

Financial Statements

Permanent Health Fund

Years ended August 31, 2004 and 2003

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PERMANENT HEALTH FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

Our discussion and analysis of the Permanent Health Fund's (Fund) financial performance provides an overview of its activities for the fiscal year ended August 31, 2004. 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 state endowment funds for health-related institutions of higher education. The University of Texas System Board of Regents (UT Board) established the Fund in August 1999 with proceeds from state tobacco litigation. The Texas Constitution and various state statutes designate the 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 University of Texas System Long Term Fund (LTF), also established by the UT Board. 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 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 distributions, increased by \$69.4 million from \$745.0 million to \$814.4 or by approximately 9.3% during the year.
- There were no participant contributions to the Fund or withdrawals from the Fund during the fiscal year.
- The Fund posted a net investment return of 14.60% for the fiscal year ended August 31, 2004, compared to a net investment return of 12.67% for the prior fiscal year.
- The Fund's distribution rate was \$.047 per unit for the fiscal year ended August 31, 2004. The per unit rate was not increased from the fiscal year ended August 31, 2003. The fiscal year distributions represented 4.81% of the Fund's average net asset value during the year.

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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 by the 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.

Statement of Fiduciary Net Assets

The Statement of Fiduciary Net Assets presents assets, liabilities, and net assets of the Fund as of the end of the fiscal year. This statement, along with all of the Fund's financial statements, is 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 the GEF units and a negligible amount of cash, the majority of the Fund's Statement of Fiduciary Net Assets is reflected in its investment in GEF units. As of August 31, 2004, the Fund owned 6,923,785 GEF units representing an ownership percentage of 19.35%. As of August 31, 2004, the fair value of the GEF units was \$814.2 million.

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.

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

	2004	2003	Amount of Increase (Decrease)	Percent Change
Assets				
General Endowment Fund Units, at Fair Value	\$ 814.2	\$ 744.8	\$ 69.4	9%
Cash and Cash Equivalents	0.2	0.2	-	-
Net Assets Held in Trust	\$ 814.4	\$ 745.0	\$ 69.4	9%

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Statement of Changes in Fiduciary Net Assets

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

The net increase in fair value of investments of the Fund was \$92.6 million during the year compared to \$71.1 million for the year ended August 31, 2003. Expenses totaled \$0.6 million in fiscal year 2004 and \$0.7 million in fiscal year 2003.

Distributions to participants totaled \$38.5 million for each of the years ended August 31, 2004 and 2003.

The net increase in fiduciary net assets totaled \$69.4 million for the year ended August 31, 2004 compared to a net increase in fiduciary net assets of \$46.7 million for the year ended August 31, 2003.

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.

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 schedule of the financial statements, the ratio of distributions to average net assets (12-quarter average) has remained between 3.5% to 5.5%.

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

	2004	2003	Amount of Increase (Decrease)	Percent Change
Investment Income	\$ 108.6	\$ 86.0	\$ 22.6	26%
Less Investment Expenses	(0.6)	(0.7)	0.1	14
Net Investment Income	108.0	85.3	22.7	27
Participant Distributions	38.6	38.6	-	-
Total Deductions	38.6	38.6	-	-
Change in Fiduciary Net Assets	69.4	46.7	22.7	49
Net Assets Held in Trust, Beginning of Period	745.0	698.3	46.7	7
Net Assets Held in Trust, End of Period	<u>\$ 814.4</u>	<u>\$ 745.0</u>	<u>\$ 69.4</u>	<u>9%</u>

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.

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
Austin, Texas

We have audited the accompanying financial statements of the Permanent Health Fund (the "Fund") as of and for the years ended August 31, 2004 and 2003, 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.

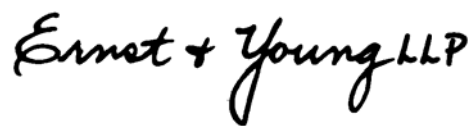
We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a 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 Permanent Health 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, 2004 and 2003 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 Permanent Health Fund as of August 31, 2004 and 2003, and the changes in its 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 1 through 4 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 Permanent Health Fund. The supplemental schedules are presented for purposes of additional analysis and are not a required part of the basic financial statements. The supplemental schedules as of and for the years ended August 31, 2004 and 2003 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 supplemental schedules for the years ended August 31, 2002, 2001 and 2000 were audited by other auditors whose report dated October 18, 2002 included an unqualified opinion.

 Ernst & Young LLP

October 22, 2004

PERMANENT HEALTH FUND

Statements of Fiduciary Net Assets

August 31, 2004 and 2003

(Dollars in thousands, except per unit amounts)

	<u>2004</u>	<u>2003</u>
Assets		
General Endowment Fund Units, at Fair Value	\$ 814,200	\$ 744,779
Cash and Cash Equivalents	<u>224</u>	<u>182</u>
Net Assets Held in Trust (820,000,000 Units)	<u>\$ 814,424</u>	<u>\$ 744,961</u>
Net Asset Value Held in Trust Per Unit	<u>\$ 0.993</u>	<u>\$ 0.908</u>

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

PERMANENT HEALTH FUND

Statements of Changes in Fiduciary Net Assets

Years Ended August 31, 2004 and 2003

(in thousands)

	<u>2004</u>	<u>2003</u>
Additions		
Investment Income		
Net Increase in Fair Value of Investments	\$ 92,625	\$ 71,121
Allocation of General Endowment Fund Net Investment Income	16,012	14,807
Interest	1	1
Dividends	4	19
Total Investment Income	<u>108,642</u>	<u>85,948</u>
Less Investment Expenses		
UTIMCO Management Fee	622	677
Other Expenses	17	20
Total Investment Expenses	<u>639</u>	<u>697</u>
Net Investment Income	108,003	85,251
Total Additions	<u>108,003</u>	<u>85,251</u>
Deductions		
Participant Distributions	<u>38,540</u>	<u>38,540</u>
Total Deductions	<u>38,540</u>	<u>38,540</u>
Change in Fiduciary Net Assets	69,463	46,711
Net Assets Held in Trust, Beginning of Period	<u>744,961</u>	<u>698,250</u>
Net Assets Held in Trust, End of Period	<u>\$ 814,424</u>	<u>\$ 744,961</u>

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

PERMANENT HEALTH FUND

Notes to Financial Statements

Note 1 – Organization and Basis of Presentation

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 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. The financial statements of the fund are prepared in accordance with the requirements of the Governmental Accounting Standards Board (GASB).

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 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, 2004, the Fund is the minority participant in the GEF, with ownership of 6,923,785 units, which represents 19.35% of the GEF. At August 31, 2003, the Fund held 7,263,383 units, which represented 20.78% of the GEF.

PERMANENT HEALTH FUND

Notes to Financial Statements (cont.)

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 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 are considered reinvested as GEF contributions. Any allocated realized losses reduce the cost basis of the units in the GEF. Since the allocation 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 5 reports financial information on the GEF for the years ended August 31, 2004 and 2003.

Because the investment in the GEF is not evidenced by securities in physical or book entry form the investment in GEF is not categorized in accordance with GASB Statement Number 3.

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 which is based on fair value.

(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 years ended August 31, 2004 and 2003 the quarterly rate was \$.01175 per unit which equates to a yearly rate of \$.047 per unit. The ratio of distributions to average net assets (12-quarter average) was 5.14% as of August 31, 2004. 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.

(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.

PERMANENT HEALTH FUND

Notes to Financial Statements (cont.)

(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.

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

(K) **Reclassifications** -- Certain items in the 2003 financial statements and related notes have been reclassified to conform with 2004 classification.

Note 4 – 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, 2004 and 2003, were \$621,526 and \$676,877, respectively.

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

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Supplemental Schedules

Financial Highlights

Years Ended August 31,

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Selected Per Unit Data					
Net Asset Value, Beginning of Period	\$ 0.908	\$ 0.852	\$ 0.965	\$ 1.113	\$ 1.000
Income From Investment Operations					
Net Investment Income	0.019	0.017	0.018	0.024	0.030
Net Realized and Unrealized Gain (Loss) on Investments	<u>0.113</u>	<u>0.086</u>	<u>(0.084)</u>	<u>(0.126)</u>	<u>0.128</u>
Total Income (Loss) from Investment Operations	<u>0.132</u>	<u>0.103</u>	<u>(0.066)</u>	<u>(0.102)</u>	<u>0.158</u>
Less Distributions					
From Net Investment Income	0.019	0.017	0.018	0.024	0.030
From Net Realized Gain and In Excess of Net Realized Investment Return	<u>0.028</u>	<u>0.030</u>	<u>0.029</u>	<u>0.022</u>	<u>0.015</u>
Total Distributions	<u>0.047</u>	<u>0.047</u>	<u>0.047</u>	<u>0.046</u>	<u>0.045</u>
Net Asset Value, End of Period	<u>\$ 0.993</u>	<u>\$ 0.908</u>	<u>\$ 0.852</u>	<u>\$ 0.965</u>	<u>\$ 1.113</u>
Ratios and Supplemental Data					
Net Assets, End of Period (in thousands)	\$ 814,424	\$ 744,961	\$ 698,250	\$ 881,433	\$ 1,016,587
Ratio of Expenses to Average Net Assets	0.31%	0.27%	0.27%	0.20%	0.20%
Ratio of Net Investment Income to Average Net Assets	1.92%	2.01%	1.91%	2.44%	2.87%
Ratio of Distributions to Average Net Assets (5-quarter average)	4.81%	5.48%	5.05%	4.51%	4.28%
Ratio of Distributions to Average Net Assets (12-quarter average)	5.14%	5.08%	4.66%	N/A	N/A