An aerial photograph of the Houston Convention Center reflecting pool. The pool is a large, rectangular body of water with a central fountain. In the background, a tall, white, conical monument stands on a small island in the pool. The surrounding area is lush with green trees and a paved walkway. The text "Houston Municipal Employees Pension System" is overlaid in white serif font at the top of the image.

**Houston Municipal Employees
Pension System**

**Summary of the
Comprehensive Annual
Financial Report for the
Year Ended June 30, 2005**



ORGANIZATIONAL OVERVIEW

ELECTED and APPOINTED TRUSTEES

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

Barbara Chelette, *Appointed*

CITY APPOINTED TRUSTEES

Richard Badger
Gilbert Garcia
Alfred Jackson
Craig T. Mason

David L. Long, Executive Director

LETTER TO PLAN PARTICIPANTS

March 1, 2006

To Houston Municipal Employees
Pension System Participants

Dear Plan Participants:

This Summary of the Comprehensive Annual Financial Report for the Year Ended June 30, 2005 (Summary) is being presented to the participants of the Houston Municipal Employees Pension System (HMEPS). It provides general information about the operations of HMEPS. Excerpts from the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2005, are included. The CAFR is available for review, in its entirety, in the HMEPS office and online at www.hmeps.org.

During the past year, HMEPS received a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association of the United States and Canada (GFOA) for its CAFR for the year ended June 30, 2004. The Certificate, a prestigious national award recognizing conformance with the highest standards of preparation of state and local government financial reports, has been awarded to HMEPS for the last 11 consecutive years (fiscal years ended June 30, 1994 through 2004). We believe our current CAFR conforms to the highest reporting standards, and we have entered it in the Certificate program.

The Board of Trustees continues its commitment to creating and implementing a pension system with benefits that will meet the long-term financial needs of City of Houston municipal employees and that will help provide a quality life-style for each member after retirement.

Sincerely,

Fred Holmes
Chairman

David L. Long
Executive Director

PROFESSIONAL CONSULTANTS AND INVESTMENT MANAGERS

Professional Consultants (Fiscal Year 2005)

Auditor

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

Board Medical Advisor

Charles Schuhmacher, M.D.

Investment Consultants

Wilshire Associates, Inc.
Pension Consulting Alliance, Inc.

Master Custodian/Trustee

State Street Bank and Trust Co.

Actuary

Gabriel, Roeder, Smith & Company

Investment Performance Analysis

Wilshire Associates, Inc.

Legal Counsel

Baker Botts, L.L.P.
Cohen, Milstein, Hausfeld
& Toll, P.L.L.C.
E. Troy Blakeney Jr., P.C.
Hinton, Sussman, Bailey
& Davidson, L.L.P.
Locke, Liddell & Sapp, L.L.P.
Schlanger, Mills, Mayer & Silver

Governmental Representation

HillCo Partners, Inc.

Database Services

Pension Benefits Information

Consulting Services

Vollmer Public Relations

Investment Managers (Fiscal Year 2005)

Domestic Equities

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

International Equities

Axiom International
Barclays Global Investors, N.A.
Brandes Investment Partners
Oechsle International Advisors
TT International Investment
Management

Fixed Income

Barclays Global Investors, N.A.
GoldenTree Asset Management
Loomis, Sayles & Co.
MDL Capital Management
Smith Graham & Co.
Western Asset Management

Real Assets

Alliance Capital Management L.P.
CB Richard Ellis Investors
Crow Holdings
Fortress Investment Group, L.L.C.
Global Forest Partners, L.P.
Goldman, Sachs & Co.

Grove International Partners
L&B Realty Advisors, Inc.
Lone Star U.S. Acquisitions, L.L.C.
Morgan Stanley
Asset Management, Inc.
Olympus Real Estate Corp.
Prudential Investments
RREEF
State Street Research
& Management Co.

Alternative Investments

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

This Summary has been prepared through the combined efforts of the HMEPS staff under the direction of the Executive Director. The Summary contains excerpts from the HMEPS Comprehensive Annual Financial Report for the Year Ended June 30, 2005 (CAFR), and is intended to provide information to plan participants that may be a basis for a better understanding of HMEPS. Because the CAFR was prepared in 2005, the following excerpts will reflect the information and conditions that applied at that time. In the event of any conflict between this Summary and Article 6243h, Texas Revised Civil Statutes, as amended (the Statute), the Statute will prevail and will supersede this Summary. Nothing contained herein can be construed to convey any right or benefit not otherwise provided by the Statute. This Summary is distributed to participants of HMEPS, and is intended to provide information of interest to them about HMEPS. It is not intended for general circulation, and may not be used as a CAFR.

MANAGEMENT OF PLAN ASSETS

The methods, practices and policies for the management of HMEPS assets are set forth in the Statement of Investment Policies and Objectives (Statement) adopted by the Board. The authority to amend the Statement rests solely with the Board. The Investment Committee, a standing Committee of the whole Board, may from time to time establish a tactical plan of asset allocation among investment types, designed to achieve the earnings objectives established by the Board to meet the needs of HMEPS.

GENERAL ECONOMIC CONDITIONS

U.S. Economy

Over the first six months of 2005, the U.S. economy continued to grow at a consistent pace, made evident by the fact that the International Monetary Fund expects U.S. growth to reach 3.5 percent in 2005. This marks the 14th consecutive quarter that the U.S. real gross domestic product (GDP) growth has been positive. Employment rates in the U.S. have been stable, with 411,000 non-farm payroll jobs being created in July and August.

One consequence of this growth was that the Federal Reserve Board (the FED) increased key interest rates to 4.0% during the fourth quarter of 2005. The FED raised interest rates 12 times since mid-2004. The strength of the economy also caused inflation to rise, a factor the FED is saying will be a big threat to the U.S. economy in the months ahead.

Hurricanes Katrina and Rita have had (and continue to have) adverse effects on the economy. While estimates vary, the costs of recovery efforts following these hurricanes could amount to almost \$200 billion, and might subtract 0.5 to 1 percentage point off U.S. economic growth in the second half of 2005. The rising cost of oil is another factor having an adverse effect on the economy. The FED will likely continue to raise interest rates as high oil prices are putting pressure on inflation.

Household spending this year has been supported by rising employment and household wealth as well as by the low level of interest rates. However, higher costs for consumer energy products have eroded households' purchasing power.

Notwithstanding expectations for moderation in growth, the economy continues to roll along at a healthy pace fueled by the massive infusion of monetary supply and tax cuts that occurred a few years ago. Low interest rates have supported strong housing appreciation and home refinancing which in turn have spurred brisk and consistent increases in consumer spending and a strong economy. Consistent consumer spending in the face of rising energy costs coupled with steady job creation have resulted in rising personal income that has been deployed in personal consumption to support economic growth rather than rising rates of personal savings.

In the past sixteen months, the U.S. yield curve has gone from the steepest ever to relatively flat as the FED has aggressively embarked on a program to slow economic growth and contain inflation. At the current time, the relative flatness of the yield curve appears to be overestimating a potential slowdown in the economy.

Into 2006, rising interest rates and resilient oil prices may lead to a more subdued business climate with the potential slowing of consumer spending and housing markets resulting in some moderation in GDP growth rates. To date in 2005, the economy continues to defy expectations with 3rd quarter GDP growth of 3.8% in spite of two major hurricanes. It is anticipated that the lagging effect of the prior eleven FED Interest rate increases, moderation in housing price appreciation, an overleveraged consumer and steep energy cost increases will ultimately slow consumer spending, and moderate the rate of economic growth. Finally, according to the FED, high energy prices and hurricane-related damage have "temporarily depressed output and employment," but planned rebuilding will almost certainly aid the economy's solid underlying growth.

Global Economy

In contrast to the U.S., economic activities in European sectors remained very moderate. Continued weak development of domestic demand, the strong rise of crude oil prices, and the strength of the Euro against the U.S. dollar in the prior year, which dampens the activities of the European exporting industries, are the main reasons for this poor economic development. According to the Office of Economic Development (OECD), the GDP of the European sector is expected to grow by only 1.9% in 2005. Japan, the world's second-largest economy, is expected to expand just 0.8 percent this year and 1.9 percent in 2006.

The pace of expansion in the industrial economies has generally increased. With the important exception of China, this increase has been offset by moderating growth in many developing economies. Inflation has remained well contained in most countries.

After having edged up during the first three months of 2005, long-term interest rates in the major foreign industrial economies have fallen and now stand below their levels at the start of the year. As in the U.S., the decline in foreign long-term interest rates continues a trend that began in mid-2004. However, long-term rates in the

major foreign industrial economies have fallen more than rates in the U.S. this year. The decline in European long-term rates occurred amid weak economic news and a shift away from market expectations of a policy rate increase.

INVESTMENT ACTIVITIES

During the period covered by this Summary, investment strategies were employed that are long-term in perspective and designed to work within predefined ranges among asset classes to produce returns that, over market cycles, will exceed the investment return assumption adopted by the Board for actuarial purposes. Diversification provides safeguards against unanticipated market volatility of one or more asset classes.

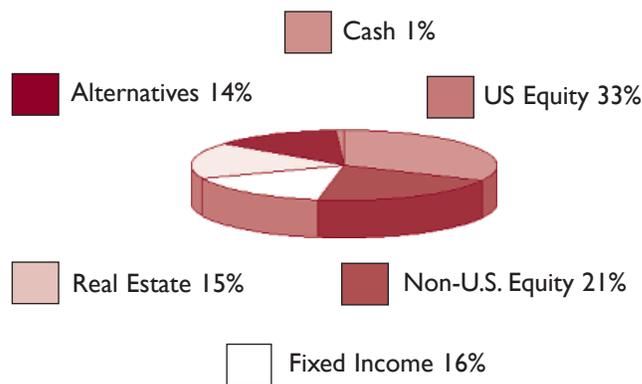
To facilitate execution of the strategic investment plan, HMEPS engages the services of a master custodian which utilizes a multi-currency reporting system that reports investments at fair value stated in terms of the base currency, the US dollar. Professional portfolio managers that specialize in a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

The year ending June 30, 2005 provided a range of opportunities to earn meaningful investment returns in many world equity markets. While the S&P 500 returned 6.3% and the Lehman Aggregate bond index returned 6.8%, international markets as reflected by MSCI EAFE returned 13.7% for the year. U.S. value stocks continued to outperform growth stocks by a significant margin and small cap stocks returned 10.7% as measured by the Wilshire Small Cap 1750. Real estate, energy and private equity had strong returns, well into the double digits.

Throughout fiscal year 2005, HMEPS maintained its existing target asset allocation mix of 30% domestic equities, 20% international equities, 20% fixed-income, 15%

real estate and 15% alternative investments. However, due to movements in the markets and rebalancing activities directed by Staff, HMEPS continued to maintain a slight underweight to fixed income and alternative investments, with a slight overweight to U.S. equities, international equities and real estate.

SYSTEM ASSET ALLOCATION



FINANCIAL HIGHLIGHTS

HMEPS received \$23,488,000 and \$26,189,000 during fiscal year 2005 and 2004, respectively, in employee contributions from about 12,000 active participants, of which over 8,000 belong to Group A. These contributions represent 5% of the employee’s qualifying base salary beginning January 2005 and 4% for fiscal year 2004 and fiscal year 2005 through December 31, 2004. Total employee contributions decreased by \$2,701,000 or 10% in fiscal year 2005 compared to fiscal year 2004. This decline is attributable to a forty-five percent decline in employees’ contributions coming from service purchase and transfers from Section 457 deferred compensation plan totaling \$5,741,000 and \$10,488,000 for fiscal years 2005 and 2004, respectively.

The City’s contribution during fiscal year 2005 represents the budgeted contributions and the net proceeds to be received through the issuance of pension obligation bonds as set forth in the Meet and Confer Agreement between HMEPS and the City of Houston dated September 15,

2004. During fiscal year 2005, HMEPS received cash contributions from the City of Houston of \$63,247,000 and recognized a \$300 million contribution in the form of a note receivable issued by the City on November 10, 2004.

INVESTMENT PERFORMANCE

HMEPS' investment performance was 13.9%, 11.8% and 4.5% for the past one, three and five-year periods. These results are consistently above HMEPS' policy benchmark, and also well above the median fund in a universe of HMEPS' public fund peers. HMEPS ranks in the top 4th, 7th and 29th percentiles, respectively, for the one, three and five-year periods ended June 30, 2005. The best performing asset classes for the past year were real assets (+30.0%) and alternative investments (+20.0%) in contrast to international equities and domestic equities which were the top two performing asset classes for 2004. The benefits of a well diversified asset allocation are evidenced by HMEPS' ability to perform very competitively in both years where different asset classes drove overall returns. For the past three and five years, real assets was the best performing asset class, providing 16.9% and 16.2% per annum. HMEPS' 15% allocation to real assets, which includes real estate and natural resources, helped position the fund to perform well in an environment whereby a 60/40 mix of S&P 500 to Lehman Aggregate Fixed Income returned 6.5%.

FUNDING STATUS

The funded ratio (the ratio of the actuarial value of assets to the actuarial accrued liability) is a standard measure of a plan's funded status. In the absence of benefit improvements, it should increase over time, until it reaches 100%. The funded ratio as of July 1, 2004 is 57.0%. This is higher than the 46.1% from the 2003 valuation. The major cause for this increase was the benefit provision changes. The new assumptions and further recognition of prior years' investment performances over the last several years also impacted the funded status. NOTE: The HMEPS Board approved the Actuarial Valuation as of

July 1, 2005 (2005 Actuarial Valuation) at the February 2006 Board meeting. The 2005 Actuarial Valuation is available on the HMEPS website at www.hmeps.org.

Net assets increased by \$406,126,000 during fiscal year 2005 compared to an increase of \$152,535,000, in 2004, primarily due to the \$300 million note from the City that was recognized as contributions during fiscal year 2005 and the net investment and interest income of \$200,782,000 earned during fiscal year 2005.

ACCOUNTING SYSTEM AND INTERNAL CONTROLS

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

HMEPS' independent auditors have audited the financial statements and issued an unqualified opinion as of June 30, 2005 and 2004. The purpose of the audit is to give reasonable assurance to users of those financial statements, the Board, and participants of HMEPS, that the financial statements present fairly, in all material respects, information regarding HMEPS' net assets held in trust for pension benefits and in conformity with accounting principles generally accepted in the United States of America.

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

STATEMENT OF PLAN NET ASSETS JUNE 30, 2005

STATEMENT OF CHANGES IN PLAN
NET ASSETS JUNE 30, 2005**Assets:**

Investments, at fair value:	
United States government securities (cost: \$62,134,178)	\$ 62,840,296
Corporate bonds (cost: \$68,409,051)	73,687,436
Capital stocks (cost: \$415,043,746)	458,701,513
Commingled funds (cost: \$348,600,875)	420,920,132
Limited partnerships, real estate trusts, and loans and mortgages (cost \$320,660,441)	372,737,677
Short-term investment funds (valued at cost)	97,408,425
	<hr/>
Total investments	1,486,295,479
Cash and cash equivalents	874,937
Proceeds due on asset sales	54,780,732
Receivables on foreign exchanges	11,172,093
Contribution receivable - City of Houston	1,005,078
Note receivable - City of Houston	300,000,000
Accrued interest on note receivable - City of Houston	16,362,500
Other receivables	2,621,140
Collateral on securities lending arrangements, at fair value	95,635,714
Furniture, fixtures and equipment, net	828,304
	<hr/>
Total assets	1,969,575,977

Liabilities:

Amounts due on asset purchases	34,247,079
Payables on foreign exchanges	11,185,158
Accrued liabilities	3,636,160
Options written	20,365
Collateral on securities lending arrangements, at fair value	95,635,714
	<hr/>
Total liabilities	144,724,476
	<hr/>
Plan net assets held in trust for pension benefits	\$ 1,824,851,501

Additions To Plan Net Assets:

Contributions:	
City of Houston	\$ 363,246,727
Participants	23,487,896
	<hr/>
Total contributions	386,734,623
Investment income:	
Interest on bonds and deposits	11,101,154
Dividends	9,891,196
Earnings from limited partnerships and real estate trusts	45,069,632
Net appreciation on investments	124,001,689
	<hr/>
Total investment income	190,063,671
Proceeds from lending securities	2,694,595
Less costs of securities lending	(2,342,722)
	<hr/>
Net proceeds from lending securities	351,873
Less costs of investment services	(5,996,174)
	<hr/>
Total investment income, net	184,419,370
Interest income - City of Houston note receivable	16,362,500
Other income	887,582
	<hr/>
Total additions to plan net assets	588,404,075

Deductions From Plan Net Assets:

Benefits paid to participants	175,479,966
Contribution refunds to participants	992,141
Professional services	1,088,411
Administration expenses	4,717,623
	<hr/>
Total deductions from plan net assets	182,278,141
Net increase in plan net assets	406,125,934
Plan net assets held in trust for pension benefits:	
Beginning of year	1,418,725,567
	<hr/>
End of year	\$ 1,824,851,501

Acknowledgement

HMEPS would like to thank the Greater Houston Convention and Visitors Bureau (GHCVB) for their assistance and generosity in the use of the photographs used in this Summary.



