Klausner & Kaufman
Lawson, Fields, & Calhoun

Money Management

American Express Asset Management
Arnhold & S. Bleichroeder
Barclays Global Investors
Brandes Investment Partners
Bridgewater Associates, Inc.
Causeway Capital Management
Credit Suisse Asset Management
Driehaus Capital Management, Inc.
FX Concepts/AIG
Gartmore Global Investments
MacKay-Shields Financial Corp.
NWQ Investment Management Company
Shenkman Capital Management, Inc.

Legal Service/Lobbyists

HillCo Partners, LLC
Locke Liddell Sapp

Certificate of Achievement

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Houston Police Officers' Pension System for its comprehensive annual financial report for the fiscal year ended June 30, 2004. 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, whose contents conform to program standards. Such a report must also satisfy both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The System has received a Certificate of Achievement for the last 11 consecutive years (fiscal years 1994-2004). We believe our current report continues to conform to the Certificate of Achievement program requirements, and we will be submitting it to the GFOA.

Acknowledgements

The compilation of this report reflects the combined effort of the System's staff under the guidance of the Board of Trustees. Its goal is to provide complete and reliable information as a basis for management decisions and compliance with legal provisions as well as responsible stewardship of funds contributed by its members and the City of Houston.

We would like to take this opportunity to express our gratitude to the staff, System advisors, and to the many other people who have contributed to the successful operation of the System.

Sincerely,

Board of Trustees

Board of Trustees

HPOPS

FOR TODAY & TOMORROW

December 6, 2005

To the Members
Houston Police Officers' Pension System
Houston, Texas

We are pleased to submit to you the Comprehensive Annual Financial Report (CAFR) for the Houston Police Officers' Pension System (HPOPS or the System) for the fiscal year ended June 30, 2005. This report provides a comprehensive picture of HPOPS' finances for the year fiscal year ending June 30, 2005, as well as an overview of the year's highlights.

As you will see in this report, we have had a very busy and productive year and we can be proud looking back at the year's accomplishments. A major accomplishment was achieved through the System's negotiation of a new agreement with the City that alters the benefit structure for all members and provides for an agreed-upon structure for the City to fund the System. By taking a long-term view in addressing funding and benefits, we have taken great strides to help ensure member benefits will be secure now and in the future. In addition, HPOPS has continued to responsibly manage the System's assets with a second consecutive fiscal year wherein we have been able to obtain a double-digit investment rate of return.

We at HPOPS continue to plan for the future of all of our current members as well as those members to come. On behalf of the Board of Trustees, I wish to express appreciation to the staff and professional consultants who work so effectively to ensure the continued successful operation of HPOPS.

Sincerely,

J. Larry Doss
Chairman

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BOARD OF TRUSTEES AND ADMINISTRATIVE STAFF

POLICE PENSION OFFICE PERSONNEL

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Executive Director

ERIC OLSON
Director of Administration

JUDY G. BAKER
Benefits Manager

PATRICK S. FRANEY
Chief Investment Officer

ROBERT ARTHUR
General Counsel

KEVIN T. O'TOOLE
Accounting Manager

BRIAN POER
IT Manager

STEPHEN SHALAGAN
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RAJ WAGLE
Investment Analyst

RICHARD GABLE
Financial Planner

AMY CROGHAN
Communications Director

TONI DEWILLIS
Administrative Assistant

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Accountant

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ANGELA LAMM
Benefits Assistant

AMELIA MILIAN
Benefits Assistant

CLARK OLINGER
Benefits Assistant

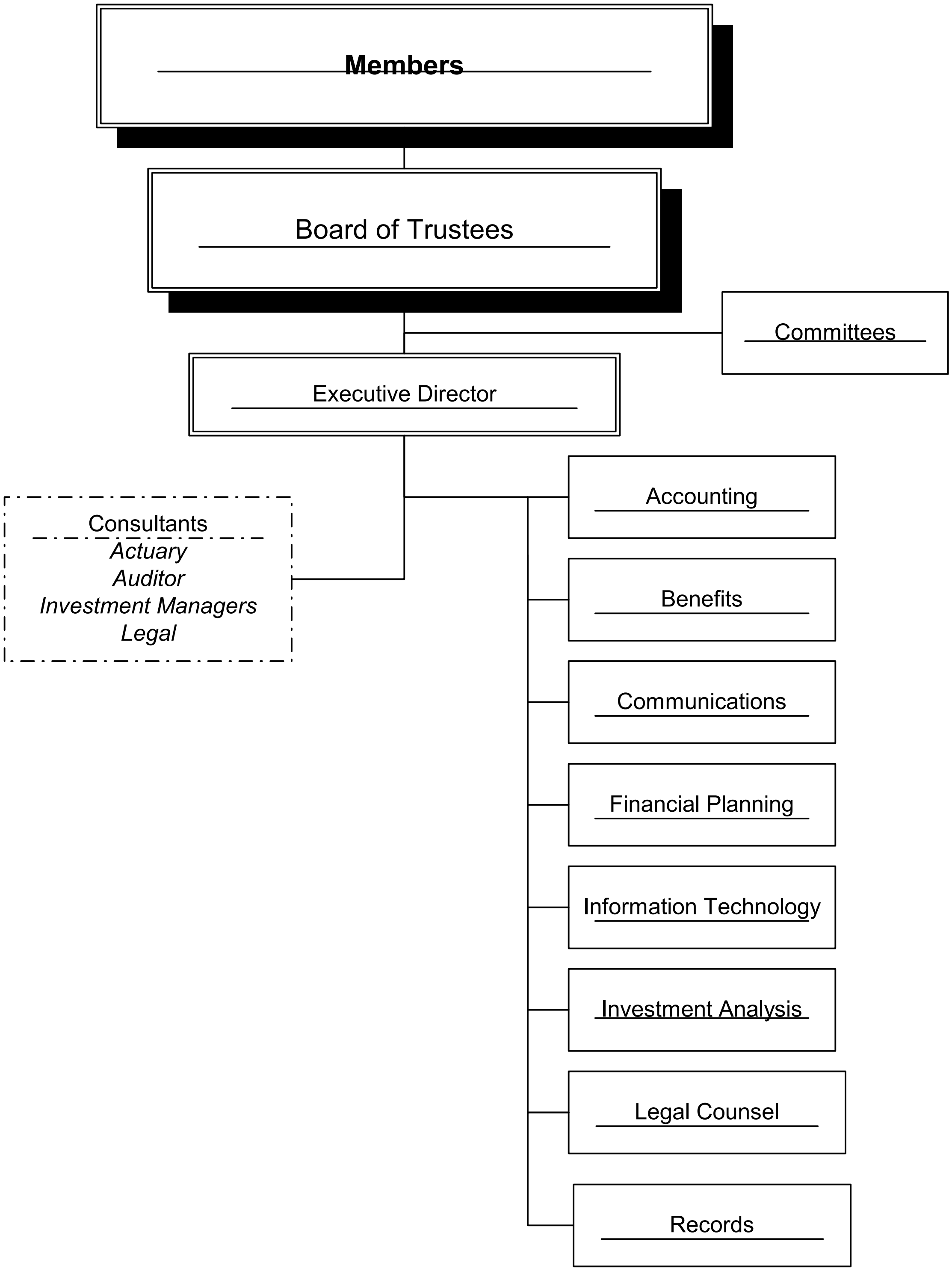
MELISSA SPENCE
Benefits Assistant

REGINA WARD
Benefits Assistant

ANGIE WILLIAMS
Receptionist

JENNIFER MONTES
Records

ORGANIZATION CHART



See Page 41 – Summary of Investment and Professional Services

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Police Officers Pension System of the City of Houston, Texas

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

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

GOVERNMENT FINANCE OFFICERS ASSOCIATION OF THE UNITED STATES AND CANADA CORPORATION SEAL CHICAGO

President

Executive Director

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SECTION TWO

FINANCIAL SECTION

BDO Seidman, LLP
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Independent Auditors' Report

The Board of Trustees
Houston Police Officers' Pension System
Houston, Texas

We have audited the accompanying statements of plan net assets of the Houston Police Officers' Pension System (the System) as of June 30, 2005 and 2004, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these 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 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 financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the System as of June 30, 2005 and 2004, and its changes in plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits of the basic financial statements were performed for the purposes of forming an opinion on those financial statements taken as a whole. The supplemental information included in Schedules I and II on pages 40 through 42, is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

"Management's Discussion and Analysis" and the "Required Supplementary Information" listed on the Table of Contents 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 supplementary information. However, we did not audit this information and express no opinion on it.

BDO Seidman, LLP

August 26, 2005, except for Note 7,
which is dated November 21, 2005.

Management's Discussion and Analysis
Fiscal Year Ended June 30, 2005

The discussion and analysis of the financial performance of the Houston Police Officers' Pension System (the System), provides an overall review of the System's financial activities for the fiscal years ended June 30, 2005, 2004 and 2003. The intent of this discussion and analysis is to look at the System's financial performance as a whole; readers should review the financial statements, notes to the financial statements, required supplementary information and other schedules, in order to enhance their understanding of the System's financial performance.

Financial Statements

These financial statements consist of the Statements of Plan Net Assets, Statements of Changes in Plan Net Assets, Notes to Financial Statements and other required supplementary information. The System is a single employer contributory defined benefit pension plan. The System is a component unit of the City of Houston, Texas (the City) only to the extent the System receives contributions equal to an amount or percentage of the pensionable pay of active members in accordance with Article 6243g-4, Vernon's Texas Civil Statutes, (the Governing Statute) or contracts pursuant to Section 27 thereof, and as such, its reports are included in the Fiduciary Funds of the City as restricted assets.

Financial Highlights

The System presents its financial statements solely on the accounts of the System. The accrual basis of accounting is used by the System, whereby revenues are recognized when they are earned and collection is reasonably assured, and expenses are recognized when the liability has been incurred. Investments are reported at fair value.

A summary of the Statements of Plan Net Assets for the System is as follows ($000's):

June 30,	**2005**	2004	2003
Assets			
Investment at fair value	**$ 2,642,693**	$ 2,421,096	$ 2,024,932
Invested securities lending collateral	**288,266**	348,478	225,531
Receivables	**28,527**	37,458	17,093
Cash	**131**	70	63
Total assets	**2,959,617**	2,807,102	2,267,619
Liabilities			
Due to brokers	**17,246**	33,093	21,823
Securities lending collateral	**288,266**	348,478	225,531
Accrued professional fees	**2,578**	2,483	1,643
Other liabilities	**319**	280	323
Total liabilities	**308,409**	384,334	249,320
Plan net assets held in trust for pension benefits	**$ 2,651,208**	$ 2,422,768	$ 2,018,299

See accompanying independent auditors' report.

The System's net assets increased by approximately $228,440 thousand in fiscal year 2005 over 2004 primarily due to strong performance in foreign and domestic equity markets. The System experienced a positive investment return of 13.5% in 2005 as opposed to positive 21.6% in 2004. These rate of return calculations were prepared using a time-weighted rate of return in accordance with The CFA Institute's Global Investment Performance Standards and, as such, cannot be recalculated from the information provided herein. The first six months of the 2005 fiscal year produced a return of 10.1% and accounted for the majority of the positive fiscal 2005 return. These investment returns can be seen in the Investment income figures in the accompanying chart. Changes in receivables are primarily a result of the timing of investment transactions.

A summary of the Statements of Changes in Plan Net Assets is as follows ($000's):

Years ended June 30:	**2005**	2004	2003
Contributions:			
City	**$ 37,125**	$ 36,645	$ 34,645
Members	**28,410**	26,393	24,008
Total contributions	**65,535**	63,038	58,653
Investment income	**320,561**	437,007	80,202
Net income from securities lending activities	**876**	741	583
Total additions	**386,972**	500,786	139,438
Deductions:			
Benefits paid to members	**153,861**	92,697	65,649
Refunds paid to members	**1,198**	852	992
Professional and administrative expenses	**3,473**	2,768	2,746
Total deductions	**158,532**	96,317	69,387
Net increase	**228,440**	404,469	70,051
Plan net assets held in trust for pension benefits, beginning of year	**2,422,768**	2,018,299	1,948,248
Plan net assets held in trust for pension benefits, end of year	**$ 2,651,208**	$ 2,422,768	$ 2,018,299

See accompanying independent auditors' report.

The City, in a contract approved in fiscal year 2001, agreed to an annual increase in its contribution of $2,000 thousand through fiscal year 2004. A new agreement with the City approved in fiscal year 2005 requires a payment of $36,645 thousand for fiscal year 2005 and then 16.0% of member compensation but not less than $53,000 thousand for fiscal 2006. This contractual change accounts for the increase in City contributions for the years ended June 30, 2005 and 2004.

Total benefits paid, which includes lump sum payments, increased by approximately $61,164 thousand or 66 percent in 2005 as compared to 2004 due to a significant number of new retirees who left service to take advantage of the April 2004 pay raise. This pay raise resulted in increased monthly benefits of 15 percent or more for many retiring members. In addition, there was a significant increase in distributions from DROP and PROP lump sum accounts by retiring and retired members due to concerns about the System's funded status as discussed in Notes 3, 4 and 5.

Similar to the 2005 fiscal year, total benefits paid in 2004 increased as compared to 2003. Once again, this was due mainly to a significant number of new retirees who left service to take advantage of the April 2004 pay raise. The increased rate of retirements in connection with the increased level of benefits has resulted in an increase in monthly benefit payments of approximately 42% when comparing the months of June 2003 with June 2005. Monthly retiree payroll in June 2005 was approximately $7,055 thousand as compared to monthly retiree payroll in June 2003 of approximately $4,974 thousand.

There was a significant increase in Professional and administrative expenses in 2005 mainly as a result of the actuarial, legal and lobbying costs associated with the litigation discussed in Note 5 and the New Agreement as discussed throughout the notes to the financial statements.

System Highlights

The System's funded ratio pursuant to its most recent actuarial valuation dated July 1, 2004 was 74% representing an unfunded actuarial accrued liability of $873,154 thousand. This 74% funding ratio compares to an 83% funding ratio as of July 1, 2003.

On June 30, 2004 the System filed suit against the City of Houston seeking to compel the City to adhere to the statutory funding requirements as outlined in Note 3. This legal action was based upon the fact that the City adopted a budget for the City of Houston for fiscal year 2005 that failed to appropriate the statutorily mandated 16% of the member's pay. See Notes 4 and 5 for a discussion of the System's funded status and related litigation. Also, see Note 1 for a discussion of an agreement reached by the System and the City on September 29, 2004. This agreement alters the benefit structure for all members and provides for a series of cash payments to be made to the System in lieu of actuarially required contributions.

Contacting the System's Management

This financial report is designed to provide members and other users with a general overview of the System's finances and to show the System's accountability for the funding it receives. If you have questions about this report, you may contact the System's Executive Director at 602 Sawyer, Suite 300, Houston, TX 77007 or by phone at 713-869-8734.

Houston Police Officers' Pension System

Statements of Plan Net Assets ($000's)

June 30,		**2005**		2004
Assets				
Investments, at fair value (Note 2):				
Short-term investments	**$**	**168,342**	$	222,763
Fixed income		**507,309**		423,282
Equity securities		**1,692,822**		1,556,154
Alternative investments		**271,526**		217,644
Foreign currency contracts		**2,694**		1,253
Total investments		**2,642,693**		2,421,096
Invested securities lending collateral (Note 2)		**288,266**		348,478
Receivables:				
Members		**1,006**		927
Investments		**8,476**		8,505
Due from brokers		**18,973**		27,986
Other receivables		**72**		40
Total receivables		**28,527**		37,458
Cash		**131**		70
Total assets	**$**	**2,959,617**	$	2,807,102

See accompanying independent auditors' report and notes to financial statements.

Houston Police Officers' Pension System

Statements of Plan Net Assets ($000's)

June 30,		**2005**		2004
Liabilities and Plan Net Assets				
Liabilities:				
Due to brokers	**$**	**17,246**	$	33,093
Securities lending collateral (Note 2)		**288,266**		348,478
Accrued investment and professional fees		**2,578**		2,483
Other liabilities		**319**		280
Total liabilities		**308,409**		384,334
Plan net assets held in trust for pension benefits (see Schedule of Funding Progress)	**$**	**2,651,208**	$	2,422,768

See accompanying independent auditors' report and notes to financial statements.

Statements of Changes in Plan Net Assets ($000's)

Years ended June 30,		**2005**		2004
Contributions (Notes 1, 3 and 5):				
City	**$**	**37,125**	$	36,645
Members		**28,410**		26,393
Total contributions		**65,535**		63,038
Investment income:				
Net appreciation in fair value of investments		**273,556**		399,838
Interest:				
Short-term investments		**6,679**		4,385
Fixed income		**29,976**		27,406
Total interest income		**36,655**		31,791
Dividends		**26,314**		16,934
Other income		**282**		333
Total investment income		**336,807**		448,896
Less – investment expense		**(16,246)**		(11,889)
Net income from investing activities		**320,561**		437,007
Securities lending activities (Note 2):				
Securities lending income		**1,332**		1,153
Securities lending expense		**(456)**		(412)
Net income from securities lending activities		**876**		741
Total additions	**$**	**386,972**	$	500,786

Houston Police Officers' Pension System

Statements of Changes in Plan Net Assets ($000's)

Years ended June 30,		**2005**		2004
Deductions:				
Benefits paid to members	**$**	**153,861**	$	92,697
Refunds paid to members		**1,198**		852
Professional and administrative expenses		**3,473**		2,768
Total deductions		**158,532**		96,317
Net increase		**228,440**		404,469
Plan net assets held in trust for pension benefits, beginning of year		**2,422,768**		2,018,299
Plan net assets held in trust for pension benefits, end of year	**$**	**2,651,208**	$	2,422,768

See accompanying independent auditors' report and notes to financial statements.

1. Plan Description and Contribution Information

General – The Houston Police Officers' Pension System (the System) was created in 1947 by an act of the Fiftieth Legislature of the State of Texas, and is governed by Article 6243g-4, Vernon's Texas Civil Statutes (the Governing Statute) and contracts pursuant to Section 27 thereof. The System is a single employer contributory defined benefit pension plan covering police officers employed full time by the City of Houston (the City) that provides for service, disability and death benefits for eligible members and their beneficiaries. The System is a local governmental plan and, therefore, is not subject to the Employee Retirement Income Security Act of 1974 (ERISA).

At June 30, 2005, the System's membership consisted of the following:

Description	Number
Retirees and beneficiaries:	
Currently receiving benefits	2,376
Not yet receiving benefits	3
Active members:	
Fully vested	1,851
Nonvested	3,016
Total members	7,246

The following sections describe the benefit structure in effect at June 30, 2005. On September 29, 2004 the System and the City entered into an agreement (the New Agreement) that altered the benefit structure of the System. The contract has a term beginning on October 9, 2004 extending through June 30, 2017 and thereafter renews for one-year terms through June 30, 2034 unless either party terminates the agreement. The benefits described below include those for members on or before October 9, 2004 as well as benefits for members hired or rehired subsequent to October 9, 2004

Eligibility – Members become eligible to receive a service pension upon retirement with twenty years of service. Members also have the option to select a Delayed Retirement, which allows for vesting after ten years of service with a pension benefit payable at age 60. Members hired or rehired subsequent to October 9, 2004 are eligible to receive a service pension upon attaining age 55 and 10 years of service.

Benefits – Retirement benefits are equal to 2.75 percent of the member's pensionable pay for each of the member's first twenty years of service plus two percent of pensionable pay for each year in excess of twenty years with no maximum percentage. Members hired or rehired subsequent to October 9, 2004 accrue benefits equal to 2.25 percent of the member's pensionable pay for each of the member's first twenty years of service plus two percent of the member's pensionable pay for each year in excess of twenty years subject to a maximum of 80 percent. Retired members and surviving spouses are entitled to receive an additional $150 per month in order to defray group medical insurance costs.

Pensionable Pay - Prior to October 9, 2004 (the date of the New Agreement) pensionable pay, as referred to herein, was referred to as Average Total Direct Pay (ATDP). ATDP was calculated as the annualized highest biweekly pay received by a member in the last twelve months before retirement or entrance into DROP. Biweekly pay was composed of recurring pay types such as for regular hours worked, plus, ad hoc items of pay such as certain types of overtime and certain types of shift pay. As a part of the New Agreement eligible members of the System have the option until October 7, 2007 of using either a "Locked-In benefit" or a "Sliding Average benefit" as pensionable pay in the calculation of their retirement or DROP benefit. The Locked-In benefit is the ATDP for the twelve months prior to October 9, 2004 and the Sliding Average benefit is an average of the ATDP for the twelve months prior to October 9, 2004 and all pay periods subsequent to that date but prior to the earlier of the member's retirement date or October 7, 2007, excluding all types of overtime pay. Members retiring after October 7, 2007 will have their retirement or DROP benefit calculated on pensionable pay, which is referred to as Final Average Pay, and is defined as the average of all pay types received by a member over the three years prior to retirement or entrance into DROP exclusive of all categories of overtime.

Deferred Retirement Option Plan – The Deferred Retirement Option Plan (DROP) provides for an optional method of accruing pension benefits. Generally, members with at least twenty years of service are eligible to participate in the DROP and upon termination of employment participating members receive their pension benefit in the form of an annuity and a lump sum benefit. The annuity is the member's pension benefit at the time of enrollment in the DROP plus any subsequent cost of living adjustments. The lump sum benefit is the accumulated balance in the member's notional DROP account which is equal to an amount calculated as if the member's annuity, employee contributions and an interest component had been deposited in a separate account in the member's name during the member's participation in DROP.

A Back-DROP benefit is also available for all eligible participants. The Back-DROP option allows a DROP member to recalculate his or her DROP notional account by selecting a different entrance date than that originally selected by the member upon entrance into DROP. The Back-DROP entry date cannot be prior to the later of October 21, 1995 or the date the member attained 20 years of credited pension service.

Members hired or rehired subsequent to October 9, 2004 are not eligible to participate in DROP or Back-DROP.

Cost of Living Adjustments – Pension benefits and the monthly DROP benefits are adjusted each year equal to eighty percent of the increase in the Consumer Price Index for all Urban Consumers for the preceding year subject to minimum and maximum increases of 2.4 percent and 8.0 percent, respectively.

Disability Benefits – Duty connected disability benefits are equal to the greater of 55% of pensionable pay or the accrued service pension. Disabled members who qualify for a Catastrophic Disability, as defined, receive a disability benefit equal to 100 percent of pensionable pay. Members hired or rehired subsequent to October 9, 2004 are eligible for a duty connected disability benefit equal to the greater of 45% of the member's pensionable pay or the accrued service pension.

Members determined to be eligible for a non duty-connected disability benefit are entitled to a benefit of either 27.5% of pensionable pay, if the member has ten or fewer credited years of service, or 2.75% per year for credited service in excess of ten years. Members hired or rehired subsequent to October 9, 2004 are eligible for a non-duty connected disability benefit equal to the greater of 22.5% of the member's pensionable pay or 2.25% per year for credited service equal to or in excess of ten years.

Death Benefits – Death benefits are available to a surviving spouse, dependent children or a dependent parent in the event of the death of a member either after disability or service retirement, or prior to retirement.

Refunds of Member Contributions – A member with less than 20 years of credited pension service may elect to obtain a refund of member contributions upon termination of service with the HPD. This refund does not include interest. Members with at least ten but less than 20 years of credited pension service, who terminate service with the HPD, have the option of a Delayed retirement. Members hired or rehired subsequent to October 9, 2004 are eligible for a refund of contributions until they attain age 55 and 10 years of service.

Delayed Retirement – A member with at least 10 but less than 20 years of credited pension service at termination of employment with the HPD has the option of either a refund of member contributions, without interest, or a Delayed Retirement benefit. The Delayed benefit is payable at age 60 and is calculated at 2.75% of pensionable pay for each year of credited pension service. Members hired or rehired subsequent to October 9, 2004 are not eligible for a Delayed Retirement.

Supplemental Monthly Benefit (13^{th} check) – In years in which certain investment performance and actuarial funding requirements are met the System issues a supplemental monthly benefit payment to retired members and a supplemental credit to DROP participant's accounts in an amount equal to their normal monthly benefit. Members hired or rehired subsequent to October 9, 2004 are not eligible for this benefit.

Lump Sum Benefit – Members retiring with a service or disability benefit receive a one-time $5,000 lump sum benefit. Members hired or rehired subsequent to October 9, 2004 are not eligible for this benefit.

Reciprocal Retirement Program – Members who have not attained the necessary years of service for retirement are eligible to participate in the System's Reciprocal Retirement Program if they also have pension service with other City departments. This program allows members with the necessary cumulative years of service to combine their service credit with other City retirement systems and receive a proportionate retirement benefit from the System.

Post Retirement Option Plan – The Post Retirement Option Plan (PROP) allows retired members and surviving spouses to have all or a portion of their monthly retirement or survivor's benefit and DROP lump sum credited to a notional account maintained by the System which accumulates interest and can be disbursed to the member under certain options as designated by the System. Surviving spouses are not eligible to credit all or a portion of their survivor benefit to a PROP account. Members hired or rehired subsequent to October 9, 2004 are not eligible for this benefit.

Partial Lump Sum Option Plan – The Partial Lump Sum Option Plan (PLOP) provides for an optional lump sum payment of a portion of a member's retirement benefit. A lump sum payment of not more than twenty percent (20%) of the actuarial value of the member's accrued pension at retirement shall be made available to persons who become active members of HPOPS subsequent to October 9, 2004. The benefit shall be actuarially neutral. Thus, the value of the pension the member receives shall be reduced actuarially to reflect the lump sum payment.

2. Summary of Significant Accounting Policies

Basis of Presentation –As defined by generally accepted accounting principles established by the Governmental Accounting Standards Board (GASB) the accompanying 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 service, disability and death benefits required under the terms of the Governing Statutes and amendments thereto. The System is a component unit of the City only to the extent the System receives contributions equal to an amount or percentage of the total direct pay of active members in accordance with the Governing Statute.

Basis of Accounting - Basis of accounting is the method by which revenues and expenses are recognized in the accounts and are reported in the financial statements. The accrual basis of accounting is used for the System. Under the accrual basis of accounting, revenues are recognized when they are earned and collection is reasonably assured, and expenses are recognized when the liability is incurred. Member contributions are recognized in the period in which the contributions are due. Employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of the Governing Statute.

Investments - Statutes of the State of Texas authorize the System to invest surplus funds in a manner provided by the Government Code, Title 8, Subtitle A, Subchapter C. Investments are reported at fair value. Securities traded on national or international exchanges are valued at the last reported sales price at current exchange rates. Investments that do not have an established market value are reported at estimated fair value.

Dividend income is recorded on the ex-dividend date. Income from other investments is recorded when earned. Gains and losses on sales of securities are recognized on the trade date. The cost of investments sold is determined using the first-in, first-out cost flow method.

Short-term investments include funds held in the Northern Trust Short Term Investment Fund (STIF) and commercial paper with maturities not exceeding one year. Fixed income investments include government securities such as Treasury securities, Federally sponsored agency issued discount notes, bonds, agency pass-through securities and collateralized mortgage obligations; US corporate bonds such as term bonds and asset backed securities; and foreign securities such as dollar denominated and non-dollar denominated issues of non-US governments and private corporations. Call options on fixed income securities give the holder the right but not the obligation to purchase US Treasury securities during the term of the option contract. The holder pays a premium for this right, which is carried as an asset of the System, subject to daily mark-to-market adjustments, during the contract term. The issuer of the option has an obligation to the holder to settle the option position in cash at the fair value of the underlying security in exchange for the price specified by the option, until the contract is exercised or expires. Equity securities consist of individual shares of equity securities plus units of commingled stock funds of both US and foreign entities. Alternative investments consist of investments in real estate and venture capital and private equity limited partnerships.

The System's investments have been categorized to address deposit and investment risks related to custodial credit risk, credit risk, concentration of credit risk, interest rate risk, and foreign currency risk.

Custodial Credit Risk – Custodial credit risk for deposits is the risk that in the event of a bank failure, the System's deposits may not be returned to them. The System considers only demand deposits as cash. As of June 30, 2005 and 2004, the System had a balance of $131 thousand and $70 thousand, respectively, on deposit at a financial institution. The Federal Depository Insurance Corporation covered cash on deposit up to $100 thousand at this financial institution. As of June 30, 2005, $31 thousand of the System's bank balance of $131 thousand was exposed to custodial credit risk as it was uninsured and uncollateralized. In addition, at June 30, 2005, the System has approximately $811 thousand on deposit and an overdraft of approximately $976 thousand with other financial institutions, which is subject to custodial credit risk, as it is not covered by depository insurance and is uncollateralized.

Credit Risk – Credit risk is the risk that the counterparty will not fulfill its obligations. As of June 30, 2005, the System's fixed income assets that are not government guaranteed represented 99.9% of the System's fixed income portfolio. The following tables summarize the System's fixed income portfolio exposure levels and credit qualities.

Average Credit Quality and Exposure Levels of Non-U.S. Government Guaranteed Securities ($000's)

Fixed Income Security Type	Market Value June 30, 2005	Percent of All Fixed Income Assets	Weighted Average Credit Quality
Corporate Bonds	$ 207,280	40.9%	B
International			
Government Agencies	1,027	0.2%	A
Government Bonds	159,636	31.5%	AA
Mutual Bond Funds	138,445	27.3%	Not Rated
Total	$ 506,388	99.9%	

Ratings Dispersion Detail
($000's)

Credit Rating Level	Corporate Bonds	International Government Bonds	Mutual Bond Funds	International Government Agencies
AAA	$ -	$ 55,448		
AA	-	76,749		
A	486	6,038		$ 1,027
BBB	1,084	12,645		
BB	44,194	6,282		
B	129,164	2,474		
CCC	17,106	-		
C	772	-		
D	544	-		
SD	100	-		
Not Rated	13,830	-	$ 138,445	
Total	$ 207,280	$ 159,636	$ 138,445	$ 1,027

The System's investment policy allows Investment managers full discretion in adopting investment strategies to deal with these risks. Unless otherwise provided in the individual investment manager agreement, the average quality rating of each individual fixed income portfolio on a weighted value basis shall be A-rated or higher, and no issue should have a rating below investment grade (Baa or higher). Certain managers, such as high yield managers, may be exempted from these requirements as provided for in their contracts.

Credit risk for derivative instruments held by the System results from counterparty risk, essentially that the counterparty will be unable to fulfill its obligations, assumed by the System. Information regarding the System's credit risk related to derivatives is found under the derivatives disclosures.

Policies regarding credit risk pertaining to credit risk associated with the System's securities lending program are found under the securities lending disclosures.

Concentration of Credit Risk – Concentration of credit risk is the risk of loss attributable to the magnitude of the System's investment in a single issue. The System's operational guidelines for each specific portfolio limits investments in any one single domestic equity issue to 15% of each portfolio at market value and for any one single international equity issue to 5% of the System's investments. For fixed income investments, the System's policy limits, by each specific portfolio, investment in any one single fixed income security to 10% of each portfolio at market value. As of June 30, 2005, the System did not have any investments in any one organization which represented greater than 5% of plan net assets.

Interest Rate Risk – Interest rate risk is the risk that changes in interest rates will adversely affect the fair values of the System's financial instruments. This risk is managed within the portfolio using the modified duration methodology. It is widely used in the management of fixed income portfolios and estimates the sensitivity of a bond's price to interest rate changes. All of the System's fixed income portfolios are managed in accordance with guidelines that are specific as to the degree of interest rate risk taken. The reporting of modified duration found in the tables below quantifies the interest rate risk of the System's fixed income investments. Interest rate risks associated with derivative instruments are found in the derivatives disclosures of these notes.

Modified Duration of Fixed Income Assets by Security Type ($000's)

Fixed Income Security Type	Market Value June 30, 2005	% of All Fixed Income Assets	Weighted Average Modified Duration (years)
US Treasuries	$ 921	0.2%	0.1
Corporate Bonds	207,280	40.9%	4.9
International			
Government Agencies	1,027	0.2%	5.5
Government Bonds	159,636	31.4%	4.8
Mutual Bond Funds	138,445	27.3%	7.0
Total	$ 507,309	100.0%	5.9

Modified Duration Analysis - Corporate and International Government Bonds ($000's)

Corporate Bonds	Market Value June 30, 2005	Average Modified Duration	Contribution Modifed Duration
Less than 1 year to maturity	$ 1,163	0.6	0.0
1 to 10 years maturities	191,232	4.7	4.3
10 to 20 years maturities	8,523	7.8	0.3
Greater than 20 years maturities	6,362	11.3	0.3
Total	$ 207,280		4.9

International Government Bonds	Market Value June 30, 2005	Average Modified Duration	Contribution Modifed Duration
Less than 1 year to maturity	$ -	0.0	0.0
1 to 10 years maturities	112,463	4.7	2.6
10 to 20 years maturities	10,778	11.3	0.6
Greater than 20 years maturities	36,395	12.7	2.2
Total	$ 159,636		5.4

Foreign Currency Risk – Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. The books and records of the System are maintained in US dollars. Foreign currencies and non-dollar denominated investments are translated into US dollars at the bid prices of such currencies against US dollars at each balance sheet date. Realized and unrealized gains and losses on investments which result from changes in foreign currency exchange rates have been included in the net appreciation in fair value of investments. Net realized foreign currency gains and losses resulting from changes in exchange rates include foreign currency gains and losses between trade date and settlement date of investment securities transactions, foreign currency transactions and the difference between the amounts of interest and dividends recorded on the books of the System and the amount actually received. The System's exposure to foreign currency risk in U.S. dollars as of June 30, 2005, is shown in the table below.

Foreign Currency Exposure by Asset Class
($000's)

Currency	Short Term Investments	Equities	Fixed Income	Options on Foreign Currencies	Total
Australian dollar	$ 157	$ 2,055		$ 41,232	$ 43,444
British pound sterling	227	82,602	$ 9,179	47,977	139,985
Canadian dollar	(50)	4,517	2,127	(16,859)	(10,265)
Chinese yuan renminbi				38,864	38,864
Czech koruna				1,658	1,658
Danish krone			1,448	(1,452)	(4)
Euro	228	186,545	69,013	(189,308)	66,478
Hong Kong dollar		3,861			3,861
Hungarian forint				1,036	1,036
Japanese yen	270	90,686	53,176	21,741	165,873
Mexican peso				6,740	6,740
New Taiwan dollar				2,339	2,339
New Zealand dollar		4,675		(1,913)	2,762
Norwegian krone		2,630			2,630
Polish zloty				1,663	1,663
Singapore dollar		8,523			8,523
South African rand				2,112	2,112
South Korean won		6,847		4,519	11,366
Swedish krona			1,492	7,652	9,144
Swiss franc	168	31,422		21,446	53,036
	$ 1,000	$ 424,363	$ 136,435	$ (10,553)	$ 551,245

Securities Lending Program –

June 30,		Fair Value ($000's) 2005		2004
Investments held by System's agent in System's name:				
Short-term investments	**$**	**168,342**	$	222,763
Fixed income		**424,028**		312,670
Equities		**1,527,437**		1,369,177
Alternative investments		**271,526**		217,644
Foreign currency contracts		**2,694**		1,253
Securities lending collateral investment pool		**288,266**		348,478
	$	**2,682,293**	$	2,471,985
Investments held by brokers under securities loans with cash collateral:				
Fixed income	**$**	**83,281**	$	110,612
Equities		**165,385**		186,976
	$	**248,666**	$	297,588

The Board of Trustees' policies permit the System to lend securities (domestic and international equities and fixed income) to securities firms on a temporary basis through its custodian bank. The System receives fees for all loans and retains the right to all interest and dividend payments while the securities are on loan. Cash, letters of credit or various government securities having market values equal to or exceeding 102 and 105 percent of the value of the loaned securities for domestic and international securities, respectively, collateralize all security loan agreements. Whenever market value of the securities on loan changes, the borrower must adjust the collateral accordingly. At June 30, 2005, the System had no credit risk exposure to borrowers because the amounts the System owes the borrowers exceed the amounts the borrowers owe the System.

The System's bank pools all collateral received from securities lending transactions and invests any cash collateral. The System holds an undivided share of the collateral provided by the borrowers of the securities. At June 30, 2005 the weighted-average maturity of the collateral pool was 29 days. The relationship between the maturities of the collateral pool and the System's loans has not been determined. Cash collateral invested in the custodian bank collateral pool at June 30, 2005 and 2004, was $256,170 thousand and $305,144 thousand, respectively. The balance of the collateral at June 30, 2005 and 2004, of $32,096 thousand and $43,334 thousand, respectively, consists of treasury securities and letters of credit.

The System cannot sell or pledge the collateral unless the borrower fails to return the securities borrowed. The market value of securities on loan at June 30, 2005 and 2004 was $279,405 thousand and $338,917 thousand, respectively.

Derivatives – The System's investment managers may invest in derivatives if permitted by the guidelines established by the System's Board of Trustees. The System's staff monitors guidelines and compliance. From time to time the System's investment managers will invest in foreign currency contracts, options, swaps, reverse repurchase agreements, index linked bonds, collateralized mortgage obligations and mortgage-backed securities. No derivatives are purchased with borrowed funds.

These derivative instruments are subject to the following risks:

- *Credit Risk* – The risk that the counterparty will not fulfill its obligations. The System's investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, and exposure monitoring procedures.

- *Interest Rate Risk* – The risk that changes in interest rates will adversely affect the fair values of the System's financial instruments or cash flows.

- *Basis Risk* – The risk that arises when variable interest rates on a derivative and an associated bond or other interest-paying financial instrument are based on different indexes.

- *Termination Risk* – The risk that a derivative's unscheduled end will adversely affect an investment manager's strategy.

- *Rollover Risk* – The risk that a derivative associated with the System's fixed income investments does not extend to the maturity of those investments.

Foreign currency contracts are used to hedge against the currency risk in the System's investments in foreign equity and fixed income securities and also as part of a total return strategy that seeks absolute returns from relative changes in the prices of foreign currencies. The other derivatives are used to enhance yields and provide incremental income.

The System is invested in a total return strategy utilizing various foreign currency derivative instruments. The strategy is managed by a third party investment management firm in an account managed by a prime broker. At June 30, 2005 the System has approximately $13,000 thousand on deposit with the prime broker and this amount changes monthly as the System and the prime broker swap cash flows each month equal to the profit or loss in the account. This amount is subject to custodial credit risk, as it is not covered by depository insurance and is uncollateralized. At June 30, 2005, the System held units in this commingled fund that represent approximately $95,000 thousand in foreign currency exposure pursuant to this strategy. As the System holds units in this fund, the underlying foreign currency contracts are not reflected in the accompanying schedule of derivative instruments.

Futures on investments are used to take advantage of mis-pricing opportunities. When a position is taken in a futures contract, a margin is posted and the contract is subject to daily mark-to-market adjustments. To liquidate the contract prior to expiration an offsetting position in the same contract must be taken. At expiration the holder of the futures contract accepts delivery of the underlying asset at the agreed-upon price.

The average futures balance outstanding, not including foreign currency contracts, during the fiscal years ending June 30, 2005 and 2004 was $284,442 thousand and $(258,723) thousand, respectively. Futures outstanding, not including foreign currency contracts, at June 30, 2005 and 2004 were $790,033 thousand and $(818,376) thousand, respectively.

The contract or notional amounts of these instruments reflect the extent of the System's involvement in each class of financial instrument as of June 30, 2005 as follows ($000's):

Contracts	Description	Notional Value	Exposure
54	Futures on Treasury Bills and Equivalents	$ 684,323	$ –
27	Fixed Income Futures	97,225	–
23	Commodity Futures	(16,284)	–
9	Equity Futures	8,485	–
1,122	Long foreign currency contracts	679,832	(5,168)
1,122	Short foreign currency contracts	(677,138)	7,863
		$ 776,444	$ 2,695

Administrative Costs –All administrative costs of the System are paid from the System's assets.

Federal Income Tax - A favorable determination that the System is qualified and exempt from Federal income taxes was received July 15, 2002. The Board believes that the System is designed and continues to operate in compliance with the applicable requirements of the Internal Revenue Code. Plan changes pursuant to the New Agreement have been submitted to the IRS for a determination review.

Use of Estimates – The preparation of the System's financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make significant estimates and assumptions that affect the reported amounts and net plan assets at the date of the financial statements and the actuarial information included in the required supplementary information as of the benefit information date, the changes in the System's net assets during the reporting period and, when applicable, disclosures of the contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Reclassifications – A loss generated by interest rate swaps previously reported for the year ended June 30, 2004 has been reclassified from interest income – short-term investments to net appreciation in fair value of investments in the amount of $(1,753) thousand. This reclassification had no effect on net plan assets held in trust for pension benefits.

Investment income generated through investments the System has made with Alternative Investment managers previously reported for the year ended June 30, 2004 have been reclassified from Alternative Investment income to Interest: Short-term investments in the amount of $561 thousand and to Dividends in the amount of $1,037 thousand. This reclassification had no effect on net plan assets held in trust for pension benefits.

3. Contributions and Reserves

Contributions – Members were required to contribute 8.75% of their pensionable pay to the System through October 9, 2004. Subsequent to that date members are required to contribute 9.0 percent of pay and members hired or rehired subsequent to October 9, 2004 contribute 10.25 percent of pay. Contributions are made on a pre-tax basis pursuant to Governing Statutes.

In the New Agreement the City has agreed that in lieu of contributions to the System made pursuant to actuarial valuations the City will make cash payments to the System in accordance with a payment schedule as provided in the New Agreement. This cash payment schedule requires a payment of $36,645 thousand for fiscal year 2005 and then 16.0% of member compensation but not less than $53,000 thousand for fiscal 2006. For fiscal years 2007 through 2012 the City has agreed to pay the amount contributed in 2006 plus an amount increasing by $5,000 thousand each year. Beginning in fiscal year 2013 and until the System's Funded Ratio reaches 100%, the City payments shall increase each fiscal year by the greater of $5,000 thousand or if the scheduled City payment is less that the actuarially required contribution, $10,000 thousand per year.

Pursuant to the terms of the New Agreement and based on the July 1, 2004 actuarial valuation the City contribution rates and the Actuarial Required Contributions are as follows for five years ending June 30, 2010.

Years Ended June 30,	Actuarial Required Contribution	Cash Payments Required by Agreements	Cash Payments as a Percent of Actuarial Required Contribution	Annual Required Contribution as a Percentage of Pay
2006	$ 105,125	$ 53,000	50.4%	31.2%
2007	111,943	58,000	51.8%	32.1
2008	119,470	63,000	52.7%	33.1
2009	122,531	68,000	55.5%	32.8
2010	124,113	73,000	58.8%	32.1

The New Agreement provides that the City may make these cash payments from any source, including pension obligation bonds. Senate Bill 1696 became law on September 1, 2003 and authorized municipalities to issue obligations to fund all or any part of an unfunded liability. This law requires the City to enter into a written agreement with the System that states the date or dates that the System will accept the net proceeds of the obligations to be issued in payment of all or a portion of the unfunded liability.

The New Agreement was based upon projections wherein the City's annual cash payments would be less than the Actuarial Required Contribution (ARC) in each year through 2017 at which time the payments would begin to exceed the ARC. Due to actuarial losses as more fully described in Note 4, the fiscal 2006 contribution rate of 31.2% is 5.1 percentage points higher than was originally estimated in the projections that were used as a basis for the New Agreement. Based on projected payroll for fiscal 2006 this increased contribution rate will result in an increase in the fiscal 2006 ARC of approximately $17,200 thousand. Scheduled payment amounts in fiscal 2006 represent 50.4% of the ARC as opposed to the original 61.3 % of ARC projection. Subsequent to 2017 the scheduled payments were originally projected to be in excess of the ARC increasing to 200% of the ARC in fiscal 2035. Due to these actuarial losses and the resulting increase in the ARC for 2006 and subsequent years, the scheduled payments are not projected to exceed the ARC in 2017 or reach 200% of the ARC in 2035 as originally estimated.

The ARC as a percentage of pay for fiscal 2005 is 31.2% which represents an average of the contribution rate for the period prior to the effective date of the New Agreement and the contribution rate for the period subsequent to the effective date of the New Agreement. This average rate consists of 16.7% to cover Normal Costs and 14.5% to amortize the unfunded actuarial accrued liability over 30 years.

4. Funding Status

The System's actuary conducts an annual valuation to determine the adequacy of the current employer contribution rates, to describe the current financial condition of the System, and to analyze changes in the System's condition. The most recent valuation shows the funded position of the System at July 1, 2004 decreased from the funding level at July 1, 2003. The actuarial accrued liability increased $464,489 thousand and the actuarial value of assets increased $71,659 thousand. As a result, the System's Unfunded Actuarial Accrued Liability increased $392,827 thousand to $873,154 thousand as of July 1, 2004. The increase in the Unfunded Actuarial Accrued Liability is due to a combination of factors including actuarial losses from liability sources and recognition of prior asset losses. Effective July 1, 2004 the System changed certain payroll growth assumptions which resulted in an actuarial gain of $46,831 thousand.

Assuming the benefit adjustments outlined in Note 1 were effective July 1, 2004 the provisions of the New Agreement would have reduced the System's unfunded actuarial accrued liability from $873,154 thousand to $698,958 thousand. Actuarial projections used as a basis for the New Agreement estimated that the provisions of the New Agreement would have reduced the System's unfunded actuarial liability to $534,804 thousand so the System's unfunded actuarial liability at July 1, 2004 is $164,154 thousand greater than originally projected. The increase in the actuarial liability is due to liability losses of approximately $188,000 thousand that occurred between June 30, 2003 and July 1, 2004 and the remaining difference is due to a change in the estimate of the effect of the benefit changes pursuant to the New Agreement. The System's Unfunded Actuarial Accrued Liability is projected to increase from approximately $873,154 thousand as of July 1, 2004 to $1,468,000 thousand in 2013. These projected Unfunded Actuarial Accrued Liabilities equate to funded ratios of 74% and 71% respectively. In the projections used as a basis for the New Agreement the System's Unfunded Actuarial Liability as of July 1, 2013 was originally projected to be $1,110,093 thousand or a funded ratio of 77.8%.

In accordance with the terms of the New Agreement the City is obligated to make certain cash payments to the System but is no longer obligated to make payments to the System in amounts that have been actuarially determined to be sufficient to cover all future benefit payments of the System. If, however, the System achieves a funded ratio of 75% or 80% in any year subsequent to 2013 then the City will be required to annually contribute amounts to the System which are sufficient to maintain such funded ratios.

If the City is unable to meet its funding obligations due to a shortfall of tax revenues, an inability to obtain or raise funds through the issuance of pension obligation bonds or from other sources, or if the System does not achieve the actuarial assumptions inherent in these projections, then the System's unfunded actuarial accrued liability and the City's funding obligations will continue to increase above the rates outlined above and ultimately there could be insufficient assets to cover all future benefit payments of the System.

The financial condition of the System and its ability to meet future obligations is predicated on the funding provisions in the governing statute and the New Agreement, which provides a revenue stream based on a percentage of active members' pensionable pay. If the funding schedule is maintained and adequate earnings and gains are provided on investments, the System is projected to eventually be adequately funded. If the City does not meet its funding obligations the System's unfunded actuarial accrued liability and the City's future funding obligations will continue to increase above the rates outlined above.

The figures in the accompanying unaudited Schedule of Funding Progress (the Unfunded Actuarial Accrued Liability (UAAL) and the Funded Ratio) are based on actuarial calculations that make use of the actuarial value of assets, not the fair value. Since asset gains and losses (earnings greater or less than the 8.50% investment return assumption for example) are recognized 20% per year for five years in the actuarial value of assets, the July 1, 2004 actuarial value $2,466,070 thousand is $43,302 thousand larger than the fair value $2,422,768 thousand. The $43,302 thousand in deferred losses will be recognized over the next four years and as these losses are recognized, the unfunded liability can be expected to increase by a corresponding amount, over and above other expected increases.

5. Litigation

On June 30, 2004 the System filed suit against the City of Houston seeking to compel the City to adhere to the statutory funding requirements as outlined in the Governing Statutes. This legal action was based upon the fact that the City adopted a budget for the City of Houston for fiscal year 2005 that failed to appropriate the statutorily mandated 16% of the member's pensionable pay.

On August 3, 2004 the City filed a motion for summary judgment to dismiss the lawsuit claiming that the City has breached no obligations to the System, that the City has made every contribution to which the System is contractually entitled, the System's claims had no merit and that the issue was currently being negotiated and was possibly the subject of an eventual legislative solution.

Pursuant to the New Agreement the System agreed to nonsuit its lawsuit against the City without prejudice. The System reserves the right to reinstate the lawsuit if the City does not meet its payment obligations under the New Agreement.

6. Commitments and Contingencies

As described in Note 1, there are 3,016 non-vested active members of the System entitled to refunds of their accumulated contributions, without interest, upon termination of employment with the City prior to being eligible for pension benefits. At June 30, 2005 and 2004, aggregate contributions from these members of the System were approximately $105,831 thousand and $113,549 thousand, respectively. The portion of these contributions, which are refundable to members who may terminate with less than twenty years of service, has not been determined.

At June 30, 2005 and 2004, the total accumulated lump sum benefit due to DROP members was approximately $390,805 thousand and $404,172 thousand, respectively.

At June 30, 2005 and 2004, the total accumulated lump sum benefit due to PROP participants was $115,814 thousand and $65,804 thousand, respectively.

The System has outstanding commitments to various limited partnerships totaling $105,395 thousand and $131,030 thousand, as of June 30, 2005 and 2004, respectively.

Effective August 1, 2004, the System executed an eleven-year office lease renewal through April 30, 2015, with the first 9 months rent-free and monthly base rentals thereafter ranging from $14.8 thousand to $16.9 thousand.

7. Subsequent Events

In August 2005, the Board approved a plan to alter the System's asset allocation by decreasing exposure to the US and international public equity markets and adding or increasing exposure to inflation indexed securities, emerging market debt, commodities, real estate and a structured beta investment strategy. Assets allocated to US and international equity markets will be decreased from 58.0 percent to 40.5 percent of plan assets.

The System has an interest in Refco Group Ltd, LLC, a subsidiary of Refco, Inc., through the System's investment in the Thomas H Lee V private equity partnership (the Partnership). In October 2005, Refco, Inc.'s chief executive officer was arrested for allegedly executing and concealing a fraud which led to a liquidity crisis at Refco, Inc. Subsequently Refco, Inc. and numerous subsidiaries including Refco Group Ltd, LLC, filed for Chapter 11 bankruptcy protection. Pursuant to these events the System intends to write down its investment in the Partnership, which had a preliminary valuation of $19.2 million, by approximately $3.7 million during the 2006 fiscal year. This write-down represents the System's proportionate interest in Refco Group Ltd, LLC through the System's investment in the Partnership. The Partnership is a named defendant in numerous class action filings that have been made pursuant to this situation, however, the System expects no further material loss as a result of the Refco, Inc. and Refco Group Ltd, LLC bankruptcy or the attendant class action proceedings.

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Schedule of Funding Progress *($000's)*

Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Accrued Liability (AAL) Entry Age (b)	Unfunded AAL (Surplus) (UAAL) (b-a)	Funded Ratio (%) (a/b)	Projected Annual Covered Payroll (c)	UAAL as Percentage of Covered Payroll ((b-a)/c)
July 1, 1998	1,518,081	1,549,341	31,260	98	196,364	16
July 1, 1999	1,746,312	1,773,829	27,517	98	246,569	11
July 1, 2000	2,013,491	1,966,404	(47,087)	102	250,691	(19)
July 1, 2001	2,226,307	2,306,427	80,120	97	264,226	30
July 1, 2002	2,337,157	2,593,730	256,573	90	286,150	90
July 1, 2003	2,394,411	2,874,738	480,327	83	300,405	160
July 1, 2004 (1) (2)	2,466,070	3,339,224	873,154	74	329,840	265

(1) The System's actuaries have indicated the results provided in the July 1, 2004 valuation are "reasonable actuarial results." However, a different set of results could also be considered reasonable actuarial results, since the Actuarial Standards of Practice describe a 'best-estimate range' for each assumption, rather than a single best-estimate value. Thus, reasonable results differing from those presented above could have been developed by selecting different points within the best-estimate ranges for various assumptions.

(2) See Note 4, Funding Status. The July 1, 2004 amounts in this schedule have not been adjusted for the effects of the New Agreement.

Schedule of Employer Contributions *($000's)*

Years Ended June 30,	Actuarial Required Contribution	Cash Payments Required by Agreements (3)	Cash Payments as a Percent of Actuarial Required Contribution	Annual Required Contribution as a Percentage of Pay
1999	31,811	30,645	96.3	16.2
2000	40,191	30,645	76.2	16.3
2001	28,328	30,645	108.2	11.3
2002	54,166	32,645	60.3	20.5
2003	69,820	34,645	49.6	24.4
2004	85,615	36,645	42.8	28.5
2005	102,910	36,645	13.4 (4)	31.2

See accompanying independent auditors' report.

(3) Amounts for 1999 through 2004 represent amounts paid pursuant to various agreements between the System and the City.
(4) The percentage contributed figure for 2005 has been calculated based on $13,780 thousand since the remainder of the fiscal 2005 cash payment was from the proceeds of pension obligation bonds and, as such, must be excluded from such calculations.

Required Supplementary Information (Unaudited)

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as to the latest actuarial valuation is as follows:

Valuation date	July 1, 2004
Actuarial cost method	Entry age
Amortization method	Level percent of payroll Amortization over a constant open period of 30 years
Remaining amortization period	30 years
Asset valuation method	5 year smoothed market
DROP interest credit rate	9.0% [1]
Actuarial assumptions:	
Investment rate of return	8.5%
Payroll growth rate:	
Attributable to inflation	3.5%
Attributable to merit increases	0.0% to 9.5%
Annual cost of living adjustment	3.0% [2]

See accompanying independent auditors' report.

(1) Pursuant to the provisions of the New Agreement discussed in Note 4, this assumption has been changed to 7.0%.
(2) Pursuant to the provisions of the New Agreement discussed in Note 4, this rate has been changed to 2.8%.

Schedule I - Investment, Professional and Administrative Expenses ($000's)

Year ended June 30,		2005		2004
Investment services:				
Custodial services	$	257	$	146
Money management services		15,186		10,960
Consulting services		399		350
Department operating expenses		404		433
Total investment services		16,246		11,889
Professional services:				
Actuarial services		326		199
Auditing services		54		37
Election audit services		1		1
Legal services		448		61
Lobbyist services		352		87
Total professional services		1,181		385
Administrative expenses:				
Computers and technology		171		244
Education		47		38
Fiduciary insurance		72		64
Office rent		55		178
Other office costs		1,947		1,860
Total administrative expenses		2,292		2,384
	$	19,719	$	14,658

See accompanying independent auditors' report.

Schedule II - Summary of Investment and Professional Services ($000's)

Year ended June 30, 2005	Official System Position	Expense	Nature of Services
Abbott Capital Management	Consultant	$ 399	Consulting
The Northern Trust Company	Custodian	257	Custodian
American Express Asset Management	Money manager	485	Money Management
Arnhold & S. Bleichroeder	Money manager	1,159	Money Management
Barclays Global Investors	Money manager	1,542	Money Management
Brandes Investment Partners	Money manager	1,526	Money Management
Bridgewater Associates, Inc.	Money manager	4,116	Money Management
Causeway Capital Management	Money manager	184	Money Management
Credit Suisse Asset Management	Money manager	361	Money Management
Driehaus Capital Management, Inc.	Money manager	1,214	Money Management
FX Concepts/AIG	Money manager	2,175	Money Management
Gartmore Global Investments	Money manager	651	Money Management
MacKay-Shields Financial Corp.	Money manager	420	Money Management
NWQ Investment Management Company	Money manager	818	Money Management
Shenkman Capital Management, Inc.	Money manager	510	Money Management

Houston Police Officers' Pension System

Schedule II - Summary of Investment and Professional Services ($000's)

Year ended June 30, 2005	Official System Position	Expense	Nature of Services
TT International	Money manager	11	Money Management
Segal Company	Actuary	66	Actuarial
Towers Perrin	Actuary	260	Actuarial
BDO Seidman, LLP	Auditors	54	Auditing
Gibbs & Bruns, LLP	Attorneys	187	Legal Service
Klausner & Kaufman	Attorneys	50	Legal Service
Lawson, Fields, & Calhoun	Attorneys	146	Legal Service
HillCo Partners, LLC	Attorneys	168	Legal Service/ Lobbyists
Locke Liddell Sapp	Attorneys	226	Lobbyists
Bickley Prescott & Co.	Consultant	1	Election Auditing
Other	Other	37	Other
Total investment and professional services		$ 17,023	

See accompanying independent auditors' report.

SECTION THREE

INVESTMENT SECTION

Responsibilities of the Board of Trustees

The primary fiduciary fiscal responsibility of the Board of Trustees is to insure that the System's assets are responsibly managed in accordance with the actuarial needs of the System, and also with sound, generally accepted financial investment procedures. The determination of the appropriate asset mix is based on capital market assumptions that incorporate historical returns, volatility and correlation of various asset classes as well as the consideration of current and forward-looking market conditions.

The Standard of Investment for the System in making investments is to exercise the judgment and care in the circumstances then prevailing which persons of prudence, discretion and intelligence exercise in the management of their own affairs. The Trustees' responsibility is to invest the System's funds solely in the interest of the membership and their beneficiaries, and for the exclusive purpose of providing benefits to the membership and their beneficiaries and defraying reasonable expenses of administering the System.

Investment Philosophy and Objectives

The Board of Trustees believes that the System's assets should be managed in a way that reflects the uniqueness of the System and that the System's assets should be diversified over a spectrum of investment vehicles. Specifically, the Board recognizes and adheres to the following philosophical positions:

- Over the long term, the risk of owning equities has been, and should continue to be, rewarded with a somewhat greater return than that available from fixed income investments.

- Fixed income investments provide the System with an investment vehicle that contributes diversification, liquidity and a predictable stream of income; and that dampens volatility in investment returns.

- Diversification into alternative investments provides the System with an opportunity to enhance returns and to achieve broader diversification of the System's assets.

Investment Policy

The Board of the Houston Police Officers' Pension System has established an Investment policy with the following broad guidelines and objectives.

- Establish overall financial objectives and set investment policy
- Select appropriate investment options
- Select qualified investment manager(s) and consultants
- Select a qualified custodian
- Communicate on a structured and ongoing basis with those responsible for investment results; and
- Monitor performance to assure that objectives are being met and that policy and guidelines are being followed.

This Investment Policy represents the formal document for HPOPS, and is to be communicated to the appointed Investment Manager(s) and is their principal source for developing an appropriate investment strategy and, in addition, serves as the basis for these Managers' and the System's future performance evaluation.

Investment Strategy and Performance

The System has an asset allocation strategy in place that was initially designed to meet its overall investment objective of a long-term 8.5% annualized rate of return. This allocation strategy is reviewed periodically by the Board and is changed in anticipation of or in response to changing market conditions. The current target asset allocation and the actual asset allocation of the System at June 30, 2005 is as follows:

	Target % of Fund	Current Actual % of Fund	Dollars Invested (000's)
Domestic Equity	40.00%	43.11%	$ 1,143,416
International Equity	18.00%	20.74%	550,033
Total Equity	58.00%	63.85%	1,693,449
Fixed Income	16.00%	12.04%	319,222
High Yield	10.00%	10.35%	274,472
Total Fixed Income	26.00%	22.38%	593,694
Private Equity	10.00%	10.20%	270,629
Hedge Funds	5.00%	1.36%	35,999
Currency	1.00%	0.51%	13,533
Real Estate	0.00%	0.03%	897
Total Alternative	16.00%	12.11%	321,058
Total Cash	0.00%	1.66%	44,041
Total Fund	100.00%	100.00%	$ 2,652,242

In recognition of the current and projected near-term relative low return environment the Board performed a review of the System's asset allocation and manager structure during the year. Based upon this review, the Board approved a plan in August 2005 to alter the System's asset allocation by decreasing exposure to the US and international public equity markets and adding or increasing exposure to inflation indexed securities, emerging market debt, commodities, real estate and a structured beta investment strategy. Assets allocated to US and international equity markets will be decreased from 58.0 percent to 40.5 percent of plan assets.

The first four months of fiscal 2005 witnessed the stock markets moving in a sideways pattern that was accompanied by significant volatility. This was followed by a two-month post-election rally and consolidation of those gains in subsequent months. The remainder of the year was marked by periods that alternately generated confidence and doubts about the strength and sustainability of the economic expansion. Analysts generally attributed these "soft patches" in the economy to high oil prices and rising short-term interest rates. While stocks managed to record a fair magnitude of gains in this environment, bonds also generated positive returns in spite of rising short-term rates, a behavior considered by many analysts to be counter to historical trends.

HPOPS was able to outperform the financial markets in most areas during our fiscal year in this uncertain environment. However, the overall effect of uneven stock market performance was a relative decline in our total return versus the 2004 fiscal year. The System experienced a positive investment return of 13.5% in 2005 as opposed to positive 21.6% in 2004. The first six months of the 2005 fiscal year produced a return of 10.1% and accounted for the majority of the System's positive fiscal 2005 return. The System has a current asset mix that includes 40% in US equities and the System's total return in the US equity markets was approximately 10.5%. HPOPS' relative performance in the international equity markets was better than domestic equities at 14.4%. The System's fixed income assets' performance was even more pronounced with a total return of approximately 19.0% due to tactical allocations relative to the System's strategic asset mix.

Domestic Equity

The System's domestic equity investments generated a 10.5% return, exceeding the 8.1% return on its benchmark, the Russell 3000. This out-performance is due to a combination of excess returns from active management and investment weightings that differed from the benchmark. In particular, the superior performance of the System's value managers and its mid-cap growth manager more than offset the below-benchmark performance of some of our other active managers. It also helped that the System's equity assets were overweight in the mid-cap area of the market because that added to returns via out-performance relative to other capitalization ranges. Assets under management, annualized rates of return and fees paid to domestic equity managers for the fiscal year ending June 30, 2005 are as follows (dollars in 000's):

Manager	Style	Assets	% Returns	Fees
American Express	**Small/MidCap Growth**	$ 73,183	6.07	$ 485
Arnhold & S Bleichroeder	**Large Cap Core**	255,899	14.98	1,159
Barclays Global Investors	**Enhanced S&P 500 Index**	359,645	9.07	905
Driehaus Capital Mgmt	**MidCap Growth**	135,874	17.13	1,214
Gartmore Asset Mgmt	**Large Cap Growth**	173,497	2.08	651
NWQ Investment Mgmt	**Core Value**	145,318	13.77	818
		$ 1,143,416		$ 5,232

	HPOPS	Benchmark
# of holdings	212	3000
Avg market cap	$51.4 Billion	$71.9 Billion
Portfolio P/E	20.2	19.0
Portfolio P/Book	3.0	2.8
Portfolio Beta (3-yr)	1.0	1.0

International Equity

International equity markets had a better year than domestic equity markets in fiscal 2005. The System's international equity investments returned 14.4%, slightly outperforming the 14.1% return on the MSCI EAFE benchmark for the year. The System's largest active manager, Brandes, with approximately 67% of HPOPS' International Equity assets slightly underperformed the EAFE index. However, the enhanced index strategy managed by Barclay's Global Investors slightly outperformed the benchmark and helped the overall International equity asset class exceed its benchmark returns. Causeway, a new international equity manager, was funded in late February 2005 utilizing the funds formerly under management by TT International (approximately $95 million). Assets under management, annualized rates of return and fees paid to international equity managers for the fiscal year ending June 30, 2005 are as shown on the following page:

International Equity (dollars in 000's)

Manager	Style	Assets	% Returns	Fees
Brandes Investment Partners	**International Equity**	$ 367,365	13.58	$ 1,526
Causeway Capital Mgmt	**International Equity**	103,220	-3.3 *	184
Barclays Global Investors	**International Equity**	79,444	15.31	621
		$ 550,033		$ 2,331

* For partial year

	HPOPS	Benchmark
# of holdings	140	1147
Avg market cap	$38.0 Billion	$48.0 Billion
Portfolio P/E	14.5	16.4
Portfolio P/Book	1.9	2.1
Portfolio Beta (3-yr)	1.1	1.0

High Yield

High yield investments are segregated as a separate asset class as the result of a 1998 asset allocation study with a target allocation of 10% of the System's total assets. The System implemented a high yield strategy in July 2000 that utilizes three separate high yield managers whose styles should complement each other in order to dampen some of the volatility in this asset class.

In October 2003 the System made a tactical allocation decision to reallocate $100 million from investment grade fixed income into high yield. Starting in November 2004, this tactical allocation was gradually unwound and assets from the high yield asset class were reallocated to other investments that offer potentially higher returns. As a consequence of this unwinding of the tactical shift, the System had approximately $274 million in high yield assets in June 2005 as compared to the peak level of $375 million in October 2004. This high yield portion of the System's investments had a return of approximately 9.3% for the year versus the benchmark Salomon Brothers High Yield Market Index return of around 10.4%. This under-performance was the result of two of the System's three high yield managers underperforming the index. In April of 2005, Credit Suisse was terminated as a high yield manager for the System and the account was substantially liquidated. The System invested the funds formerly under management by Credit Suisse (approximately $112 million) partly in global and core domestic bonds while the remainder was temporarily reallocated to the outperforming high yield manager. Assets under management, annualized rates of return and fees paid to high yield managers for the fiscal year ending June 30, 2005 are as follows (dollars in 000's):

Manager	Style	Assets	% Returns	Fees
MacKay Shields	**High Yield**	$ 149,450	11.09	$ 420
Shenkman	**High Yield**	100,453	8.01	510
Credit Suisse	**High Yield**	24,569	8.95 *	361
		$ 274,472		$ 1,291

* For partial year

	HPOPS	Benchmark
# of securities	147	1357
Yield	8.05	7.98
Duration	2.96	4.54
Quality Rating-S&P	B	B+

Fixed Income

The System's fixed income strategy consists of a passive allocation to the Lehman Brothers Aggregate via an index strategy managed by Barclay's Global Investors (BGI) in combination with separate allocations to a global fixed income mandate and an emerging markets mandate. As discussed above in the section on high yield, a tactical re-allocation was in place for part of the fiscal year that substantially reduced the System's exposure to the BGI strategy from June 2004 through May 2005. With the unwinding of the high yield tactical shift, $20 million were re-allocated to the BGI strategy in May 2005. The System's fixed income assets performed strongly with a fiscal year return of 19.0%, versus the 6.8% return on the Lehman Brothers Aggregate Bond Index for the same time period. One of the causes of this out-performance was that the System was underweight in the lowest returning core bond sector in the strategy due to the aforementioned tactical allocation out of this sector of the market and into high yield. This proved to be a successful strategy as high yield assets generated a return of 9.3% versus the 6.8% return of the core bond sector. The out-performance is also due to the separate allocations to a global fixed income mandate and an emerging markets mandate, both of which generated higher returns than the core bond sector. Annualized rates of return and fees paid to fixed income managers for the fiscal year ending June 30, 2005 are as follows (dollars in 000's):

Manager	Style	Assets	% Returns	Base fee	Incentive fee
Ashmore	**Emerging Markets**	$ 115,104	32.13	$ 257	
Barclay's Global Investors	**Core Bond Index**	23,341	7.59	4	12
Bridgewater	**Global Fixed Income**	180,777	11.42	470	
		$ 319,222		$ 731	$ 12

Alternative Investments

The System's alternative investment program consists of allocations to private equity, hedge funds and a total return currency strategy. The private equity strategy is managed by Abbott Capital Management and is a relatively mature strategy in that the System has reached its investment target of 10% of total assets while still having $105 million of outstanding commitments. The System had investments in or commitments to 46 individual private equity partnerships at June 30, 2005. The current allocation within this strategy is approximately 38% in leveraged buyouts, 38% in special situations funds and 23% in venture capital. This program required $61.9 million in additional funding during fiscal 2005 while at the same time generating distributions of $73.7 million for the same period. This private equity program generated returns for the 2005 fiscal year of 24.8% versus its benchmark return of 11.3%.

The System also has a 5% allocation to hedge funds (approximately $132 million) but only has $36 million actually invested as of June 30, 2005 in the Bridgewater Pure Alpha hedge fund strategy. This strategy generated very strong fiscal year performance of 49% on invested capital and 14.2% on notional value. There is an additional 1% allocation to currency strategies with a $20 million risk limit. The currency strategy managed by FX Concepts under-performed during the fiscal year with a return of a negative 11.7% on invested capital and a positive 1.15% on notional value. Assets under management, annualized rates of return and fees paid to alternative investments managers for the fiscal year ending June 30, 2005 are as follows (dollars in 000's):

Manager	Style	Assets	% Returns	Base fee	Incentive fee
Abbott Capital	**Private Equity**	$ 270,629	24.80	$ 399	
Bridgewater	**Hedge Fund**	35,999	49.02	977	2,669
FX Concepts AIG	**Currency**	13,533	-11.67	1,187	988
Real Estate	**Various**	897	-4.02	-	
		$ 321,058		$ 2,563	$ 3,657

Securities Lending

The System's master custodian, Northern Trust, operates the Securities Lending program on behalf of HPOPS. Securities are loaned on a short-term basis to brokers in exchange for (generally) cash collateral. Northern Trust then invests this collateral and the investment income is divided between HPOPS and Northern Trust in accordance with agreed-upon percentages.

This program generates incremental income for HPOPS but is subject to certain risks. These risks include (1) the possibility that the borrower cannot return the securities and (2) that the investments in which Northern invests the collateral lose money. This first risk is controlled by strict guidelines on which borrowers will be approved to participate in the program and daily adjustment of the collateral for changes in the market value of the securities that are out on loan. The second risk is controlled by strict quality and duration guidelines on the securities that the collateral can be invested in.

Vendors other than Northern Trust could be used for this program who could generate additional income but this is not likely without what has been determined to be an unacceptable increase in risk. Northern's participation in the Securities Lending program also allows for a reduction in custody fees.

Northern has never experienced a loss due to borrower default or collateral reinvestment in a collateral fund. Following is a chart of securities lending activity for the most recent three fiscal years (dollars in 000's).

	2005	2004	2003
Avg Securities on Loan	$ 279,405	$ 338,917	$ 216,728
Avg Eligible Securities	$ 2,200,131	$ 1,979,436	$ 1,692,147
% on Loan	12.7%	17.1%	12.8%
HPOPS Net Earnings	$ 876	$ 741	$ 583
Duration of Collateral Pool (days)	29	24	38

Investment Department Initiatives

The System undertook numerous initiatives during the year in order to restructure the Investment Department's operations, reduce investment and operational risks and to enhance returns. Following is a brief review of this year's initiatives that have been approved by the Board and are in various stages of implementation.

Implementation of a Risk Budget

These initiatives included the implementation of a risk budget which should more closely focus our attention on active versus passive allocation decisions and the relative risk of individual manager's strategies. In the past, our allocation to passive strategies had been somewhat arbitrary and our new strategy provides us with a framework in which to develop our passive versus active allocation decisions. This new tool also has helped us to better quantify and assess the effect of each active manager's risk on our portfolio and to adjust our asset allocation accordingly.

Cash Equitization Program

The Board has approved a cash equitization strategy that is intended to allow the System to ensure that excess cash balances do not detract from returns. We are in the process of contracting with an investment manager to implement this program in accordance with guidelines established by the Board

Redesign of Rebalancing Policy

Another significant initiative was the redesign of our rebalancing policy which should provide the System with an improved tool to monitor and maintain the Board approved asset allocation. The new policy established volatility based rebalancing ranges, new implementation and reporting requirements and provides for the utilization of a third-party rebalancing manager to assist in the implementation of the program.

Design of Investment Manager Structure

We also reviewed the structure of our public equity portfolio and implemented a new methodology to allocate assets among our asset managers. This new methodology is intended to provide increased assurance that the System maintains market weightings in all capitalization ranges and thus minimize any unintended capitalization or growth-versus-value bets in the portfolio.

Cost Control

In an effort to hold down operating costs we also reviewed our securities lending and directed brokerage programs and were able to obtain improved rebate rates in both of these programs that should provide incremental income to the System. In addition, through a detailed review and analysis of our Investment Department resource needs we were able to decrease the Investment Department business office operating budget by approximately $100 thousand.

Reporting

Finally, we implemented a new investment performance reporting structure that is intended to provide more timely and meaningful investment performance information to the Board.

Report Preparation

This report was prepared by the Investment Department of the Houston Police Officers' Pension System.

Rates of Return by Year (%)

Years Ended June 30

Year	System Total	Composite Benchmark	Domestic Equity	Russell 3000	International Equity	MSCI EAFE	Fixed Income	Lehman Brothers Aggregate	High Yield	Citi-group HY	Alternative Investments
2001	-4.0	-9.1	-3.9	-13.9	-14.1	-23.3	5.3	11.2	2.7	-1.2	0.5
2002	-8.8	-8.8	-15.4	-17.2	-9.5	-9.2	7.1	8.6	3.0	-4.7	-12.1
2003	4.2	4.3	3.4	0.8	-5.3	-6.1	15.1	10.4	17.7	26.4	-16.5
2004	21.6	19.0	22.9	20.4	41.0	32.6	4.6	0.3	11.6	10.3	30.1
2005	13.5	9.7	10.5	8.1	14.4	14.1	19.0	6.8	9.3	10.4	24.8

Compound Annualized Rates of Return by Year (%)

Years Ended June 30, 2005

Year	System Total	Composite Benchmark	Domestic Equity	Russell 3000	International Equity	MSCI EAFE	Fixed Income	Lehman Brothers Aggregate	High Yield	Citi-group HY	Alternative Investments
2	17.4	14.2	16.5	14.1	27.0	23.0	11.6	3.5	10.5	10.3	27.4
3	12.8	10.6	12.0	9.5	15.2	12.5	12.7	5.8	12.8	15.5	10.1
5	4.7	1.8	2.7	-1.4	3.5	-0.2	10.1	7.4	8.7	7.7	3.7
10	10.1	9.2	11.5	10.0	10.6	5.6	7.8	6.8	na	7.3	na

These calculations were prepared using a time-weighted rate of return in accordance with The CFA Institute's Global Investment Performance Standards. The System's total rates of return are net of fees. All other rates of return are presented gross of fees. Though these standards do not apply to plan sponsors per se, we have used them herein for purposes of presenting investment rates of return.

Schedule of Ten Largest Domestic Equity Holdings
As of June 30, 2005

Shares	Description	Market Value ($000's)	% of Total Domestic Equity
545,868	J. C. Penney	$ 28,702	2.51%
343,695	L-3 Communications Holdings Corp	26,320	2.30%
672,329	Countrywide Financial Corp	25,959	2.27%
400,500	Exelon Corp	20,558	1.80%
584,100	Tyco International	17,113	1.50%
149,900	General Dynamics Corp	16,480	1.44%
512,800	Viacom	16,427	1.44%
277,319	Gillette	14,041	1.23%
151,635	Aetna Inc	12,558	1.10%
355,100	General Electric	12,381	1.08%

Schedule of Ten Largest International Equity Holdings
As of June 30, 2005

Shares	Description	Market Value ($000's)	% of Total International Equity
55,300	Nestle (Switzerland)	$ 14,158	2.57%
473,500	Glaxosmithkline (UK)	11,551	2.10%
174,409	Unilever (Netherlands)	11,328	2.06%
609,300	Deutsche Telekom (Germany)	11,286	2.05%
2,338	Nippon Telegraph & Telephone (Japan)	10,022	1.82%
585,021	Telefonica (Spain)	9,590	1.74%
2,750,983	Morrison Supermarket (UK)	9,172	1.67%
220,900	Daimlerchrysler (Germany)	8,980	1.63%
2,086,358	British Telecom Group (UK)	8,601	1.56%
173,203	Carrefour (France)	8,408	1.53%

A complete list of all individual holdings is available upon request.

Schedule of Ten Largest Domestic Fixed Income Holdings
As of June 30, 2005

Par Value	Description	Market Value ($000's)	% of Total Fixed Income
2,130,000	El Paso Production 7.75% due 6/1/2013	$ 2,288	0.72%
1,830,000	AES Corp. 9% due 5/15/2015	2,075	0.65%
1,805,000	Be Aerospace Inc 8% due 3/1/2008	1,853	0.58%
1,485,000	Fisher Scientific Intl Inc 6.75% due 8/15/2014	1,590	0.50%
1,425,000	PS&E Energy Holdings 8.625% due 2/15/2008	1,561	0.49%
1,827,000	Calpine Corp. 8.5% due 7/15/2010	1,478	0.46%
1,580,000	Pinnacle Foods 8.25% due 12/1/2013	1,425	0.45%
1,161,486	Cedar Brakes 9.875% due 9/1/2013	1,404	0.44%
1,225,000	Vanguard Health 9% due 10/1/2014	1,351	0.42%
1,490,000	General Motors Accepantance Corp. 8% due 11/1/2031	1,349	0.42%

Schedule of Ten Largest Non-U.S. Fixed Income Holdings
As of June 30, 2005

Par Value	Description	Market Value ($000's)	% of Total Fixed Income
1,450,000,000	Japan(Govt Of) 0.8% due 6/20/2009	$ 13,358	4.18%
1,200,000,000	Japan(Govt Of) 0.3% due 12/20/2007	10,883	3.41%
800,000,000	Japan(Govt Of) 1.4% due 12/20/2011	7,578	2.37%
6,400,000	Russian Federation Variable Rate 3/30/2006	7,225	2.26%
700,000,000	Japan(Govt Of) 1.5% due 03/20/2014	6,610	2.07%
4,000,000	Bundesobligation Tbond 4.5% due 08/17/2007	5,278	1.65%
4,000,000	Italy(Rep Of) 5% due 10/15/2007	5,199	1.63%
3,000,000	Italy(Rep Of) 6% due 5/1/2031	4,904	1.54%
490,000,000	Japan(Govt Of) 2.1% due 09/20/2024	4,658	1.46%
3,000,000	Germany(Fed Rep) 5.375% due 4/1/2010	4,174	1.31%

A complete list of all individual holdings is available upon request.

Schedule of Brokerage Commissions Paid

Domestic Equity Trading - Ten Largest by Total Commissions Paid
For the year ended June 30, 2005

Brokers	Shares	Commissions	Principal	Commissions Per Share
Driehaus Securities Corp	21,882,338	$ 1,296,205	$ 976,784,782	$0.059
Merrill Lynch	8,799,257	434,424	473,826,535	0.049
Jefferies & Company	5,128,518	156,912	150,629,355	0.031
Goldman Sachs & Company	8,417,796	134,481	273,271,072	0.016
UBS	2,112,731	105,188	76,805,231	0.050
Lehman Brothers Inc	2,095,727	103,459	86,786,125	0.049
Bear, Stearns, Securities Corp	2,869,866	91,028	123,656,279	0.032
Cantor Fitzgerald & Co	1,636,820	79,905	53,202,016	0.049
Citigroup Global/Smith Barney	1,682,915	79,379	58,350,111	0.047
Bernstein, Sanford C. & Co	1,577,969	77,101	57,298,970	0.049

International Equity Trading - Ten Largest by Total Commissions Paid
For the year ended June 30, 2005

Brokers	Shares	Commissions	Principal	Commissions In Basis Points
Citigroup Global	1,422,242	$ 38,056	$ 23,478,600	16.21
Morgan Stanley	1,716,401	29,210	25,375,967	11.51
Goldman Sachs	1512741	26,455	21,831,692	12.12
Deutsche Bank	611,568	26,126	14,609,212	17.88
Lehman Brothers	2,324,216	20,921	15,069,191	13.88
ABN AMRO	2,125,352	20,688	14,451,163	14.32
Merrill Lynch	728,414	19,840	13,456,109	14.74
Credit Suisse First Boston	4,337,558	17,626	12,071,081	14.60
Societe Generale	571,438	17,379	11,020,993	15.77
UBS	1,823,316	15,776	9,468,592	16.66

SECTION FOUR

ACTUARIAL SECTION

Towers Perrin

Actuarial Certification, Reliances and Distribution

This report describes the results of an actuarial valuation of the Houston Police Officers Pension System. The Houston Police Officers Pension System retained Towers Perrin to perform this actuarial valuation for the purposes of determining the funding status for the plan year July 1, 2004 through June 30, 2005.

The consulting actuaries are members of the Society of Actuaries and other professional actuarial organizations and meet their "General Qualification Standard for Prescribed Statements of Actuarial Opinions" relating to pension plans.

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

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

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

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

It should be noted that other than the City agreement to maintain a funded status floor as specified under the 2004 Meet and Confer (see City Contribution Schedule on page 29), the City funding schedule could potentially not be sufficient to cover all future benefit payments of the Houston Police Officers Pension System. Moreover, it is possible that the Houston Police Officers Pension System will fall below the funded status floor as actual experience differs from assumed and/or assumptions change. Towers Perrin has not been provided detailed provisions on how the funded status floor will be maintained if the funded status declines below specified levels.

The information contained in this report was prepared for the internal use of the Houston Police Officers Pension System and its auditors in connection with our actuarial valuation of the pension plan. It is neither intended nor necessarily suitable for other purposes. The Houston Police Officers Pension System may also distribute this actuarial valuation report to the appropriate authorities who have the legal right to require the Houston Police Officers Pension System to provide them with this report, in which case, the Houston Police Officers Pension System will use best efforts to notify Towers Perrin in advance of this distribution. Further distribution to, or use by, other parties of all or part of this report is expressly prohibited without Towers Perrin's prior written consent.

Towers Perrin

Adam S. Berk
ASA, CFA, EA, MAAA

Steven R. Rusher
FSA, EA, MAAA

February, 2005

Historical Unfunded Actuarial Accrued Liability (Surplus) ($000)

Valuation Date	Actuarial Accrued Liability (AAL)	Actuarial Value of Assets (AVA)	AVA as a Percentage of AAL	Unfunded AAL (Surplus)	Covered Payroll	UAAL (Surplus) as a Percentage of Covered Payroll
July 1, 1984	$ 507,883	$ 230,143	45%	$ 277,740	$ 111,489	249%
July 1, 1986	454,067	420,487	93	33,580	125,963*	27
July 1, 1987	488,387	505,483	104	(17,096)	126,960	(13)
July 1, 1988	524,894	516,177	98	8,717	121,667	7
July 1, 1989	581,681	585,358	101	(3,677)	122,803	(3)
July 1, 1990	663,278	676,684	102	(13,406)	126,665**	(11)
July 1, 1992	853,975	774,785	91	79,190	143,020	55
July 1, 1993	936,674	857,535	92	79,139	159,321	50
July 1, 1994	984,495	947,456	96	37,039	162,143	23
July 1, 1995	1,000,423	1,038,256	104	(37,833)	174,761	(22)
July 1, 1996	1,199,748	1,168,056	97	31,692	182,251	17
July 1, 1997	1,258,217	1,329,570	106	(71,353)	187,134	(38)
July 1, 1998	1,549,341	1,518,081	98	31,260	196,364	16
July 1, 1999	1,773,829	1,746,312	98	27,517	246,569***	11
July 1, 2000	1,966,404	2,013,491	102	(47,087)	250,691	(19)
July 1, 2001	2,306,427	2,226,307	97	80,120	264,226	30
July 1, 2002	2,593,730	2,337,157	90	256,573	286,150	90
July 1, 2003	2,874,738	2,394,411	83	480,327	300,405	160
July 1, 2004	3,339,224	2,466,070	74	873,154	329,840	265

* Reflects the July 5, 1986 pay decrease.
** Reflects the November 1, 1990 pay increase.
*** Definition of covered payroll changed from base pay to total direct pay less overtime.

Prepared by Towers Perrin

Historical Solvency Test ($000)

Valuation Date	Actuarial Accrued Liability for: Employee Contributions	Inactive Participants	Active Participants (City-Financed Portion)	Actuarial Value of Assets	Portion of Actuarial Accrued Liability Covered by Assets		
	(1)	(2)	(3)		(1)	(2)	(3)
July 1, 1989	$ 82,919	$ 222,585	$ 276,177	$ 585,358	100%	100%	100%
July 1, 1990	87,430	261,114	314,734	676,684	100	100	100
July 1, 1991	98,099	338,914	416,962	774,785	100	100	81
July 1, 1992	105,464	372,674	458,536	857,535	100	100	83
July 1, 1993	114,279	401,989	468,227	947,456	100	100	92
July 1, 1994	123,471	416,053	460,899	1,038,256	100	100	100
July 1, 1995	91,687	764,518	343,543	1,168,056	100	100	91
July 1, 1996	95,615	812,498	350,104	1,329,570	100	100	100
July 1, 1998	99,298	1,017,723	432,320	1,518,081	100	100	93
July 1, 1999	107,008	1,157,882	508,939	1,746,312	100	100	95
July 1, 2000	111,099	1,324,079	531,225	2,013,491	100	100	100
July 1, 2001	138,248	707,152	1,461,027*	2,226,307	100	100	95
July 1, 2002	145,255	718,779	1,729,696	2,337,157	100	100	85
July 1, 2003	153,634	838,090	1,883,014	2,394,411	100	100	74
July 1, 2004	153,088	995,841	2,190,295	2,466,070	100	100	60

* Prior to July 1, 2001 the Actuarial Accrued Liability for DROP Participants was included in the Inactive liability.

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Historical Active Participant Data

Valuation Date	Number of Participants	Average Age	Annual Covered Payroll ($000)	Average Annual Covered Payroll	Percentage Increase in Average Covered Payroll
January 1, 1980	3,029	N/A	$ 58,169	$ 19,204	10.4%
January 1, 1982	3,243	N/A	89,529	27,607	43.8
July 1, 1984	3,997	N/A	111,489	27,893	1.0
July 1, 1986	4,526	33.5	125,963(1)	27,831	(0.2)
July 1, 1987	4,494	34.4	126,960	28,251	1.5
July 1, 1988	4,239	35.0	121,667	28,702	1.6
July 1, 1989	4,105	35.7	122,803	29,915	4.2
July 1, 1990	4,073	36.2	126,665(2)	31,099	4.0
July 1, 1992	4,120	36.8	143,020	34,714	11.6
July 1, 1993	4,498	36.7	159,321	35,420	2.0
July 1, 1994	4,705	36.8	162,143	34,462	(2.7)
July 1, 1995	4,921	36.9	174,761	35,513	3.0
July 1, 1996(3)	4,395	35.1	150,903	34,335	(3.3)
July 1, 1997	4,282	35.5	149,631	34,944	1.8
July 1, 1998	4,247	35.9	153,479	36,138	3.4
July 1, 1999	4,253	36.3	187,967(4)	44,196(4)	22.3(4)
July 1, 2000	4,137	36.7	179,415	43,368	(1.9)
July 1, 2001(5)	5,325	40.2	264,226(6)	49,620(6)	14.4(6)
July 1, 2002	5,352	40.7	286,150	53,466	7.8
July 1, 2003	5,387	41.3	300,405	55,765	4.3
July 1, 2004	5,225	41.7	329,840	63,127	13.2

(1) Reflects the July 5, 1986 pay decrease.
(2) Reflects the November 1, 1990 pay increase.
(3) Includes those participants currently accruing benefits from the July 1, 1996 to July 1, 2000 valuation dates (excludes current DROP participants).
(4) Definition of covered payroll changed from base pay to total direct pay less overtime.
(5) Includes active participants eligible for DROP beginning July 1, 2001.
(6) Beginning July 1, 2001 the definition of total direct pay changed from the average of the last 26 pay periods to the highest bi-weekly pay period.

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Inactive Participants Added to and Removed from Rolls

	Added to Rolls		Removed from Rolls		Rolls at the End of the Year		Percentage Increase in Annual Benefits	Average Annual Benefit
Period Ended	Number	Annual Benefits ($000)	Number	Annual Benefits ($000)	Number	Annual Benefits ($000)		
December 31, 1979	68	$ 845	12	$ 126	548	$ 4,370	19.6%	$ 7,974
December 31, 1980	73	1,120	19	123	602	5,389	23.3	8,951
December 31, 1981	81	1,191	17	184	666	6,499	20.6	9,759
December 31, 1982	104	1,106	24	240	746	7,842	20.7	10,513
December 31, 1983	82	967	35	362	793	8,931	13.9	11,262
June 30, 1984	53	779	18	150	855	4,760	6.6	11,095
June 30, 1985	83	1,141	42	259	896	10,166	6.8	11,346
June 30, 1986	44	530	37	431	903	10,939	7.6	12,114
June 30, 1987	42	585	36	421	909	11,321	3.5	12,455
June 30, 1988	138	2,668	25	243	1,022	14,069	24.3	13,766
June 30, 1989	89	1,349	46	502	1,065	16,127	14.6	15,142
June 30, 1990	105	1,811	29	457	1,141	18,029	11.8	15,801
June 30, 1992	222	4,662	75	1,127	1,288	22,999	27.6	17,857
June 30, 1993	105	2,012	16	205	1,377	25,474	10.8	18,500
June 30, 1994	106	2,172	64	953	1,419	27,286	7.1	19,229
June 30, 1995	107	2,425	48	847	1,478	29,464	8.0	19,935
June 30, 1996*	893	19,109	36	602	2,335	48,624	65.0	20,824
June 30, 1997	182	3,481	29	618	2,488	52,772	8.5	21,211
June 30, 1998	159	3,483	28	589	2,619	63,957	21.2	24,420
June 30, 1999	150	3,770	46	1,001	2,723	70,432	10.1	25,866
June 30, 2000	233	6,421	36	857	2,920	76,401	8.5	26,165
June 30, 2001**	131	3,755	1,250	33,892	1,801	54,006	(29.3)	29,987
June 30, 2002	104	2,809	46	1,113	1,859	55,013	1.9	29,593
June 30, 2003	106	2,967	47	1,109	1,918	61,531	11.8	32,081
June 30, 2004	220	9,172	33	1,014	2,105	70,307	14.3	33,400

* Includes DROP participants from June 30, 1996 through June 30, 2000

** Beginning July 1, 2001 excludes active participants eligible for DROP.

Prepared by Towers Perrin

Change in Unfunded Actuarial Accrued Liability (Surplus) Since the Prior Valuation ($000)

■ Unfunded Actuarial Accrued Liability (Surplus) as of July 1, 2003	$ 480,327
■ Expected Change Due to Normal Operation	
– Normal Cost (City Portion)	56,776
– City Actuarially Determined Contribution	(73,299)
– Interest (1)	72,109
– Recognition of Prior Asset Losses (Gains)	121,055
– Net Change	176,641
■ Expected Change Due to City Funding Less Than Actuarial Rate	38,180
■ Change Due to Actuarial Experience	
– Actuarial (Gain) Loss From Asset Sources	(52,939)
– Actuarial (Gain) Loss From Liability Sources Other Than Additional Pay Components	206,137
– Actuarial (Gain) Loss From Additional Pay Components (2)	71,639
– Net Change	224,837
■ Change in Actuarial Assumptions and Methods	(46,831)
■ Unfunded Actuarial Accrued Liability (Surplus) as of July 1, 2004 Before Plan Provision Changes	873,154
■ Change in Plan Provisions	
– Change Due to Provisions Other Than Pay Definition	(162,783)
– Change Due to Change in Pay Definition (3)	(27,640)
– Net Change	(190,423)
■ Change in DROP Assumptions Subsequent to Changes in Plan Provisions	16,227
■ Unfunded Actuarial Accrued Liability (Surplus) as of July 1, 2004 After Plan Provision Changes	698,958

(1) Excludes interest on the unrecognized investment losses

(2) Includes CMEPP, SOSP, and Weekend/Shift Differential

(3) Excludes CMEPP and SOSP

Summary of Actuarial Methods and Assumptions

The following methods and assumptions were adopted for the Actuarial Valuation Report as of July 1, 2004.

Actuarial Methods

Actuarial Value of Assets	Gains and losses in the market value of assets, based on the difference between the actual and the assumed rate of return, are recognized over five years.
Actuarial Cost Method	Entry Age Normal Method with liabilities allocated from date of entry to assumed retirement age. The Unfunded Actuarial Accrued Liability (Surplus), including effects of actuarial gains and losses, is amortized as a level percentage of pay over 30 years. The contribution is increased for interest for one-half of a year to reflect timing of payments.

Economic Assumptions

Investment Return	8.5% per year, net of expenses
Payroll Growth Rate/Inflation	3.5% per year

Individual Merit Increase Rate

Service	*Increase*
1	7.00%
2	0.25
3	0.25
4	5.00
5	9.50
6	8.50
7	0.75
8	0.50
9	7.75
10	1.00
11	9.00
12	0.75
13	1.25
14	1.50
15	0.50
16	5.50
17	0.75
18 and over	0.00

Individual Pay Increase Rate	Merit plus 3%
DROP Crediting Rate	9.0% per year

Summary of Actuarial Methods and Assumptions

Demographic Assumptions	
Entry Age	Date sworn.
DROP Participation Rates	100% of active participants are assumed to elect the DROP. Participants are assumed to elect the maximum duration for the back DROP, up to 20 years.
DROP Antiselection	DROP benefits are loaded by 1% to reflect possible antiselection of back DROP provisions.
PROP Antiselection	PROP benefits are loaded by 1% to reflect possible antiselection of PROP provisions. PROP benefits are assumed to be paid as a lump sum.

Retirement Rates

	Service						
Age	20-21	22-23	24-25	26-27	28-29	30-39	40 and over
40-54	5%	5%	5%	10%	20%	20%	100%
55-59	5	10	10	30	30	40	100
60-64	10	10	25	50	50	50	100
65 and over	100	100	100	100	100	100	100

Mortality Rates	
< Active participants and nondisabled retirees	1994 Group Annuity Mortality Table (see table below for sample rates).
< Disabled retirees	1987 Commissioners Group Disabled Mortality Table (see table below for sample rates).
Disability Rates	Graduated rates (see table below for sample rates).
Percentage of Deaths and Disabilities in the Line of Duty	100%.
Termination Rates and Terminated Vested Pension Benefit Election	Graduated rates (see table below for sample rates). 50% of members eligible to receive a terminated vested pension are assumed to elect the pension at age 60 instead of a refund of contributions.

Summary of Actuarial Methods and Assumptions (cont.)

Marital Status at Benefit Eligibility

< Percentage married	90%. (No beneficiaries other than the spouse assumed).
< Age difference	Husbands assumed to be three years older than wives.
Valuation Earnings	Highest pay in the last 26 pay periods preceding the valuation date, annualized and increased for one-half year of assumed pay increases. For participants who are not Police officers or senior Police officers with less than 17 years of employment, no increase is assumed for 2004.

Sample Rates

	Sample Rates per 100 Participants						
	Nondisabled Mortality		Disabled Mortality (Ultimate)	Termination	Disability	
Age	Male	Female	All	All	Male	Female
20	0.05	0.03	0.00	4.44	0.00	0.00
25	0.07	0.03	0.00	3.99	0.00	0.00
30	0.08	0.04	2.82	3.02	0.08	0.12
35	0.09	0.05	2.82	1.92	0.10	0.16
40	0.11	0.07	2.82	0.92	0.14	0.22
45	0.16	0.10	2.82	0.21	0.21	0.30
50	0.26	0.14	2.82	0.00	0.37	0.54
55	0.44	0.23	2.82	0.00	0.79	1.08
60	0.80	0.44	3.14	0.00	2.15	2.86
65	1.45	0.86	3.98	0.00	0.00	0.00

Changes in Methods and Assumptions Since the Prior Valuation

The individual merit increase component of the salary increase assumption was revised to better reflect future anticipated experience. The previous assumption is shown below:

Age	Increase
20	5.00%
21	4.30
30	1.80
35	0.55
40	0.25
45	0.25
Over 50	0.00

The non-merit component of the salary increase assumption was changed from 4.0% to 3.0%.

Summary of Actuarial Methods and Assumptions (cont.)

The assumed retirement rates were revised to better reflect future anticipated plan experience. The previous rates are shown below:

Number of Years of Service	*Probability of Retiring Within One Year*
20	15%
21 – 22	5
23	10
24 – 25	15
26 – 28	30
29 – 40	20
Over 40	100

The assumed rate of payroll growth/inflation was changed from 4.0% to 3.5% to better reflect the anticipated future experience of the plan.

Summary of Plan Provisions

Covered Members	All police officers sworn before September 1, 1975 are covered under Plan 1, except those who elected by December 31, 1981 to participate in Plan 3. All police officers sworn on or after September 1, 1975, but before September 1, 1981 are covered under Plan 2, except those who elected by December 31, 1981 to participate in Plan 3 and those from Police Cadet Classes 70 and 71 who elected to transfer to Plan 1. All other police officers are covered by Plan 3, except those from Police Cadet Classes 70 and 71 who elected to pay additional contributions and transfer to Plan 1.
Final Compensation	
Prior to November 28, 1998	Monthly base salary paid to the participant in his/her last month of service. For any participant from a position held for less than 3 years, final compensation is the average monthly base salary for the 3 years prior to retirement.
After November 28, 1998 but prior to July 1, 2001	Monthly total direct pay less overtime paid to the participant in his/her last month of service. For any participant from a position held for less than 3 years, final compensation is the average monthly base pay for the 3 years prior to retirement plus the other current components of total direct pay.
After July 1, 2001	Highest biweekly pay period (excluding overtime) during the last 26 pay periods annualized. Amounts not paid on a biweekly basis are deducted from period paid. Annual amounts are divided by 26 and added to the highest pay period, including motorcycle allowances.
Service Retirement	
Eligibility	20 years of service.
Benefit:	
< Prior to November 1, 1955	$75 per month plus $2 per month for each year of service in excess of 25 years.
< After November 1, 1955 but prior to January 13, 1968	30% of final compensation plus 1% of final compensation for each year of service in excess of 20 years.

Summary of Plan Provisions (cont.)

< After January 13, 1968 but prior to July 1, 1986	Plans 1 and 2: 30% of final compensation plus 2% of final compensation for each year of service in excess of 20 years. Plan 3: 2% of final compensation for each year of service up to 40 years, reduced 0.42% for each month benefit commencement precedes age 55.
< After July 1, 1986 but prior to July 1, 1988	2% of final compensation for each year of service up to 40 years.
< After July 1, 1988 but prior to September 1, 1997	45% of final compensation plus 2% of final compensation for each year of service in excess of 20 years; maximum 80% of final compensation. Benefit based on prior formula is payable until July 1, 1991 and recomputed benefit is payable thereafter.
< After September 1, 1997 but prior to July 1, 2001	50% of final compensation plus 2% of final compensation for each year of service in excess of 20 years; maximum 80% of final compensation.
< After July 1, 2001	55% of final compensation plus 2% of final compensation for service in excess of 20 years. The Pension System recomputed the benefit of each person who retired before July 1, 2001. The retiree's benefit was increased by the result of multiplying the difference between 55% and the percentage used at the time of retirement in computing the retiree's benefit for the first 20 years of service by the base salary of the retiree at the time of retirement. Retroactive cost-of-living increases were not applied to the increased benefit. This recomputed benefit is effective for all payments on or after July 1, 2001.
Additional Benefits	An extra monthly benefit of $150.00 is payable for life. Effective November 28, 1998, a $5,000 lump sum is payable upon retirement.
Terminated Vested Pension Benefit	
Eligibility	More than 10 but less than 20 years of service. Termination on or after November 28, 1998.
Benefit	2.75% of final compensation times years of service. This benefit commences at age 60 or at termination of service if later.

Summary of Plan Provisions (cont.)

Deferred Retirement
Option Plan (DROP)

Eligibility	20 years of service
Benefit:	
< After September 1, 1995 but prior to September 1, 1997	Eligible participants may elect to participate in the DROP until they leave active service. The member's retirement pension will be calculated based on service and earnings at the time the DROP is elected. A notional account will be maintained for each DROP participant. This account will be credited with the following amounts while the member is participant of the DROP: < The member's monthly retirement pension, including applicable cost-of-living adjustments, < The member's contribution to the Pension System, and < Investment earnings/losses at the rate of the Pension System's earnings/losses averaged over a five-year period. Effective July 1, 2001, this rate is subject to a minimum of 0%. A benefit equal to the DROP account balance is paid at the time the member leaves active service. The payment is made as a single lump sum. If a DROP participant suffers an on-duty disability resulting in the inability to perform his/her usual and customary duties as a police officer or dies in the line of duty, he (or his survivors) are allowed to revoke the DROP election and to receive the more generous on-duty disability or death benefits.
< After September 1, 1997 but prior to December 1, 1998	The Pension System recomputed the benefit of each person who entered the DROP before September 1, 1997. The benefit was increased in the same manner as the retiree's benefit.
< After December 1, 1998 but prior to July 1, 2001	The Pension System recomputed the benefit of each person who entered the DROP before December 1, 1998. The benefit was recalculated based on Total Direct Pay less overtime upon entry to the DROP. This recomputed benefit is effective for all payments on or after December 1, 1998.

Summary of Plan Provisions (cont.)

< After July 1, 2001	The Pension System recomputed the benefit of each person who entered the DROP before July 1, 2001. The member's benefit was increased by the result of multiplying the difference between 55% and the percentage used at the time of DROP entry in computing the member's benefit for the first 20 years of service by the base salary of the member at the time of DROP entry. Retroactive cost-of-living increases were applied to the increased benefit. The account balance for each participant was recomputed as if this new benefit had been effective since DROP entry.
Benefit Recalculation	Effective July 1, 2001, monthly benefit at retirement will be recalculated to be the greater of (i) current monthly benefit, or (ii) monthly benefit based on service at DROP entry and Final Compensation at retirement date.
Back DROP Option	Effective on July 1, 2001, a back DROP option is available for all eligible participants. The DROP account is recalculated under the option based on what the account balance would have been had the participant elected the DROP earlier than he/she actually did. The initial DROP entry date cannot be backdated prior to September 1, 1995 or prior to 20 years of credited service, and must be on the first of the month selected.
Postretirement Option Plan (PROP)	
Eligibility	Retired from DROP
Benefit:	
< After November 28, 1998 but prior to July 1, 2001	A retired member is allowed to leave all or a portion of their DROP account in the System. These accounts are credited every calendar year with the 30-year Treasury bond rate as of June of the preceding year.
< After July 1, 2001	The interest rate earned on PROP accounts will be the same as the interest rate credited to DROP accounts, including a minimum credited rate of 0%.

Summary of Plan Provisions (cont.)

Disability Retirement

Eligibility	Effective July 1, 2001, participant partially or totally disabled is eligible for Disability Retirement as defined below: < Total: Disability is defined as "unable to perform his/her usual and customary duties as a police officer". < Partial: Disability is an impairment which renders the participant unable to work as a police officer and which is expected to last 12 months.
Benefit:	
< Duty-connected	Total: The service retirement benefit accrued to date of disability (or 20 years, if greater). Partial: 35% of final compensation is payable for life or as long as he remains incapacitated.
< Not duty-connected	Total or partial: The disability benefit is 2.75% of final compensation times years of service up to 20, minimum 27.5% of final compensation.
Additional benefits	An education allowance equal to 100% of final compensation less disability benefit is payable for up to four years for off-duty or duty-related disability. Proportionate members injured while on-duty as a municipal worker will receive immediate off-duty benefit upon Board approval.

Survivor Benefits

Eligibility	Surviving spouses and dependent children and parents of participants, including surviving spouses of retired or disabled participants who were not married at the time of retirement or disability, provided the spouse was married to the participant for at least 5 years at the time of death:
Benefit	Spouse's benefit upon death before retirement:
< Prior to September 1, 1997	If duty-connected: Monthly lifetime benefit equal to 100% of final compensation at date of death. If not duty-connected: Monthly lifetime benefit equal to 100% of the service retirement benefit the participant had accrued at the time of death. Spouse's benefit upon death after retirement monthly lifetime benefit equal to actual benefit payable at time of death.

Summary of Plan Provisions (cont.)

	Dependent children's benefit if no surviving spouse, the benefit that would have been payable to the spouse is divided equally among the dependent children.
	If there is a surviving spouse, the dependent children of Plan 1 and Plan 2 participants receive $25 per month. Dependent children include unmarried children who are under age 18, and for Plan 3, full-time students under age 22, or permanently disabled children.
	Dependent parent's income if no surviving spouse or children, but there is a dependent parent, the benefit that would have been payable to the spouse will be paid to the dependent parent.
< After September 1, 1997 but prior to July 1, 2001	The Pension System recomputed the benefit of each survivor whose original benefit was computed prior to September 1, 1997. The benefit was increased in the same manner as the retiree's benefit.
< After July 1, 2001	The Pension System recomputed the benefit of each survivor whose original benefit was computed prior to July 1, 2001. The benefit was increased in the same manner as the retiree's benefit.
Additional benefits	Effective December 1, 1998, a $5,000 lump sum is paid upon the death of an active member.
	Effective July 1, 2001, an extra monthly benefit of $150.00 is payable for life. Children receiving equivalent of the spouse's benefit do not receive this additional benefit.
Benefit Adjustments	
Cost-of-living	Monthly benefits for participants receiving payments are increased each April 1 by 2/3 of the increase in the Consumer Price Index for All Urban Consumers (CPI-U) for the preceding calendar year. Effective September 1, 1997 this increase is subject to a minimum of 3.0% per year compounded and a maximum increase of 8.0% per year compounded.

Summary of Plan Provisions (cont.)

13th benefit check

Effective November 28, 1998, a 13th benefit check is paid to current retirees and DROP members when:

- The assets on the fund equal or exceed the liabilities after the 13th benefit check is paid.
- The return on investments for the preceding fiscal year exceeds 9.25%.
- The payment of the benefit will not cause the City of Houston's contribution to the System to increase.

Service Adjustments

Effective November 28, 1998, participants with previous service with the City in non-classified positions may use that service to satisfy the service requirement of 20 years for retirement purposes only.

Effective July 1, 2001, participants who have service credit in more than one City of Houston Pension Plan may use their combined service to qualify for DROP participation.

Effective July 1, 2001, participants involuntarily transferred to the System from the Houston Municipal Employees System will receive service under this plan for years worked while serving as a City Marshall, Airport Police or Park Police.

Contributions

Employee Contributions

Prior to December 1, 1998, each participant contributes 8.75% of base salary. After December 1, 1998, each participant contributes 8.75% of average total direct pay less overtime.

Refunds

Refunds of contributions are made if

(i) The participant dies before 10 years of service and the death is not duty-connected,

(ii) The participant dies with no eligible survivor,

(iii) A Plan 1 or 2 participant leaves service before eligibility for retirement after completing 5 years of service, or

(iv) A Plan 3 participant leaves service with less than 20 years of service.

Contributions are refunded without interest.

Summary of Plan Provisions (cont.)

Employer Contribution

The city will follow the following contribution schedule:

Fiscal Year Ending (June 30)	City Contribution Amount
2001	$ 30,645,000
2002	32,645,000
2003	34,645,000
2004	36,645,000
2005	36,645,000

For fiscal years ending after June 30, 2005 the City will contribute the greater of:

(i) 16% of pay

(ii) The actuarially determined rate.

Changes in Plan Provisions from Since the Prior Valuation

There have been no changes to the plan provisions since the prior valuation.

Changes in Plan Provisions Subsequent to Current Valuation

Effective October 9, 2004, the System entered into an agreement with the City to change benefits to members as described below.

Pension Compensation

The definition of compensation was changed to exclude Exempt Time and Strategic Officer Staffing Pay as well as overtime pay.

Final Average Compensation

Compensation used to determine the retirement benefit was changed from the highest biweekly pay period during the last 26 pay periods to an average of the last three years of compensation. This average will be phased in beginning with the pay period ending after October 9, 2004 until the new definition is fully phased in after 78 pay periods.

Service Retirement Eligibility

For new members who become participants after October 9, 2004, retirement eligibility will begin at age 55 with 10 years of service, rather than at any age with 20 years of service.

Summary of Plan Provisions (cont.)

Service Retirement Benefit	For current members, the benefit will be calculated using the new definition of Final Average Compensation. During the transitional period before October 7, 2007, a member may receive a monthly pension or DROP benefit determined under one of three alternatives: 1) the benefit calculated using the new definition of Final Average Compensation; 2) the benefit the member would have received had he retired or entered the - DROP immediately before October 9, 2004; or 3) a benefit calculated using a sliding average of the pay received for the pay periods elapsed since October 9, 2004. For new members, the benefit will be 2.25% of Final Average Compensation for each of the first 20 years of service plus 2% of Final Average Compensation for each year of service in excess of 20 years, with a maximum of 80% of Final Average Compensation.
Additional Benefits	New members after October 9, 2004 will not receive a $5,000 lump-sum benefit upon retirement, death, or disability.
Deferred Retirement Option Plan (DROP)	The DROP is closed to new members after October 9, 2004. Instead, new members will have a partial lump sum optional payment (PLOP) of up to 20% of the actuarial value of the accrued pension at retirement. Additionally, a minimum of 3.00% interest will be credited to existing DROP accounts with a maximum of 7.00%. If the actuary certifies that past service costs are fully funded, the credit may be as high as 10.00%.
Postretirement Option Plan (PROP)	The PROP is closed to new members after October 9, 2004.
Disability Education Allowance	New members after October 9, 2004 will not be eligible for this benefit.
Benefit Adjustments	The annual cost-of-living adjustment will be 80% of the increase in the Consumer Price Index for All Urban Consumers (CPI-U) for the preceding year, with a minimum of 2.4% and a maximum of 8%, rather than 2/3 of the CPI-U with a minimum of 3% and a maximum of 8%.
13th Benefit Check	No 13th benefit payment will be paid unless the funded ratio of the plan is at least 120%.

Summary of Plan Provisions (cont.)

Contributions

Beginning October 9, 2004, members will contribute 9% of pay rather than 8.75%. The additional 0.25% of pay will be credited to the plan's general fund and not to a member's DROP account. New members who become participants after October 9, 2004 will contribute 10.25% of pay. This amount will be credited to the plan's general fund.

Employer Contribution

The city agrees to the following contribution schedule:

Fiscal Year	Amount
2005	$36,645,000
2006	16% of total compensation, with a minimum of $53,000,000
2007 - 2012	$5,000,000 above the prior year's payment

Beginning in Fiscal Year 2013 and continuing until the plan's funded ratio is 100%, payments will increase each year by $5,000,000 or, if the scheduled payment is less than the actuarial rate, $10,000,000. In addition, once the plan's funded ratio is 100%, the city will pay the actuarially required rate, but not less than 16% of covered pay.

Additionally, beginning in Fiscal Year 2013 and once the funded ratio reaches 75%, if the funded ratio drops below 75%, the City will pay additional amounts in the following fiscal year to return the plan to 75% funded. Once the fund ratio reaches 80%, the City will contribute additional amounts to return the plan to 80% funded.

Summary of Changes in Assumptions Due to Meet & Confer Agreement

Retirement rates for new members after October 9, 2004

100% of members are assumed to retire after reaching 37.5 years of service

	Service						
Age	20-21	22-23	24-25	26-27	28-29	30-37.5	37.5 and over
40-54	5%	5%	5%	10%	20%	20%	100%
55-59	5	10	10	30	30	40	100
60-64	10	10	25	50	50	50	100
65 and over	100	100	100	100	100	100	100

Summary of Plan Provisions (cont.)

DROP Participation Rates	100% of eligible active participants are assumed to elect the DROP. Participants are assumed to elect the maximum duration for the back DROP, up to 20 years, except in cases where the DROP benefit as of October 9, 2004 determined using the highest biweekly pay period during the last 26 pay periods is greater than the back-DROP benefit using the new definition of Final Average Compensation. If the employee is currently participating in the DROP and his current actual DROP benefit is greater than his estimated back-DROP benefit, then his current DROP benefit is used for valuation purposes.

These provisions have been reflected only in the development of the October 9, 2004 through June 30, 2005 contribution rate and the projection of assets and liabilities. The remaining results reflect only those plan provisions in effect July 1, 2004.

SEGAL

The Segal Company
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T 678.306.3100 F 678.306.3190 www.segalco.com

October 25, 2004

Board of Trustees
Houston Police Officers Pension System
602 Sawyer, Suite 300
Houston, TX 77007

Dear Board Members:

In conjunction with our actuarial audit of the July 1, 2003 pension system valuation, we are pleased to submit this Actuarial Valuation and Review. It summarizes the actuarial data used in the valuation, establishes the funding requirements for fiscal 2003 and provides an analysis of the work by the current actuary, Towers Perrin, on this valuation.

The census information on which our calculations were based was prepared by the Houston Police Officers Pension System and the financial information was provided by the Towers Perrin. Additional information was provided by Adam Berk and David Fee of Towers Perrjn. That assistance is gratefully acknowledged. The actuarial calculations were completed under the supervision of Leon F. Joyner Jr., ASA, MAAA, EA, Enrolled Actuary.

This actuarial valuation has been completed in accordance with generally accepted actuarial principles and practices. To the best of our knowledge, the information supplied in this actuarial valuation is complete and accurate.

We look forward to reviewing this report at your next meeting and to answering any questions.

Sincerely,

THE SEGAL COMPANY

By: ______________________

Leon F. Joyner Jr., ASA, MAAA, EA
Vice President and Consulting Actuary

Valuation Summary for the Houston Police Officers Pension System

Purpose

This valuation was performed as part of The Segal Company's actuarial audit of the July 1, 2003 Houston Police Officers Pension System Valuation. The main purpose of this part of the audit is to determine that all liabilities for the plan have been valued accurately. In the process of completing this valuation, Segal approximated Towers Perrin's actuarial methodology and procedures as closely as possible. Included in our review were the following major areas:

- **Data** – Did the data reconciliation process produce reasonable and accurate data for the valuation?
- **Benefits** – Are the benefits valued consistent with those stated in the actuarial report and plan provisions?
- **Assumptions** – Are the economic and actuarial assumptions stated in the actuarial report those that are being followed?
- **Asset valuation and actuarial cost methods** – Are these methods being applied correctly and do they meet generally accepted actuarial standards?

Summary of Findings

In general, we found the following:

- The data reconciliation process performed by Towers Perrin does produce reasonable and accurate data for the valuation. Our counts of participants and other demographic data closely matched Towers Perrin. The only difference was the recognition of QDRO participants and a small number of inactive vested members.
- The benefits valued stated in the actuarial report are those that are being valued.
- The asset valuation method and actuarial cost method are applied correctly and meet generally accepted actuarial standards.
- The economic and actuarial assumptions stated in the actuarial report are those that are being followed in the valuation process.

The following page summarizes key Segal and Towers Perrin valuation results. The required city contribution rate was determined to be 28.5% by both consulting firms. Our report provides supportive sections and tables that we trust will be useful to your understanding of the valuation.

At June 30, 2003 there were $376,112,000 of net unrecognized investment losses remaining. If these losses had been fully recognized on the valuation date the required city contribution would have increased by 7.6% to a total of 36.1% of covered payroll. The plans funding ratio would decrease to 70.2% from 83.3%.

An estimate of the City of Houston's Net Pension Obligation (NPO) at June 30, 2003 totals $91,422,210 and represents the accumulated value of actual contributions that were less than actuarially required contributions (ARC). About 65 million of the NPO was generated in the last two years as investment losses were recognized.

Valuation Summary for the Houston Police Officers Pension System

Summary of Key Valuation Results

	Segal 2003	Towers Perrin 2003	Percent Difference
Actuarially Required Contributions as of July 1, 2003:			
Dollar amount, adjusted for timing*	$85,132,000	$85,529,000	(0.5%)
As a percentage of payroll	28.5%	28.5%	--
Funding elements for July 1:			
Total Normal cost, adjusted for timing*	$82,537,000	$82,969,000	(0.5%)
Expected employee contributions	26,178,000	26,285,000	(0.4%)
City portion of normal cost, adjusted for timing*	56,359,000	56,684,000	(0.6%)
Payment on unfunded actuarial accrued liability, adjusted for timing*	28,773,000	28,845,000	(0.2%)
Market value of assets	2,018,299,000	2,018,299,000	--
Actuarial value of assets	2,394,411,000	2,394,411,000	--
Actuarial accrued liability	2,873,537,000	2,874,738,000	0.0%
Unfunded actuarial accrued liability	479,126,000	480,327,000	(0.2%)
Funded ratio	83.3%	83.3%	--
Demographic data for plan year beginning July 1:			
Number of inactive participants*	1,925	1,918	(0.4%)
Number of other active participants	3,723	3,723	--
Number of active participants enrolled in DROP	1,656	1,664	(0.5%)
Total payroll	$299,180,000	$300,405,000	(0.4%)
Average payroll	55,620	55,765	(0.3%)

* *Payments are assumed to be made mid-year.*

** *Includes 8 former spouses with deferred benefits.*

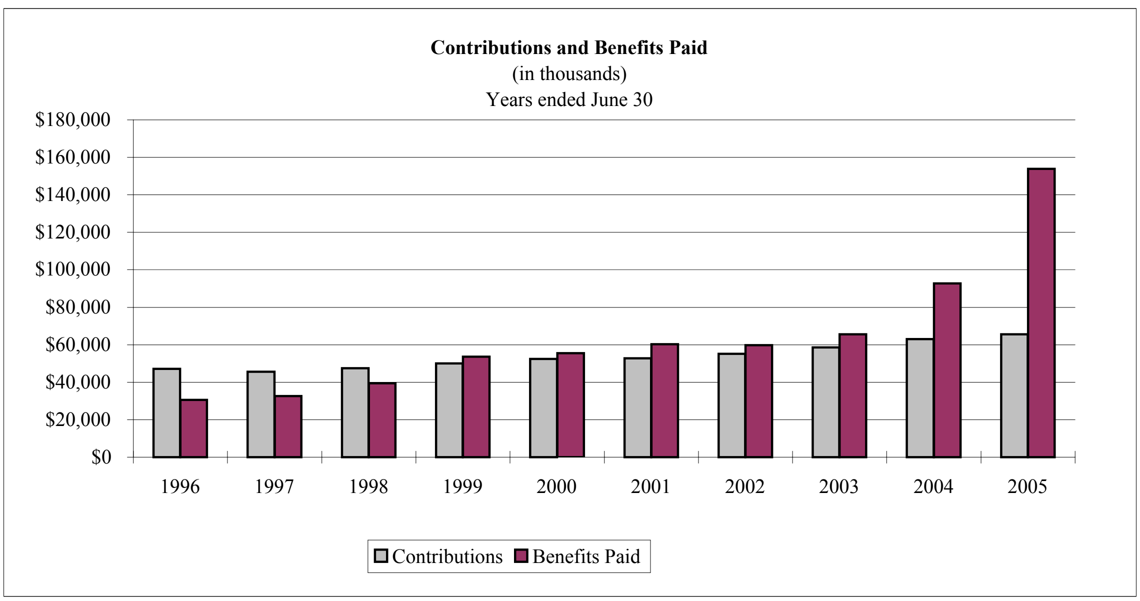
Prepared by The Segal Company

SECTION FIVE

STATISTICAL SECTION

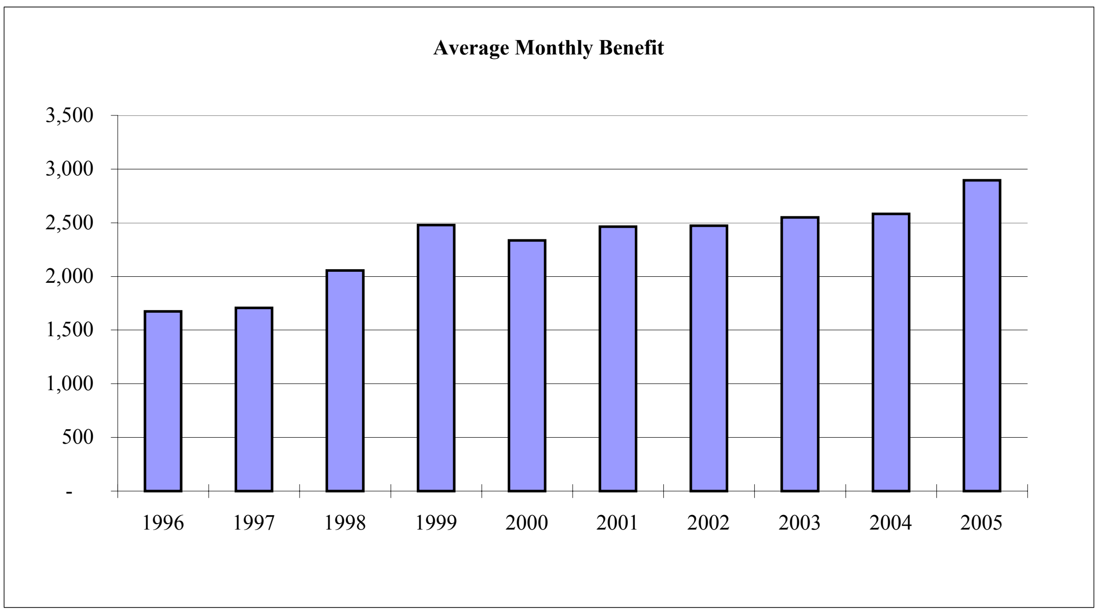
Schedule of Revenue by Source and Expenses by Type
(000's)
For years ended June 30

Fiscal Year	Member Contributions	City Contributions	Investment Income (Loss)	Total Additions (Deductions)	Benefits Paid	Administrative Expenses	Refunds	Total Deductions	Net Increase (Decrease)
1996	$ 15,533	$ 31,562	$ 186,111	$ 233,206	$ 30,552	$ 886	$ 829	$ 32,267	$ 200,939
1997	16,012	29,503	216,567	262,082	32,676	1,272	946	34,894	227,188
1998	16,832	30,564	214,448	261,844	39,440	1,166	986	41,592	220,252
1999	19,347	30,645	251,412	301,404	53,626	1,678	1,127	56,431	244,973
2000	21,761	30,645	292,603	345,009	55,421	2,216	1,545	59,182	285,827
2001	22,043	30,645	(80,232)	(27,344)	60,328	2,854	884	64,066	(91,410)
2002	22,484	32,645	(185,802)	(130,673)	59,783	2,881	1,194	63,858	(194,531)
2003	24,008	34,645	80,785	139,438	65,649	2,746	992	69,387	70,051
2004	26,393	36,645	437,748	500,786	92,697	2,768	852	96,317	404,469
2005	28,410	37,125	321,437	386,972	153,861	3,473	1,198	158,532	228,440

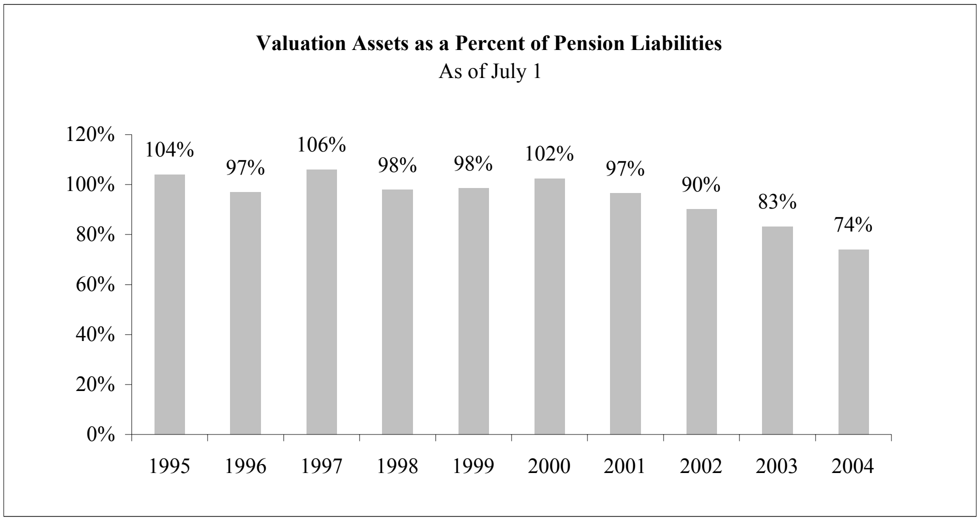


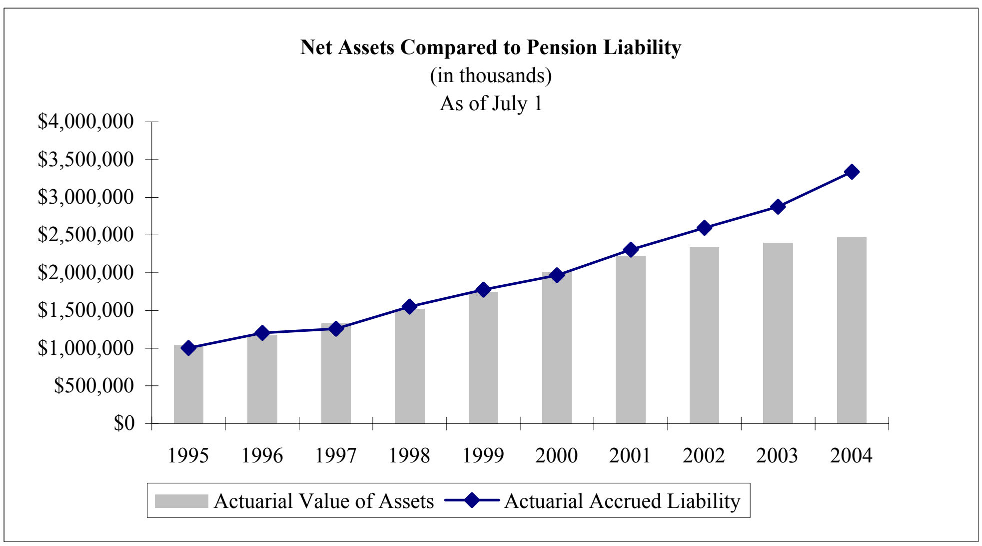
Average Monthly Benefit
Years Ended June 30,

Year	Retirees and Beneficiaries at Year End	Monthly Annuity Payments	DROP Distributions	PROP Distributions	Average Monthly Benefit	
1996	1,548	30,415,628	136,791		1,675	
1997	1,582	32,042,856	633,520		1,706	
1998	1,614	39,440,091	1,801,464		2,057	
1999	1,658	48,676,297	4,948,733		2,479	*
2000	1,723	47,401,683	8,019,553		2,337	*
2001	1,786	51,864,507	8,366,211	97,000	2,463	*
2002	1,864	54,172,009	4,262,647	1,348,270	2,474	*
2003	1,886	57,393,030	5,441,178	2,814,643	2,551	*
2004	2,100	61,742,419	22,603,155	8,351,758	2,582	*
2005	2,376	77,718,710	59,492,691	16,649,190	2,894	*



* The Average Monthly Benefit has been computed by deducting, from Total Benefits Paid, the amounts attributable to the $5,000 lump sum payments and the "13th" check, where applicable.


Valuation Assets as a Percent of Pension Liabilities
As of July 1
120%
100%
80%
60%
40%
20%
0%
104%
97%
106%
98%
98%
102%
97%
90%
83%
74%
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004


Net Assets Compared to Pension Liability
(in thousands)
As of July 1
$4,000,000
$3,500,000
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
Actuarial Value of Assets
Actuarial Accrued Liability

STATISTICAL SECTION

Pensions Awarded in Current Year by Type and by Age

Year Ended June 30, 2005

		Type of Pension		
Age on June 30,	Total	Service	Disability	Survivor
Under 40	7		5	2
40-44	34	25	7	2
45-49	48	40	6	2
50-54	99	95	2	2
55-59	98	92	3	3
60-64	29	26		3
65-69	10	7		3
70-74	8	3		5
75 and over	4			4
Total	337	288	23	26

Total Pensions in Force by Type and by Age

Year Ended June 30, 2005

		Type of Pension		
Age on June 30,	Total	Service	Disability	Survivor
Under 40	45		17	28
40-44	88	51	23	14
45-49	175	135	14	26
50-54	387	340	15	32
55-59	519	456	13	50
60-64	332	274	4	54
65-69	320	251	7	62
70-74	241	175	2	64
75-79	166	97		69
80-84	74	24	2	48
85 and over	29	6		23
Total	2,376	1,809	97	470

Pensions Awarded in Current Year by Type and by Monthly Amount

Year Ended June 30, 2005

		Type of Pension		
Monthly Amount	Total	Service	Disability	Survivor
Under $1000	7	7		
$1000 - 2000	10	6	2	2
$2000 - 3000	38	17	7	14
$3000 - 4000	185	165	13	7
$4000 - 5000	70	67	1	2
$5000 and over	27	26		1
Total	337	288	23	26

Benefit Expenses by Type
(dollars in thousands)
Years ended June 30,

Year	Service Retirement	Disability	Survivor	Children	DROP Distributions	PROP Distributions	Total Benefits Paid
2000	$ 36,984	$ 1,179	$ 9,149	$ 89	$ 8,020	$ -	$ 55,421
2001	38,078	1,608	12,077	102	8,366	97	60,328
2002	40,510	1,869	11,695	98	4,263	1,348	59,783
2003	42,608	1,968	12,730	87	5,441	2,815	65,649
2004	46,115	2,100	13,316	211	22,603	8,352	92,697
2005	60,119	2,962	14,242	396	59,493	16,649	153,861

DROP Activity
(dollars in thousands)
Years ended June 30

	DROP Accounts			DROP Participants		
Year	Accumulations	Distributions	Total	Entrants	Withdrawals	Total
2000	$ 51,892	$ (8,020)	$ 144,810	178	(59)	1,191
2001	104,753	(8,366)	241,197	159	(52)	1,298
2002	72,527	(4,263)	309,461	212	(74)	1,436
2003	74,268	(5,441)	378,288	297	(62)	1,671
2004	48,487	(22,603)	404,172	285	(185)	1,771
2005	46,126	(59,493)	390,805	372	(298)	1,845

Note: DROP Activity data for 2001 has been restated for the effect of the recalculation of DROP accounts pursuant to the 2001 Meet and Confer Agreement with the City of Houston.

PROP Activity
(dollars in thousands)
Years ended June 30

	PROP Accounts			PROP Participants		
Year	Accumulations	Distributions	Total	Entrants	Withdrawals	Total
2000	$ 385	$ -	$ 385	8	-	8
2001	918	(97)	1,206	8	(1)	15
2002	14,935	(1,348)	14,793	95	(1)	109
2003	17,034	(2,815)	29,012	48	(4)	153
2004	45,144	(8,352)	65,804	119	(15)	257
2005	66,659	(16,649)	115,814	159	(32)	384

HPOPS

FOR TODAY & TOMORROW

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