

**PERMANENT HEALTH FUND**

**FINANCIAL STATEMENTS**

**Years Ended August 31, 2002 and 2001**

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## INDEPENDENT AUDITORS' REPORT

The Board of Directors  
The University of Texas Investment Management Company  
Austin, Texas

We have audited the accompanying statements of assets and liabilities of the Permanent Health Fund (Fund) as of August 31, 2002 and 2001, the related statements of operations and changes in net assets for the years then ended, and the financial highlights for each of the three years in the period ended August 31, 2002. These financial statements and financial highlights are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of August 31, 2002 and 2001, by correspondence with the custodian. 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.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of the Fund as of August 31, 2002 and 2001, the results of its operations and the changes in its net assets for the years then ended, and the financial highlights for each of the three years in the period ended August 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

*Deloitte & Touche LLP*

October 18, 2002

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## PERMANENT HEALTH FUND

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### Financial Highlights

Years Ended August 31,

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<b>Selected Per Unit Data</b>			
Net Asset Value, Beginning of Period	\$ 0.965	\$ 1.113	\$ 1.000
Income From Investment Operations			
Net Investment Income	0.018	0.024	0.030
Net Realized and Unrealized Gain (Loss) on Investments	<u>(0.084)</u>	<u>(0.126)</u>	<u>0.128</u>
Total Income (Loss) from Investment Operations	<u>(0.066)</u>	<u>(0.102)</u>	<u>0.158</u>
Less Distributions			
From Net Investment Income	0.018	0.024	0.030
From Net Realized Gain and In Excess of Net Investment Return	<u>0.029</u>	<u>0.022</u>	<u>0.015</u>
Total Distributions	<u>0.047</u>	<u>0.046</u>	<u>0.045</u>
Net Asset Value, End of Period	<u>\$ 0.852</u>	<u>\$ 0.965</u>	<u>\$ 1.113</u>
<b>Ratios and Supplemental Data</b>			
Net Assets, End of Period (in thousands)	\$ 698,250	\$ 881,433	\$ 1,016,587
Ratio of Expenses to Average Net Assets	0.27%	0.20%	0.20%
Ratio of Net Investment Income to Average Net Assets	1.91%	2.44%	2.87%
Ratio of Distributions to Average Net Assets (5-quarter average)	5.05%	4.51%	4.28%
Ratio of Distributions to Average Net Assets (12-quarter average)	4.66%	N/A	N/A

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

## PERMANENT HEALTH FUND

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### Statements of Assets and Liabilities

August 31, 2002 and 2001

(Dollars in thousands, except per unit amounts)

	<u>2002</u>	<u>2001</u>
<b>Assets</b>		
General Endowment Fund Units, at Value (Cost \$757,590 and \$902,041, respectively)	\$ 698,060	\$ 881,268
Money Market Investments	190	165
<b>Net Assets</b>	<u>\$ 698,250</u>	<u>\$ 881,433</u>
<b>Net Assets Consist Of:</b>		
Participant Contributions (Net of Withdrawals)	\$ 820,000	\$ 915,000
Accumulated Net Realized Loss on Investments including Foreign Currency Transactions	(23,420)	-
Net Unrealized Depreciation of Investments including Translation of Assets and Liabilities in Foreign Currencies	(59,529)	(20,773)
Distributions in Excess of Net Investment Return	<u>(38,801)</u>	<u>(12,794)</u>
<b>Net Assets for 820,000,000 and 913,765,506 Units, respectively</b>	<u>\$ 698,250</u>	<u>\$ 881,433</u>
<b>Net Asset Value Per Unit</b>	<u>\$ 0.852</u>	<u>\$ 0.965</u>

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

## PERMANENT HEALTH FUND

### Statements of Operations and Changes in Net Assets

Years Ended August 31, 2002 and 2001

(in thousands)

	<u>2002</u>	<u>2001</u>
<b>Investment Income</b>		
Allocation of General Endowment Fund Net Investment Income	\$ 16,380	\$ 11,011
Interest	1	8,387
Dividends	37	4,196
Income Distributions from Limited Partnerships	-	29
Other	-	192
<b>Total Investment Income</b>	<u>16,418</u>	<u>23,815</u>
<b>Expenses</b>		
UTIMCO Management Fee	558	386
Other Expenses	17	65
Custodial Fees and Expenses	4	166
Investment Management and Consulting Fees	-	438
<b>Total Expenses</b>	<u>579</u>	<u>1,055</u>
<b>Net Investment Income</b>	<u>15,839</u>	<u>22,760</u>
<b>Realized And Unrealized Loss on Investments</b>		
Net Realized Loss on GEF Units	(2,307)	(258)
Net Realized Loss on Investments Securities and Foreign Currency Related Transactions	-	(26,486)
Allocation of General Endowment Fund Realized Loss	(27,884)	(8,697)
Net Unrealized Depreciation on Investment Securities and Foreign Currency Related Transactions	-	(58,491)
Net Unrealized Depreciation on General Endowment Fund Units	<u>(38,756)</u>	<u>(21,948)</u>
<b>Net Loss on Investments</b>	<u>(68,947)</u>	<u>(115,880)</u>
<b>Net Decrease in Net Assets Resulting From Operations</b>	\$ (53,108)	\$ (93,120)
<b>Net Assets</b>		
Beginning of Period	881,433	1,016,587
Participant Withdrawals:		
Cost	(95,000)	-
Loss	6,771	-
Distributions to Participants:		
Net Investment Income	(15,839)	(22,760)
Net Realized Appreciation	-	(6,480)
In Excess of Net Investment Return	<u>(26,007)</u>	<u>(12,794)</u>
<b>End of Period</b>	<u>\$ 698,250</u>	<u>\$ 881,433</u>

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

# PERMANENT HEALTH FUND

## *Notes to Financial Statements*

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### **Note 1 – Organization**

The Permanent Health Fund (Fund) is an internal University of Texas System mutual fund for the pooled investment of state endowment funds for health-related institutions of higher education, created August 30, 1999, with proceeds from state tobacco litigation. The distributions from the Fund endowments support programs that benefit medical research, health education, public health, nursing, and treatment programs at health-related institutions of higher education. Fiduciary responsibility for the Fund rests with the Board of Regents of The University of Texas System (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 University of Texas System Long Term Fund (LTF), also established by the Board of Regents. The GEF is organized as a mutual fund in which the Fund and the LTF 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 accompanying financial statements follow the form and content of investment company financial statements and related disclosures in accordance with accounting principles generally accepted in the United States of America. The principles followed will differ from the principles applied in governmental and fund accounting. The annual combined financial statements of The University of Texas 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 governmental accounting principles or 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. At August 31, 2002, the Fund is the minority participant in the GEF, with ownership of 7,676,762 units, which represents 21.2% of the GEF. At August 31, 2001, the Fund held 9,009,891 units, which represented 23.7% 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 for accounting purposes, the GEF distributes its net investment income and realized gain or loss to the Fund based on its ownership of GEF units at month end. The distributed investment income and realized gain amounts are considered reinvested as GEF contributions. Any distributed realized losses reduce the cost basis of the units in the GEF. Since

## PERMANENT HEALTH FUND

*Notes to Financial Statements (cont.)*

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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 7 reports financial information on the GEF for the year ended August 31, 2002, and for the period from inception (March 1, 2001) to August 31, 2001.

### **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) **Foreign Currency Translation** -- The accounting records of the Fund are maintained in U.S. dollars. Prior to March 1, 2001, investments in securities and securities sold short were valued at the daily rates of exchange on the valuation date. Purchases and sales of securities of foreign entities and the related income receipts and expense payments were translated into U.S. dollars at the exchange rate on the dates of the transactions. The Fund did not isolate that portion of the results of operations resulting from changes in foreign exchange rates on investments from fluctuations arising from changes in market prices of securities held. Such fluctuations were included with the net realized and unrealized gain or loss from investments.

(C) **Investment Income** -- Interest income is accrued as earned. Prior to March 1, 2001, dividend income was recorded on the ex-dividend date. Dividend and interest income was recorded net of foreign taxes where recovery of such taxes was not assured. Investment income included net realized and unrealized currency gains and losses recognized between accrual and payment dates on dividend and interest transactions. Premiums and discounts on bonds were not amortized.

(D) **Security Transactions** -- Prior to March 1, 2001, security transactions were recorded on a trade date basis for most securities. International index fund transactions were recorded on a settle date basis due to trading practices which imposed restrictions in acquiring per unit information on the trade date. Gains and losses on securities sold were determined on the basis of average cost. A loss was recognized if there was an impairment in the value of the security that was determined to be other than temporary. Beginning March 1, 2001, a gain or loss is recognized on GEF unit sales on the basis of average cost.

(E) **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, 2002, the quarterly rate was \$.01175 which equates to a yearly rate of \$.047 per unit. For the year ended August 31, 2001, the quarterly rate was \$.0115 per unit which equated to a yearly rate of \$.046 per unit. The ratio of distributions to average net assets (12-quarter average) was 4.66% as of August 31, 2002. The investment policy provides that the annual payout will be adjusted by the average consumer price index of the prior 36 months including August 31 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.

(F) **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.

## PERMANENT HEALTH FUND

Notes to Financial Statements (cont.)

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(G) **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.

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

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

(J) **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.

(K) **Foreign Currency Contracts** -- Prior to March 1, 2001, the Fund entered into forward foreign currency exchange contracts to hedge against foreign currency exchange rate risks on its non-U.S. dollar denominated investment securities and to facilitate trading strategies primarily as a tool to increase or decrease market exposure to various foreign currencies. When entering into a forward currency contract, the Fund agreed to receive or deliver a fixed quantity of foreign currency for an agreed-upon price on an agreed future date. These contracts were valued daily and the Fund's net equity therein, representing unrealized gain or loss on the contracts as measured by the difference between the forward foreign exchange rates at the dates of entry into the contracts and the forward rates at the reporting date, was included in the statement of assets and liabilities. Realized and unrealized gains and losses were included in the statements of operations. These instruments involved market and/or credit risk in excess of the amount recognized in the statement of assets and liabilities. Risks arose from the possible inability of counterparties to meet the terms of their contracts and from movement in currency and securities values and interest rates.

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

### Note 4 – Acquisitions and Dispositions of Investments

Acquisitions and dispositions (including sales, maturities and prepayments) of securities, other than short-term securities, and the associated net realized losses, which include amounts allocated from the GEF, are as follows for the years ended August 31, 2002 and 2001:

	<u>2002</u>	<u>2001</u>
Acquisitions	\$ 16,379,466	\$1,618,057,223
Dispositions	(130,640,579)	(1,564,665,247)
Net Realized Losses on Investments	(30,190,578)	(35,440,605)



## PERMANENT HEALTH FUND

*Notes to Financial Statements (cont.)*

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Included in acquisitions for the year ended August 31, 2001, is \$922,338,502 related to the initial purchase of GEF units by the Fund on March 1, 2001. Included in dispositions for the year ended August 31, 2001, is \$855,007,626 related to the contribution of investment assets to the GEF. The contribution of investment assets, excluding limited partnerships and one other equity investment, to the GEF on March 1, 2001, was accounted for by the Fund as sales at the market value of the assets contributed. A realized loss in the amount of \$10,810,995 was recognized and is included in the net realized gains (losses) on investments. The contribution of the market value of the limited partnerships and one other equity investment in the amount of \$30,460,955, which included cost basis of \$29,285,623 and unrealized appreciation of \$1,175,332, was accounted for as a carryover in basis, and therefore, no realized gain or loss was recorded.

The net realized losses on investments included \$4,669,011 of reinvested capital gains earned on the index funds and commingled investments for the year ended August 31, 2001. Also included in net realized losses were \$1,139,303 of currency exchanges losses for the year ended August 31, 2001.

### **Note 5 – 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 fees assessed for the years ended August 31, 2002 and 2001, were \$558,026 and \$385,773, respectively.

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

Custodial fees and expenses were assessed quarterly by the financial institution which holds the Fund's assets. Fees were based on the number of accounts, market value of the Fund, and transaction activity in accordance with the contractual agreement with the institution. Additional fees were assessed for performance measurement and on-line communication services per the contractual agreement. Beginning March 1, 2001, the Fund is assessed only a negligible fee for the maintenance of two accounts.

Prior to March 1, 2001, the Fund incurred investment management fees from various external managers of the Fund. The fees, generally assessed quarterly, were based on a percentage of the market value of investments held by each individual investment manager and ranged from 0.01% to 1.0%. In addition to quarterly investment management fees, the Fund paid annual performance-based management fees for investment performance in excess of certain defined benchmarks as provided for in the manager's contract. Beginning March 1, 2001, the Fund no longer incurred external investment management fees.

### **Note 6 – Futures Contracts**

Prior to March 1, 2001, the Fund's activities included trading in derivatives such as futures contracts. Futures contracts were used to facilitate various trading strategies, primarily as a tool to increase or decrease market exposure to various asset classes of the Fund. When deemed appropriate, a portion of the index funds and commingled investments held by the Fund also may have been invested in futures contracts for the purpose of acting as a temporary substitute for other investments. The asset classes that used futures included domestic and foreign equities, domestic

## PERMANENT HEALTH FUND

*Notes to Financial Statements (cont.)*

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and foreign debt, and commodities. Commodity index exposure was obtained through the Goldman Sachs Commodity Index (GSCI). The GSCI is a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. It was the intention of the Fund not to utilize leverage when entering into these contracts and to maintain cash balances that, when combined with the collateral deposited with a broker, exceeded the notional value of the futures contracts held. Futures contracts were marked to market daily; that is, they were valued at the close of business each day, and a gain or loss was recorded between the value of the contracts that day and on the previous day. The daily gain or loss was referred to as the daily variation margin, which was settled in cash with the broker each morning for the amount of the previous day's mark to market. The amount that was settled in cash with the broker each morning was the carrying and fair value of the futures contracts. The Fund recognized a loss on the futures contracts of \$5,116,796 for the period ended February 28, 2001. The Fund executed such contracts either on major exchanges or with major international financial institutions and minimized market and credit risk associated with these contracts through the manager's various trading and credit monitoring techniques.

# PERMANENT HEALTH FUND

Notes to Financial Statements (cont.)

## Note 7 –Financial Information on GEF

The following presents the investments and net assets of the GEF, in thousands, as of August 31, 2002 and 2001.

	<u>2002</u>	<u>2001</u>
<b>Equity Securities</b>		
Index Funds	\$ 775,885	\$ 881,803
Commingled Investments	617,064	640,911
Domestic Common Stock	507,797	733,637
Limited Partnerships	353,556	366,491
Foreign Common Stock	98,713	116,147
Other	1,263	1,093
<b>Total Equity Securities</b>	<u>2,354,278</u>	<u>2,740,082</u>
<b>Debt Securities:</b>		
U.S. Government Obligations (Direct and Guaranteed)	110,388	204,349
U.S. Government Agencies (Non-Guaranteed)	196,481	303,343
U.S. Government Agencies (Non-Guaranteed) (Non-U.S. Dollar Denominated)	899	-
Foreign Government and Provincial Obligations (U.S. Dollar Denominated)	5,865	4,417
Foreign Government and Provincial Obligations (Non-U.S. Dollar Denominated)	58,928	62,569
Municipal and County Bonds	2,831	9,105
Corporate Bonds	221,220	230,395
Foreign Corporate Bonds	10,117	14,861
Commingled Investment	8,711	11,690
Commercial Paper	3,086	-
Other	1,470	3,331
<b>Total Debt Securities</b>	<u>619,996</u>	<u>844,060</u>
<b>Preferred Stock</b>		
Domestic Preferred Stock	5,047	12,842
Foreign Preferred Stock	618	1,305
<b>Total Preferred Stock</b>	<u>5,665</u>	<u>14,147</u>
<b>Convertible Securities</b>	<u>2,183</u>	<u>2,915</u>
<b>Cash and Cash Equivalents</b>		
Money Markets	404,900	320,832
<b>Total Investment in Securities</b>	<u>\$ 3,387,022</u>	<u>\$ 3,922,036</u>
<b>Other Assets</b>	178,863	171,399
<b>Liabilities</b>	<u>(272,691)</u>	<u>(369,523)</u>
<b>Net Assets</b>	\$ 3,293,194	\$ 3,723,912
<b>Fund Ownership</b>	<u>21.20%</u>	<u>23.67%</u>
<b>Value of Fund Interest</b>	<u>\$ 698,060</u>	<u>\$ 881,268</u>

# PERMANENT HEALTH FUND

Notes to Financial Statements (cont.)

The following presents information on the operations of the GEF, in thousands, for the year ended August 31, 2002, and for the period from inception (March 1, 2001) to August 31, 2001.

	<u>2002</u>	<u>2001</u>
<b>Investment Income</b>		
Interest	\$ 40,067	\$ 29,790
Dividends	34,458	17,308
Income Distributions from Limited Partnerships	2,887	1,631
Other	1,504	1,187
<b>Total Investment Income</b>	<u>78,916</u>	<u>49,916</u>
<b>Total Expenses</b>	<u>7,245</u>	<u>3,402</u>
<b>Net Investment Income</b>	<u>71,671</u>	<u>46,514</u>
<b>Realized And Unrealized Loss on Investments</b>		
Net Realized Loss on Investments Securities and Foreign Currency Related Transactions	(124,188)	(36,860)
Net Unrealized Depreciation on Investment Securities and Foreign Currency Related Transactions	<u>(199,983)</u>	<u>(94,253)</u>
<b>Net Loss on Investments</b>	<u>(324,171)</u>	<u>(131,113)</u>
<b>Net Decrease in Net Assets Resulting From Operations</b>	\$ (252,500)	\$ (84,599)
<b>Net Assets</b>		
Beginning of Period	3,723,912	-
Contribution of Participant Net Assets to GEF on March 1, 2001	-	3,839,708
Subsequent Participant Contributions	103,516	71,544
Participant Withdrawals:		
Cost	(290,653)	(104,220)
Loss	8,919	1,479
<b>Ending Net Assets</b>	<u>\$ 3,293,194</u>	<u>\$ 3,723,912</u>
<b>The Fund's share of the above transactions are as follows:</b>		
Beginning Value of Fund Interest	\$ 881,268	\$ -
Net Investment Income	16,380	11,011
Net Realized Losses	(27,884)	(8,697)
Net Unrealized Depreciation	(38,756)	(21,948)
Initial Purchase of GEF units on March 1, 2001	-	922,339
Sale of GEF Units	<u>(132,948)</u>	<u>(21,437)</u>
<b>Ending Value of Fund Interest</b>	<u>\$ 698,060</u>	<u>\$ 881,268</u>