

Financial Statements

The University of Texas System

Long Term Fund

Years Ended August 31, 2006 and 2005

The University of Texas System Long Term Fund

Financial Statements

Years Ended August 31, 2006 and 2005

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Report of Independent Auditors

The Board of Regents of The University of Texas System
The Board of Directors of The University of Texas Investment Management Company

We have audited the accompanying financial statements of The University of Texas System Long Term Fund (the "Fund") as of and for the years ended August 31, 2006 and 2005, as listed in the table of contents. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

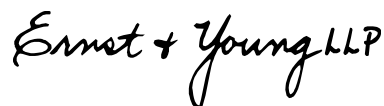
We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only The University of Texas System Long Term Fund and do not purport to, and do not, present fairly the fiduciary net assets of The University of Texas Investment Management Company nor The University of Texas System as of August 31, 2006 and 2005 and the changes in its fiduciary net assets for the years then ended in conformity with accounting principles generally accepted in the United States.

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net assets of The University of Texas System Long Term Fund as of August 31, 2006 and 2005, and the changes in the fiduciary net assets for the years then ended, in conformity with accounting principles generally accepted in the United States.

Management's discussion and analysis on pages 2 through 5 is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming opinions on the financial statements of The University of Texas System Long Term Fund. The supplemental schedules are presented for purposes of additional analysis and are not a required part of the financial statements. The supplemental schedules as of August 31, 2006, 2005, 2004 and 2003 and for the years then ended have been subjected to the audit procedures applied in the audits of the financial statements and, in our opinion, based on our audits, are fairly stated in relation to the financial statements taken as a whole. The Fund's financial statements for the year ended August 31, 2002, which are not presented with the accompanying financial statements, were audited by other auditors whose report thereon dated October 18, 2002, expressed an unqualified opinion on the financial statements. Their report on the 2002 supplemental schedules stated that, in their opinion, such information was fairly stated in all material respects in relation to the financial statements taken as a whole.



October 27, 2006

THE UNIVERSITY OF TEXAS SYSTEM LONG TERM FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

Our discussion and analysis of The University of Texas System Long Term Fund's (Fund) financial performance provides an overview of its activities for the fiscal year ended August 31, 2006. This discussion was prepared by The University of Texas Investment Management Company (UTIMCO) and should be read in conjunction with the Fund's financial statements and notes. The Fund is an internal UT System mutual fund for the pooled investment of approximately 7,200 privately raised endowments and other long-term funds of the 15 institutions of the UT System. The Texas Constitution and various state statutes designate The University of Texas System Board of Regents (UT Board) as the fiduciary for the management of certain public endowment and operating funds. The UT Board has entered into an Investment Management Services Agreement delegating investment management responsibility for all investments to UTIMCO.

On March 1, 2001, the Fund purchased units in the newly created General Endowment Fund (GEF) in exchange for the contribution of its investment assets. The GEF, established by the UT Board effective March 1, 2001, is a pooled fund for the collective investment of long-term funds under the control and management of the UT Board. The GEF has only two participants: the Fund and the Permanent Health Fund (PHF), which was also established by the UT Board. The GEF is organized as a mutual fund in which the Fund and the PHF purchase and redeem units quarterly. The GEF is under the fiduciary responsibility of the UT Board and is provided day-to-day operations by UTIMCO.

The purpose of the MD&A is to provide an objective and easily readable analysis of the Fund's financial statements based upon currently known facts, decisions or conditions.

Financial Highlights

- The Fund's net fiduciary assets, after contributions, withdrawals and distributions, increased by \$439.9 million from \$4,000.9 million to \$4,440.8 million or approximately 11.0% for the year ended August 31, 2006, compared to an increase of \$607.6 million or approximately 17.9% for the ended August 31, 2005. The change in net fiduciary assets from year to year is mainly attributable to the following:
 1. Participant contributions to the Fund increased by 92.2% from fiscal year 2005 to 2006. Fiscal year contributions of \$281.2 million represented 6.7% of the average value of the Fund assets during the year. Participant contributions consist of endowment and other long-term funds that have been forwarded to the Fund for management by UTIMCO.
 2. The Fund posted a net investment return of 11.06% for the fiscal year ended August 31, 2006, compared to a net investment return of 18.68% for the prior fiscal year. The net investment return of the Fund is dependent on the results of the investments held in the GEF. The GEF's investments in real estate investment trusts, private market investments and global equities were the leading contributors to the 2006 return. For the fiscal year ended

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August 31, 2005, the commodities, private market investments and global equities asset classes were the leading performers.

3. The Fund's distribution rate per unit was increased by 2.5%, approximately the average rate of inflation, for the year ended August 31, 2006. This equated to an increase in the 2006 rate to \$0.2764 per unit from the 2005 rate of \$0.2697 per unit. The 2005 rate represented an increase of 2.0% over the fiscal year 2004 rate of \$0.2645 per unit. Fiscal year 2006 distributions represented 4.27% of the Fund's average net asset value during the year, compared to the fiscal year 2005 distributions which represented 4.51% of the Fund's average net asset value for the year.

Use of Financial Statements and Notes

The Fund's financial statements were prepared in accordance with standards issued by the Governmental Accounting Standards Board (GASB). Two financial statements are required under GASB: the Statement of Fiduciary Net Assets and the Statement of Changes in Fiduciary Net Assets.

The notes to the financial statements contain supplemental information that is essential for the fair presentation of the financial statements.

Statements of Fiduciary Net Assets

The Statements of Fiduciary Net Assets present assets, liabilities, and net assets of the Fund as of the end of the fiscal year. These statements, along with all of the Fund's financial statements, are prepared using the accrual basis of accounting, whereby Fund investment income is recognized when earned and Fund expenses are recognized when incurred.

Since the Fund no longer invests in individual securities except for GEF units and a negligible amount of cash, the majority of the Fund's Statements of Fiduciary Net Assets are reflected in its investment in GEF units.

As of August 31, 2006, the Fund owned GEF 28,623,092 units representing an ownership percentage of 81.82%, compared to 28,652,350 GEF units representing an ownership percentage of 81.21% as of August 31, 2005. As of August 31, 2006 and 2005, the fair value of the GEF units was \$4,441.0 million and \$4,001.1 million, respectively.

The GEF invests in a broad mix of investments and is actively managed to its benchmark, the Endowment Policy Portfolio. The Endowment Policy Portfolio is the index or benchmark for the endowment funds that UTIMCO manages. The return of the Endowment Policy Portfolio is the sum of the weighted benchmark returns for each asset class that comprise it. UTIMCO allocates GEF's assets to internally and externally managed portfolios in accordance with approved asset allocation policies, and attempts to supplement the original endowment corpus by increasing purchasing power over time. In doing so, UTIMCO increases the endowment resources available to fund the teaching, research, and health care programs specified by the various donors.

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The following table summarizes the Statements of Fiduciary Net Assets (in millions):

| | 2006 | 2005 | 2004 |
|---|-------------------|-------------------|-------------------|
| Assets | | | |
| General Endowment Fund Units | \$ 4,441.0 | \$ 4,001.1 | \$ 3,393.4 |
| Cash and Cash Equivalents | - | - | - |
| Receivable for Investment Securities Sold | 2.1 | 1.5 | 16.0 |
| Total Assets | <u>4,443.1</u> | <u>4,002.6</u> | <u>3,409.4</u> |
| Liabilities | | | |
| Payable to Participants | 2.1 | 1.5 | 16.0 |
| Other Payables | 0.2 | 0.2 | 0.1 |
| Total Liabilities | <u>2.3</u> | <u>1.7</u> | <u>16.1</u> |
| Net Assets Held in Trust | <u>\$ 4,440.8</u> | <u>\$ 4,000.9</u> | <u>\$ 3,393.3</u> |

Statement of Changes in Fiduciary Net Assets

Changes in fiduciary net assets as presented on the Statements of Changes in Fiduciary Net Assets are based on activity of the Fund. The purpose of these statements is to present additions to the Fund resulting from net investment income and participant contributions and to present deductions from the Fund resulting from administrative expenses and participant distributions.

The net increase in investments of the Fund was \$371.3 million during the year compared to \$558.6 million for the year ended August 31, 2005. Investment expenses totaled \$2.1 million, \$2.4 million and \$3.1 million, respectively for the years ended August 31, 2006, 2005 and 2004.

Distributions to participants totaled \$180.5 million, \$167.8 million and \$158.0 million, respectively, for the years ended August 31, 2006, 2005 and 2004. The increase in distributions is a result of the UT Board increasing the distribution rate from \$0.2697 per unit to \$0.2764 per unit for fiscal year 2006, and additional contributions into the Fund. The increase for fiscal year 2005, is a result of the UT Board's increase of the distribution rate from \$.2645 per unit to \$.2697 per unit, and additional contributions to the Fund. The Fund is structured as a mutual fund in which each endowment or account purchases units at the Fund's market value per unit. Cash distributions are paid quarterly, on a per unit basis, directly to the UT System institution of record.

The Fund's two primary investment objectives are:

- Provide for current beneficiaries by increasing the annual distribution rate at least equal to the rate of inflation so that real purchasing power is maintained, and
- Provide for future beneficiaries by increasing the market value of endowment funds after the annual distribution at a rate at least equal to the rate of inflation so that future distributions maintain purchasing power as well.

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Fund distributions are controlled by a spending policy approved by the UT Board. The key to preservation of endowment purchasing power over the long-term is control of spending through a target distribution rate. This target rate should not exceed the endowment's average annual investment return after fund expenses and inflation. The Fund distributions are increased annually at an average rate of inflation provided that the distribution rate remains within a range of 3.5% to 5.5% of the Fund's net asset value. As reported on the financial highlights statement in the supplemental schedules, the ratio of distributions to average net assets (12-quarter average) has remained between 3.5% to 5.5%.

The following table summarizes the Statements of Changes in Fiduciary Net Assets (in millions):

| | 2006 | 2005 | 2004 |
|---|-------------|-------------|-------------|
| Investment Income | \$ 454.1 | \$ 640.6 | \$ 441.1 |
| Less Investment Expenses | (2.1) | (2.4) | (3.1) |
| Net Investment Income | 452.0 | 638.2 | 438.0 |
| Participant Contributions | 281.2 | 146.3 | 315.1 |
| Total Additions | 733.2 | 784.5 | 753.1 |
| Administrative Expenses | 3.7 | 3.4 | 3.0 |
| Participant Withdrawals | 109.1 | 5.7 | 38.6 |
| Participant Distributions | 180.5 | 167.8 | 158.0 |
| Total Deductions | 293.3 | 176.9 | 199.6 |
| Change in Fiduciary Net Assets | 439.9 | 607.6 | 553.5 |
| Net Assets Held in Trust, Beginning of Period | 4,000.9 | 3,393.3 | 2,839.8 |
| Net Assets Held in Trust, End of Period | \$ 4,440.8 | \$ 4,000.9 | \$ 3,393.3 |

Contacting UTIMCO

The above financial highlights are designed to provide a general overview of the Fund's investment results and insight into the following financial statements. Additional information may be found on our website and inquiries may be directed to UTIMCO via www.utimco.org.

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Statements of Fiduciary Net Assets

August 31, 2006 and 2005

(Dollars in thousands, except per unit amounts)

| | <u>2006</u> | <u>2005</u> |
|---|---------------------|---------------------|
| Assets | | |
| General Endowment Fund Units | \$ 4,441,001 | \$ 4,001,136 |
| Cash and Cash Equivalents | 1 | 2 |
| Receivable for Investment Securities Sold | 2,092 | 1,547 |
| Total Assets | <u>4,443,094</u> | <u>4,002,685</u> |
| Liabilities | | |
| Payable to Participants | 2,092 | 1,547 |
| Other Payables | 222 | 200 |
| Total Liabilities | <u>2,314</u> | <u>1,747</u> |
| Net Assets Held in Trust (658,470,815 Units and 631,354,939 Units, respectively) | <u>\$ 4,440,780</u> | <u>\$ 4,000,938</u> |
| Net Asset Value Held in Trust Per Unit | <u>\$6.744</u> | <u>\$6.337</u> |

*The accompanying notes are an integral
part of these financial statements.*

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LONG TERM FUND**

Statements of Changes in Fiduciary Net Assets

Years Ended August 31, 2006 and 2005

(in thousands)

| | <u>2006</u> | <u>2005</u> |
|--|---------------------|---------------------|
| Additions | | |
| Investment Income | | |
| Net Increase in Investments | \$ 371,346 | \$ 558,584 |
| Allocation of General Endowment Fund Net Investment Income | 82,750 | 82,016 |
| Other | 5 | 10 |
| Total Investment Income | <u>454,101</u> | <u>640,610</u> |
| Less Investment Expenses | | |
| UTIMCO Management Fee | 1,965 | 2,237 |
| Other Expenses | 138 | 119 |
| Total Investment Expenses | <u>2,103</u> | <u>2,356</u> |
| Net Investment Income | 451,998 | 638,254 |
| Participant Contributions | <u>281,191</u> | <u>146,261</u> |
| Total Additions | 733,189 | 784,515 |
| Deductions | | |
| Administrative Expenses | | |
| Fee for Endowment Compliance | 2,720 | 2,526 |
| Fee for UT System Oversight | 200 | 120 |
| Internal Fee for Educational Purposes | 856 | 761 |
| Total Administrative Expenses | <u>3,776</u> | <u>3,407</u> |
| Participant Withdrawals | 109,104 | 5,612 |
| Participant Distributions | <u>180,467</u> | <u>167,833</u> |
| Total Deductions | <u>293,347</u> | <u>176,852</u> |
| Change in Fiduciary Net Assets | 439,842 | 607,663 |
| Net Assets Held in Trust, Beginning of Period | <u>4,000,938</u> | <u>3,393,275</u> |
| Net Assets Held in Trust, End of Period | <u>\$ 4,440,780</u> | <u>\$ 4,000,938</u> |

*The accompanying notes are an integral
part of these financial statements.*

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Notes to Financial Statements

Note 1 – Organization and Basis of Presentation

The University of Texas System Long Term Fund (Fund) is a pooled fund established for the collective investment of private endowments and other long-term funds supporting various programs and purposes of the 15 institutions comprising The University of Texas System (UT System). The Fund was formerly known as the Common Trust Fund. The Long Term Fund was established February 9, 1995, by the Board of Regents of The University of Texas System (Board of Regents) to succeed the Common Trust Fund pooled investment fund. Fiduciary responsibility for the Fund rests with the Board of Regents. The day-to-day operational responsibilities of the Fund are delegated to The University of Texas Investment Management Company (UTIMCO), pursuant to an Investment Management Services Agreement with the Board of Regents.

On March 1, 2001, the Fund purchased units in the newly created General Endowment Fund (GEF) in exchange for the contribution of its investment assets. The GEF, established by the Board of Regents effective March 1, 2001, is a pooled fund for the collective investment of long-term funds under the control and management of the Board of Regents. The GEF has only two participants: the Fund and the Permanent Health Fund (PHF) which was also established by the Board of Regents. The GEF is organized as a mutual fund in which the Fund and the PHF purchase and redeem units quarterly. The GEF is under the fiduciary responsibility of the Board of Regents and is provided day-to-day operations by UTIMCO.

The activities of the Fund are accounted for as a fiduciary fund. The financial statements of the Fund use an economic resources measurement focus and the accrual basis of accounting, whereby revenues are recorded when earned and expenses are recorded when a liability is incurred regardless of the timing of cash flows. This fund is subject to the pronouncements of the Governmental Accounting Standards Board (GASB).

The annual combined financial statements of UT System are prepared in accordance with Texas Comptroller of Public Accounts' Annual Financial Reporting Requirements and include information related to the Fund. The accompanying financial statements may differ in presentation from the Texas Comptroller of Public Accounts' Annual Financial Reporting Requirements.

Note 2 – Investment in GEF

Beginning with the purchase of GEF units on March 1, 2001, the Fund no longer invests in individual securities except for GEF units and a negligible amount of cash. The Fund also continues to receive securities as proceeds in class action suits from the securities the Fund previously owned. These securities are normally sold when received, but from time to time will be reflected as a Fund investment. Subsequent participant contributions received by the Fund are also used to purchase GEF units. At August 31, 2006, the Fund is the majority participant in the GEF, with ownership of 28,623,092 units, which represents 81.82% of the GEF. At August 31, 2005, the Fund held 28,652,350 units, which represented 81.21% of the GEF.

The GEF and the Fund have identical investment objectives. Additionally, the GEF's accounting policies follow the Fund's, as described in Note 3, except for the distributions to participants. On a monthly basis

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Notes to Financial Statements (cont.)

for accounting purposes, the GEF allocates its net investment income and realized gain or loss to the Fund based on its ownership of GEF units at month end. The allocated investment income and realized gain amounts increase the cost basis of the units in the GEF, and any allocated realized losses reduce the cost basis of the units in the GEF. Since the distribution is proportional to the percentage of ownership by the unitholders, no additional units are purchased. The Fund redeems GEF units quarterly to meet its distribution requirements to its unitholders.

Note 3 – Significant Accounting Policies

(A) **Security Valuation** -- The Fund's investment in GEF Units is valued at the net asset value per unit reported by the GEF.

(B) **Investment Income** -- Interest income is accrued as earned.

(C) **Security Transactions** -- A gain or loss is recognized on GEF unit sales on the basis of average cost.

(D) **Distributions to Participants** -- Cash distributions to participants are paid quarterly based on a per unit payout established by the Board of Regents. For the fiscal year ended August 31, 2006, the quarterly rate was \$.0691 which equates to an annual rate of \$.2764 per unit. For the fiscal year ended August 31, 2005, the quarterly distribution rate was \$.067425 which equated to an annual rate of \$.2697 per unit. The ratio of distributions to average net assets (12-quarter average) was 4.44% as of August 31, 2006. The investment policy provides that the annual payout will be adjusted by the average consumer price index of the prior 36 months subject to a maximum distribution of 5.5% of the Fund's average market value and a minimum distribution of 3.5% of the Fund's average market value.

(E) **Fund Valuation** -- Valuation of the Fund's units occurs on a quarterly basis. Unit values are determined by dividing the value of the Fund's net assets by the number of units outstanding on the valuation date.

(F) **Purchases and Redemption of Units** -- The value of participating units, upon admission to the Fund, is based upon the market value of net assets held as of the valuation date. Redemptions from the Fund will also be made at the market value price per unit at the valuation date at the time of the withdrawal. There are no transaction costs incurred by participants for the purchase or redemption of units.

(G) **Participants' Net Assets** -- All participants in the Fund have a proportionate undivided interest in the Fund's net assets.

(H) **Federal Income Taxes** -- The Fund is not subject to federal income tax.

(I) **Use of Estimates** -- The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

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Notes to Financial Statements (cont.)

(J) **Cash and Cash Equivalents** -- Cash and Cash Equivalents consist of money markets and other overnight funds.

Note 4 – Investment Risk

The investment risk disclosure that follows relates to the GEF's investments before securities lending transactions and the investment of cash collateral. Disclosures relating to the GEF's securities lending are provided in Note 5. Values presented are the Fund's pro-rata share of GEF investments based on its unit ownership in the GEF. As of August 31, 2006 and 2005, the Fund's unit ownership in the GEF was 81.82% and 81.21%, respectively, of the total.

(A) Credit Risk

Article VII, Section 11b of the Texas Constitution authorizes the Board of Regents, subject to procedures and restrictions it establishes, to invest the Permanent University Fund (the "PUF") in any kind of investment and in amounts it considers appropriate, provided that it adheres to the prudent investor standard. This standard provides that the Board of Regents, in making investments, may acquire, exchange, sell, supervise, manage, or retain, through procedures and subject to restrictions it establishes and in amounts it considers appropriate, any kind of investment that prudent investors, exercising reasonable care, skill and caution, would acquire or retain in light of the purposes, terms, distribution requirements, and other circumstances of the fund then prevailing, taking into consideration the investment of all of the assets of the fund rather than a single investment. Pursuant to Section 51.0031(c) of the Texas Education Code, the Board of Regents has elected the PUF prudent investor standard to govern its management of the GEF.

Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization (NRSRO). The Fund's investment policy limits investments in U.S. Domestic bonds and non-dollar denominated bond investments to those that are rated investment grade, Baa3 or better by Moody's Investor Services, BBB- or better, by Standard & Poor's Corporation, or BBB- or better by Fitch Investors Service at the time of acquisition. This requirement does not apply to investment managers that are authorized by the terms of an investment advisory agreement to invest in below investment grade bonds.

Per GASB Statement No. 40 (GASB 40), *Deposit and Investment Risk Disclosures, an amendment to GASB Statement No. 3*, unless there is information to the contrary, obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. GASB 40 also provides that securities with split ratings, or a different rating assignment between NRSROs, are disclosed using the rating indicative of the greatest degree of risk. The following table presents the Fund's pro-rata share of each applicable GEF investment type grouped by rating as of August 31, 2006 and 2005.

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Notes to Financial Statements (cont.)

| GEF Investment Type | Fund's Pro Rata Share | | Rating |
|---|-----------------------|----------------|------------------------|
| | 2006 | 2005 | |
| Investments: | | | |
| U.S. Government Guaranteed | \$ 399,789,769 | \$ 333,713,358 | Exempt from Disclosure |
| U.S. Government Non-Guaranteed: | | | |
| U.S. Agency | 12,071,315 | 33,784,029 | AAA |
| U.S. Agency | - | 2,831,468 | A |
| U.S. Agency Asset Backed | 135,277,523 | 154,225,101 | AAA |
| Total U.S. Government Non-Guaranteed | 147,348,838 | 190,840,598 | |
| Total U.S. Government | 547,138,607 | 524,553,956 | |
| Corporate Obligations: | | | |
| Domestic | 26,631,800 | 21,299,403 | AAA |
| Domestic | 4,303,334 | 3,238,080 | AA |
| Domestic | 14,134,024 | 21,576,558 | A |
| Domestic | 18,144,314 | 14,847,651 | BAA/BBB |
| Domestic | - | 4,660,559 | BBB |
| Domestic | 121,671 | 3,267,426 | BAA |
| Domestic | 2,806,291 | 4,641,767 | BA/BB |
| Domestic | 230,943 | 1,888,500 | BB |
| Domestic | 653,521 | 193,012 | BA |
| Domestic | 4,757,876 | 2,326,917 | B |
| Domestic | 140,475 | 242,849 | CAA |
| Domestic | - | 225,124 | CA |
| Domestic | 96,211 | - | CCC |
| Domestic | 8,606 | 1,243,048 | Rating Withdrawn |
| Commercial Paper | 83,448,752 | 24,574,649 | P |
| Commercial Paper | 102,794,805 | - | A |
| Foreign | 4,223,984 | 6,000,885 | AAA |
| Foreign | 2,750,112 | 1,755,034 | AA |
| Foreign | 6,805,731 | 4,658,360 | A |
| Foreign | 5,783,343 | 2,057,339 | BAA/BBB |
| Foreign | - | 175,598 | BBB |
| Foreign | - | 290,840 | BAA |
| Foreign | - | 80,581 | BA/BB |
| Foreign | - | 23,315 | B |
| Total Corporate Obligations | 277,835,793 | 119,267,495 | |
| Foreign Government and Provincial Obligations | 30,360,916 | 44,685,870 | AAA |
| Foreign Government and Provincial Obligations | 9,677,440 | 9,374,839 | AA |
| Foreign Government and Provincial Obligations | 2,978,652 | 1,269,451 | A |
| Foreign Government and Provincial Obligations | 1,569,377 | 3,677,402 | BAA/BBB |
| Foreign Government and Provincial Obligations | - | 171,597 | BAA |
| Foreign Government and Provincial Obligations | 1,201,527 | 3,077,680 | BA |
| Foreign Government and Provincial Obligations | - | 466,126 | B |
| Total Foreign Government and Provincial Obligations | 45,787,912 | 62,722,965 | |
| Other Debt Securities | 1,308,101 | 3,415,040 | AAA |
| Other Debt Securities | 479,921 | 965,634 | AA |
| Other Debt Securities | - | 971,782 | A |
| Other Debt Securities | 3,058,109 | 3,174,218 | BAA/BBB |
| Total Other Debt Securities | 4,846,131 | 8,526,674 | |
| Total Debt Securities | \$ 875,608,443 | \$ 715,071,090 | |
| Other Investment Funds - Debt | \$ 29,230,742 | \$ 871,560 | AAA |
| Other Investment Funds - Debt | 42,320,841 | - | AA |
| Other Investment Funds - Debt | 3,590,910 | 9,589,486 | BB |
| Total Other Investment Funds - Debt | \$ 75,142,493 | \$ 10,461,046 | |
| Cash and Cash Equivalents - Money Market Funds | \$ 426,985,904 | \$ 414,667,426 | AAA |
| Cash and Cash Equivalents - Other | 5,323,908 | 8,683,551 | Exempt from Disclosure |
| Total Cash and Cash Equivalents | \$ 432,309,812 | \$ 423,350,977 | |
| Deposit with Brokers for Derivative Contracts: | | | |
| U.S. Government Guaranteed | \$ 36,043,506 | \$ 21,550,347 | Exempt from Disclosure |
| Cash | 10,542,248 | 3,161,340 | Exempt from Disclosure |
| | \$ 46,585,754 | \$ 24,711,687 | |
| Deposit with Broker for Securities Sold Short: | | | |
| Cash | \$ 3,297,537 | \$ - | Exempt from Disclosure |

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Notes to Financial Statements (cont.)

(B) Concentrations of Credit Risk

The GEF's investment policy statement contains the limitation that no more than 5% of the market value of domestic fixed income securities may be invested in corporate or municipal bonds of a single issuer. The GEF does not hold any direct investments in any one issuer that represents five percent or more of total investments.

(C) Custodial Credit Risk

Custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, the GEF will not be able to recover its deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the GEF will not be able to recover the value of its investment or collateral securities that are in the possession of another party. Texas State Statutes and the GEF's investment policy statements do not contain legal or policy requirements that would limit the exposure to custodial credit risk for deposits or investments. As of August 31, 2006 and 2005, the GEF does not have any investments that are exposed to custodial credit risk.

(D) Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates will adversely affect the value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its value to changes in market interest rates. Interest rate risk inherent in the GEF is measured by monitoring the modified duration of the overall investment portfolio. Modified duration estimates the sensitivity of the GEF's investments to changes in interest rates. The GEF has no specific policy statement limitations with respect to its overall modified duration. The following table summarizes the GEF's modified duration and the Fund's pro-rata share of the GEF investment value by investment type as of August 31, 2006 and 2005.

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LONG TERM FUND
Notes to Financial Statements (cont.)

| GEF Investment Type | August 31, | | | |
|---|-------------------------|-------------------|-------------------------|-------------------|
| | 2006 | | 2005 | |
| | Value | Modified Duration | Value | Modified Duration |
| Investments in Securities: | | | | |
| U.S. Government Guaranteed: | | | | |
| U.S. Treasury Bonds and Notes | \$ 100,961,118 | 7.28 | \$ 92,046,016 | 6.47 |
| U.S. Treasury Strips | 2,392,508 | 5.00 | 2,964,587 | 6.00 |
| U.S. Treasury Bills | 4,072,706 | 0.04 | 5,707,356 | 0.15 |
| U.S. Treasury Inflation Protected | 290,490,657 | 7.91 | 231,052,065 | 8.03 |
| U.S. Agency Asset Backed | 1,872,781 | 5.88 | 1,943,333 | 2.34 |
| Total U.S. Government Guaranteed | <u>399,789,770</u> | 7.65 | <u>333,713,357</u> | 7.42 |
| U.S. Government Non-Guaranteed: | | | | |
| U.S. Agency | 12,071,315 | 3.05 | 36,615,497 | 5.21 |
| U.S. Agency Asset Backed | 135,277,523 | 5.46 | 154,225,102 | 3.39 |
| Total U.S. Government Non-Guaranteed | <u>147,348,838</u> | 5.26 | <u>190,840,599</u> | 3.74 |
| Total U.S. Government | <u>547,138,608</u> | 7.00 | <u>524,553,956</u> | 6.08 |
| Corporate Obligations: | | | | |
| Domestic | 72,251,893 | 4.41 | 79,650,894 | 5.06 |
| Commercial Paper | 186,020,730 | 0.07 | 24,574,648 | 0.23 |
| Foreign | 19,563,169 | 11.18 | 15,041,952 | 6.80 |
| Total Corporate Obligations | <u>277,835,792</u> | 1.98 | <u>119,267,494</u> | 4.28 |
| Foreign Government and Provincial Obligations | <u>45,787,912</u> | 6.52 | <u>62,722,965</u> | 8.54 |
| Other Debt Securities | <u>4,846,131</u> | 12.30 | <u>8,526,675</u> | 11.31 |
| Total Debt Securities | <u>875,608,443</u> | 5.41 | <u>715,071,090</u> | 5.90 |
| Other Investment Funds - Debt | <u>75,142,493</u> | 3.77 | <u>10,461,046</u> | 5.97 |
| Cash and Cash Equivalents: | | | | |
| Money Market Funds | 426,985,904 | 0.08 | 414,667,426 | 0.08 |
| Other | 5,323,908 | - | 8,683,551 | - |
| Total Cash and Cash Equivalents | <u>432,309,812</u> | 0.08 | <u>423,350,977</u> | 0.08 |
| Total | <u>\$ 1,383,060,748</u> | 3.66 | <u>\$ 1,148,883,113</u> | 3.76 |
| Deposit with Brokers for Derivative Contracts: | | | | |
| U.S. Government Guaranteed: | | | | |
| U.S. Treasury Bonds and Notes | \$ - | - | \$ 89,474 | 0.41 |
| U.S. Treasury Bills | 35,100,926 | 0.15 | 20,530,609 | 0.21 |
| U.S. Treasury Inflation Protected | 942,580 | 0.36 | 930,264 | 1.33 |
| Total U.S. Government Guaranteed | <u>36,043,506</u> | 0.16 | <u>21,550,347</u> | 0.26 |
| Cash | <u>10,542,248</u> | - | <u>3,161,340</u> | - |
| Total Deposit with Brokers for Derivative Contracts | <u>\$ 46,585,754</u> | 0.11 | <u>\$ 24,711,687</u> | 0.22 |
| Deposit with Broker for Securities Sold Short: | | | | |
| Cash | <u>\$ 3,297,537</u> | - | <u>\$ -</u> | - |

(E) Investments with Fair Values That Are Highly Sensitive to Interest Rate Changes

In accordance with the GEF's investment policy statement, the GEF may invest in various mortgage backed securities, such as collateralized mortgage backed obligations. The GEF also may invest in investments that have floating rates with periodic coupon changes in market rates, zero coupon bonds and stripped Treasury

THE UNIVERSITY OF TEXAS SYSTEM

LONG TERM FUND

Notes to Financial Statements (cont.)

and Agency securities created from coupon securities. As of August 31, 2006 and 2005, the GEF's investments include the following investments that are highly sensitive to interest rate changes.

Collateralized mortgage obligations which are subject to early payment in a period of declining interest rates. The resultant reduction in expected total cash flows will affect the fair value of these securities. The Fund's pro-rata share of these securities amounted to \$29,538,799 and \$40,655,395 as of August 31, 2006 and 2005, respectively.

Mortgage backed securities which are subject to early payment in a period of declining interest rates. The resultant reduction in expected total cash flows will affect the fair value of these securities. The Fund's pro-rata share of these securities amounted to \$124,633,768 and \$78,930,029 as of August 31, 2006 and 2005, respectively.

Asset backed securities which are backed by home equity loans, auto loans, equipment loans and credit card receivables. Prepayments by the obligees of the underlying assets in periods of decreasing interest rates could reduce or eliminate the stream of income that would have been received. The Fund's pro-rata share of these securities amounted to \$10,835,053 and \$8,971,720 as of August 31, 2006 and 2005, respectively.

Step-up notes that grant the issuer the option to call the note on certain specified dates. At each call date, should the issuer not call the note, the coupon rate of the note increases (steps up) by an amount specified at the inception of the note. The call feature embedded within a step-up note causes the fair value of the instrument to be considered highly sensitive to interest rate changes. The Fund's pro-rata share of these securities amounted to \$1,623,158 and \$4,034,187 as of August 31, 2006 and 2005, respectively.

(F) *Foreign Currency Risk*

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of the GEF's non-U.S. dollar investments. The GEF's investment policy statement limits investments in non-U.S. denominated bonds to 50% of the GEF's total fixed income exposure. The following table summarizes the Fund's pro-rata exposure of the GEF's non-U.S. dollar investments as of August 31, 2006 and 2005.

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LONG TERM FUND

Notes to Financial Statements (cont.)

| GEF Investment Type | Fund's Pro-Rata Share | |
|---|-----------------------|----------------|
| | August 31, | |
| | 2006 | 2005 |
| Foreign Common Stock: | | |
| Australian Dollar | \$ 6,982,681 | \$ 8,222,338 |
| Canadian Dollar | 30,820,782 | 29,791,257 |
| Swiss Franc | 4,168,337 | 6,336,019 |
| Danish Krone | 1,530,269 | 1,987,029 |
| Euro | 18,297,330 | 49,556,081 |
| UK Pound | 22,283,357 | 17,511,842 |
| Hong Kong Dollar | 9,221,064 | 3,183,857 |
| Japanese Yen | 100,410,888 | 84,667,181 |
| South Korean Won | 2,753,853 | 1,306,984 |
| New Zealand Dollars | 297,585 | - |
| Norwegian Krone | 2,388,818 | 7,942,724 |
| Swedish Krona | 2,906,049 | 3,523,665 |
| Singapore Dollar | 4,693,892 | 4,601,320 |
| Total Foreign Common Stock | 206,754,905 | 218,630,297 |
| Other - Equity Securities | | |
| Canadian Dollar | 21 | - |
| Foreign Government and Provincial Obligations: | | |
| Australian Dollar | - | 361,409 |
| Canadian Dollar | 103,964 | 351,357 |
| Danish Krone | 408,618 | 413,095 |
| Euro | 36,635,887 | 46,414,115 |
| Japanese Yen | 1,799,746 | - |
| New Zealand Dollar | 275,195 | 657,999 |
| Polish Zloty | 1,491,133 | 1,269,451 |
| UK Pound | - | 4,401,588 |
| Total Foreign Government and Provincial Obligations | 40,714,543 | 53,869,014 |
| Corporate Obligations: | | |
| Euro | 8,966,724 | 6,208,069 |
| UK Pound | 627,242 | 611,110 |
| Japanese Yen | 1,404,031 | - |
| Total Corporate Obligations | 10,997,997 | 6,819,179 |
| Purchased Options: | | |
| Canadian Dollar | 29,680 | 549,760 |
| Euro | 418,288 | 29,404 |
| UK Pound | 63,374 | - |
| Japanese Yen | 1,380,149 | - |
| Total Purchased Options | 1,891,491 | 579,164 |
| Private Market Investment Funds: | | |
| Euro | 46,959,493 | 40,030,635 |
| UK Pound | 2,233,464 | 3,546,500 |
| Total Private Market Investment Funds | 49,192,957 | 43,577,135 |
| Cash and Cash Equivalents: | | |
| Australian Dollar | 74,275 | 51,355 |
| Canadian Dollar | 563,786 | 2,779,592 |
| Swiss Franc | 39,910 | 35,108 |
| Danish Krone | 14,267 | 18,764 |
| Euro | 843,851 | 1,158,033 |
| UK Pound | 415,119 | (29,438) |
| Hong Kong Dollar | 97,792 | 8,980 |
| Japanese Yen | 4,288,565 | 9,773,808 |
| Norwegian Krone | 33,128 | 4,243 |
| New Zealand Dollar | 229,253 | 6,683 |
| Polish Zloty | 166,031 | 73,056 |
| Swedish Krona | 110,861 | 3,967 |
| Singapore Dollar | 91,602 | 24,287 |
| New Taiwan Dollar | 271 | 270 |
| Total Cash and Cash Equivalents | 6,968,711 | 13,908,708 |
| Total | \$ 316,520,625 | \$ 337,383,497 |

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LONG TERM FUND**

Notes to Financial Statements (cont.)

Note 5 – Securities Lending

In accordance with the prudent investor investment standards, the GEF loans securities to certain brokers who pay the GEF negotiated lenders' fees. These fees are included in the GEF investment income, and related expenses are included in investment expenses. The GEF receives qualified securities and/or cash as collateral against the loaned securities. The collateral, when received, will have a market value of 102% of loaned securities of U.S. issuers and a market value of 105% for loaned securities of non-U.S. issuers. If the market value of the collateral held in connection with loans of securities of U.S. issuers is less than 100% at the close of trading on any business day, the borrower is required to deliver additional collateral by the close of the next business day to equal 102% of the market value. For non-U.S. issuers, the collateral should remain at 105% of the market value of the loaned securities at the close of any business day. If it falls below 105%, the borrower must deliver additional collateral by the close of the following business day. The Fund's pro-rata share of the value of GEF securities loaned and the value of collateral held are as follows at August 31, 2006 and 2005:

| GEF Securities on Loan | 2006 Value | 2005 Value | Type of Collateral | 2006 Value of Collateral | 2005 Value of Collateral |
|-----------------------------------|-----------------------|-----------------------|-------------------------------|-------------------------------------|-------------------------------------|
| U.S. Government | \$275,944,327 | \$296,993,190 | Cash | \$280,758,788 | \$300,011,659 |
| Foreign Government | 9,917,110 | 14,973,393 | Cash | 10,411,481 | 15,677,974 |
| Corporate Bonds | 3,909,828 | 4,019,874 | Cash | 4,007,846 | 4,129,325 |
| Common Stock | 86,827,685 | 78,264,764 | Cash | 90,506,589 | 81,414,372 |
| Total | \$376,598,950 | \$394,251,221 | Total | \$385,684,704 | \$401,233,330 |
| U.S. Government | \$18,359,843 | \$6,142,807 | Non-Cash | \$18,756,205 | \$6,354,186 |
| Common Stock | 619,407 | 597,943 | Non-Cash | 631,951 | 618,518 |
| Total | \$18,979,250 | \$6,740,750 | Total | \$19,388,156 | \$6,972,704 |

Cash received as collateral for securities lending activities is invested and reinvested in a commingled pool managed exclusively for the benefit of the GEF, the Permanent University Fund, the Intermediate Term Fund and other Board of Regent accounts that participate in securities lending activities. The pool is managed in accordance with investment guidelines established in the securities lending contract between the GEF and its securities lending agent. The maturities of the investments in the pool do not necessarily match the term of the loans, rather the pool is managed to maintain a maximum dollar weighted average maturity of 60 days and an overnight liquidity of 20 percent. Lending income is earned if the returns on those investments exceed the rebate paid to borrowers of the securities. The income remaining after the borrower rebates is then shared with the lending agent on a contractually negotiated split. If the investment of the cash collateral does not provide a return exceeding the rebate or if the investment incurs a loss of principal, the payment of the shortfall to the borrower would come from the Fund and the securities lending agent in the same proportion as the split of income.

The Fund's pro-rata share of the GEF's portion of the collateral pool investments, rating by NRSRO, and weighted average maturity as of August 31, 2006 and 2005 is shown in the following table.

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LONG TERM FUND

Notes to Financial Statements (cont.)

| Description | August 31, | | | | | |
|----------------------------------|----------------------------------|-----------|-----------------------------------|----------------------------------|-----------|-----------------------------------|
| | 2006 | | | 2005 | | |
| | Fund's Pro-Rata Share Fair Value | Rating | Weighted Average Maturity In Days | Fund's Pro-Rata Share Fair Value | Rating | Weighted Average Maturity In Days |
| Repurchase Agreements | \$ 140,414,486 | No Rating | 14 | \$ 189,073,593 | No Rating | 1 |
| Commercial Paper | 167,724,957 | P | 26 | 162,508,339 | P | 36 |
| Floating Rate Notes | 22,012,133 | AAA | | 3,672,704 | AAA | |
| Floating Rate Notes | <u>15,810,248</u> | AA | | <u>41,098,882</u> | AA | |
| Total Floating Rate Notes | <u>37,822,381</u> | | 69 | <u>44,771,586</u> | | 37 |
| Certificates of Deposit | 48,256,759 | P | 67 | 6,042,950 | P | 50 |
| Asset Backed Securities | 691,698 | AAA | 11 | 229,033 | AAA | 168 |
| Other Receivables/Payables | <u>(9,225,576)</u> | Not Rated | - | <u>(1,392,170)</u> | Not Rated | - |
| Total Collateral Pool Investment | <u>\$ 385,684,705</u> | | 31 | <u>\$ 401,233,331</u> | | 20 |

Collateral pool investments are uninsured, and are held by the securities lending agent, in its name, on behalf of the GEF, except for the investments in repurchase agreements which are held in the securities lending agent's name by a third party custodian not affiliated with the GEF or the borrower of the associated loaned securities. Therefore, the collateral pool is not exposed to custodial credit risk because the pool investments are not held by counterparties to the lending transactions or a counterparties trust department or agent.

Cash collateral is recorded as an asset with an equal and offsetting liability to return the collateral on the statements of fiduciary net assets. Investments received as collateral for securities lending activities are not recorded as assets because the investments remain under the control of the transferor, except in the event of default.

In the event of default, where the borrower is unable to return the securities loaned, the GEF has authorized the securities lending agent to seize the collateral held. The collateral is then used to replace the borrowed securities where possible. Due to some market conditions, it is possible that the original securities cannot be replaced. If the collateral is insufficient to replace the securities, the securities lending agent has indemnified the GEF from any loss due to borrower default.

As of August 31, 2006 and 2005, the GEF had no credit risk exposure to borrowers because the amounts the GEF owed to borrowers exceeded the amounts the borrowers owed the GEF.

There were no significant violations of legal or contractual provisions, no borrower or securities lending agent default losses, and no recoveries of prior period losses during the years ended August 31, 2006 and 2005.

Note 6 – Fees and Expenses

The Fund is assessed a management fee by UTIMCO to cover the costs of managing the Fund and providing day-to-day operations. The fee assessed for the year ended August 31, 2006, was \$1,965,491, net of a rebate of \$1,293,600 of prior year reserves from UTIMCO to the Fund. The fee assessed for the year ended August 31, 2005 was \$2,236,783, net of a rebate of \$1,246,673 of prior year reserves from UTIMCO to the Fund.

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LONG TERM FUND

Notes to Financial Statements (cont.)

The Fund is assessed an annual administrative fee on behalf of UT System institutions based on 0.08% of the market value of the Fund for the support of enhanced and expanded endowment compliance efforts. This fee is assessed and paid at the beginning of each fiscal year. The fees assessed for the fiscal years ending August 31, 2006 and 2005, were \$2,720,170 and \$2,525,960, respectively.

The Fund is assessed a quarterly internal fee by UT System for educational purposes based on 0.005% of the Fund's net asset value on the last day of each quarter for the years ended August 31, 2006 and 2005. The fees assessed for the years ended August 31, 2006 and 2005, were \$855,873 and \$761,378, respectively.

The Fund is assessed a fee to cover costs associated with UT System personnel and UT System consultants hired to provide assistance to the Board of Regents and the Chancellor of the UT System in their oversight responsibilities of UTIMCO. The fees assessed for the years ended August 31, 2006 and 2005, were \$200,047 and \$120,446, respectively.

The Fund incurs other expenses related to its operations primarily consisting of audit fees, printing and graphic expenses, legal, consultation fees and custodial fees.

THE UNIVERSITY OF TEXAS SYSTEM
LONG TERM FUND
Supplemental Schedule

Financial Highlights
Years Ended August 31,

| | <u>2006</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|-------------|-------------|-------------|-------------|-------------|
| Selected Per Unit Data | | | | | |
| Net Asset Value, Beginning of Period | \$ 6.337 | \$ 5.585 | \$ 5.114 | \$ 4.788 | \$ 5.412 |
| Income from Investment Operations | | | | | |
| Net Investment Income | 0.117 | 0.123 | 0.099 | 0.097 | 0.098 |
| Net Realized and Unrealized Gain (Loss) on Investments | 0.566 | 0.899 | 0.637 | 0.487 | (0.471) |
| Total Income (Loss) from Investment Operations | 0.683 | 1.022 | 0.736 | 0.584 | (0.373) |
| Less Distributions | | | | | |
| From Net Investment Income | 0.117 | 0.123 | 0.099 | 0.097 | 0.098 |
| From Net Realized Gain | 0.159 | 0.147 | 0.166 | 0.161 | 0.153 |
| Total Distributions | 0.276 | 0.270 | 0.265 | 0.258 | 0.251 |
| Net Asset Value, End of Period | \$ 6.744 | \$ 6.337 | \$ 5.585 | \$ 5.114 | \$ 4.788 |

Ratios and Supplemental Data

| | | | | | |
|--|-------------|-------------|-------------|-------------|-------------|
| Net Assets, End of Period (in thousands) | \$4,440,780 | \$4,000,938 | \$3,393,275 | \$2,839,846 | \$2,595,063 |
| Ratio of Investment Expenses to Average Net Assets | 0.38% | 0.32% | 0.33% | 0.29% | 0.29% |
| Ratio of Total Expenses to Average Net Assets | 0.47% | 0.42% | 0.43% | 0.40% | 0.39% |
| Ratio of Net Investment Income to Average Net Assets | 1.82% | 2.05% | 1.84% | 2.01% | 1.89% |
| Ratio of Distributions to Average Net Assets (5-quarter average) | 4.27% | 4.51% | 4.89% | 5.40% | 4.86% |
| Ratio of Distributions to Average Net Assets (12-quarter average) | 4.44% | 4.78% | 4.98% | 4.86% | 4.38% |