

INTRODUCTION

- SECTION 1 -

**Strive for
progress,
no matter
how difficult
the path.**



HMEPS
HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

Board of Trustees CHAIRMAN Sherry Mose VICE CHAIRMAN Roy W. Sanchez SECRETARY Lonnie Vara
Barbara Chelette | Roderick J. Newman | Asha Patnaik | Lenard Polk
Denise Castillo-Rhodes | David Donnelly | Edward J. Hamb II | Adrian Patterson

Executive Director David L. Long



December 30, 2021

Tantri Emo
Director, Finance Department
City of Houston
611 Walker, 10th Floor
Houston, Texas 77002

Dear Ms. Emo:

We are pleased to present the Annual Comprehensive Financial Report (Annual Report) of the Houston Municipal Employees Pension System (the System), a Component Unit of the City of Houston, Texas (the City), for the fiscal years ended June 30, 2021 and June 30, 2020. The accuracy, fairness of presentation and completeness of this report are the responsibility of the Board of Trustees (the Board) of the System. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of the operations of the System. The System's basic financial statements will be included in the annual financial report of the City.

ACCOUNTING SYSTEM AND INTERNAL CONTROLS

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

The System's independent auditors have audited the financial statements and issued an unmodified opinion as of June 30, 2021 and 2020 (pages 12-13). The purpose of the audit is to give reasonable assurance to users of those financial statements, the Board, and participants of the System, that the financial statements present fairly, in all material respects, information regarding the System's net position held in trust for pension benefits and in conformity with accounting principles generally accepted in the United States of America.

A significant responsibility of the Board is to ensure that the System has in place an adequate system of internal controls. A system of internal controls is an entity's plan of organization and its coordinated methods and measures adopted to safeguard its assets, ensure the accuracy and reliability of the accounting system and promote adherence to management policies. These controls include strategic design of the entity's business systems, the appropriate segregation of duties and responsibilities, sound practices in the performance of those duties, retaining capable personnel, and the organizational structure itself. For each implemented control, the cost of the control should not exceed the benefits to be derived. An objective of these controls is to provide reasonable assurance that the financial statements are free of any material misstatement. We believe the System's internal controls are adequate and are working as designed.

FINANCIAL INFORMATION

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

PLAN HISTORY AND PROFILE

The System was created in 1943 under Chapter 358, Acts of the 48th Texas Legislature, Regular Session, Article 6243g, Vernon's Annotated Revised Texas Civil Statutes, and was reenacted and continued under HB1573, 77th Texas Legislature, as Article 6243h, Vernon's Annotated Revised Texas Civil Statutes, as amended (the Statute).

The System is a multiple-employer, defined benefit pension plan that provides service retirement, disability retirement and death benefits for eligible participants, which includes all municipal employees, except police officers and fire fighters (other than certain police officers in the System as authorized by the Statute) employed full time by the City, elected City officials, and the full-time employees of the System (collectively referred to as “participants”). The System’s plan net assets are used to pay benefits for eligible participants of Group A, Group B and Group D. The System is administered by an eleven-member Board of Trustees. The Trustees include four elected trustees who are members of the System, two elected trustees who are retirees of the System, a trustee appointed by the elected trustees, the mayor’s appointee, the controller’s appointee, and two city council appointees.

The Statute was amended by SB 2190 in the 85th Texas Legislature, with most funding and benefit changes effective July 1, 2017. The Actuarial Section of this Annual Report contains additional information on the funding and benefit changes, as well as the annual risk sharing valuation process for purposes of the funding corridor, corridor midpoints, and legacy liability that are integral to the amended contribution requirements.

BUDGET

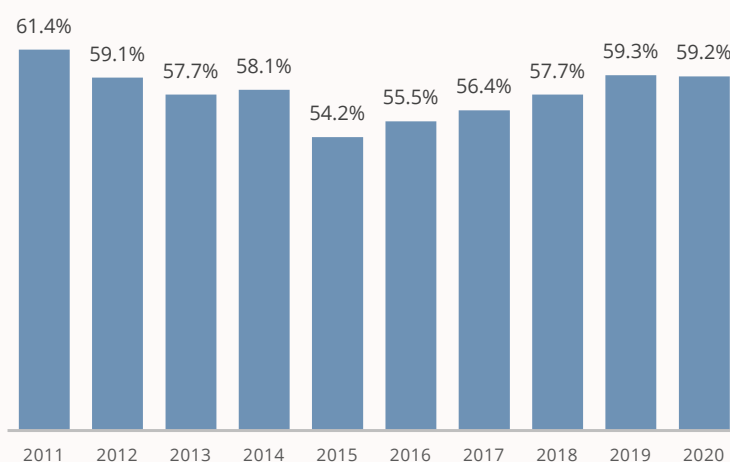
The costs of administering the System, consisting of operating administrative expenses and capitalized items, are paid by the System from current earnings pursuant to an annual fiscal budget adopted by the Board.

FUNDING STATUS

The System’s funding objective is to establish contributions which, when combined with present assets and future investment returns, will be sufficient to meet the financial obligations to present and future retirees and beneficiaries.

HMEPS receives contributions from two sources: employer contributions and member contributions. Under the Statute, the System’s actuary assumes that the System’s investments will return 7.0 percent annualized over the long-term. The differences between the assumed and actual investment return are phased in over 5 years, yielding an actuarial value of assets. This smoothing is intended to avoid extreme volatility in employer contribution rates due to short-term fluctuations in the investment markets. However, as part of SB 2190, all prior years’ bases were fully recognized as of July 1, 2016, and therefore the smoothing process recommenced for purposes of the actuarial valuation as of July 1, 2017. The funded ratio, the ratio of the actuarial value of assets (AVA) to the actuarial accrued liability (AAL), is a standard measure of a plan’s funded status. In the absence of benefit improvements or reduced funding, a plan’s funded ratio should increase over time, until it reaches 100%. The funded status alone is not appropriate for assessing the sufficiency of plan assets to cover the estimated cost of settling the plan’s benefit obligations.

As of July 1, 2020, HMEPS’ AVA and AAL were \$3.07 billion and \$5.2 billion, respectively, resulting in a funded ratio of 59.2%. A historical perspective of the System’s funding levels is presented in the following graph.



MARKET ENVIRONMENT

Fiscal year 2021 saw significant investment gains as financial markets responded to the steady reopening of the economy after the dramatic shock in early 2020 caused by COVID-19. The Federal Reserve continued to employ an accommodative monetary policy and indicated that interest rates would not rise until 2022. Congress maintained substantial stimulus programs to financially assist both households and businesses. The fiscal year began with a 14.7% unemployment rate, the highest level since the Great Depression. Strong, albeit unsteady, job growth drove the unemployment rate below 6% by the end of the fiscal year. Although the economy is still short about 7 million jobs relative to pre-pandemic highs, reported job openings have been rising and almost equal the number of unemployed.

U.S. equity markets performed strongly, with the Wilshire 5000 index rising every quarter and returning 44.2% for the 12-month period ending June 30, 2021. This marked the 12th consecutive positive fiscal year for the index since the global financial crisis of 2008-2009. Growth stocks and value stocks performed equally well, but smaller capitalization stocks tended to perform better than large-cap stocks.

International equities followed a similar pattern to U.S. stocks with the MSCI ACWI ex-U.S. (net) Index increasing in value each quarter during the fiscal year. Emerging markets performed better than developed markets as a new coronavirus variant caused a second wave of economic shutdowns in many European countries. The MSCI ACWI ex-U.S. (net) Index was up 35.7% during FY 2021.

Investment grade fixed income securities were down slightly in fiscal year 2021 as interest rates rebounded slightly from the historic lows of 2020. Investment grade bonds as represented by the Barclay's U.S. Aggregate Bond index posted a return of -0.3% for the fiscal year. High yield bonds as represented by the Merrill Lynch High Yield Master Trust II Index returned 15.6% for the fiscal year as credit spreads tightened when investors became comfortable that the pandemic would not cause widespread defaults. HMEPS' Private Credit portfolio returned 23.3% for the fiscal year.

Among the alternative asset classes, Real Estate and Private Equity returned 17.8% and 64.6% respectively in FY 2021. Resilient and improving housing markets for both multi-family and single family housing led the positive performance in real estate markets. Robust capital markets, including a strong IPO market during the fiscal year, helped propel increasing valuations leading to one of the best years for private equity. The Inflation-linked asset class was among the best performing sections of the portfolio, returning 52.8% as commodity prices, including energy prices, rebounded and travel and economic activity increased from pandemic lows.

Overall, the System's investments returned 38.7% for fiscal year 2021. Through the efforts of the Board of Trustees, the System's investment portfolio is more broadly diversified than many other public pension plans and tends to perform well in most market environments. During the 10-year period ending June 30, 2021, the system's annualized return was 9.7%.

MEMBER SERVICES

Benefits Counselors worked remotely during FY 2021, providing participant services by telephone, email and other electronic means, and by mail. The Benefits Division successfully provided important pension information to participants and timely processed new applications, including retirements, DROP distributions, refunds and survivor benefits. In FY 2021:

- HMEPS participated in 18 joint virtual presentations held for new employee orientations for the benefit of 1,132 attendees.
- Staff members processed 2,029 benefit applications, including retirement, DROP, survivor benefits, refunds, cash balance account, and lump-sum payments.
- HMEPS participated in a two day virtual Fall Financial Retirement Educational Event, an annual event co-sponsored by the System that helps City of Houston employees better plan for their financial future. This two-day event benefited approximately 457 attendees.

INVESTMENTS

The System's strategic asset allocation policy is designed to manage risk by diversifying among public and private asset classes. In order to develop a strategic asset allocation policy, risk-return assumptions and correlations for asset classes are examined taking into account current and forecasted economic conditions. The current strategic asset allocation policy has been in place since October 2017.

The target allocation to Global Equity is 32.5%. The target allocation to Fixed Income is 10%, while Real Estate is 12.5%, Private Credit is 5%, and Private Equity is 17%. The target allocation of the Absolute Return asset class is 8%, and the target allocation for the Inflation-Linked asset class is 15%. During fiscal year 2021, the System rebalanced its portfolio to move closer to these strategic asset allocation policy targets. With the help of the System's alternative investment consultant, Cliffwater LLC, the System committed to five private equity partnerships, a private real estate partnership, and a private credit partnership.

The System's investment portfolio closed its 2021 fiscal year at \$3.9 billion. The total investment return for the fiscal year was 38.7%. The System's investment performance was 13.8%, 12.7% and 9.7% for the past three-, five- and ten-year periods. Compared to similar investment portfolios (Wilshire TUCS Master Trusts – Public Universe), the fund posts above median investment returns over both long and short time periods. The best performing asset classes for fiscal year 2021 were Private Equity (+64.6%) and the Inflation-linked asset class (+52.8%).

In the upcoming fiscal year, the System will continue to work with its consultants to identify attractive public and private market investments consistent with the strategic asset allocation policy.

BOARD GOVERNANCE

During FY 2021, Lenard Polk was re-elected to active employee Trustee Position 3, Rhonda Smith was elected to active employee Trustee Position 4, and Lonnie Vara was re-elected to retiree Trustee Position 7. Appointed Board members serve three-year terms. Elected Board members serve staggered four-year terms, with elections for two active members and one retiree occurring every even-numbered year. The next Board election will occur in 2022. In the January 2021 officer elections, Sherry Mose was elected Chairman, Lenard Polk was elected Vice-Chairman and Rhonda Smith was elected Secretary of the Board.

CERTIFICATE OF ACHIEVEMENT

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Houston Municipal Employees Pension System for its comprehensive annual financial report for the fiscal year ended June 30, 2020. This was the 27th consecutive year that the System has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

ACKNOWLEDGEMENT

This Annual Report was prepared through the combined efforts of the System staff and was subject to the scrutiny of the Board. It is intended to provide information to its user that may be a basis for a general understanding of the System. This Annual Report is being forwarded to the City of Houston, the Texas Pension Review Board, the GFOA, and other interested parties who may from time to time request it.

In Closing...

A core purpose of the System is to help provide for the financial security of its participants when they are eligible to receive benefits. Municipal public sector employees are vital to providing and maintaining important city services for Houston residents, workers and visitors. Quality employees are attracted to and retained by the public sector in part by the security and benefits offered by a sound pension system.

Letter of Transmittal

Houston is in the midst of responding to the challenges posed by the coronavirus, one of the worst health pandemics this area, and the nation, has experienced. Many HMEPS members have gone above and beyond to assist Houstonians adversely affected by the coronavirus, even at great personal risk. Many members also have volunteered their time and expertise to provide people with information and assistance to help keep them safe, healthy, sheltered and nourished. The System is proud to serve these members and all of the dedicated municipal employees and retirees who have made tremendous contributions to Houston and its citizens.

Sincerely,



Sherry Mose
Chairman



David L. Long
Executive Director



Sherry Mose
Chairman



Lenard Polk
Vice Chairman



Rhonda Smith
Secretary



Roderick J. Newman
Elected Trustee



Roy W. Sanchez
Elected Trustee



Lonnie Vara
Elected Trustee

BOARD OF TRUSTEES



Barbara Chelette
Appointed Trustee



David Donnelly
Mayoral Appointee



Edward J. Hamb II
Controller Appointee



Adrian Patterson
Council Appointee



Denise Castillo-Rhodes
Council Appointee



David L. Long
Executive Director

BOARD COMMITTEES

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

ADMINISTRATIVE ORGANIZATION

EXECUTIVE DIRECTOR

GENERAL COUNSEL

CHIEF INVESTMENT OFFICER

- Investment Managers' Services
- Market Research
- Performance Measurement

MEMBER SERVICES

- Benefit Administration Services
- Communications
- Member Services

OPERATIONS

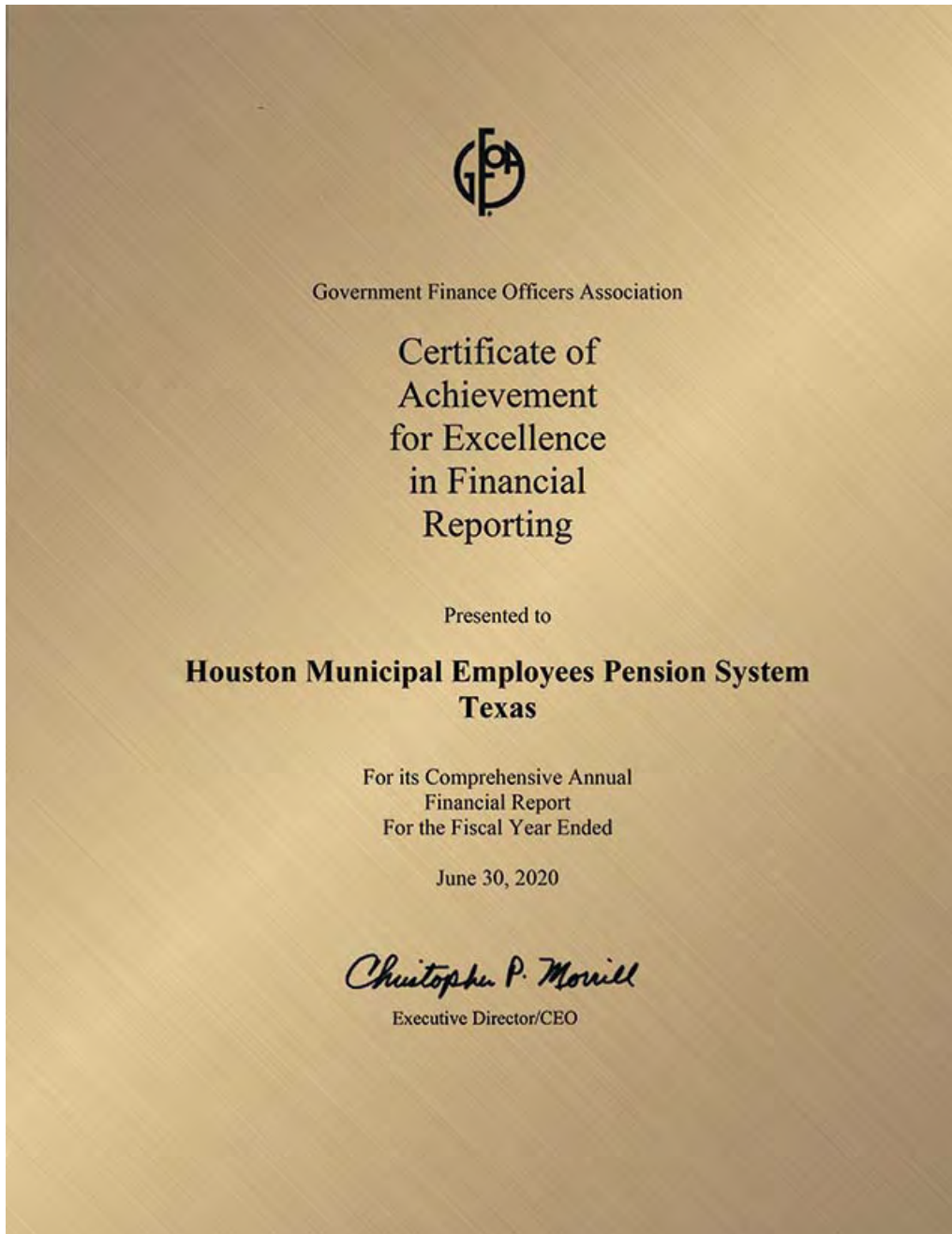
- Accounting
- Financial Reporting
- Records
- Technology Support

For more information on investment professionals who provide services to HMEPS, refer to the *Other Supplemental Information* beginning on page 59 and the *Schedule of Fees and Commissions Paid* table on page 72.

CERTIFICATE OF ACHIEVEMENT FOR EXCELLENCE IN FINANCIAL REPORTING

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**PROFESSIONAL CONSULTANTS
(FY 2021)**

ACTUARY

Gabriel, Roeder, Smith & Company

AUDITOR

Weaver and Tidwell, L.L.P.

BOARD MEDICAL ADVISOR

Charles Schuhmacher, M.D.

COMMUNICATION SERVICES

KLM Public Affairs, LLC

GOVERNMENTAL REPRESENTATION

Harris Law Firm, P.C.
HillCo Partners, L.L.C.
Locke Lord L.L.P.

INVESTMENT CONSULTANTS

Cliffwater, L.L.C.
Wilshire Associates, Inc.

**INVESTMENT PERFORMANCE
ANALYSIS**

Cliffwater, L.L.C.
Wilshire Associates, Inc.

LEGAL COUNSEL

Baker Botts, L.L.P.
DLA Piper L.L.P.
Jackson Walker, L.L.P.
Locke Lord L.L.P.

MASTER CUSTODIAN/TRUSTEE

State Street Bank and Trust Company

OTHER POSTEMPLOYMENT BENEFITS

US Bank
HighMark Capital Management
Public Agency Retirement Services

**INVESTMENT MANAGERS
(FY 2021)**

ABSOLUTE RETURN

Anchorage Capital Group, L.L.C.
Angelo Gordon & Co., L.P.
Brigade Capital Management, L.P.
Davidson Kempner Capital
Management, L.P.
Graham Capital Management, L.P.
MKP Capital Management, L.L.C.
Sculptor Capital Management, Inc.
Samlyn Capital, L.L.C.

FIXED INCOME

AllianceBernstein Holding, L.P.
BlackRock, Inc.
DDJ Capital Management, L.L.C.
GMO L.L.C.
Loomis, Sayles & Company, L.P.
Pugh Capital Management, Inc.

GLOBAL EQUITY

Baillie Gifford & Co.
BlackRock, Inc.
DePrince, Race & Zollo, Inc.
Globeflex Capital, L.P.
Invesco, Ltd.
Neumeier Poma Investment Counsel,
L.L.C.
T. Rowe Price Associates, Inc.

INFLATION-LINKED

BlackRock, Inc.
Cohen & Steers Capital Management,
Inc.
EIV Capital, L.L.C.
EnCap Investments, L.P.
Global Forest Partners, L.P.
NGP Energy Capital Management,
L.L.C.
Oaktree Capital Management, L.P.
Quantum Energy Partners, L.P.
Riverstone Investment Group, L.L.C.
Salient Partners, L.P.
State Street Global Advisors, Inc.
Tailwater Capital, L.L.C.
Taurus Funds Management, Pty. Ltd.
Tillridge Global Agribusiness Partners
Tortoise Capital Advisors, L.L.C.

PRIVATE CREDIT

Angelo, Gordon & Co., L.P.
DRC Capital, L.L.P.
Orbimed Advisors, L.L.C.
Summit Capital Partners, L.L.C.

PRIVATE EQUITY

Adams Street Partners, L.L.C.
Anchorage Capital Group, L.L.C.
Carrick Capital Management, L.L.C.
Centerbridge Partners, L.P.
Clearlake Capital Group, L.P.
GTCR, L.L.C.
HarbourVest Partners, L.L.C.
Hellman & Friedman, L.L.C.
ICV Partners, L.L.C.
JMI Management, Inc.
Lexington Partners, Inc.
New Enterprise Associates, L.L.C.
New Mainstream Capital
Management Holding, L.L.C.
Oaktree Capital Management, L.P.
Onex Corporation
Orbimed Advisors, L.L.C.
PacVen Walden Management Co.,
Ltd.
Pegasus Capital Advisors, L.P.
Pharos Capital Group, L.L.C.
Platinum Equity, L.L.C.
Siris Capital Group, L.L.C.
Summit Capital Partners, L.L.C.
Sun Capital Partners, Inc.
TCMI, Inc.
The CapStreet Group, L.L.C.
The Carlyle Group, Inc.
The Jordan Company, L.P.
TrueBridge Capital Partners, L.L.C.
Valor Management, L.L.C.
Vista Equity Partners Management,
L.L.C.
Wayzata Investment Partners, L.L.C.

REAL ESTATE

Aermont Capital, L.L.P.
Aetos Capital Real Estate, L.P.
Angelo, Gordon & Co., L.P.
Artemis Real Estate Partners, L.L.C.
Berkeley Partners Management,
L.L.C.
Crow Holdings Capital
FIG, L.L.C.
GEM Realty Capital, Inc.
Kildare Partners U.S., L.L.C.
Lone Star Global Acquisitions, L.L.C.
Long Wharf Capital, L.L.C.
Morgan Stanley & Co., L.L.C.
Oak Street Real Estate Capital, L.L.C.
Orion Capital Managers, L.L.P.
Pennybacker Capital Management,
L.L.C.
The Prime Group, Inc.
Rockpoint Group, L.L.C.
Starwood Capital Group Global, L.P.
State Street Global Advisors, Inc.