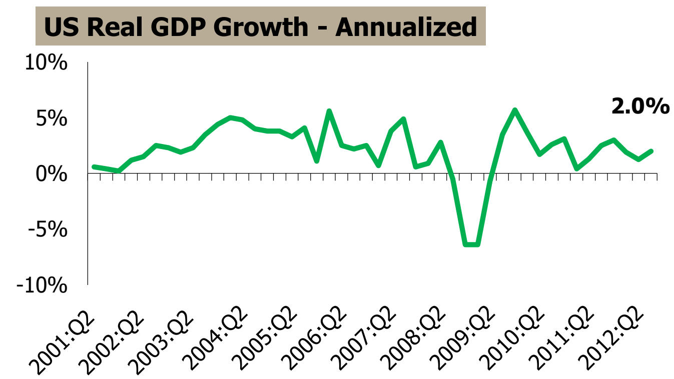
Port of Houston Authority
Pension Plan

Third Quarter 2012 Report

Gregory W Group

MARKET ENVIRONMENT - THIRD QUARTER 2012

The third quarter of 2012 saw equity prices move higher worldwide as fears about a global economic contagion abated after the European Central Bank and the U.S. Federal Reserve enacted new programs to stabilize and reinvigorate economic activity. Investors enjoyed gains in equities, both domestically and abroad. Europe's economic situation remains fragile. It is widely expected that the Eurozone fell into a recession during the third quarter. Unemployment has risen to 10.5% for the Eurozone area. Young worker unemployment is much higher. U.S. economic growth expectations remained dampened. However, concerns about the European debt crisis have recently subsided, giving support to equity markets. The U.S. Dollar declined against major foreign currencies as Quantitative Easing III kept downward pressure on interest rates.



- Third quarter U.S. Real GDP growth was 2.0%, an increase from the previous quarter's 1.3% gain. The unemployment situation improved modestly in the U.S. It decreased from 8.2% to 7.8% during the quarter. However, the labor participation rate, a measure of how many working age individuals are working or looking for work, fell to 64%. Most economists believe real GDP growth must be sustained above 2.5% to decrease U.S. unemployment. Inflation, measured by the Consumer Price Index, remained modest during the quarter, rising 2.0% over the last year. Producer Prices rose 2.1% over the same period. U.S. housing prices showed some improvement. The Case Shiller Housing Price index rose 2.0% for the year ended August, 2012.

- The Federal Reserve took no action on short-term interest rates, leaving them unchanged at 0.00% to 0.25%. They did embark on another Quantitative Easing program, intending to hold interest rates lower, increase stock prices, and inspire consumers to spend more.

- The S&P 500 has earned a cumulative return of +130% since reaching its bear market low on March 9, 2009. It closed the quarter 3% *above* its previous high reached on October 9, 2007.

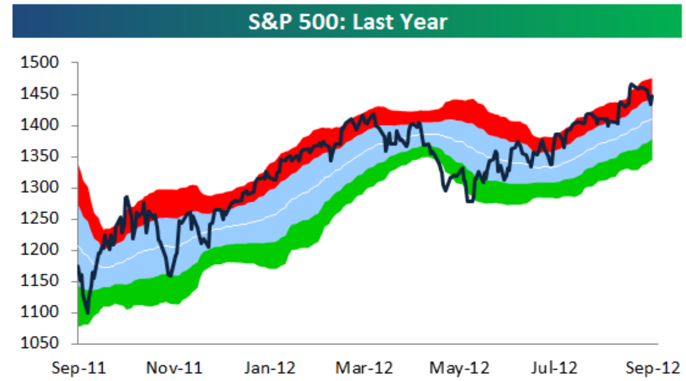
- Worldwide economic growth expectations remain suppressed. U.S. GDP growth is forecast to be only 2% per year, with significant danger to the downside if the so-called "fiscal cliff" causes major tax increases on January 1, 2013. Unemployment is expected to remain near current levels unless economic growth accelerates.

- Crude oil and natural gas prices moved higher during the quarter. Crude prices (West Texas Intermediate) ended the quarter at $92 a barrel while gas was priced at just under $4.

- Hedge funds had a difficult time keeping pace with traditional portfolios. The Hedge Fund Research HFRX equal weighted index of hedge funds gained 5.8% for the trailing year versus 30.2% for the S&P 500. Most hedge fund subcategories earned single digit returns for the year ended September 30, 2012. Private equity deal volume increased to $72 billion during the quarter. The majority of transactions were in the U.S. Several high profile venture capital backed IPOs performed very badly during the quarter.

Domestic and International Equity Summary

The U.S. and foreign equity markets posted welcome gains during the later summer quarter. The broad U.S. equity market gained more than 6% during the quarter, bringing its twelve month return to more than 30%. International equities rallied even more during the quarter, posting a gain of over 7% despite significant economic uncertainty. Share price volatility was relatively low during the quarter. Correlations between individual equities were fairly low during the quarter.



- Top contributing sectors of the domestic equity market were **Information Technology (+7% return), Energy (+10%), and Financials (+6%)**. The lowest contributing index sectors were Utilities (0%), Telecommunications (0%), and Materials (0%).

- The three largest individual contributors to the Russell 1000's third quarter return were **Apple (+15% return), Google (+30%), and Exxon Mobil (+8%)**. The index's three largest positions were Apple (4% of the index), Exxon Mobil (3%) and General Electric (2%)

- Value stocks narrowly outperformed growth stocks during the third quarter. However, **growth led value among large caps over the trailing year period**. Value led by a tiny margin among mid caps and small caps for the same period.

- Major segments of the U.S. equity market remain relatively cheap. The **Russell 1000's price/earnings ratio ended the third quarter of 2012 at 15.9,** a large increase from 12.9 as of June 30, 2012**.** The Russell Mid Cap and Russell 2000's price/earnings ratios were 17.3 and 17.7 respectively, versus 14.3 and 17.2 last quarter. The dividend yields of the three indexes were 2.1%, 1.7%, and 1.4%. By comparison, the 10 year Treasury Bond ended the quarter at 1.6%.

- Thailand, the Philippines, and Denmark were the top performing markets for the year to date period, gaining 29%, 28%, and 25% in U.S. Dollar terms. Poorest performing markets were Portugal (-11%), Spain (-10%), and Brazil (-6%). The U.S. ranked 11th out of 33 markets for the period.

Twelve Month Forward P/E Ratio	**Europe ex UK**	**UK**	**Japan**	**Asia ex Japan**
Current Value	10.3	9.9	10.8	12.2
Post 1990 Average	**14.0**	**12.6**	**28.9**	**13.9**
Discount/Premium	*-26.4%*	*-21.4%*	*-62.6%*	*-12.2%*

- All ten MSCI ACWI ex-US sectors posted third quarter gains. The quarter's leading performance contributors were Financials (10%), Energy (9%), and Materials (8%). Utilities (2%), Consumer Discretionary (4%) and Telecommunication Services (6%) were the leading detractors during the quarter. The index ended the quarter with a P/E ratio of 13.3 versus 11.3 last quarter. The top three individual contributors to the index's third quarter return were Samsung (+16% return), BASF (+22%), and Siemens (+19%). The bottom three contributors were Canon (-19% return), Honda Motor (-10%), and Cia Vale do Rio Doce (-10%). Emerging markets stocks posted strong gains during the third quarter.

FIXED INCOME SUMMARY

Domestic and foreign bonds performed relatively well despite historically low interest rates. Bond markets responded to a significant new round of central bank actions in the U.S. and Europe. The Chinese government took steps to stabilize what appears to be a slowdown in production, consumption and foreign demand for their exports. The economic situation in Europe and the U.S. will dampen worldwide growth regardless of the size and scope of Central Bank actions. However, Europe's economic outlook remains bleak and divided despite these large, experimental measures aimed to stabilize its overall economy. Member nations continue to argue about who will carry the burden of the region's over-indebtedness.

Risk Level	Time Horizon			
	One Year		Three Years (annualized)	
	Terminal Yield	**Total Return**	Terminal Yield	**Total Return**
Low Risk				
2 Year Treasury (9.30 = 0.2%)	2.5%	**-4.2%**	4.0%	**-2.2%**
	1.3%	**-1.8%**	3.0%	**-1.6%**
	0.5%	**-0.3%**	2.0%	**-0.9%**
Medium Risk				
10 Year Treasury (9.30 = 1.6%)	4.5%	**-21.3%**	5.5%	**-8.9%**
	3.3%	**-12.1%**	4.5%	**-6.4%**
	2.5%	**-6.0%**	3.5%	**-3.7%**
High Risk				
30 Year Treasury (9.30 = 2.8%)	5.5%	**-36.3%**	6.0%	**-13.5%**
	4.3%	**-21.3%**	5.0%	**-9.1%**
	3.5%	**-9.7%**	4.0%	**-4.1%**

- Last quarter, government bonds enjoyed substantial price gains versus equities and other fixed income assets. This quarter, government bonds underperformed as long-term interest rates rose and yield spreads narrowed.

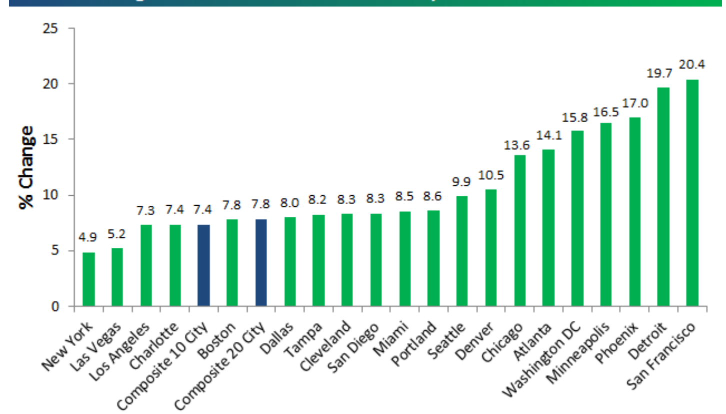
- In aggregate, bonds posted modest returns during the third quarter, led higher by lower quality issues. Yield spreads among highly rated and lower rated bonds declined during the quarter. Yield spreads among mid tier bonds remained stable, slightly above their long term averages. U.S. Treasury bond yields declined modestly. The Treasury yield curve steepened as short term interest rates declined more than long term rates.

- Ninety-one Day T-bills ended the third quarter with a yield of 0.09%, an increase of 0.01%. Five year Treasury bonds fell from 0.70% to 0.67% during the quarter. Ten year Treasury bond yields decreased to 1.6% from 1.7% while the yield on the thirty year Treasury bond ended the quarter at 2.8%, modestly higher than on June 30, 2012. The net effect was a steepening yield curve as the market reacted to QE3. All investment grade sectors outperformed Treasuries during the quarter. Institutional investors continued to expand fixed income mandates to gain more yields.

- High yield bonds led investment grade issues during the third quarter. Cash flows into the asset remained strong. High yield bonds posted a gain of almost 5% for the quarter and 19% for the trailing year. The yield spread between high yield issues and comparable maturity Treasuries declined from 6.6% to 5.9%. Current spreads are near their long-term averages. Defaults remained extremely low at 1.8% of outstanding issues versus their historical average of 4.2%. High yield bond funds have seen $35 billion of inflows year to date.

- Residential real estate showed early signs of recovery during the summer. Commercial real estate portfolios produced returns of more than 11% over the trailing year.

% Change from Most Recent Lows in S&P/Case-Shiller Home Prices



Domestic Equity	*Last Quarter*	*Last Year*	*Last Three Years Annualized*	*Last Five Years Annualized*	*Last Ten Years Annualized*
S&P 500	6.4	30.2	13.2	1.1	8.0
Russell 1000	6.3	30.1	13.3	1.2	8.4
Russell 1000 Value	6.5	30.9	11.8	-0.9	8.2
Russell 1000 Growth	6.1	29.2	14.7	3.2	8.4
Russell 3000	6.2	30.2	13.3	1.3	8.5
Russell Midcap	5.6	28.0	14.3	2.2	11.2
Russell Midcap Value	5.8	29.3	13.9	1.7	11.0
Russell Midcap Growth	5.4	26.7	14.7	2.5	11.1
Russell 2000	5.3	31.9	13.0	2.2	10.2
Russell 2000 Value	5.7	32.6	11.7	1.4	9.7
Russell 2000 Growth	4.8	31.2	14.2	3.0	10.6
Alerian MLP	8.9	26.2	25.1	14.0	17.3
Fixed Income					
Barclays Capital Aggregate Bond	1.6	5.2	6.2	6.5	5.3
Barclays Capital Credit	3.5	10.1	8.7	7.9	6.5
Barclays Capital Government	0.6	3.0	5.2	6.0	4.7
Barclays Capital Govt/Credit	1.7	5.7	6.5	6.6	5.4
Barclays Capital Interm Credit	2.9	8.3	7.3	7.0	5.8
Barclays Capital Interm Govt	0.6	2.4	4.1	5.2	4.2
Barclays Capital Interm Govt/Cred	1.4	4.4	5.2	5.7	4.8
Barclays Capital Long Credit	5.2	14.9	12.7	10.6	8.6
Barclays Capital Long Term Govt	0.3	6.4	11.9	10.9	7.7
Barclays Capital Long Govt/Credit	3.1	11.1	12.5	10.9	8.1
Barclays Capital Fixed Rate MBS	1.1	3.7	5.0	6.4	5.2
Merrill Lynch US High Yield Master II	4.6	18.9	12.6	9.1	10.8
91 Day T-Bill	0.0	0.1	0.1	0.6	1.7
Consumer Price Index	0.7	1.7	2.2	2.1	2.5
International					
MSCI EAFE	6.9	13.8	2.1	-5.2	8.2
MSCI World ex US	7.3	13.8	2.5	-4.8	8.7
MSCI Europe	8.7	17.3	2.0	-5.7	8.8
MSCI Japan	-0.8	-1.7	-0.6	-6.5	3.7
MSCI Pacific ex Japan	11.0	24.5	8.0	0.2	14.7
MSCI Emerging Markets	7.0	13.9	3.1	-3.6	14.2
Citigroup Non-$ World Gov	4.0	3.5	4.0	6.6	7.3

Portfolio Summary as of September 30, 2012

Manager	Quarter	One Year	Three Year	Five Year	Market Value	% of Total
Smith Affiliated	1.26%	4.28%	6.55%	6.95%	$12,164,964	9.2%
Smith Graham	1.76%	7.44%	7.29%	7.05%	$22,747,958	17.2%
Trevor Stewart Burton & Jacobsen	1.88%	5.58%	4.56%	5.27%	$7,975,257	6.0%
Barclays Capital Aggregate	1.59%	5.16%	6.19%	6.53%		
Loomis Sayles High Income	5.33%	-	-	-	$6,706,070	5.1%
ML High Yield	4.59%	18.89%	12.60%	9.07%		
FAMCO	10.37%	25.60%	-	-	$6,938,954	5.2%
Alerian MLP	8.89%	26.22%	25.10%	14.04%		
Cohen & Steers Real Estate	0.20%	-	-	-	$6,934,258	5.2%
FTSE NAREIT All REITS	1.03%	33.81%	20.73%	2.28%		
Fiduciary Management	5.15%	28.13%	12.24%	4.24%	$11,597,118	8.8%
Russell 1000 Value	6.51%	30.92%	11.84%	-0.90%		
S&P 500	6.35%	30.20%	13.20%	1.05%		
Stacey Braun	5.50%	25.92%	14.54%	-	$9,494,971	7.2%
Russell 1000 Growth	6.11%	29.19%	14.73%	3.24%		
S&P 500	6.35%	30.20%	13.20%	1.05%		
Meridian	2.39%	27.78%	-	-	$16,909,106	12.8%
Russell Midcap Growth	5.35%	26.69%	14.73%	2.54%		
Barrow Hanley Small Cap	8.63%	45.79%	14.76%	6.44%	$14,550,053	11.0%
Russell 2000 Value	5.67%	32.63%	11.72%	2.54%		
Eagle Global	6.26%	18.86%	1.07%	-6.32%	$16,373,271	12.4%
MSCI EAFE	6.92%	13.76%	2.12%	-5.24%		
Total Plan	**4.10%**	**19.09%**	**9.39%**	**4.19%**	**$132,418,605**	
Benchmark	4.52%	17.97%	9.48%	3.13%		
Actuarial Assumption	1.77%	7.25%	7.25%	7.25%		

The Total Plan Benchmark is composed as follows; S&P 500 (47.5%), MSCI EAFE (12.5%), and Barclay's US Aggregate (40%).

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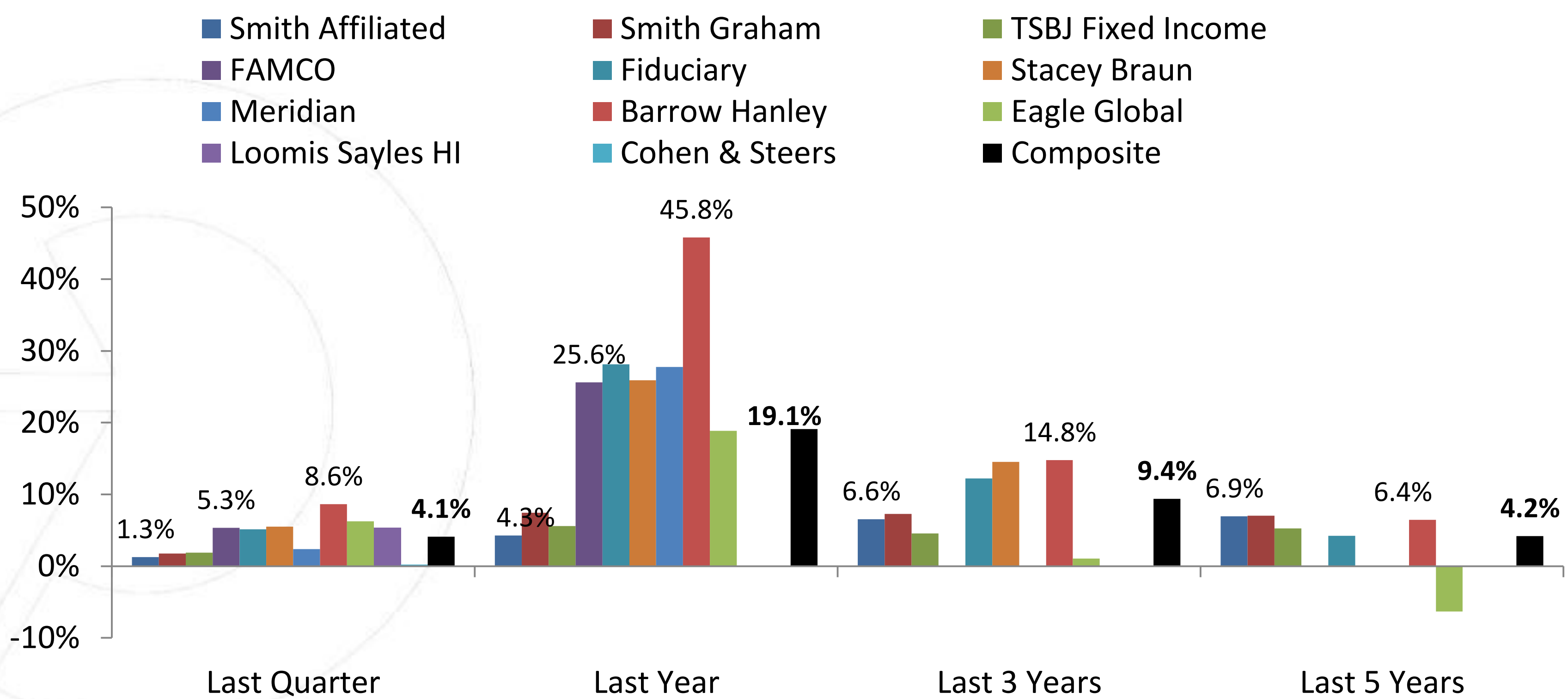
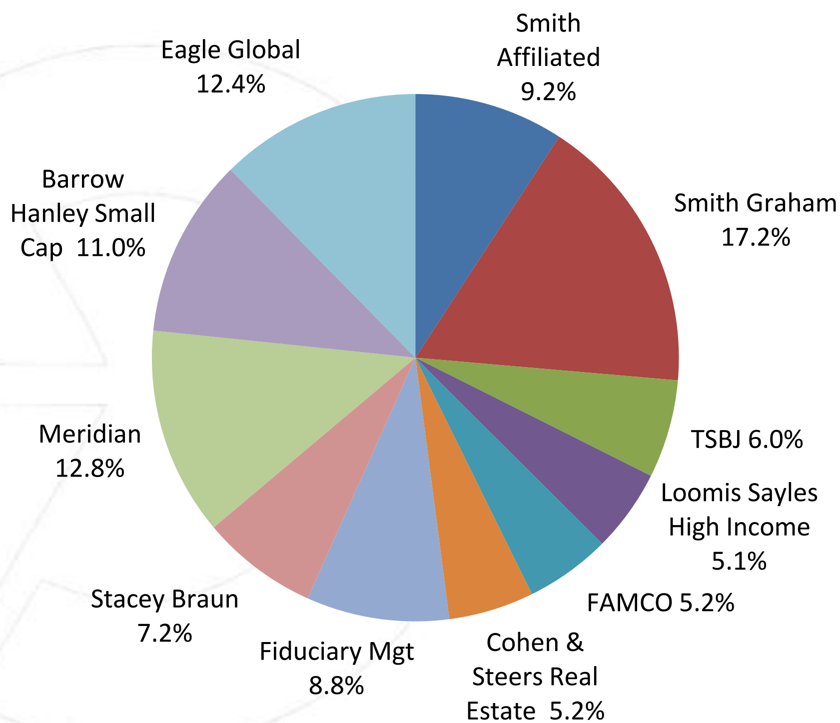
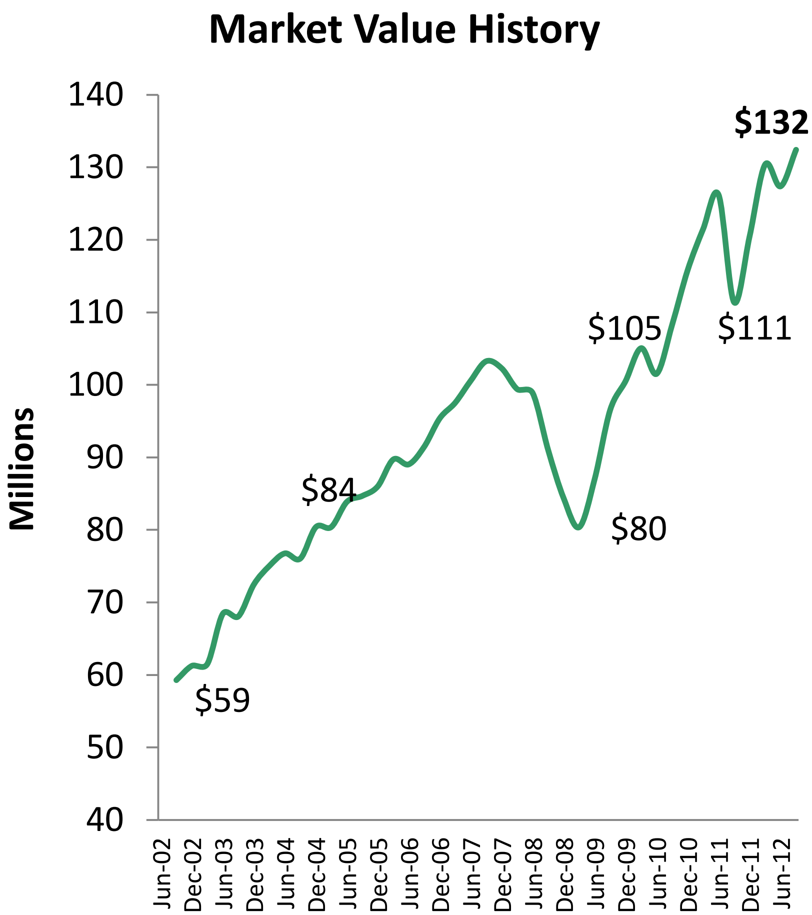
Performance Summary

Periods ended September 30, 2012



Portfolio Review





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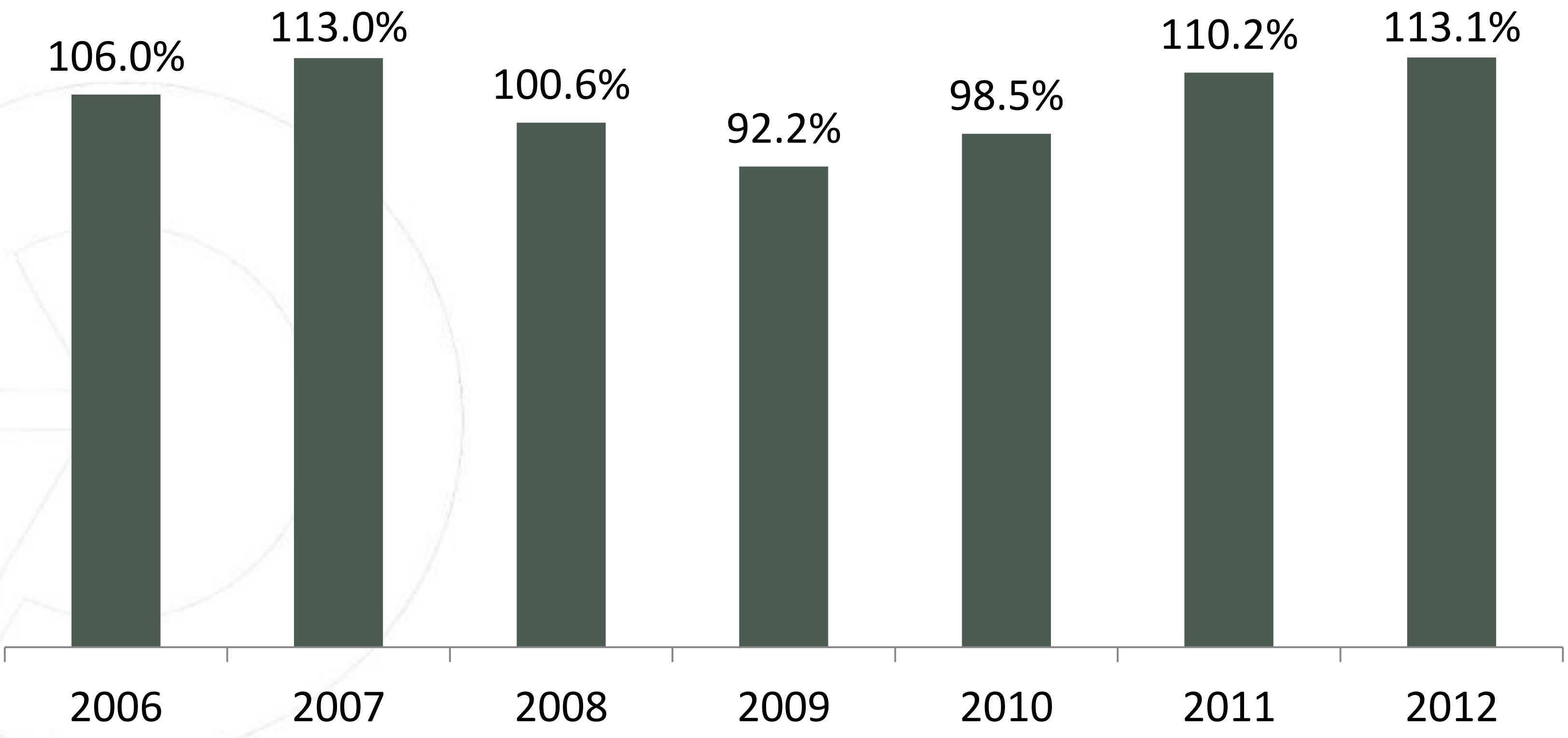
Current vs. Target Asset Allocation

Manager	Actual Portfolio[1]	Investment Policy Target	Difference	Minimum	Maximum
Large Cap Domestic Equity	15.9%	**15.0%**	0.9%	10.0%	20.0%
Mid Cap Domestic Equity	12.8%	**12.5%**	0.3%	7.5%	17.5%
Small Cap Domestic Equity	11.0%	**10.0%**	1.0%	5.0%	15.0%
International Equity	12.4%	**12.5%**	-0.1%	7.5%	17.5%
Core Fixed Income	32.4%	**35.0%**	-2.6%	30.0%	40.0%
High Yield Fixed Income	5.1%	**5.0%**	0.1%	0.0%	10.0%
Real Estate	5.2%	**5.0%**	0.2%	0.0%	10.0%
Master Limited Partnerships	5.2%	**5.0%**	0.2%	0.0%	10.0%
Total	100.0%	**100.0%**		100.0%	100.0%

[1] The Plan's asset allocation may not equal 100.0% due to rounding.

Funded Status Monitor



Source: Port of Houston Authority Restated Retirement Plan Actuarial Valuation Report as of August 1, 2012. Valuation method used: FASB ASC Topic 960 basis.

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Manager Status Summary

Manager	Mandate	Status	Note
Fixed Income			
Smith Affiliated Smith Graham Trevor Stewart	Core Fixed Income Core Fixed Income Core Fixed Income	In Compliance In Compliance Termination Pending	Being replaced by Hoisington
High Yield			
Loomis Sayles	High Yield Fixed Income	In Compliance	
MLP			
FAMCO	MLPs	In Compliance	
Real Estate			
Cohen & Steers	Real Estate	In Compliance	
Domestic Equity			
Fiduciary Stacey Braun Meridian Barrow Hanley	Large Cap Equity Large Cap Equity Mid Cap Equity Small Cap Equity	In Compliance In Compliance Termination Pending In Compliance	Being replaced by Stephens
International Equity			
Eagle Global	International Equity	On Alert	On Alert – Performance (3Q2011)

In Compliance – The portfolio is acting in full compliance with its guidelines and it is performing according to expectations.

On Alert – Concerns exist with the portfolio's performance, a change in investment characteristics, management style, ownership structure, staff or other related events.

On Notice – A continued and serious problem with any of the issues mentioned above. If the situation is not resolved to the Committee's satisfaction, a replacement will be selected and hired.

Fee Analysis

Manager	Mandate	Expense Ratio	Category Average	Difference
Domestic Equity				
Fiduciary Management	Large Cap Equity	0.55%	1.31%	**0.76%**
Stacey Braun	Large Cap Equity	0.45%	1.31%	**0.86%**
Meridian	Mid Cap Growth Equity	0.81%	1.40%	**0.59%**
Barrow Hanley	Small Cap Value Equity	0.84%	1.48%	**0.63%**
International Equity				
Eagle Global	International Value Equity	0.89%	1.45%	**0.55%**
Fixed Income				
Smith Affiliated	Fixed Income	0.25%	0.97%	**0.72%**
Smith Graham	Fixed Income	0.40%	0.97%	**0.57%**
Trevor Stewart Burton & Jacobsen	Fixed Income	0.40%	0.97%	**0.57%**
Loomis Sayles	High Yield Fixed Income	0.69%	1.18%	**0.49%**
MLP				
FAMCO	Master Limited Partnership	0.75%	1.00%	**0.25%**
Real Estate				
Cohen & Steers	Real Estate	0.75%	1.39%	**0.64%**
Total Plan		**0.62%**	**1.23%**	**0.61%**

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Discussion Items

- The International Equity portion of the Plan is currently under review.
- Eagle Global International Equity has shown recent signs of improvement.
- Investment manager searches were completed for core fixed income and mid cap growth.
  - Replacements were selected
  - Transition will occur pending Commission's approval
- The pending allocation to the Hoisington Active Duration Portfolio will diversify the overall portfolio and provide additional downside protection.