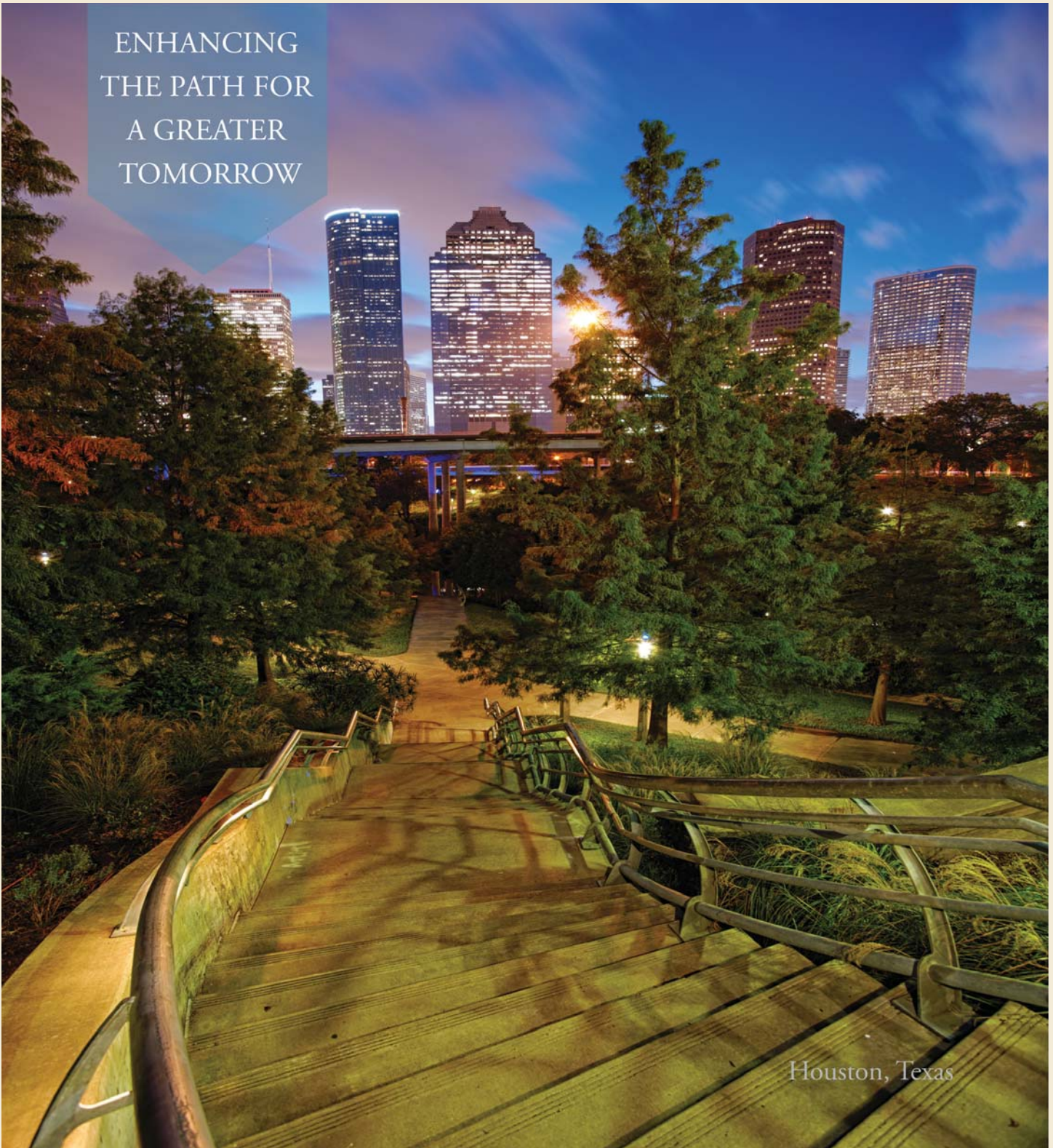




HMEPS
HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

ENHANCING
THE PATH FOR
A GREATER
TOMORROW



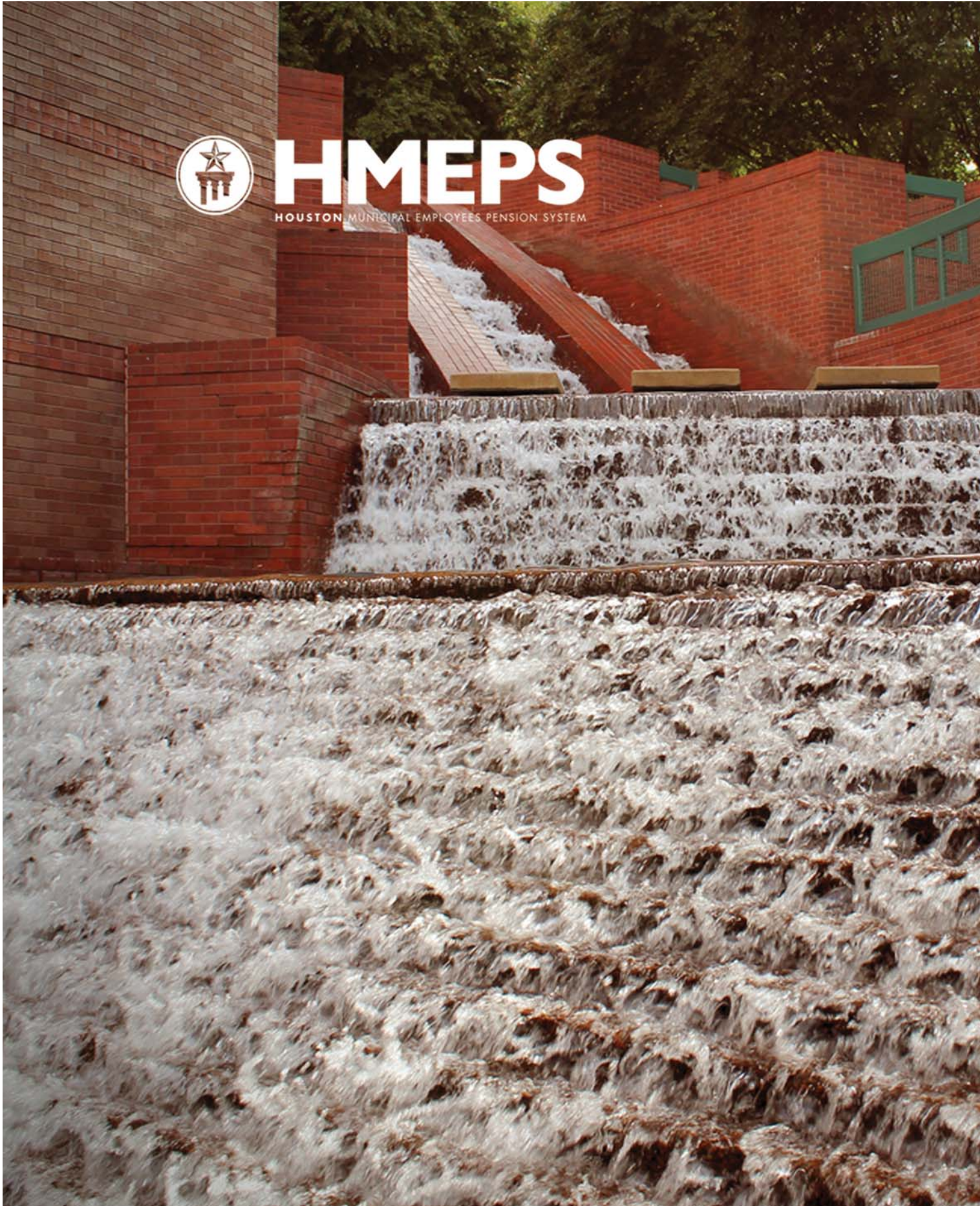
Houston, Texas

2013 **REPORT TO PARTICIPANTS**



HMEPS

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM



Wortham Center Waterfall at Fish Plaza.



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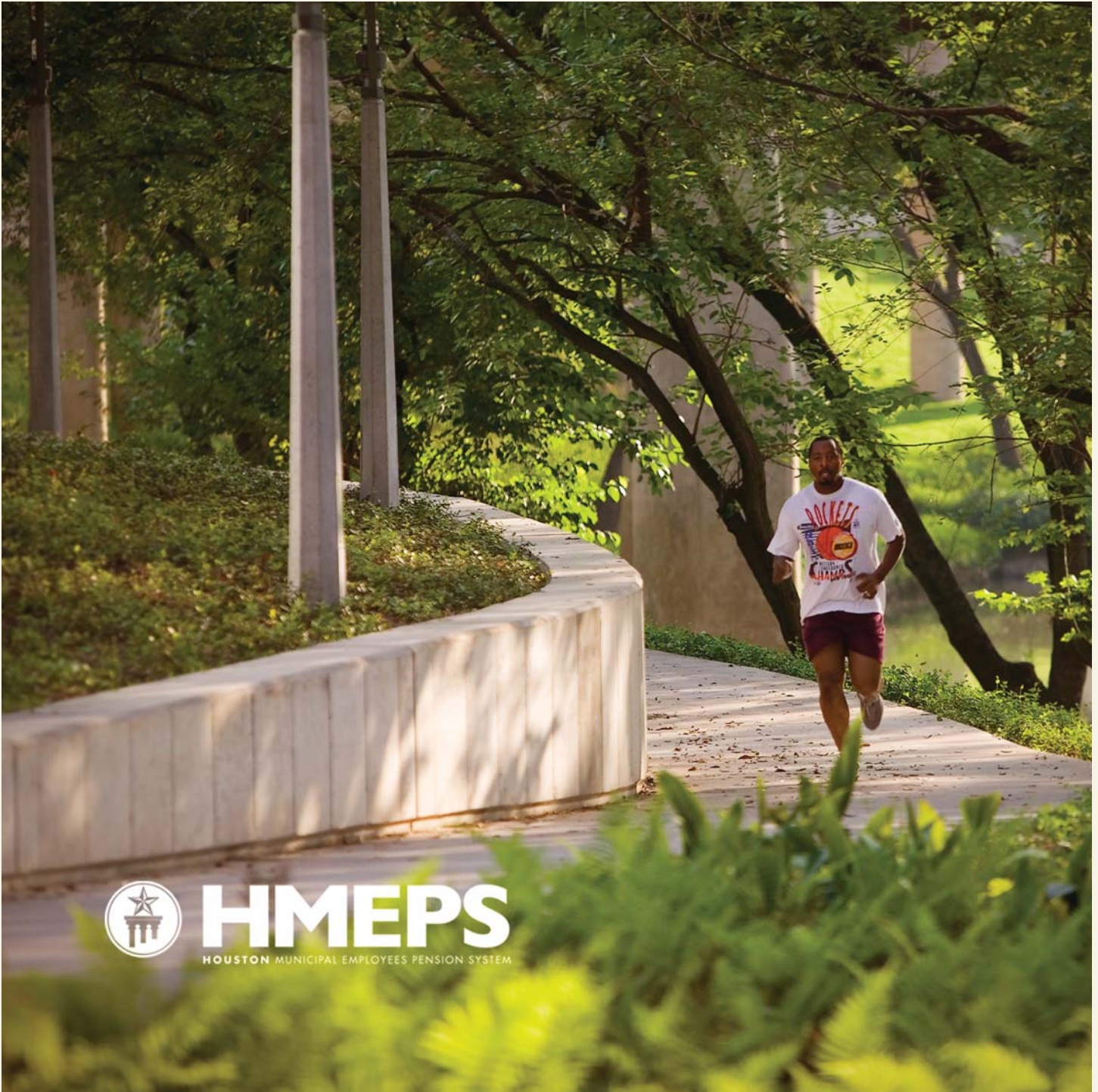
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HISTORICAL OVERVIEW

Note to Participants

We prepared this report for our participants to serve as a summary of the primary investment, benefit and financial information you care about. All the information in this report is derived from our Comprehensive Annual Financial Report (CAFR) and is consistent with Generally Accepted Accounting Principles (GAAP). All financial information is as of June 30, 2013. (The full CAFR is available on our website at www.hmeps.org/publications.html.)



Buffalo Bayou Park running trail.



LETTER FROM THE CHAIRMAN

January 15, 2014

Dear Participants,

I am pleased to present the 2013 Report to Participants, which summarizes the HMEPS 2013 Comprehensive Annual Financial Report (CAFR) and provides an overview of the System's operations.

We have had a very productive year at HMEPS thanks to the hard work and commitment of the Board of Trustees and staff of HMEPS. We accomplished many goals and continued our dedicated and quality service to our participants while protecting and growing the fund.

First, I am extremely pleased to report that our investment performance of 13.58 percent for the fiscal year ending June 30, 2013 was very strong and reflects a sound, long-term investment strategy. We wisely resisted knee-jerk reactions to short-term fluctuations in the market and instead focused on a prudent, professional investment strategy that has yielded the System 10- and 30-year returns in excess of the fund's 8.5 percent return target.

These are truly excellent results and further proof that HMEPS is on the right path to meeting its current and future obligations.

In 2013, the Texas Legislature considered a number of pension-related bills. We educated and informed legislators about HMEPS, particularly as a local pension structure created by the Texas Legislature that works – both for its participants and for the citizens of Houston. Two bills that are relevant to HMEPS were ultimately passed. Please see page 10 for a full report on the 83rd legislative session.

With pension systems facing continued and often unfair attacks across the nation, HMEPS increased its efforts to tell the real story about the System and its members to city, state and national officials, local taxpayers and others. These efforts included a presentation before Houston City Council, an op-ed in the Houston Chronicle and numerous meetings with individual elected officials in Houston and Austin. We will continue to educate and inform all stakeholders of our efforts for members here at HMEPS.

We also remain committed to improving our overall communications efforts. During the year, we made great strides in increasing the number of emails we sent to members, expanded our presence on social media venues such as Facebook and Twitter, and redesigned our website – www.hmeps.org. The new website contains innovative and interactive features, including an improved members-only site, increased pension resources, easier navigation and more use of color photography to make the site more visually appealing.

Our members-only website, AccessHMEPS, allows all active and retired participants to view their personal, pension and/or DROP information online. HMEPS continues to strive to keep our participants informed and up-to-date on matters related to the pension system.

Additionally, our annual Financial Retirement Employees Educational (FREE) Summit was attended by over 500 people and has become so popular we are planning a second smaller event in spring 2014.

Houston continues to be one of the fastest-growing cities in the U.S. and is an economic success story during a slow national recovery from the most recent economic downturn. As our population grows, so does the demand for reliable City services, making it all the more important to maintain a quality workforce. Key to retaining that workforce is a strong pension system that will deliver for its members for decades to come. Continuing to strengthen HMEPS is the top priority of our outstanding staff and Board of Trustees and for me as your Chairman. It is an honor to serve each of you.

Sincerely,

Sherry Mose
Chairman





BOARD OF TRUSTEES

At the heart of HMEPS is the hard work and dedication of everyone who serves it, beginning with the Board of Trustees. A significant responsibility of the Board is to ensure that HMEPS has in place an adequate system of internal controls. The majority of the Board's work is conducted at the Board level and within six committees, each of which addresses a specific aspect of the System's operations.

- **The Audit Committee** reviews and monitors the System's audit process and oversees the reporting of financial information for HMEPS.
- **The Budget and Oversight Committee** reviews and monitors HMEPS' operational and administrative expenditures, as well as its actuarial process.
- **The Disability Committee** reviews the submitted medical reports and other relevant information for each disability claim and makes recommendations to the Board as to the appropriate course of action.
- **The External Affairs Committee** deals with matters concerning state and federal legislative issues that affect HMEPS and any agreement or proposed agreement with the City regarding pension issues and benefits.
- **The Investment Committee** reviews investment strategies and has authority over HMEPS' asset allocation, tactical asset allocation, managers and other aspects of HMEPS' operations relating to investments. The Investment Committee is a committee of the entire Board.
- **The Personnel and Procedures Committee** deals with matters concerning HMEPS' employees, changes in policies in the working of HMEPS, and constructing the procedures for HMEPS' adherence to applicable laws.

LEADERSHIP IS A
POTENT COMBINATION
OF STRATEGY AND
CHARACTER



The HMEPS Boardroom.

ORGANIZATIONAL OVERVIEW

Board of Trustees

Elected and Appointed Trustees



Sherry Mose
Chairman



Roy W. Sanchez
Vice Chairman



Lonnie Vara
Secretary



David L. Long
Elected Trustee



Asha Patnaik
Elected Trustee



Lenard Polk
Elected Trustee



Barbara Chelette
Appointed Trustee



Richard Badger
Council Appointee



Ramon Manning
Controller Appointee



Craig T. Mason
Mayoral Appointee



Adrian Patterson
Council Appointee



Rhonda Smith
Executive Director

Administrative Organization

Board

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

Executive Director

General Counsel

Chief Investment Officer

- Investment Managers' Services
- Market Research
- Performance Measurement

Member Services

- Benefit Administration Services
- Member Services
- Financial Counseling
- Communications

Operations

- Accounting and Financial Reporting
- Records
- Technology Support



THE STAFF

HMEPS' experienced staff members provide expert advice to the Board and make informed decisions every day on a wide range of issues important to the fund and its participants. These individuals are talented professionals who bring their very best to the pension system each day.

Serving City of Houston Employees for 70 Years

Member Services

The **Member Services** division is responsible for serving the needs of our participants on a daily basis. The division's benefits section oversees members' needs from the time they enter the system through retirement, providing them the support needed to understand and access their benefit options.

During the fiscal year, the Member Services division continued to improve processes designed to expand and improve customer service, including:

- Responded to increased demand for the Outreach Program, which reaches hundreds of members with individual and group sessions provided by our benefits counselors and our Certified Financial Planner. This past year, these staff members conducted 130 individual counseling sessions and hosted 75 joint presentations for various City departments as well as new employee orientations for 2,395 attendees. A growing number of participants requested financial counseling based on other participants' recommendations.
- Processed 1,957 benefit applications for payroll, including retirements, survivor benefits and lump-sum payments.
- Initiated social media efforts to provide information relating to pension benefits to participants through Facebook and Twitter,

two platforms that provide methods of communicating and interacting with participants.

- The HMEPS financial counselor conducted 400 one-on-one counseling sessions with participants during the past fiscal year in addition to numerous group presentations. He also monitored pension related issues nationally and locally, a critical part of fulfilling HMEPS' obligation to keep participants fully informed.
- Benefits counselors and the financial counselor participated in the 2013 Financial Retirement Employees Educational Summit, an annual event that helps City of Houston employees better plan their financial futures.



Hope May, Benefits Counselor, Carole Snyder, Benefits Manager, and Judy Li, Accountant.

Investment Division

The **Investment** division develops and implements investment strategies to maximize returns while minimizing risks. This division is responsible for portfolio management and is charged with effectively and prudently investing and monitoring HMEPS' assets while adhering to laws, regulations and policy guidelines.

The System's strategic asset allocation policy is designed to manage risk by diversifying among public and private asset classes. The strategic asset allocation policy was reevaluated in April 2013. Risk-return assumptions

COMING TOGETHER FOR A SOLID FUTURE



Steve Waas, Manager of Policy and Financial Planning and Mary Sosa, HMEPS participant.

and correlations for asset classes were reexamined, taking into account current and forecasted economic conditions, and resulted in several changes to the System's asset allocation targets. These changes were intended to reduce the volatility of the System's investment returns while providing an adequate investment return.

The System's investment portfolio closed its 2013 fiscal year at \$2.2 billion, up from \$2.05 billion at the beginning of the year. The total investment return for the fiscal year was 13.6%, surpassing the three-year 11.5% and five-year 5.5% returns. Although the System lagged the policy benchmark for fiscal year 2013, it outperformed the policy benchmark for the ten-year period.

Operations Division

The **Operations** division is responsible for accounting, records and the technology that is critical to serving HMEPS' participants.

The accounting section of the Operations division manages the accounting, budgeting, retiree payments, internal audit and financial reporting functions at HMEPS.

The operations group extended the organization's document management system to enhance workflows and controls over Accounts Payable and purchase order documents, and to reduce or eliminate the use and routing of paper records.

The operations group also launched a redesigned and enhanced website that contains innovative and interactive features, including a members-only site.



Lily Leonardo, Administrative Assistant of Operations.

Further developments were made to the online calculator to allow Group D members to project benefit amounts and eligibility dates.

Legal Division

The **Legal** division works with all HMEPS divisions as well as the Board to help ensure that the System is providing the best service possible to our members in compliance with federal, state and local laws.

System Milestones

New Strategic Asset Allocation

In April 2013, the System performed an asset allocation study and, as a result, the Board approved a change in the target allocation for fiscal year 2014. As of June 30, 2013 the System was transitioning to the new allocation.

Public Website

The public website (www.hmeps.org) was redesigned to include better navigation and to make the site more interactive using videos and other multimedia tools. Additionally, the public website's benefit calculator was modified to allow Group D participants, who began service in or after 2008, to forecast normal and early retirement options. Finally, new content was released within the members-only section of the website (*AccessHMEPS*) to expand the amount of information accessible on the website for participants.



PARTICIPANT OVERVIEW



HMEPS
HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

Eleanor Tinsley Park running trail.



Solid Waste Department employees (from left) Roderick Bailey, Leslie Porter and Isidro Sammeron.

AS OF JULY 1, 2012 THERE WERE 26,419 PARTICIPANTS IN HMEPS

Our members come from all City departments and serve their communities' diverse and special needs night and day, in good weather and bad – each contributing their special skills to make Houston a great place to live. The System is honored to serve each and every one of our hardworking members.

The System is a defined benefit pension plan covering all municipal employees, except police officers and firefighters (other than certain police officers in the System as authorized by the Pension Statute), employed full time by the City of Houston, elected City Officials, and the full time employees of the System. The System includes a contributory group (Group A)

and two noncontributory groups (Group B and Group D) and provides service, disability and death benefits for eligible participants.

As of July 1, 2012, there were 26,419 participants in HMEPS. Included in this figure are active members, inactive participants, service retirees, disabled retirees and beneficiaries and spouses. Of the 11,670 active employees, 6,356 are male and 5,314 are female. HMEPS also serves 7,031 service retirees, 391 disabled retirees, 1,656 beneficiaries, and 5,671 inactive participants.



Mark McAvoy, Executive Director of the Houston Permitting Center.



Sarah Mason, Senior Environmental Analyst of Solid Waste Management, and Steven Stelzer, Program Director Green Building Resource Center.



Connie Johnston, Houston Airport System.

PARTICIPANT DATA AS OF JUNE 30, 2012

PARTICIPANT DATA					
	Number	Number Vested	Average Salary or Annual Benefit	Average Age	Average Service
Active Members	11,670	8,158	\$45,792	46.8	11.1
Inactive Participants	5,671	3,237	6,769	—	—
Service Retirees	7,031	—	23,116	68.0	—
Disabled Retirees	391	—	9,755	64.0	—
Beneficiaries & Spouses	1,656	—	12,786	69.5	—

SCHEDULE OF ANNUITANTS BY TYPE						
	June 30, 2012			June 30, 2011		
	Number	Benefits (\$000)	Average Benefit	Number	Benefits (\$000)	Average Benefit
SCHEDULE OF ANNUITANTS BY TYPE						
Retirees Receiving Benefits	7,031	162,527	23,116	6,663	151,806	22,783
Retired on Disability	391	3,814	9,755	398	3,723	9,355
Survivors and Beneficiaries	1,656	21,174	12,786	1,656	19,681	11,884
Total Retirees, Survivors and Beneficiaries	9,078	187,515	20,656	8,717	175,210	20,100
Former Participants Eligible But Not Yet Receiving Benefits	3,237	21,912	6,769	3,178	20,507	6,453
Total Eligible for Benefits	12,315	209,427	17,006	11,895	195,717	16,454

HISTORICAL ACTIVE PARTICIPANT DATA								
Valuation Date	Active Vested/Nonvested			Number of Participants	Annual Payroll (\$000)	Average Salary (\$)	% Salary Increase	
	Group A	Group B	Group D					
July 1, 2003	7,576	4,544		12,120	390,314	32,204	0.9	
July 1, 2004	8,361	3,495		11,856	366,190	30,886	(4.1)	
July 1, 2005	8,811	3,163		11,974	404,565	33,787	9.4	
July 1, 2006	9,544	2,601		12,145	422,496	34,788	3.0	
July 1, 2007	9,947	2,429		12,376	448,925	36,274	4.3	
July 1, 2008	9,587	2,195	871	12,653	483,815	38,237	5.4	
July 1, 2009	8,906	2,153	2,274	13,333	539,023	40,428	5.7	
July 1, 2010	8,323	1,999	2,591	12,913	550,709	42,648	5.5	
July 1, 2011	7,857	1,932	2,556	12,345	544,665	44,120	3.5	
July 1, 2012	7,167	1,759	2,744	11,670	534,394	45,792	3.8	

Beginning with 2005, a change in methodology now annualizes payroll for new entrants. If the methodology had not been changed, the covered payroll for 2005 would have been \$376,208,345 and the average payroll would have been \$31,422.

All information was derived from the July 1, 2012 Actuarial Valuation.

REVIEW OF THE 2013 LEGISLATIVE SESSION

The Texas Legislature's 83rd session concluded on May 27, 2013, marking another successful session for the System. About a dozen bills concerning pension issues were filed during the session. Of those, two were passed that are relevant to HMEPS. Following are the two bills and what they mean:

- House Bill 13. Under the bill, the State Pension Review Board (PRB) is required to develop and administer model ethical standards, conflict of interest policies and disclosure requirements for use by pension systems. The PRB also is required to develop an education training program for trustees and administrators. Pension systems are required to post on their websites the contact information for administrators and all reports submitted to the PRB.

(HMEPS already complies with the requirements in HB 13.) The system also worked with the PRB as they develop the model policies. HMEPS' ethics policy was used along with other samples as an example of best practice.

- Senate Bill 200. This bill addresses the continuation and function of the State Pension Review Board (PRB). Under the bill, the PRB is required to develop a policy to encourage the use of appropriate alternative dispute resolution procedures. In addition, the PRB is authorized to conduct training and educational activities for trustees and administrators. The bill also provides a definition for a "defined contribution plan" and exempts such a plan from the statute's actuarial provisions.

Throughout the session, HMEPS officials frequently met with lawmakers to provide information about the effects of various pension measures and to educate them about the System and the importance of defined benefit pension systems. HMEPS officials also kept close track of activity on each pension-related bill.

It continues to be a challenging time for public retirement systems at all levels of government. Although the Texas Legislative Session has come to a close, work in this area is ongoing, both at the state and national levels. HMEPS remains vigilant in working to safeguard the system and its members.

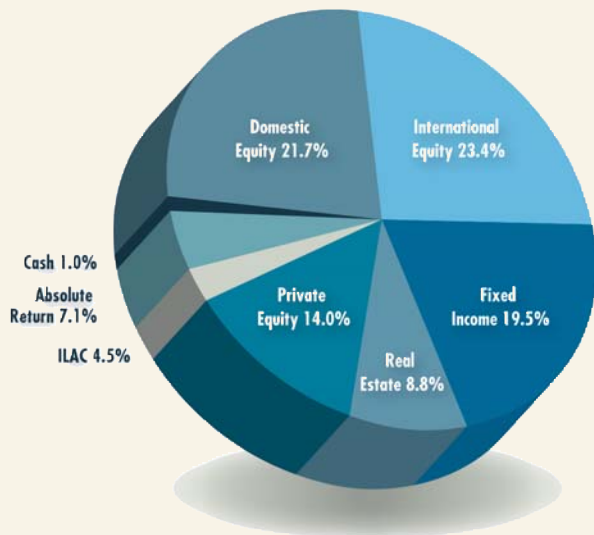


INVESTMENTS

The 10-year period ended June 30, 2013 encompasses the 2008 financial crisis and has produced volatile returns, both for the markets as a whole, and also for the System. The System generated double digit positive returns in seven of the past ten fiscal years, met or exceeded its policy index in five of those ten fiscal years, and outperformed its peer group in eight of those ten years. Due to the diversification of assets, the System's 10-year annualized return is 9.52%, in excess of its return target of 8.50%. The 20-year return stands at 8.67%.

An integral part of HMEPS' overall investment policy is its strategic asset allocation policy. The System's investment allocation provides an efficient diversification of assets designed to achieve portfolio risk and return objectives.

SYSTEM ASSET ALLOCATION

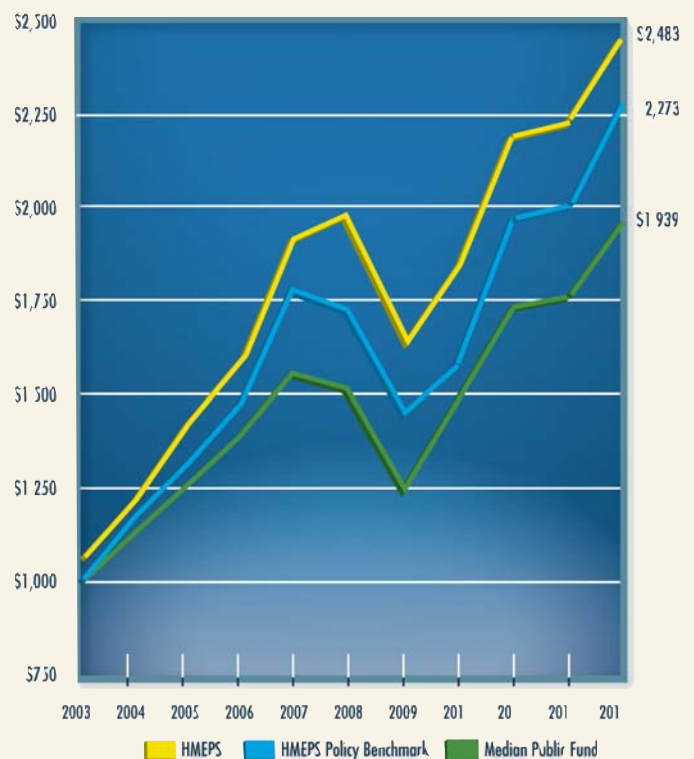


As shown in the table on page 14, HMEPS' total fund return exceeds its policy portfolio over the last ten years. In addition, HMEPS' total fund performance compares very favorably to the median public fund, as represented by the TUCS Master Trusts – Public Universe, and has outperformed this benchmark for the five- and ten-year periods. Over the ten-year period, HMEPS is in the top decile of funds in the TUCS Master Trusts – Public Universe.

The consistent long-term above-benchmark performance is best illustrated by the growth of \$1,000 invested in HMEPS' total fund,

the policy benchmark portfolio and median public fund during the past 10 years. The ending points indicate that \$1,000 invested in HMEPS' total fund would have grown to \$2,483, while the same \$1,000 would have grown to \$2,273 and \$1,939 respectively in the policy benchmark portfolio and the median public fund.

GROWTH OF \$1,000



COMPARISON OF INVESTMENT RETURNS – YEARS ENDED JUNE 30

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

	2013	3 Yrs.	5 Yrs.	10 Yrs.	2012	2011	2010	2009
Total Portfolio	13.58	11.48	5.49	9.52	-0.14	22.17	12.2	-16.0
Actuarial Rate	8.5	8.5	8.5	8.5	8.5	8.5	8.5	8.5
Policy Benchmark	14.00	13.10	6.20	8.60	3.23	22.89	13.0	-17.6
Median of Wilshire Public Fund Universe/TUCS	12.27	11.52	5.35	6.94	1.25	21.19	14.8	-19.2
U.S. Equity	22.58	19.25	7.58	7.67	3.43	33.77	17.3	-29.0
Wilshire 5000 Index	21.10	18.45	7.19	7.95	3.96	31.99	15.7	-26.4
International Equities	17.15	9.37	-0.80	8.83	-12.86	28.14	7.9	-31.9
MSCI All Country World ex US Index	14.14	8.48	-0.34	9.09	-14.15	30.30	10.9	-30.5
Fixed Income	5.99	7.20	7.70	6.53	6.31	9.33	17.0	0.4
Barclays Aggregate Index	-0.69	3.51	5.19	4.52	7.48	3.90	9.5	6.1
Merrill Lynch High Yield Master II Index	9.57	10.43	10.63	8.75	6.51	15.40	27.5	-3.5
HMEPS Private Equity	7.85	13.63	6.27	12.21	11.00	22.54	16.8	-20.9
S&P 500 Index +3%	23.60	21.45	10.00	10.30	8.44	33.68	17.4	-23.2
Real Estate	12.80	9.10	-6.87	7.41	3.78	10.92	-9.5	-40.4
NCREIF Property Index	10.73	13.14	2.79	8.59	12.00	16.73	-1.5	-19.6
Inflation-Linked	14.52	7.68	n/a	n/a	-21.96	39.72	21.5	n/a
Consumer Price Index +4%	5.75	6.60	n/a	n/a	5.66	7.70	5.1	n/a
HMEPS Absolute Return	10.87	7.79	n/a	n/a	-0.86	13.94	23.4	n/a
LIBOR +4%	4.31	4.60	n/a	n/a	4.46	5.10	4.3	n/a

□ - HMEPS Assets

□ - Benchmark

TO SUCCEED IS TO
FIND SOMETHING THAT
MOTIVATES AND
INSPIRES YOU



FINANCIALS

Each year, HMEPS is subject to an independent external audit to review the System's financial statements to provide assurance that the statements are free of material misstatement. This outside opinion considers internal control over financial reporting. All HMEPS divisions collaborate to produce the System's Comprehensive Annual Financial Report (CAFR). The System's CAFR is submitted to the Government Finance Officers Association (GFOA), which oversees governmental entity CAFR certification. For the 19th consecutive year, HMEPS received the GFOA Certificate of Achievement for Excellence in Financial Reporting for its thorough financial reporting work on the 2012 CAFR.

Revenues (Additions) and Expenditures (Deductions)

The Summary Comparative Statement of Changes in Plan Net Position table (see below) shows the Fund's primary income is derived from income appreciation/loss on investments, and member and employer contributions. For 2013, net investment income was \$264 million dollars and total contributions were \$129 million dollars.

On the expenditure side, the majority of the fund's expenses were associated with participants' periodic and one-time (refund or DROP) payments of \$214.4 million, or 96.7% of total expenses. The remainder of the fund's expenses is comprised of administrative expenses of \$6.3 million or 2.9% of total expenses, and professional fees of \$870,765 or .4% of total expenses.

SUMMARY COMPARATIVE STATEMENT OF PLAN NET POSITION (\$'000)

ASSETS	FY 2013	FY 2012
Cash and equivalents	\$6,168	\$1,647
Investments	2,202,676	2,048,112
Receivables on asset sales	12,395	9,935
Other receivables	5,697	6,718
Collateral on securities lending	161,317	261,194
Furniture, fixtures and equipment, net	247	325
Total Assets	2,388,500	2,327,931
LIABILITIES		
Payable on asset purchases	25,458	36,997
Accrued liabilities	5,109	5,505
Collateral on securities lending	161,317	261,194
Total Liabilities	191,884	303,696
PLAN NET POSITION	\$2,196,616	\$2,024,235

SUMMARY COMPARATIVE STATEMENT OF CHANGES IN PLAN NET POSITION (\$'000)

	FY 2013	FY 2012
Additions		
Contributions	\$128,900	\$115,635
Investment and interest (loss) income, net	263,891	(11,964)
Other income	1,246	654
Total additions	394,037	104,325
Deductions		
Benefits paid	213,178	200,014
Contribution refunds	1,266	2,205
Administration and professional fees	7,212	7,312
Total deductions	221,656	209,531
Net increase (decrease) in plan net position	172,381	(105,206)
Plan net position, beginning of year	2,024,235	2,129,441
PLAN NET POSITION, ENDING OF YEAR	\$2,196,616	\$2,024,235

Financial Markets

The nation's economy showed improvement during the fiscal year, and by June 2013 consumer confidence was at its highest level since 2008. Unemployment dropped to 7.6% and GDP growth continued to be positive. After a year of steady gains, equity markets fell in June, following indications of a change in policy by the Federal Reserve. Despite the June drawdown, the US Equity markets, as represented by the Wilshire 5000 index, finished the fiscal year with gains of 21.1%.

Across the Atlantic, European markets continued to lag US markets due to political uncertainty and concerns over the future of the Euro. In Japan, new government policies led to a strong rally in the equity markets, with the Nikkei hitting a five year high on May 22, 2013. Emerging markets were held back by the slowdown in China's economy and turmoil in Brazil and Turkey, with the MSCI EMF index returning 2.9% for the year. Overall, international markets had a positive return of 14.1%.

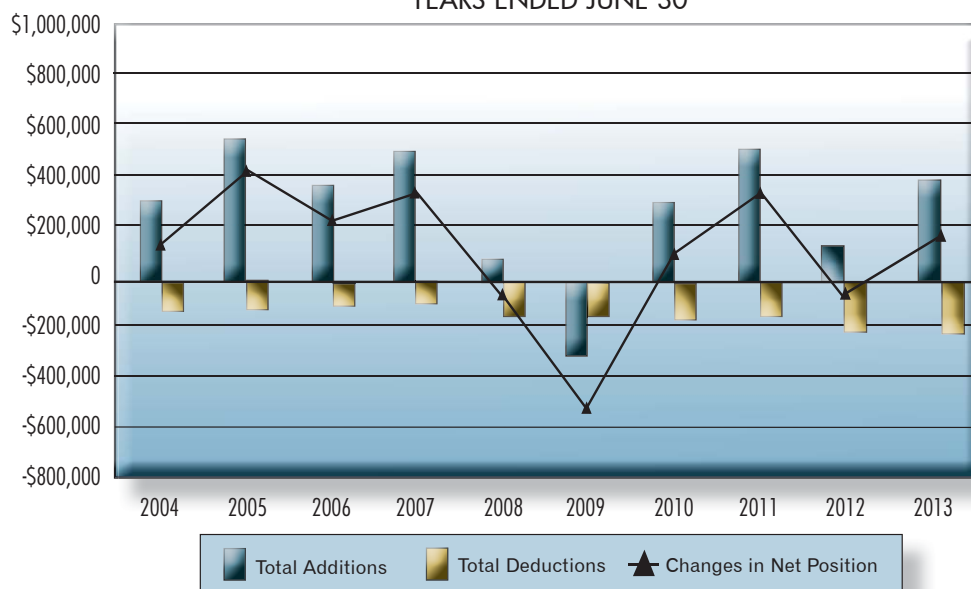
(Cont'd on the following page)

SCHEDULE OF CHANGES IN PLAN NET POSITION (\$'000)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Additions										
Employer contributions	57,308	363,247 ¹	66,968	70,265	73,272	76,837	82,052	87,285	97,161	111,859
Member contributions	26,189	23,488	21,888	20,966	21,176	20,449	19,736	19,326	18,473	17,041
Investment Income	227,361	184,419	272,766	337,259	(29,133)	(440,298)	195,433	391,095	(11,963)	263,891
Other income	726	17,250	26,950	29,031	29,839	489	557	1,185	654	1,246
Total additions	311,584	588,404	388,572	457,521	95,154	(342,523)	297,778	498,891	104,325	394,037
Deductions										
Benefit payments	153,202	175,480	154,311	157,716	169,483	180,361	191,048	189,199	200,014	213,178
Refund of contributions	635	992	1,037	1,398	1,760	1,795	1,285	1,620	2,206	1,266
Professional services fees	712	1,088	708	883	638	792	805	1,103	1,048	871
Cost of administration	4,500	4,718	5,072	5,223	5,837	6,420	6,290	6,020	6,264	6,341
Total deduction	159,049	182,278	161,128	165,220	177,718	189,368	199,428	197,942	209,532	221,656
Changes in net position	152,535	406,126	227,444	292,301	(82,564)	(531,891)	98,350	300,949	(105,207)	172,381
Net position as of June 30	1,418,726	1,824,852	2,052,296	2,344,597	2,262,033	1,730,142	1,828,492	2,129,441	2,024,234	2,196,615

¹ 2005 employer contributions include \$300 million pension obligation note

CHANGES IN PLAN NET POSITION (IN THOUSANDS) YEARS ENDED JUNE 30



* 2005 employer contributions include \$300 million pension obligation note

(Cont'd from page 14)

In the fixed income markets, high yield bonds benefited from the recovering economy, gaining 9.6% for the fiscal year, as represented by the Merrill Lynch High Yield Master II Index. Investment grade fixed income was the asset class most negatively affected by the announcement of tapering of Federal Reserve accommodative policies, ending the fiscal year down -0.7%.

Among the alternative asset classes, Inflation Linked performed the best for the System, returning 14.5%. This was largely driven by the performance of Master Limited Partnerships, a new asset category the System funded at the beginning of the fiscal year.

Overall, the System's investments returned 13.58%, compared to the actuarially assumed rate of return of 8.5%.

Through the efforts of the Board over the past 10 years, the System's investment portfolio is more broadly diversified than most public pension plans, and consequently, exhibits less volatility, particularly during extreme market environments.

The 10-year period ended June 30, 2013 encompasses the 2008 financial crisis and has produced volatile returns, both for the markets as a whole, and also for the System. The System generated double digit positive returns in seven of the past ten fiscal years, met or exceeded its policy index in five of those ten fiscal years, and outperformed its peer group in eight of those ten years. Due to the diversification of assets, the System's 10-year annualized return is 9.52%, in excess of its return target of 8.50%. The 20-year return stands at 8.67%.

Funding Status

The HMEPS' 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.

Annual actuarial valuations measure the progress toward these goals, as well as test the adequacy of the contribution rate.

The System's actuary assumes that the System's investments will return 8.5 percent over the long-term. 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. As of July 1, 2012 had a funded ratio of 59.1%, which is lower than the 61.4% funded ratio as of July 1, 2011.

Based on actuarial estimates, the System's projected funded ratio as of July 1, 2012 would be 68.3%, or approximately 10 percentage points higher, if the City had contributed the annual required contribution rate (ARC) in each of the preceding 10 years.

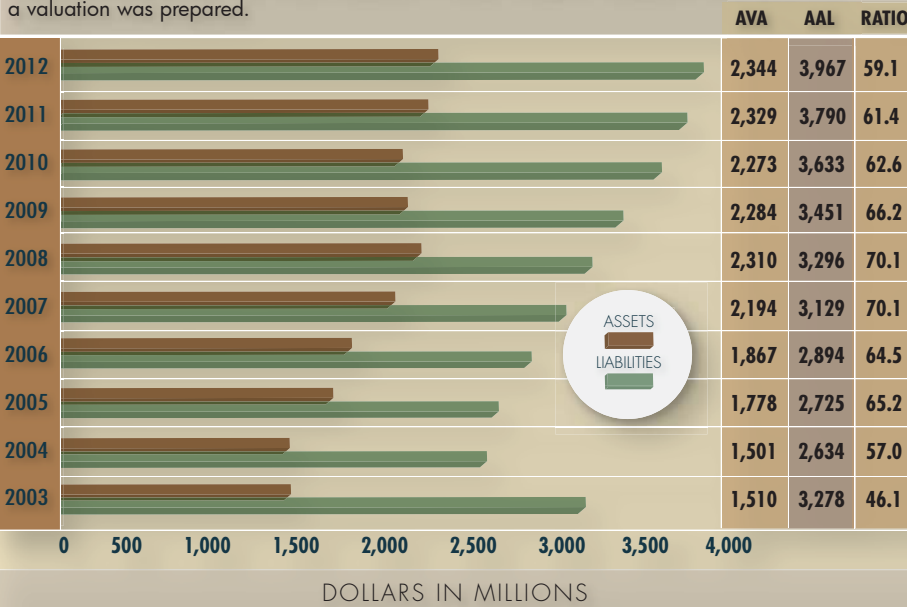
The current Meet and Confer Agreement provides a program for steadily improving the funded status of the System, as future City contributions will increase by 2% or at least \$10 million per year until the actuarially

determined contribution rate is met, at which time the actuarially determined contribution rate will be the required rate.

Like most large public pension plans, HMEPS was significantly impacted by the volatility in the investment markets after 2008. While the 2010, 2011 and 2013 returns substantially exceeded the 8.5% assumed rate of return, the 2012 return was significantly less than the assumed rate. In the absence of future investment gains, the contribution rate needed to amortize the unfunded liability will increase over the next few valuation cycles.

HISTORICAL ACTUARIAL FUNDING RATIO

The funding ratio reflects the System's actuarial value of assets (AVA) relative to its actuarial accrued liability (AAL). This chart indicates a 10-year history of the plan for each year that a valuation was prepared.



Over longer periods of time (10 years), the System's investment performance exceeds 95% of its peers. During the 10-year period ending June 30, 2013, the System's annualized return was 9.52%, with the median comparable fund returning 6.94%.

Fiscal Year 2013 Financial Highlights

For the fiscal year ended June 30, 2013, the System returned 13.58%. This rate of return lagged the System's policy benchmark return of 13.99%, but exceeded the return of the median fund in the TUCS Master Trusts – Public Universe of 12.27%.

HISTORICAL OVERVIEW

City of Houston officials in 1934 began setting aside funds with a special goal in mind – creating a retirement system to serve its hard-working employees. Nine years later, they had accumulated \$281,000 that they used to create the Municipal Pension System. The Texas Legislature established the plan, making the system official on May 3, 1943.

Seventy years of service later, the System remains true to the original vision of providing retirement benefits to its members. But there have been a few changes along the way, as well as plenty of growth in assets and membership.

In the System's early years, membership included 108 retirees who received average monthly pensions of \$44.98 and 1,067 active members who made monthly contributions of \$2.00.

By 1950, Houston was the nation's 14th largest city – behind Milwaukee – with a population of 596,163. As the city continued to expand, officials knew they needed a solid workforce to fuel the growth and so they promised new hires a pension. The offer attracted many citizens to local government work, spurring a dramatic increase in the pension system's membership.

Membership in the mid-1950s reached 4,548 and assets grew to \$3,966,825. An employee retiring in 1956 with 28 years of service was entitled to a pension benefit of \$100 per month. The monthly contribution by employees rose to \$7. Also during that time, employees became eligible for Social Security benefits.

As a new decade began in 1960, the System's assets surpassed the \$10 million mark for the first time to total \$10,596,901. Membership stood at 5,376 and active members were contributing \$10 a month to help fund the System's positive trend.

More change came in 1981, when bills were introduced in the Texas Legislature to establish a noncontributory pension group for employees, Group B.

In 1987, the U.S. stock market suffered a severe decline and budgets in most of the nation's cities, including Houston, were adversely affected.

Despite the economic turmoil of the 1980s, the System's market value continued to grow. The 1989 fund was \$546.3 million – a 400 percent increase from 1980. That same year, the System published the first issue of the *Pension Press* newsletter.

In 1992, Roderick J. Newman was elected as the first African American to serve on the HMEPS Board. In 1993, the Board hired its first executive director, David L. Long, and his administrative staff. That same year, the name was changed to the Houston Municipal Employees Pension System, HMEPS.

HMEPS thrived and its market value climbed to \$1.17 billion in 1997, another major first for the pension system. Also, that year the Deferred Retirement Option Plan (DROP) was instituted.

In 2004, HMEPS and the City entered into its first Meet and Confer Agreement to make certain changes to the pension plan. In subsequent years, there have been additional amendments to the original Meet and Confer Agreement. The Meet and Confer Agreement also established a new noncontributory group – Group D.

HMEPS continued to expand services to its membership in 2006 by participating in the City's first Financial Fitness Expo and introducing AccessHMEPS, an online service for DROP participants.

After serving the System for 35 years in different capacities, Chairman Fred Holmes stepped down from the HMEPS Board in 2008. Rod Newman was elected Chairman, the first African American elected to the post since the creation of the fund in 1943. In September of 2008, Sherry Mose became the first female elected to the office of Chairman.

Effective on July 1, 2011 the Amended and Restated Meet and Confer Agreement (Agreement) between the City and the System went into effect. The Agreement provides for structured contributions from the City to provide the City budgetary flexibility while strengthening the System, enhancements to Board operations to promote best practices, and increased options for eligible participants that are cost neutral to the System.

As of June 30, 2013 the System had total assets of more than \$2.2 billion. HMEPS is honored to continue the commitment set forth so many decades ago for the valued employees of the City of Houston.



HOUSTON MUNICIPAL EMPLOYEES
PENSION SYSTEM
1201 LOUISIANA, SUITE 900
HOUSTON, TEXAS 77002

TEL. 713 595 0100

www.hmepps.org



Buffalo Bayou Carruth Bridge.