

Financial Statements

Permanent Health Fund

*Years Ended August 31, 2006 and 2005*

Permanent Health 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 Permanent Health 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.

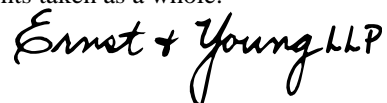
We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a 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 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, 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 Permanent Health 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 Permanent Health 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

## **PERMANENT HEALTH FUND**

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### **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 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 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), which was 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 \$61.1 million from \$925.9 million to \$987.0 million or by approximately 6.6% for the year ended August 31, 2006, compared to an increase of \$111.5 million or approximately 13.7% for the year ended August 31, 2005. The change in net fiduciary assets from year to year is mainly attributable to the following:
  1. The Fund posted a net investment return of 11.05% 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 investment funds and global equities were the leading contributors to the 2006 return. For the fiscal year ended August 31, 2005, the commodities, private market investments and domestic and global equity asset classes were the leading performers.
  2. The Fund's distribution rate was increased by 2.6%, approximately the rate of inflation, for the year ended August 31, 2006. This equated to an increase in the 2006 rate to \$.0482 per unit from the 2005 rate of \$.047 per unit. The 2005 rate was not increased from the fiscal year ended August 31, 2004 rate. The fiscal year distributions represented 4.13% of the

## **PERMANENT HEALTH FUND**

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Fund's average net asset value for the year ended August 31, 2006, and 4.39% of the Fund's average net asset value for the year ended August 31, 2005.

3. There were no participant contributions to the Fund or withdrawals from the Fund during the years ended August 31, 2006 and 2005.

### **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.

### **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 the GEF units and a negligible amount of cash, the majority of the Fund's Statements of Fiduciary Net Assets is reflected in its investment in GEF units.

As of August 31, 2006, the Fund owned 6,359,817 GEF units representing an ownership percentage of 18.18%, compared to 6,628,710 GEF units representing an ownership percentage of 18.79% as of August 31, 2005. As of August 31, 2006 and 2005, the fair value of the GEF units was \$986.8 million and \$925.7 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.

## PERMANENT HEALTH FUND

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

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<b>Assets</b>			
General Endowment Fund Units	\$ 986.8	\$ 925.7	\$ 814.2
Cash and Cash Equivalents	0.2	0.2	0.2
<b>Net Assets Held in Trust</b>	<u>\$ 987.0</u>	<u>\$ 925.9</u>	<u>\$ 814.4</u>

### Statements 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 participant distributions.

The net increase in investments of the Fund was \$82.6 million during the year compared to \$131.3 million for the fiscal year ended August 31, 2005. Investment expenses totaled \$0.5 million for the fiscal years ended August 31, 2006 and 2005, and \$0.6 for the fiscal year ended August 31, 2004.

Distributions to participants totaled \$39.5 million for the year ended August 31, 2006 and \$38.5 million for the years ended August 31, 2005 and 2004.

The net increase in fiduciary net assets totaled \$61.1 million for the year ended August 31, 2006 compared to a net increase in fiduciary net assets of \$111.5 million for the year ended August 31, 2005.

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%.

## PERMANENT HEALTH FUND

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

	2006	2005	2004
Investment Income	\$ 101.2	\$ 150.6	\$ 108.6
Less Investment Expenses	(0.5)	(0.5)	(0.6)
Net Investment Income	100.7	150.1	108.0
Administrative Fee for UT System Oversight	0.1	-	-
Participant Distributions	39.5	38.6	38.6
Total Deductions	39.6	38.6	38.6
Change in Fiduciary Net Assets	61.1	111.5	69.4
Net Assets Held in Trust, Beginning of Period	925.9	814.4	745.0
Net Assets Held in Trust, End of Period	\$ 987.0	\$ 925.9	\$ 814.4

### 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](http://www.utimco.org).

## PERMANENT HEALTH FUND

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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>
<b>Assets</b>		
General Endowment Fund Units	\$ 986,754	\$ 925,661
Cash and Cash Equivalents	<u>274</u>	<u>237</u>
<b>Net Assets Held in Trust (820,000,000 Units)</b>	<u>\$ 987,028</u>	<u>\$ 925,898</u>
<b>Net Asset Value Held in Trust Per Unit</b>	<u>\$ 1.204</u>	<u>\$ 1.129</u>

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



## PERMANENT HEALTH FUND

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### Statements of Changes in Fiduciary Net Assets

Years Ended August 31, 2006 and 2005

(in thousands)

	<u>2006</u>	<u>2005</u>
<b>Additions</b>		
Investment Income		
Net Increase in Investments	\$ 82,649	\$ 131,345
Allocation of General Endowment Fund Net Investment Income	18,594	19,225
Interest	1	3
Dividends	-	1
Total Investment Income	<u>101,244</u>	<u>150,574</u>
Less Investment Expenses		
UTIMCO Management Fee	528	517
Other Expenses	<u>16</u>	<u>11</u>
Total Investment Expenses	<u>544</u>	<u>528</u>
Net Investment Income	<u>100,700</u>	<u>150,046</u>
<b>Total Additions</b>	<u>100,700</u>	<u>150,046</u>
<b>Deductions</b>		
Administrative Fee for UT System Oversight	46	32
Participant Distributions	<u>39,524</u>	<u>38,540</u>
<b>Total Deductions</b>	<u>39,570</u>	<u>38,572</u>
<b>Change in Fiduciary Net Assets</b>	61,130	111,474
Net Assets Held in Trust, Beginning of Period	<u>925,898</u>	<u>814,424</u>
<b>Net Assets Held in Trust, End of Period</b>	<u>\$ 987,028</u>	<u>\$ 925,898</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 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), which was 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, 2006, the Fund is the minority participant in the GEF, with ownership of 6,359,817 units, which represents 18.18% of the GEF. At August 31, 2005, the Fund held 6,628,710 units, which represented 18.79% of the GEF.

**PERMANENT HEALTH FUND**  
***Notes to Financial Statements (continued)***

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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 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 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 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 year ended August 31, 2006 the quarterly rate was \$.01205 per unit which equates to an annual rate of \$.0482 per unit and for the year ended August 31, 2005 the quarterly rate was \$.01175 per unit which equates to an annual rate of \$.047 per unit. The ratio of distributions to average net assets (12-quarter average) was 4.36% 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.

**PERMANENT HEALTH FUND**  
***Notes to Financial Statements (continued)***

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(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.

**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 transactions 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 18.18% and 18.79%, 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.

**PERMANENT HEALTH FUND**  
**Notes to Financial Statements (continued)**

GEF Investment Type	PHF Fund's Pro Rata Share August 31,		Rating
	2006	2005	
<b>Investments:</b>			
U.S. Government Guaranteed	\$ 88,831,313	\$ 77,213,077	Exempt from Disclosure
U.S. Government Non-Guaranteed:			
U.S. Agency	2,682,186	7,816,795	AAA
U.S. Agency	-	655,132	A
U.S. Agency Asset Backed	<u>30,057,998</u>	<u>35,683,902</u>	AAA
Total U.S. Government Non-Guaranteed	<u>32,740,184</u>	<u>44,155,829</u>	
Total U.S. Government	<u>121,571,497</u>	<u>121,368,906</u>	
Corporate Obligations:			
Domestic	5,917,455	4,928,159	AAA
Domestic	956,179	749,212	AA
Domestic	3,140,510	4,992,286	A
Domestic	4,031,577	3,435,382	BAA/BBB
Domestic	-	1,078,339	BBB
Domestic	27,035	756,002	BAA
Domestic	623,544	1,073,991	BA/BB
Domestic	51,315	436,952	BB
Domestic	145,209	44,658	BA
Domestic	1,057,177	538,392	B
Domestic	31,213	56,189	CAA
Domestic	-	52,088	CA
Domestic	21,377	-	CCC
Domestic	1,912	287,611	Rating Withdrawn
Commercial Paper	18,541,901	5,685,970	P
Commercial Paper	22,840,498	-	A
Foreign	938,548	1,388,457	AAA
Foreign	611,061	406,072	AA
Foreign	1,512,200	1,077,830	A
Foreign	1,285,030	476,018	BAA/BBB
Foreign	-	40,629	BBB
Foreign	-	67,293	BAA
Foreign	-	18,644	BA/BB
Foreign	-	5,395	B
Total Corporate Obligations	<u>61,733,741</u>	<u>27,595,569</u>	
Foreign Government and Provincial Obligations	6,746,046	10,339,213	AAA
Foreign Government and Provincial Obligations	2,150,279	2,169,108	AA
Foreign Government and Provincial Obligations	661,842	293,720	A
Foreign Government and Provincial Obligations	348,708	850,860	BAA/BBB
Foreign Government and Provincial Obligations	-	39,703	BAA
Foreign Government and Provincial Obligations	266,973	712,100	BA
Foreign Government and Provincial Obligations	-	107,850	B
Total Foreign Government and Provincial Obligations	<u>10,173,848</u>	<u>14,512,554</u>	
Other Debt Securities	290,653	790,157	AAA
Other Debt Securities	106,636	223,424	AA
Other Debt Securities	-	224,847	A
Other Debt Securities	679,497	734,436	BAA/BBB
Total Other Debt Securities	<u>1,076,786</u>	<u>1,972,864</u>	
Total Debt Securities	<u>\$ 194,555,872</u>	<u>\$ 165,449,893</u>	
Other Investment Funds - Debt	\$ 6,494,927	\$ 201,658	AAA
Other Investment Funds - Debt	9,403,482	-	AA
Other Investment Funds - Debt	<u>797,883</u>	<u>2,218,771</u>	BB
Total Other Investment Funds - Debt	<u>\$ 16,696,292</u>	<u>\$ 2,420,429</u>	
Cash and Cash Equivalents - Money Market Funds	\$ 94,874,160	\$ 95,943,861	AAA
Cash and Cash Equivalents - Other	1,182,946	2,009,161	Exempt from Disclosure
Total Cash and Cash Equivalents	<u>\$ 96,057,106</u>	<u>\$ 97,953,022</u>	
<b>Deposit with Brokers for Derivative Contracts:</b>			
U.S. Government Guaranteed	\$ 8,008,689	\$ 4,986,221	Exempt from Disclosure
Cash	2,342,435	731,457	Exempt from Disclosure
	<u>\$ 10,351,124</u>	<u>\$ 5,717,678</u>	
<b>Deposit with Broker for Securities Sold Short:</b>			
Cash	<u>\$ 732,697</u>	<u>\$ -</u>	Exempt from Disclosure

**PERMANENT HEALTH FUND**  
***Notes to Financial Statements (continued)***

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***(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.

**PERMANENT HEALTH FUND**  
**Notes to Financial Statements (continued)**

GEF Investment Type	Fund's Pro Rata Share			
	August 31,			
	2006	Modified	2005	Modified
	Value	Duration	Value	Duration
<b>Investments in Securities:</b>				
U.S. Government Guaranteed:				
U.S. Treasury Bonds and Notes	\$ 22,433,062	7.28	\$ 21,297,188	6.47
U.S. Treasury Strips	531,603	5.00	685,933	6.00
U.S. Treasury Bills	904,935	0.04	1,320,542	0.15
U.S. Treasury Inflation Protected	64,545,590	7.91	53,459,775	8.03
U.S. Agency Asset Backed	416,123	5.88	449,640	2.34
Total U.S. Government Guaranteed	<u>88,831,313</u>	7.65	<u>77,213,078</u>	7.42
U.S. Government Non-Guaranteed:				
U.S. Agency	2,682,186	3.05	8,471,927	5.21
U.S. Agency Asset Backed	30,057,998	5.46	35,683,902	3.39
Total U.S. Government Non-Guaranteed	<u>32,740,184</u>	5.26	<u>44,155,829</u>	3.74
Total U.S. Government	<u>121,571,497</u>	7.00	<u>121,368,907</u>	6.08
Corporate Obligations:				
Domestic	16,054,014	4.41	18,429,261	5.06
Commercial Paper	41,332,888	0.07	5,685,970	0.23
Foreign	4,346,840	11.18	3,480,338	6.80
Total Corporate Obligations	<u>61,733,742</u>	1.98	<u>27,595,569</u>	4.28
Foreign Government and Provincial Obligations	<u>10,173,848</u>	6.52	<u>14,512,554</u>	8.54
Other Debt Securities	<u>1,076,786</u>	12.30	<u>1,972,863</u>	11.31
Total Debt Securities	<u>194,555,873</u>	5.41	<u>165,449,893</u>	5.90
Other Investment Funds - Debt	<u>16,696,291</u>	3.77	<u>2,420,429</u>	5.97
Cash and Cash Equivalents:				
Money Market Funds	94,874,160	0.08	95,943,861	0.08
Other	1,182,946	-	2,009,161	-
Total Cash and Cash Equivalents	<u>96,057,106</u>	0.08	<u>97,953,022</u>	0.08
Total	<u>\$ 307,309,270</u>	3.66	<u>\$ 265,823,344</u>	3.76
<b>Deposit with Brokers for Derivative Contracts:</b>				
U.S. Government Guaranteed:				
U.S. Treasury Bonds and Notes	\$ -	-	\$ 20,702	0.41
U.S. Treasury Bills	7,799,252	0.15	4,750,279	0.21
U.S. Treasury Inflation Protected	209,437	0.36	215,240	1.33
Total U.S. Government Guaranteed	<u>8,008,689</u>	0.16	<u>4,986,221</u>	0.26
Cash	<u>2,342,435</u>	-	<u>731,457</u>	-
Total Deposit with Brokers for Derivative Contracts	<u>\$ 10,351,124</u>	0.11	<u>\$ 5,717,678</u>	0.22
<b>Deposit with Broker for Securities Sold Short:</b>				
Cash	<u>\$ 732,697</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

**PERMANENT HEALTH FUND**  
***Notes to Financial Statements (continued)***

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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 \$6,563,375 and \$9,406,660 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 \$27,693,008 and \$18,262,471 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 \$2,407,495 and \$2,075,836 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 \$360,658 and \$933,412 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.



**PERMANENT HEALTH FUND**  
**Notes to Financial Statements (continued)**

GEF Investment Type	Fund's Pro-Rata Share	
	August 31,	
	2006	2005
<b>Foreign Common Stock:</b>		
Australian Dollar	\$ 1,551,517	\$ 1,902,447
Canadian Dollar	6,848,226	6,892,965
Swiss Franc	926,184	1,465,999
Danish Krone	340,018	459,750
Euro	4,065,576	11,466,061
UK Pound	4,951,252	4,051,811
Hong Kong Dollar	2,048,875	736,666
Japanese Yen	22,310,803	19,589,906
South Korean Won	611,893	302,404
New Zealand Dollars	66,122	-
Norwegian Krone	530,783	1,837,751
Swedish Krona	645,710	815,289
Singapore Dollar	1,042,960	1,064,632
Total Foreign Common Stock	45,939,919	50,585,681
<b>Other - Equity Securities</b>		
Canadian Dollar	5	-
<b>Foreign Government and Provincial Obligations:</b>		
Australian Dollar	-	83,622
Canadian Dollar	23,100	81,295
Danish Krone	90,793	95,580
Euro	8,140,313	10,739,086
Japanese Yen	399,895	-
New Zealand Dollar	61,147	152,245
Polish Zloty	331,323	293,720
UK Pound	-	1,018,420
Total Foreign Government and Provincial Obligations	9,046,571	12,463,968
<b>Corporate Obligations:</b>		
Euro	1,992,362	1,436,395
UK Pound	139,370	141,396
Japanese Yen	311,969	-
Total Corporate Obligations	2,443,701	1,577,791
<b>Purchased Options:</b>		
Canadian Dollar	6,595	127,201
Euro	92,941	6,803
UK Pound	14,082	-
Japanese Yen	306,662	-
Total Purchased Options	420,280	134,004
<b>Private Market Investment Funds:</b>		
Euro	10,434,168	9,262,106
UK Pound	496,265	820,573
Total Private Market Investment Funds	10,930,433	10,082,679
<b>Cash and Cash Equivalents:</b>		
Australian Dollar	16,503	11,882
Canadian Dollar	125,270	643,130
Swiss Franc	8,868	8,123
Danish Krone	3,170	4,341
Euro	187,499	267,941
UK Pound	92,237	(6,811)
Hong Kong Dollar	21,729	2,078
Japanese Yen	952,898	2,261,419
Norwegian Krone	7,361	982
New Zealand Dollar	50,939	1,546
Polish Zloty	36,891	16,903
Swedish Krona	24,633	918
Singapore Dollar	20,354	5,619
New Taiwan Dollar	60	62
Total Cash and Cash Equivalents	1,548,412	3,218,133
Total	\$ 70,329,321	\$ 78,062,256

**PERMANENT HEALTH FUND**  
**Notes to Financial Statements (continued)**

**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 GEF investment income, and the 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:

<b>GEF Securities on Loan</b>	<b>2006 Value</b>	<b>2005 Value</b>	<b>Type of Collateral</b>	<b>2006 Value of Collateral</b>	<b>2005 Value of Collateral</b>
U.S. Government	\$61,313,467	\$68,716,932	Cash	\$62,383,217	\$69,415,332
Foreign Government	2,203,533	3,464,476	Cash	2,313,380	3,627,498
Corporate Bonds	868,745	930,100	Cash	890,524	955,425
Common Stock	19,292,683	18,108,545	Cash	20,110,117	18,837,287
<b>Total</b>	<b>\$83,678,428</b>	<b>\$91,220,053</b>	<b>Total</b>	<b>\$85,697,238</b>	<b>\$92,835,542</b>
U.S. Government	\$4,079,466	\$1,421,295	Non-Cash	\$4,167,536	\$1,470,203
Common Stock	137,629	138,349	Non-Cash	140,416	143,110
<b>Total</b>	<b>\$4,217,095</b>	<b>\$1,559,644</b>	<b>Total</b>	<b>\$4,307,952</b>	<b>\$1,613,313</b>

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, 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 GEF 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.

**PERMANENT HEALTH FUND**  
**Notes to Financial Statements (continued)**

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	\$ 31,199,406	No Rating	14	\$ 43,746,987	No Rating	1
Commercial Paper	37,267,657	P	26	37,600,440	P	36
Floating Rate Notes	4,890,987	AAA		849,773	AAA	
Floating Rate Notes	3,512,959	AA		9,509,272	AA	
Total Floating Rate Notes	8,403,946		69	10,359,045		37
Certificates of Deposit	10,722,413	P	67	1,398,190	P	50
Asset Backed Securities	153,692	AAA	11	52,993	AAA	168
Other Receivables/Payables	(2,049,877)	Not Rated	-	(322,114)	Not Rated	-
Total Collateral Pool Investment	<u>\$ 85,697,237</u>		31	<u>\$ 92,835,541</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 \$528,017, net of a rebate of \$176,800 of excess reserves from UTIMCO to the Fund. The fee assessed for the year

## **PERMANENT HEALTH FUND**

### ***Notes to Financial Statements (continued)***

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ended August 31, 2005, was \$516,757, net of a rebate of \$169,581 of excess reserves from UTIMCO to the Fund.

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. For the years ended August 31, 2006 and 2005, the fees amounted to \$46,295 and \$31,793, 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.

**PERMANENT HEALTH FUND**  
**Supplemental Schedules**

**Financial Highlights**

*Years Ended August 31,*

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>Selected Per Unit Data</b>					
Net Asset Value, Beginning of Period	\$ 1.129	\$ 0.993	\$ 0.908	\$ 0.852	\$ 0.965
Income From Investment Operations					
Net Investment Income	0.022	0.023	0.019	0.017	0.018
Net Realized and Unrealized Gain (Loss) on Investments	<u>0.101</u>	<u>0.160</u>	<u>0.113</u>	<u>0.086</u>	<u>(0.084)</u>
Total Income (Loss) from Investment Operations	<u>0.123</u>	<u>0.183</u>	<u>0.132</u>	<u>0.103</u>	<u>(0.066)</u>
Less Distributions					
From Net Investment Income	0.022	0.023	0.019	0.017	0.018
From Net Realized Gain and In Excess of Net Realized Investment Return	<u>0.026</u>	<u>0.024</u>	<u>0.028</u>	<u>0.030</u>	<u>0.029</u>
Total Distributions	<u>0.048</u>	<u>0.047</u>	<u>0.047</u>	<u>0.047</u>	<u>0.047</u>
Net Asset Value, End of Period	<u>\$ 1.204</u>	<u>\$ 1.129</u>	<u>\$ 0.993</u>	<u>\$ 0.908</u>	<u>\$ 0.852</u>
<b>Ratios and Supplemental Data</b>					
Net Assets, End of Period (in thousands)	\$ 987,028	\$ 925,898	\$ 814,424	\$ 744,961	\$ 698,250
Ratio of Expenses to Average Net Assets	0.39%	0.32%	0.31%	0.27%	0.27%
Ratio of Net Investment Income to Average Net Assets	1.88%	2.13%	1.92%	2.01%	1.91%
Ratio of Distributions to Average Net Assets (5-quarter average)	4.13%	4.39%	4.81%	5.48%	5.05%
Ratio of Distributions to Average Net Assets (12-quarter average)	4.36%	4.79%	5.14%	5.08%	4.66%