Houston Municipal Employees Pension System

Summary of the Comprehensive Annual Financial Report for the Year Ended June 30, 2007

ORGANIZATIONAL OVERVIEW

ELECTED and APPOINTED TRUSTEES

Roderick J. Newman, *Chairman*
Ray Kennedy, *Vice Chairman*
Sherry Mose, *Secretary*
Shiou-Huey "Sophia" Chang
Mark Mancuso
Lonnie Vara

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 14, 2008

To Houston Municipal Employees
Pension System Participants

Dear Plan Participants:

This Summary of the Comprehensive Annual Financial Report for the Year Ended June 30, 2007 (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, 2007, 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, 2006. 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 13 consecutive years (fiscal years ended June 30, 1994 through 2006). 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,

Roderick J. Newman
Chairman

David L. Long
Executive Director

Professional Consultants (Fiscal Year 2007)

Actuary
Gabriel, Roeder, Smith & Company

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

Board Medical Advisor
Charles Schuhmacher, M.D.

Consulting Services
Ennis, Knupp & Associates, Inc.
TCG Solutions

Database Services
Pension Benefits Information

Governmental Representation
HillCo Partners, Inc.
Locke, Liddell & Sapp, L.L.P

Investment Consultants
Wilshire Associates, Inc.
Pension Consulting Alliance, Inc.

Investment Performance Analysis
Wilshire Associates, Inc.
State Street Bank and Trust Co.

Legal Counsel
Baker Botts, L.L.P.
Hughes & Luce, L.L.P.
Locke, Liddell & Sapp, L.L.P.
Groom Law Group

Master Custodian/Trustee
State Street Bank and Trust Co.

Investment Managers (Fiscal Year 2007)

Alternative Investments
Adams Street Partners
Angelo, Gordon & Co.
Brera Capital Partners, L.L.C.
Brockway Moran & Partners, Inc.
Goldman, Sachs & Co.
HarbourVest Partners, L.L.C.
J.W. Childs Associates, L.P.
Lexington Partners, Inc.
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
Quantum Energy Partners
Sun Capital Partners, Inc.
The Carlyle Group
The Jordan Company, L.P.
TSG Capital Group, L.L.C.

Domestic Equities
Barclays Global Investors, N.A.
Benchmark Plus Partners, L.L.C.
DePrince, Race & Zollo, Inc.
EARNEST Partners, L.L.C.
Legg Mason Capital Management
Neumeier Investment Counsel, L.L.C.
Profit Investment Management
Russell Investment Group
State Street Global Advisors

Fixed Income
Barclays Global Investors, N.A.
DDJ Capital Management, L.L.C.
Highland Capital Management
Loomis, Sayles & Co.
Smith Graham & Co.
Western Asset Management
Whippoorwill Associates, Inc.

International Equities
Axiom International
Barclays Global Investors, N.A.
Brandes Investment Partners

Real Assets
Aetos Capital
BlackRock, Inc.
CB Richard Ellis Investors
Crow Holdings
Fortress Investment Group, L.L.C.
Global Forest Partners, L.P.
Goldman, Sachs & Co.
Grove International Partners
Lone Star U.S. Acquisitions, L.L.C.
Morgan Stanley Asset Management, Inc.
Olympus Real Estate Corp.
Prudential Strategic Investment Corp.
RREEF America L.L.C.

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, 2007 (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 2007, 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

In the second half of 2006, a further slowdown in residential construction activity and a contraction in motor vehicle production created a significant drag on economic activity. However, consumer spending held up, and employment rose at a solid pace. Core inflation also eased somewhat, although to a rate above its previous year's level. Against this backdrop, the Federal Open

Market Committee (FOMC) left the stance of policy unchanged at its final four meetings of 2006. Committee discussions in those meetings focused in part on developments in the housing market and their implications for the broader economy. Although the housing market was weakening throughout this period, the Committee judged that the downturn had not spilled over significantly to consumer spending. The economy was expected to expand over coming quarters at a rate close to or slightly below its long-run sustainable pace.

The U.S. economy generally performed well in the first half of 2007. Activity continued to increase moderately, on average, over the period; businesses added jobs at a steady pace and the unemployment rate remained at 4.5%. Overall inflation, however, picked up as a result of sizable increases in energy and food prices. At the same time, core inflation (which excludes the direct effects of movements in energy and food prices) held at about the same rate as in 2006.

Economic activity should strengthen gradually into 2008. The ongoing correction in the housing market seems likely to continue to weigh on the rate of economic expansion over the near term. But as that process runs its course, the rate of growth of economic activity should move up somewhat. The pace of consumer spending may be restrained in the near term as households continue to adjust to the latest run-up in energy prices and to softer house prices. Still, household balance sheets are generally in good shape, and increases in employment and real wages over the next year and a half should be sufficient to sustain further gains in spending. Regarding business investment, solid gains in real outlays on equipment and software seem likely in light of the anticipated expansion in business output, continuing strong profits, and generally favorable financial conditions. Opportunities to realize significant gains in efficiency by investing in high-tech equipment should provide ongoing support to equipment spending as well.

Global Economy

Growth of real gross domestic product (GDP) in the euro area moved down to 2.75% in the first quarter after posting growth of 3.25% over the four quarters of 2006. Although export growth moderated from its strong performance of 2006, recovery of domestic demand appears to have taken firmer hold, as investment accelerated in the first quarter. Private consumption in Germany had been muted earlier this year, partly because of a hike in the value-added tax at the start of the year, but lately retail sales in Germany and the euro area more broadly have picked up.

Household consumption rose at a robust rate of about 3%, and real exports increased almost 14%. Investment growth slowed, although recent surveys report that businesses are optimistic about the outlook. The labor market in Japan improved further in the first five months of the year. Its unemployment rate fell below 4%, and the ratio of job offers to applicants remained elevated. Despite the strong growth of output and improved labor markets, consumer prices were largely unchanged on a twelve-month basis in May; the GDP deflator has continued to fall, though, during the period. Core consumer prices have shown small twelve-month declines over the past several months, and wages have declined relative to their previous year levels.

MAJOR CURRENT AND FUTURE INITIATIVES

Fiscal Year 2007 initiatives continued to emphasize improved information technology. The Administration Information System (AIS), HMEPS' proprietary system for participant data, continues to undergo upgrades including the further development of the web-based pension calculator, and the development of the *Access*HMEPS online service for DROP participants. HMEPS' website also had continual improvements to facilitate ease-of-use.

During the year, the HMEPS' benefits division, in conjunction with the communications division, conducted numerous on-site field meetings and pre-retirement seminars. These meetings involved HMEPS staff members making presentations at the City's numerous Departments on various pension subjects including benefits programs, qualifications for retirement, plan changes and answering questions directly from members.

On June 27, 2007 the Fourth Amendment to Meet and Confer Agreement was approved by and between the Board and the City of Houston, Texas. Some of the salient provisions of the Agreement are listed in the Notes to Basic Financial Statements.

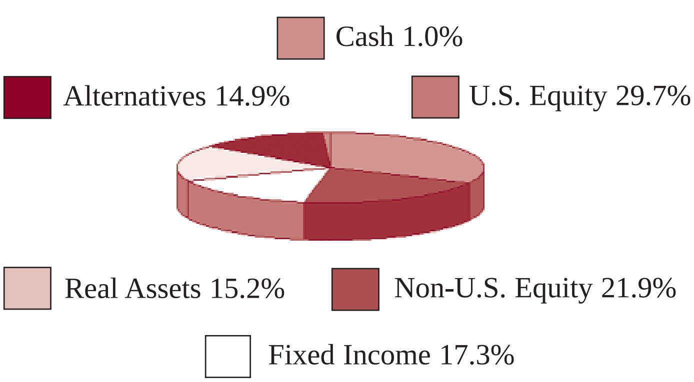
INVESTMENT ACTIVITIES

During the period covered by this Report, 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.

Throughout fiscal year 2006, HMEPS maintained its existing target asset allocation mix of 30% domestic equities, 20% international equities, 20% fixed-income, 15% real assets and 15% alternative investments. However, due to movements in the markets and rebalancing activities directed by staff, HMEPS ended fiscal year 2007 with a slight underweight to domestic equity, fixed income and alternative investments and a slight overweight to international equity and real assets.

SYSTEM ASSET ALLOCATION



FINANCIAL HIGHLIGHTS *(In Thousands of Dollars, Unless Otherwise Noted)*

The System received $20,966 and $21,888 during fiscal years 2007 and 2006, respectively, in employee contributions from about 9,500 Group A active participants. For fiscal years 2007 and 2006, the contributions represent 5% of the employee's qualifying base salary. Total employee contributions decreased by $922 or 4% in fiscal year 2007 compared to fiscal year 2006. This decline is attributable to a 73% decline in service purchase contributions and transfers from the Section 457 deferred compensation plan totaling $347 and $1,270 for fiscal years 2007 and 2006, respectively. Effective January 1, 2006, conversion of previous Group B service to Group A is no longer permitted.

The City of Houston's (the City) contributions during fiscal years 2007 and 2006 represent the budgeted contributions and the net proceeds received through the issuance of pension obligation bonds as set forth in the Meet and Confer Agreement between the System and the City dated September 15, 2004. During fiscal years 2007 and 2006, the System received cash contributions from the City of $70,265 and $66,968 (net of contributions to the replacement benefit plan of $1,735 and $1,715 for fiscal years 2007 and 2006, respectively).

INVESTMENT PERFORMANCE

The System's investment portfolio (excluding the $300 million note from the City and its associated accrued interest) closed its 2007 fiscal year at $2.02 billion, up from $1.74 billion at the beginning of the year. The investment return for the total portfolio in the current fiscal year is 18.6%.

The System's investment performance is 18.6%, 16.9% and 14.4% for the past one-, three- and five-year periods. These results are above the System's policy benchmark for the trailing three- and five-year periods, but trail the policy benchmark for the one-year period. Relative to its peer group, the System's fund continues to post attractive investment returns. As of June 30, 2007, the System ranks in the top 34th, 3rd and 4th percentiles respectively, for the trailing one-, three- and five-year periods. The best performing asset classes for the fiscal year 2007 were Non-U.S. Equities (+29.5%) and Alternative Investments (+25.4%), while Real Assets (+36.4%) and Non-U.S. Equities (+30.1%) were the top two performing asset classes for fiscal year 2006. The benefits of a well-diversified asset allocation are evidenced by the System's ability to perform very competitively in both years where different asset classes drove overall returns. For the past three- and five- year periods, Real Assets, which include public and private real estate and natural resource investments, was the best performing asset class, providing 28.7% and 21.2% per annum. The System's target allocation of 15% to Real Assets helped enable the investment to perform well in an environment where a more traditional asset allocation (60% / 40% mix of S&P 500 Index / Lehman Aggregate Bond Index) would have returned 14.8%, 8.6% and 8.3% over the trailing one-, three- and five-year periods.

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, 2006 is 64.5%. This is lower than the 65.2% from the 2005 valuation. This small decrease was expected as the remaining deferred loss from FY 2002 and another portion of the

deferred loss from FY 2003 were recognized in this valuation, and the actual City contribution of $67 million was less than the estimated ARC for FY2006 of $119 million (based on the July 1, 2004 valuation.)

The calculated employer contribution rate for FY 2008 is 24.63%. This rate is modestly higher than the 24.10% calculated in the 2005 valuation, but very close to the 24.61% rate projected in the 2005 report.

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).

The System's independent auditors have audited the financial statements and issued an unqualified opinion as of June 30, 2007 and 2006. 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 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 the System 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 the System's internal controls are adequate and are working as designed.

STATEMENT OF PLAN NET ASSETS JUNE 30, 2007

Assets	
Investments, at fair value:	
Government securities	
(cost: 2007 $47,177,842)	$ 48,020,004
Corporate bonds	
(cost: 2007 $84,630,079)	88,502,341
Capital stocks	
(cost: 2007 $537,602,300)	652,858,988
Commingled funds	
(cost: 2007 $407,871,324)	588,540,704
Limited partnerships, real estate trusts,	
and loans and mortgages	
(cost: 2007 $417,564,144)	551,969,734
Short-term investment funds (valued at cost)	91,351,681
Total investments	2,021,243,452
Cash and cash equivalents	3,148,398
Proceeds due on asset sales	14,714,160
Receivables on foreign exchanges	4,156,155
Note receivable - City of Houston	300,000,000
Accrued interest on note receivable - City of Houston	52,343,253
Other receivables	2,707,564
Collateral on securities lending	
arrangements, at fair value	132,467,071
Furniture, fixtures and equipment, net	418,576
Total assets	2,531,198,629
Liabilities	
Amounts due on asset purchases	45,727,213
Payables on foreign exchanges	4,158,211
Accrued liabilities	4,203,884
Options written	44,966
Collateral on securities lending	
arrangements, at fair value	132,467,071
Total liabilities	186,601,345
Plan net assets held in trust for pension benefits	$ 2,344,597,284

STATEMENT OF CHANGES IN PLAN NET ASSETS JUNE 30, 2007

Additions to plan net assets:	
Contributions:	
City of Houston	$ 70,264,721
Participants	20,966,469
Total contributions	91,231,190
Investment income:	
Interest on bonds and deposits	15,923,067
Dividends	15,275,523
Earnings from limited partnerships	
and real estate trusts	25,034,767
Net appreciation on investments	287,179,126
Total investment income	343,412,483
Proceeds from lending securities	6,726,695
Less costs of securities lending	(6,442,900)
Net proceeds from lending securities	283,795
Less costs of investment services	(6,437,145)
Total investment income, net	337,259,133
Interest income - City of Houston note receivable	27,845,681
Other income	1,185,141
Total additions to plan net assets	457,521,145
Deductions from plan net assets:	
Benefits paid to participants	157,716,433
Contribution refunds to participants	1,397,504
Professional services	882,886
Administration expenses	5,223,051
Total deductions from plan net assets	165,219,874
Net increase in plan net assets	292,301,271
Plan net assets held in trust for pension benefits:	
Beginning of year	2,052,296,013
End of year	$ 2,344,597,284

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HOUSTON
MUNICIPAL
EMPLOYEES
PENSION SYSTEM