



HMEPS
HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM



**HAND
IN
HAND**

HOUSTON HAS
A BETTER FUTURE
BECAUSE OF YOU

Comprehensive Annual Financial Report
FOR THE YEARS ENDED JUNE 30, 2019 AND JUNE 30, 2018



NURTURING



**YOUR
DEDICATION
MAKES EVERYTHING**



MEMORABLE

BETTER



HMEPS
HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

**YOUR
COMMITMENT**

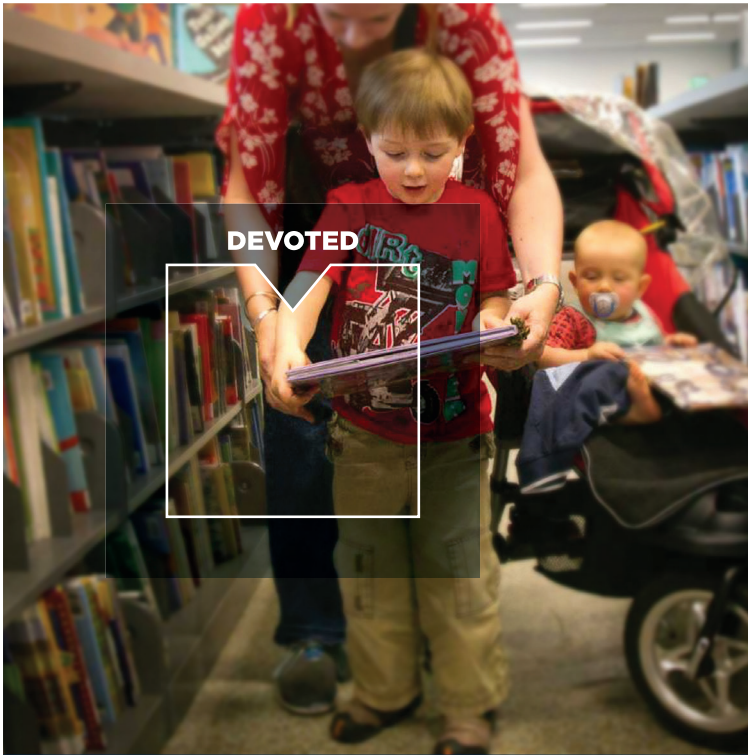
DETERMINED

DEDICATED

**MAKES
ALL**

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM
A Component Unit of the City of Houston, Texas

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DEVOTED

THE
DIFFERENCE

HMEPS

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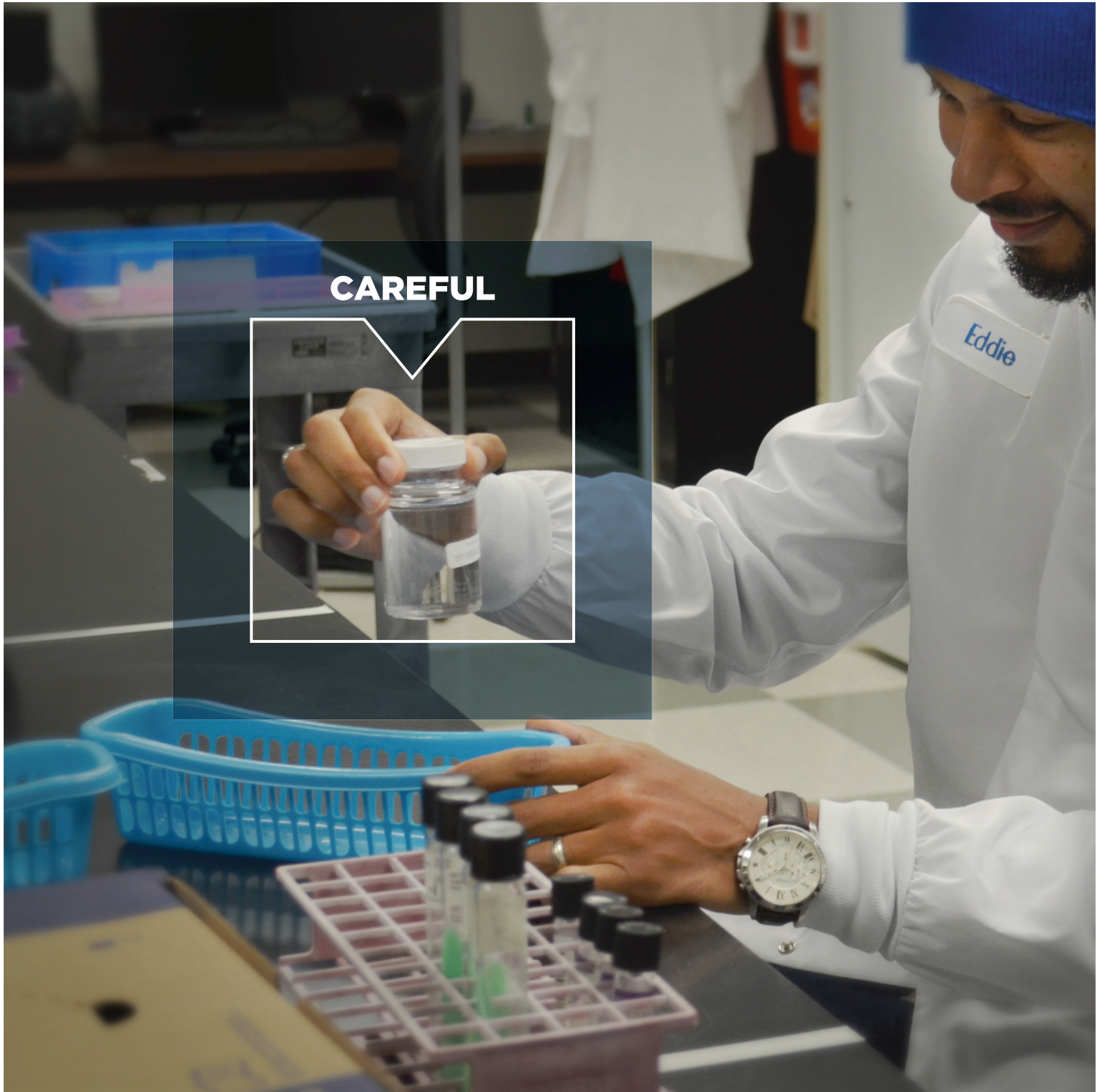
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INTRODUCTION

- SECTION 1 -



**YOU HELP
BUILD THE
FOUNDATION
FOR GREAT
COMMUNITIES**



CAREFUL



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 19, 2019

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

Dear Ms. Emo:

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the Houston Municipal Employees Pension System (the System), a Component Unit of the City of Houston, Texas (the City), for the fiscal years ended June 30, 2019 and June 30, 2018. 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, 2019 and 2018 (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 CAFR 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.

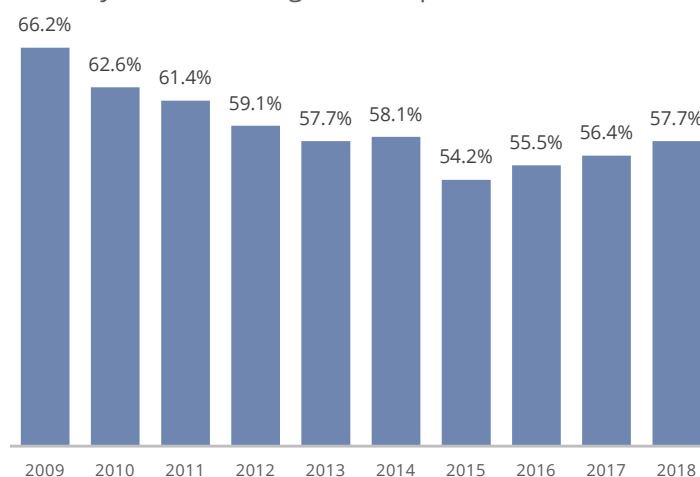
FUNDING STATUS

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 as amended by SB 2190, 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, 2018, HMEPS’ AVA and AAL were \$2.87 billion and \$4.98 billion, respectively, resulting in a funded ratio of 57.7%. This is higher than the funded ratio as of July 1, 2017, which was 56.4%. This change is primarily the result of positive investment performance.

A historical perspective of the System’s funding levels is presented in the following graph.



MARKET ENVIRONMENT

Fiscal year 2019 began with strong macroeconomic indicators pointing toward a positive economic environment. The U.S. economy continued its expansion with GDP growing in the sustainable 2-3% range. For the first half of the fiscal year, the Federal Reserve maintained its policy of gradual interest rate hikes with two rate increases. By March 2019, with the target Fed Funds rate at 2.25-2.50%, the Federal Reserve signaled a pause in rate increases, observing that inflation had declined and that “the economy is in a good place.” Meanwhile, uncertainty regarding ongoing trade negotiations between the U.S. and China introduced volatility to equity markets. The Wilshire 5000 declined 14.3% in the quarter ending December 31, 2018, only to rebound 14.1% in the subsequent quarter.

U.S. equity markets emerged from volatility during the fiscal year with the Wilshire 5000 index gaining 9.1%. The Wilshire 5000's gain marked the tenth consecutive positive fiscal year for the index since the credit crisis of 2008-2009. Growth stocks once again outperformed value stocks during the fiscal year, and larger capitalization stocks tended to do better than smaller stocks.

During the first quarter of the fiscal year, the U.S. Dollar appreciated against a number of foreign currencies, but the U.S. Dollar experienced mixed performance throughout Fiscal Year 2019. Concern about trade tensions dominated headlines throughout the fiscal year, but international stock markets were able to generate very modest gains. Concerns about weakening in Eurozone and U.K. manufacturing sectors weighed on international stocks as did lackluster consumption and capital spending in Japan. International equities as represented by the MSCI ACWI ex-U.S. (net) Index were up 3.0% during FY 2019.

Investment grade fixed income securities generated positive returns in fiscal year 2019. The Treasury yield curve flattened during the fiscal year with the 30-year Treasury declining about 60 basis points. Yield spreads for corporate and high yield bonds tightened even though spreads began the fiscal year at low levels in historical terms. These factors provided the catalyst for good returns for fixed income securities. Investment grade bonds as represented by the Barclay's U.S. Aggregate bond index posted positive returns (7.9%) for the fiscal year. High yield bonds as represented by the Merrill Lynch High Yield Master Trust II Index were likewise up 7.6% for the fiscal year.

Among the alternative asset classes, Real Estate and Private Equity returned 7.7% and 14.1% respectively in FY 2019. Strong real estate fundraising, low interest rates, and healthy job growth led to positive returns in real estate. Inexpensive credit and near record levels of available capital contributed to higher valuations, leading to another good year in Private Equity.

Overall, the System's investments returned 7.2% for fiscal year 2019. Through the efforts of the Board of Trustees, the System's investment portfolio is more broadly diversified than most public pension plans and exhibits less volatility, particularly during extreme market events. During the 10-year period ending June 30, 2019, the system's annualized return was 9.7%.

MAJOR CURRENT AND FUTURE INITIATIVES

MEMBER SERVICES

The Benefits Division has continued its effort to provide information relating to pension benefits by holding seminars at City departments and individual benefit meetings at HMEPS. In FY 2019, HMEPS:

- Responded to continued 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 213 individual counseling sessions and hosted 12 joint presentations for various City departments as well as new employee orientations for the benefit of 1,390 attendees.
- Conducted 140 one-on-one counseling sessions between the HMEPS financial counselor and participants in addition to numerous presentations in the field with the Benefits Division.
- Processed 2,100 benefit applications, including retirements, the Deferred Retirement Option Plan, survivor benefits, refunds, and lump-sum payments.

- Participated in the Spring and Fall Financial Retirement Educational Event, an annual event co-sponsored by the System that help City of Houston employees better plan for their financial futures.

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 2019, 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 nine private equity partnerships, three private real estate partnerships, and two private real asset (inflation-linked asset class) partnerships.

The System's investment portfolio closed its 2019 fiscal year at \$3.1 billion. The total investment return for the fiscal year was 7.2%. The System's investment performance was 9.7%, 6.8% 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 2019 were Private Equity (+14.1%) and Private Credit (+8.8%).

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

BOARD GOVERNANCE

During FY 2019, the Board's membership did not change. Appointed Board members serve three-year terms, with the current term scheduled to expire in July 2020 absent an earlier vacancy and appointment. 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 2020.

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, 2018. This was the 25th 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 CAFR was prepared through the combined efforts of the System staff and was subject to the scrutiny of the Board. It is intended to provide information to its user that may be a basis for a general understanding of the System. This CAFR is being forwarded to the City of Houston, the Texas 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. The System is proud to serve the dedicated municipal employees who have made tremendous contributions to Houston and its citizens.

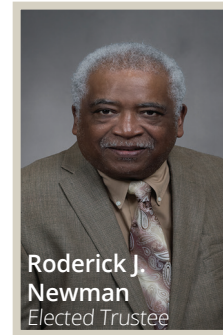
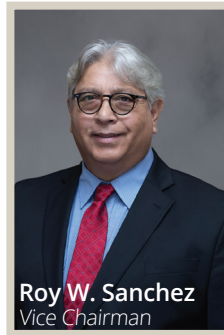
Sincerely,

A handwritten signature in black ink, appearing to read "Sherry Mose". The signature is fluid and cursive, with the first name being more prominent.

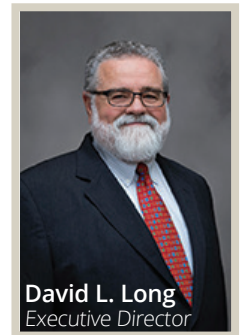
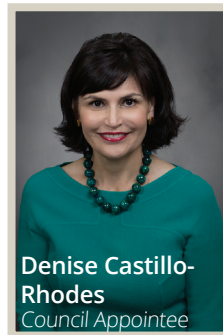
Sherry Mose
Chairman

A handwritten signature in black ink, appearing to read "David L. Long". The signature is cursive and stylized, with a long, sweeping tail on the final letter.

David L. Long
Executive Director



BOARD OF TRUSTEES



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
- Financial Counseling
- Member Services

OPERATIONS

- Accounting
- Financial Reporting
- Records
- Technology Support

For more information on investment professionals who provide services to HMEPS, refer to the *Other Supplementary Information* on page 55 and the *Schedule of Fees and Commissions Paid* table on page 67.

CERTIFICATE OF ACHIEVEMENT FOR EXCELLENCE IN FINANCIAL REPORTING

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



**PROFESSIONAL CONSULTANTS
(FY 2019)**

ACTUARY

Gabriel, Roeder, Smith & Company

AUDITOR

Weaver and Tidwell, L.L.P.

BOARD MEDICAL ADVISOR

Charles Schuhmacher, M.D.

COMMUNICATION SERVICES

LT Communications, L.L.C.
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 2019)**

ABSOLUTE RETURN

Anchorage Capital Group LLC
Angelo, Gordon & Co.
Brevan Howard US LLC
Brigade Capital Management
Davidson Kempner Capital
Management, LLC
Graham Capital Management L.P.
Highland Capital Management
MKP Capital Management, LLC
Och-Ziff Capital Management Group
Samlyn Capital, LLC
Scopia PX LLC
Soroban Capital Partners, LLC

FIXED INCOME

Alliance Bernstein Institutional
Investments
BlackRock, Inc.
DDJ Capital Management, L.L.C.
GMO LLC
Loomis, Sayles & Co.
Pugh Capital Management
Smith Graham & Co.
Whippoorwill Associates, Inc.

INFLATION-LINKED

BlackRock, Inc.
Cohen & Steers
EnCap Investments LP
Envest, Ltd
Global Forest Partners, L.P.
NGP Energy Capital
Oaktree Capital Management
Quantum Energy Partners
Riverstone Holdings
Salient Partners
Taurus Funds Management
Tillridge Global Agribusiness
The Carlyle Group
Tortoise Capital Advisors

GLOBAL EQUITY

Ariel Investments
Ballie Gifford & Co
BlackRock, Inc.
DePrince, Race & Zollo, Inc.
Globeflex Capital
INTECH Investment Management,
L.L.C.
Neumeier Investment Counsel, L.L.C.
OFI Institutional Management
PanAgora Asset Management, Inc.
State Street Global Advisors
T. Rowe Price Associates

PRIVATE CREDIT

Angelo, Gordon & Co
DRC Capital
Mesa West Capital
Summit Capital

PRIVATE EQUITY

Adams Street Partners
Anchorage Capital Group LLC
Brera Capital Partners, L.L.C.
Brockway Moran & Partners, Inc.
Carrick Capital Management LLC
Centerbridge Capital Partners
Clearlake Capital Partners
TrueBridge Capital Partners
GTCR Management LC
Goldman, Sachs & Co.
HarbourVest Partners, L.L.C.
Hellman & Friedman, L.L.C.
ICV Partners, L.P.
J.W. Childs Associates, L.P.
JMI Equity
Lexington Partners, Inc.
Matlin Patterson Global Advisors
New Enterprise Associates
New Mainstream Capital
Oaktree Capital Management
Onex Corporation
Pacven Walden Management Co.,
Ltd.
Pegasus Investors, L.P.
Pharos Capital Partners, L.L.C.
Platinum Equity Capital Partners
Siris Capital Group
Summit Partners
Sun Capital Partners, Inc.
Technology Crossover Ventures
The Carlyle Group
The Jordan Company, L.P.
Valor Equity Partners
Vista Equity Partners
Wayzata Investment Partners, LLC

REAL ESTATE
Aetos Capital Real Estate LP
Aermont Capital
Angelo, Gordon & Co.
Artemis Real Estate Partners
Crow Holdings Capital
Fortress Investment Group, L.L.C.
GEM Realty Capital
IC Berkeley Partners
Kildare Partners
Lone Star U.S. Acquisitions, L.L.C.
Long Wharf Real Estate Partners
Morgan Stanley Asset Management,
Inc.
Orion Capital Managers, LLP
Prime Storage Group
State Street Global Advisors
Starwood Capital Group Global LP