P
U
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PERMANENT UNIVERSITY FUND

75 years

# evolution

**Investment Report** for the year ended August 31, 1998

oil and
gas
production

# historical value

The investment history of the Permanent University Fund began in 1923 with the discovery of oil and gas at the Santa Rita No. 1 well.

1923

# Contents

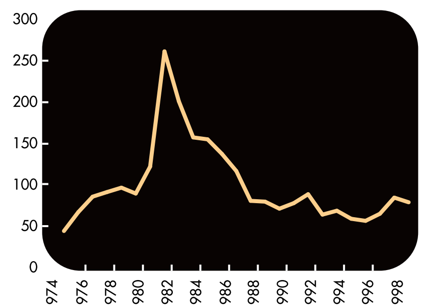


A detailed schedule of investment in securities at August 31, 1998 is available on the UTIMCO website at www.utimco.org

**The 75 year investment history of the Permanent University Fund (the "PUF") originated in 1923 with the discovery of oil and gas from the legendary Santa Rita No. 1 well.** In 1926, the Texas Supreme Court ruled that the proceeds from the sale of mineral production from PUF lands should be considered proceeds from the sale of the corpus of the estate, and therefore invested as endowment corpus. The mineral income contributed to the PUF investment portfolio over the ensuing 75 years has totaled $3.1 billion. PUF mineral royalties represent the foundation for the creation and development of two major public institutions of higher education in the State of Texas; The University of Texas System and The Texas A&M University System.

During the first 60 years following the initial discovery of oil in 1923, mineral royalties were the primary factor in the growth of both PUF corpus and the distributed investment income to the Available University Fund ("AUF"). Investment appreciation during this same time period was nominal as the majority of the mineral royalties were invested in bonds which were then held to maturity. Growth in distributions to the AUF was facilitated by the steady contribution of mineral royalties which were invested in bonds at consecutively higher yields due to rising interest rates. During the 1970's and into the mid 1980's following the OPEC oil embargo, the role of mineral royalties in growing PUF investment income was magnified. Mineral royalties and lease bonuses surged as both production and prices spiked and reached 23% of the value of the investment portfolio in 1981 alone. Growth in investment income was further enhanced by the investment of royalties at doubledigit interest rates available during this period of high inflation. Following the mid 1980's, there has been a continual decline in interest rates accompanied by a decline in mineral royalties earned from mature oil and gas fields.

Mineral Royalties and Lease Bonuses Per Year
($ millions)

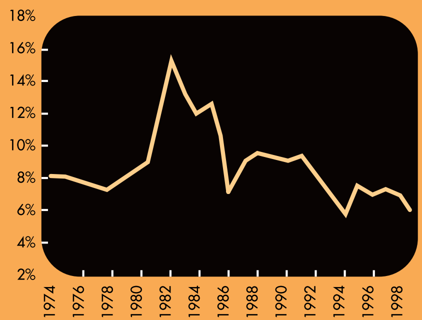





Today, annual royalties and lease bonuses earned from mature oil and gas fields constitute 1% of the total value of the PUF investment portfolio. It is clear that future growth in annual PUF distributions to the AUF must be generated through return on investment capital. Furthermore, the imperative to maintain both the productive capacity of the education infrastructure and the reputation of flagship academic programs funded with PUF distributions requires that distributions grow on an inflation adjusted basis. Preservation of the purchasing power of PUF distributions over the long term can only occur by tying distributions to the AUF based on the market value of PUF investment assets.

Unfortunately, current constitutional provisions governing the PUF ignore preservation of endowment purchasing power. The Texas Constitution mandates the distribution of all interest and dividend income to the AUF and prohibits the distribution of realized and unrealized gains. These constitutional provisions reflect an era when fixed rate bonds were the only eligible investment, and mineral income, not investment appreciation, was the source of income growth. Today, these provisions are incompatible with universal endowment policies that restrict distributions to the average total investment return after inflation. The Constitution's income based distribution policy divorces distributions from the total investment return earned on endowment assets and often contributes to financial disequilibrium. Such was the case during the 1980's when income should have been reinvested and during the 1990's when gains should have been distributed, to preserve purchasing power.

**10 Yr. U.S. Treasury Yields**




The PUF's transition from a mineral based fund to an investment based fund accelerated during the 1990's. Since 1990, cumulative PUF investment return has totaled $4.4 billion or $1.3 billion more than all mineral royalties and lease bonuses contributed since inception in 1923. Despite the above average investment returns and low inflation since 1990, annual PUF distributions to the AUF declined by 1.8% in nominal dollars and by approximately 25.9% when adjusted for inflation on a cumulative basis. Under the Constitution, growth in PUF distributions is determined in large part by the interest rate spread on the reinvestment of maturing bonds, not the total return on PUF investments. This spread has been negative during the 1990's as high coupon bonds acquired during the 1970's and 1980's have matured and been replaced by low coupon bonds. Without the ability to distribute a portion of the considerable securities gains generated during this same period, accrued income growth has been non-existent. The result has been a significant loss in the purchasing power of the PUF distributions used by the U. T. System and The Texas A&M University System to fund teaching, research and health care programs across the State.

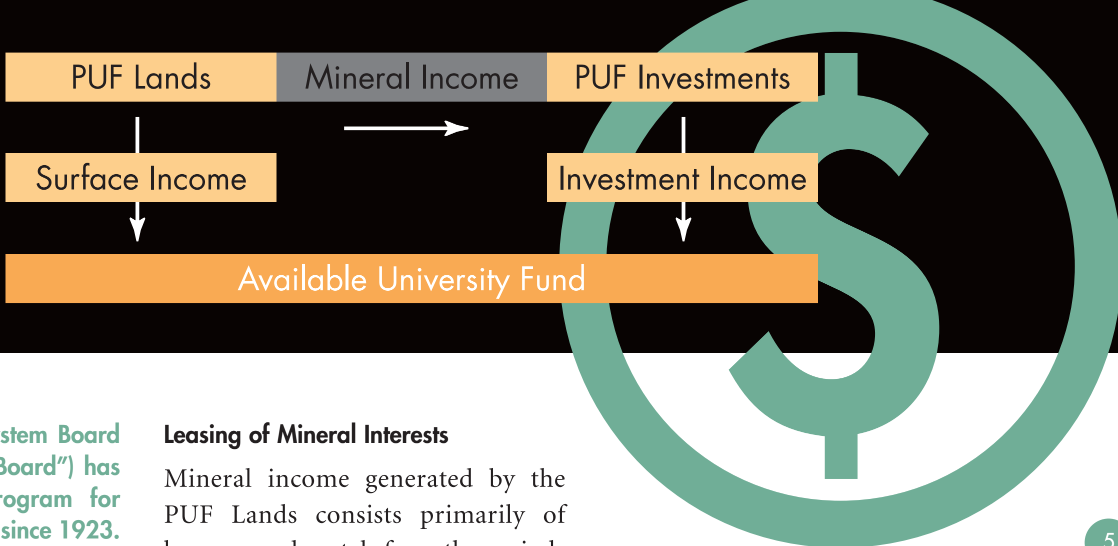
Working within the constraints of the Constitution, the U. T. System Board of Regents, through The University of Texas Investment Management Company ("UTIMCO"), has sought to offset a portion of the continuing losses in the purchasing power of AUF distributions by increasing the PUF's allocation to equity securities. This approach, however, is imperfect in that dividend growth comes at the price of lower distributable yields. Notwithstanding these limitations, the U. T. System Board and UTIMCO are committed to identifying strategies to enhance income growth. Only in this manner can the West Texas land grants and the legacy of the Santa Rita deliver the enduring support for academic excellence at the U. T. System and Texas A&M University System originally envisioned by the Legislature in 1839.

**Donald L. Evans,** Chairman (standing)
Board of Regents
The University of Texas System

**Thomas O. Hicks,** Chairman (seated)
Board of Directors
The University of Texas Investment Management Company

Regent
The University of Texas System

**The Permanent University Fund is a public endowment contributing to the support of certain institutions of The University of Texas System and The Texas A&M University System. The PUF was established in the Texas Constitution of 1876 through the appropriation of land grants previously given to The University of Texas at Austin plus one million acres. The land grants to the PUF were completed in 1883 with the contribution of an additional one million acres of land.**




**The University of Texas System Board of Regents ("U. T. System Board") has maintained an active program for leasing of mineral interests since 1923.**

### Leasing of Surface Interests

Surface acreage of the sparsely-populated PUF Lands has been leased primarily for grazing and easements for power lines and pipelines.

During the period 1970-1990, surface income grew rapidly to reach $5 million per year by 1987. Since then, surface income has leveled off and fluctuates in the $4-5 million range per year. As mandated by the Constitution, all surface income from the PUF Lands is distributed to the AUF and expended in the year in which it is earned.

### Leasing of Mineral Interests

Mineral income generated by the PUF Lands consists primarily of bonuses and rentals from the periodic sale of mineral leases and royalties on gross revenues from oil, gas, and sulfur production. Additional mineral income is generated through royalties and rentals of water and other miscellaneous income.

As interpreted by the Supreme Court of the State of Texas and the Attorney General for the State of Texas, constitutional provisions governing the PUF require that all proceeds from the sale of lands and leasing of minerals be invested in securities. Furthermore, all net realized gains from the sale of securities must be reinvested as corpus and may not be distributed to the AUF and expended.

On January 10, 1901 the discovery of oil at Spindletop ushered in drilling along the Texas Gulf Coast and marked the birth of the modern oil industry. Flowing at a rate of 100,000 barrels a day, Spindletop was the first well to prove conclusively that the earth contained vast quantities of oil which could be successfully produced.

### Investment of Mineral Royalties and Lease Bonuses

The Constitution delegates to the U. T. System Board the authority to invest PUF assets. Initially, the investment of PUF mineral income was restricted by the Constitution to bonds of the U.S. Treasury and State of Texas. Throughout the 20th century, the definition of eligible investments under the Constitution has been amended to reflect the evolution of securities markets and trust law. Investment in corporate stocks and bonds was made possible in 1956. Most recently, in 1988, the Constitution was amended to authorize the U. T. System Board to invest the PUF in accordance with the "prudent person" investment standard.

In order to enhance the process by which PUF investments are governed and managed, the U. T. System Board on March 1, 1996, contracted with The University of Texas Investment Management Company ("UTIMCO") to invest all funds under its fiduciary control. UTIMCO is a 501(c)(3) corporation formed in March of 1996 to invest endowment and other assets of the Board. UTIMCO is governed by a board of directors with experience in investment management. UTIMCO's governance structure is designed both to preserve ultimate regental control of investments for fiduciary purposes and to increase the level of investment expertise in the governance of investments. Day-to-day management of funds is delegated to UTIMCO's employees, who provide a full range of investment services exclusively to the U. T. System Board.

### Distribution of Income Return from the PUF to the AUF

The Constitution requires that the dividends, interest, and other income from PUF investments be distributed to the AUF.

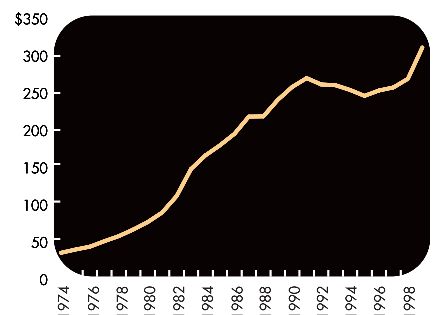
In accordance with this constitutional distribution policy, a cumulative $4.8 billion, or approximately 58% of the $8.2 billion of cumulative investment return generated since 1923 has been distributed to the AUF for expenditure in support of the U. T. System and The Texas A&M University System.

The cumulative contributions, investment return and distributions of income return to the AUF are summarized below.

**1923-1998** (millions)

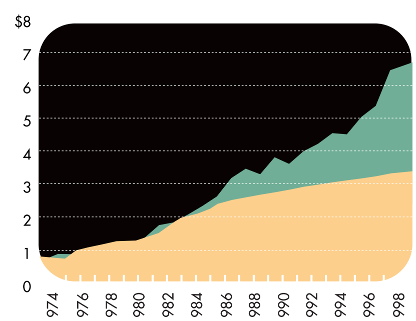
| | |
|---|---|
| Beginning Market Value (1923) | $ – |
| Contributions of Mineral Income from PUF Lands | 3,145.7 |
| Investment Return | 8,163.2 |
| Distributions of Income Return to the AUF | (4,791.8) |
| Ending Market Value (1998) | $6,517.1 |

**Distributions of PUF Income to the AUF 1973-1998** ($ millions)




1998 includes a special distribution of $47.3 million (see Income Distributions to the AUF)

**PUF Asset Growth 1973-1998** ($ billions)



Operations

Historic Claudia Taylor Johnson Hall, located in downtown Austin, is the site for UTIMCO's operations. This building was constructed in 1915 and served as the U.S. Post Office until its renovation for office space by the U. T. System.

The PUF began receiving a standard one-eighth oil royalty from the wells drilled on PUF lands. Within a decade both U. T. Austin and Texas A&M University were able to expand their campuses to accommodate increased enrollment because of this new source of funds.



### Funding of Administrative Expenses

The U. T. System Board, as trustee for the PUF, incurs costs in the management of PUF Lands and Investments. Texas statutes require that all administrative expenses be paid from the AUF. This constraint means that investment expenses incurred to produce both income return and price return must be paid from the income portion of investment return only.

### Funding of Permanent Improvements

Under the Constitution, PUF income return and surface income distributed from the PUF to the AUF – rather than State general revenue appropriations – are used by the U. T. System and the Texas A&M University System as a major source of funding for capital expenditures at eligible component institutions. The Constitution authorizes the U. T. System Board and the Texas A&M University System Board to issue bonds payable from their respective interests in annual distributions to the AUF to finance construction and renovation projects, major library acquisitions, and educational and research equipment at the 17 eligible campuses of their systems. The U. T. System Board and the Texas A&M University System Board are authorized to issue bonds secured by each System's interest in PUF distributions in an amount not to exceed 20% and 10%, respectively, of the book value of PUF assets at the time of issuance.

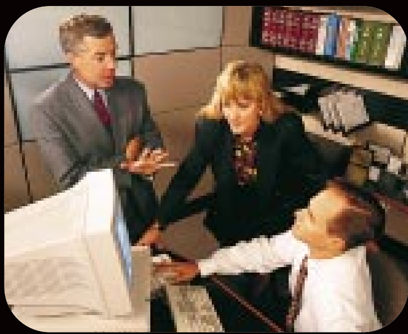
Since bond issuance was first authorized in 1932, the U. T. System and the Texas A&M System have issued a combined total of $1.81 billion of bonds to fund the acquisition of permanent improvements. To date, $1.48 billion of distributions from the PUF to the AUF has been expended by the two systems to fund debt service on PUF bonds. The outstanding PUF bonds have been assigned ratings of AAA, Aaa and AAA by Fitch IBCA, Moody's Investors Service, Inc. and Standard & Poor's Rating Group, respectively.

### Funding of Excellence Programs

The residual annual distributions from the PUF to the AUF, after administrative expenses and debt service on PUF bonds, are dedicated to the funding of excellence programs at The University of Texas at Austin and Texas A&M University at College Station and system administration. Expenditures for excellence programs encompass library enhancements, specialized science and engineering equipment, student counseling services, graduate student fellowships, National Merit and other scholarships.

**PUF Financial Highlights** (in millions)

| For the Year Ended August 31, | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|
| PUF Mineral Contributions | $ 59.6 | $ 57.1 | $ 65.7 | $ 85.2 | $ 79.5 |
| Investment Return | 150.1 | 724.4 | 522.1 | 1,254.0 | 329.3 |
| Investment Assets (market value) | 4,428.0 | 4,958.5 | 5,292.1 | 6,368.3 | 6,517.1 |
| Distributions to the AUF | | | | | |
| Investment Income | 242.3 | 249.5 | 253.6 | 265.2 | 260.0 |
| One-time Adjustment* (cash to accrual distribution of income) | | | | | 47.3 |
| AUF Surface and Other Income | 5.1 | 4.3 | 5.3 | 5.7 | 6.9 |
| Administrative Expenses | $ 9.6 | $ 9.5 | $ 9.0 | $ 10.8 | $ 10.7 |



Strategy

UTIMCO staff frequently work together using the latest investment software to evaluate investment opportunities.

PUF BENEFICIARIES



U. T. Arlington
U. T. Austin
U. T. Dallas
U. T. El Paso
U. T. Permian Basin
U. T. San Antonio
U. T. Tyler
U. T. Southwestern Medical Center at Dallas
U. T. Medical Branch at Galveston
U. T. Health Science Center at Houston
U. T. Health Science Center at San Antonio
U. T. M.D. Anderson Cancer Center
U. T. Health Center at Tyler

Texas A&M University
Texas A&M at Galveston
Texas A&M at Prairie View
Texas A&M at Tarleton State
Agencies of Texas A&M University System

### Contributions

Contributions of mineral royalties and lease bonuses to PUF corpus decreased by 6.6% from $85.2 million to $79.5 million. Of this total, 50.2% was contributed by royalties on the production of crude oil, which decreased by 13.5% to $39.9 million. Average oil prices during the year decreased by $5.40 per barrel to $15.05 per barrel. Production for the year increased by 915,377 barrels, or by 5.9% to 16,441,820 barrels. Royalties on the production of gas accounted for approximately 31.2% of fiscal year mineral income. Gas royalties increased by 4.6% from $23.7 million to $24.8 million. This increase was a result of an increase in gas and casinghead production combined with a slight decrease in wellhead gas prices. Wellhead gas prices for the fiscal year averaged $2.40 per mmbtu while production increased by 8,847,855 mcf to 81,741,748 mcf. Renewal of oil and gas leases and miscellaneous royalties accounted for 3.0% of the mineral income for 1998. Finally, roughly 15.6% of fiscal year mineral contributions was generated by bonuses paid on the sale of oil and gas leases covering 485,455 acres. Bonuses contributed $12.4 million to the PUF, representing a decrease of 10% when compared to the prior year. As of year end, 1.34 million acres out of the 2.1 million acres of PUF land were under mineral leases, the highest level in the history of the PUF.

### Investment Return

During the year, the PUF produced income, net realized gains, and net unrealized gains of $329.3 million. This represented a 73.7% decrease from the prior year's return of $1,254.0 million. Of the $329.3 million return, $260.0 million was income return and $69.3 million was price return. In accordance with statutory requirements, the income return of $260.0 million was distributed to the AUF and the price return of $69.3 million was retained as PUF corpus.

### Fund Market Value

The market value of the PUF's investment (net of distributions) grew by 2.3% during the year to $6,517.1 million. The components of the $148.8 million growth in value were contributions of $79.5 million, net realized gains of $467.6 million, and net unrealized losses of $398.3 million.

### Income Distributions to the AUF

As stated previously, the Constitution requires that the dividends, interest, and other income from PUF investments be distributed to the AUF. Effective September 1, 1997 a statutory amendment changed the distribution of income from cash to an accrual basis of accounting. This change resulted in a one time distribution adjustment to the AUF of $47.3 million. During the year accrued investment income of $260.0 million was distributed to the AUF in addition to this one-time adjustment. The distribution of $260.0 million represented a decrease of 1.1% from the prior year's accrued income of $263.0 million. When added to surface income of $6.6 million and miscellaneous interest income on AUF balances, total gross divisible AUF income decreased by 0.7% to $266.9 million total. Total PUF administrative expenses during the year decreased by 0.9% to $10.7 million. Within this total, expenses associated with the management of PUF lands increased by 7.5% from $4.0 million to $4.3 million. Expenses associated with the management of PUF investments decreased by 5.9% from $6.8 million to $6.4 million, and represented 0.10% of average PUF market value. After deducting PUF administrative expenses, net divisible AUF income available for expenditure by the U. T. System and The Texas A&M University System decreased by 0.7% to $256.2 million.

### Investment Objectives

The primary investment objective of the PUF is to preserve the purchasing power of Fund assets and annual distributions by earning an average annual total return after inflation of 5.5% over rolling ten-year periods or longer. The Fund's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objective is to generate a fund return in excess of the policy portfolio benchmark over rolling five-year periods or longer. The policy portfolio benchmark is established by UTIMCO and is comprised of a blend of asset class indices weighted to reflect the asset allocation policy of a conventional endowment fund.

**Achievement of the Fund's investment objectives is substantially hindered by the inability to make distributions to the AUF on a total return basis. The objective to preserve the purchasing power of the distribution stream subordinates the fund's allocation among various asset classes to the management of income return. In an environment of low or declining interest rates, the U. T. System Board must allocate a higher than optimal percentage of PUF investment assets to higher-yielding, fixed income securities in order to maintain distributions on a level-dollar basis.**

# Primary Investment Objectives

1.2.3.

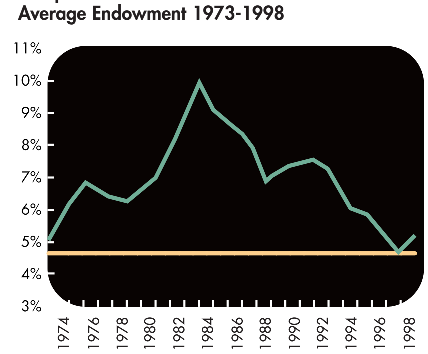
**Investment Performance Against Inflation Benchmarks** There are three primary investment objectives for the PUF. 1. Provide the U. T. System and Texas A&M University System with a stable and predictable stream of distributions to the AUF. 2. Maintain the purchasing power of this distribution stream. 3. Maintain the purchasing power of the PUF's investment assets after distributions to the AUF.

### Investment Performance

It is important to note that these primary objectives are contradictory in that they require the balancing of current distributions with growth in future distributions. Higher rates of annual distributions require larger annual withdrawals from the PUF, thus reducing the PUF's ability to maintain or grow purchasing power over time. The key to preservation of endowment purchasing power over the long term is to control the distribution stream by employing a neutral distribution rate. Control of the PUF's distribution rate, however, is difficult because of the legal restraints imposed by the Texas constitution. The PUF's distribution stream is the PUF's income return. Income return is heavily influenced by market-driven variables, such as interest rates, which determine the levels of distributable interest, and dividend income.

The majority of U.S. colleges and universities set endowment distribution rates around 4.5% of the endowment's average market value. This distribution rate is chosen because it represents the average investment return after inflation, that has been generated by the securities markets over time using an equity oriented asset allocation. The chart below presents the volatility of the PUF's average distribution rate over the last 25 years.

**Comparison of PUF Distribution % to the Average Endowment 1973-1998**




1998 includes one time adjustment of $47.3 million

The PUF's investment performance against its primary benchmarks are as follows:

**Provide the U. T. and Texas A&M Systems with a stable and predictable stream of distributions to the AUF.**

The PUF's accrued investment income decreased by 1.1% versus the prior fiscal year. For the preceding five-year period, starting with the fiscal year ended August, 1994, the rate of increase (decrease) in the PUF's accrued investment income was (1.0)%, 0.2%, 1.3%, 3.4% and (1.1)%.

**Maintain purchasing power of this distribution stream over the long term.**

Accrued investment income of $260.0 million for the year decreased by a nominal rate of 1.1% and decreased by an inflation adjusted rate of 2.7%.

Interest income from fixed income securities, which represented approximately 67% of total distributable income, declined by 5.1% to $174.0 million. Replacement of existing coupon rates on maturing bonds during this phase of the interest rate cycle continues to represent a major impediment to the preservation of the purchasing power of annual distributions. Dividend income from equities, on the other hand, despite a substantially lower book yield than fixed income investments, continued to grow, increasing by 10.7% to $72.6 million. Income from alternative equities decreased by 25.2% to $8.9 million. Miscellaneous income increased by 114% to $4.5 million. During the preceding five years, accrued investment income increased from $253.0 million in fiscal year 1993 to $260.0 million in fiscal year 1998, or by 2.8% in nominal terms. The cumulative rate of inflation during this period was 12.8%, resulting in a cumulative loss in purchasing power over this period of 10.0%. Again, this loss in distributions to the AUF was attributable to the inability to replace yields on the fixed income portfolio. Since fiscal year end 1990, the distributable (book) yield on the fixed income portfolio has declined by approximately 22%, from 9.9% to 7.7%.

**Maintain the purchasing power of PUF's investment assets after distributions to the AUF.**

Despite the 38% year end allocation to fixed income securities and an above-average distribution rate, the PUF's investment assets generated net real returns after distributions of (1.1)% and 4.1% for the one-year and five-year periods ending August 31, 1998, respectively.

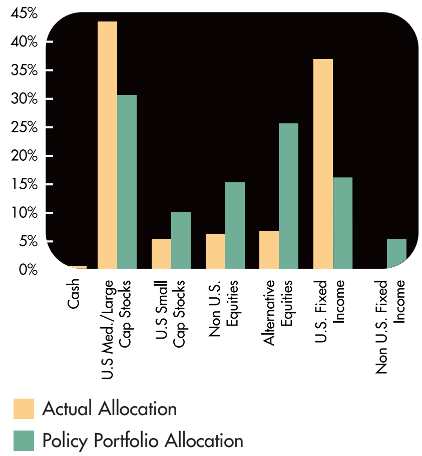
| | 1 Yr | 5 Yrs (annualized) |
|---|---|---|
| Total Return | 5.0% | 11.5% |
| Inflation Rate | (1.6)% | (2.4)% |
| Net Real Return | 3.4% | 9.1% |
| Distributions to the AUF* | (4.5)% | (5.0)% |
| Net Real Return (net of distributions) | (1.1)% | 4.1% |

* includes one time adjustment of $47.3 million

### Asset Allocation

Asset allocation is the primary determinant of performance. As previously discussed the PUF's allocation to equity asset classes is compromised because of the constitutionally mandated payout formula to the AUF. As of August 31, 1998, the actual asset allocation of the PUF's investments versus the neutral policy allocation is shown in the chart below.

**Actual Allocation vs. Policy Portfolio Allocation**




### Secondary Objective - Investment Performance Against Policy Portfolio Benchmark

For the year, the PUF's investment assets produced a total return of 5.0% versus a return for the neutral policy portfolio of 3.0%. The outperformance relative to the policy portfolio was attributable primarily to an overweighting in fixed income securities and an underweighting in small cap and international equities. For the year ended August 31, 1998, domestic fixed income outperformed equities on a broad basis. The policy portfolio's asset allocation is 80% to broadly defined equities. In order to achieve the objective of maintaining a stable income stream to the AUF, fixed income securities with higher yields, but lower long term total returns than equities, were overweighted relative to the policy for the PUF.



**Period Ended August 31, 1998**

| **Total Return** | 1 yr | 2 yrs | 3yrs | 5 yrs | 7 yrs |
|---|---|---|---|---|---|
| Permanent University Fund | 5.0% | 14.0% | 12.9% | 11.5% | 11.6% |
| Benchmark: Policy Portfolio Return | 3.0% | 14.0% | 14.0% | 13.1% | 13.5% |

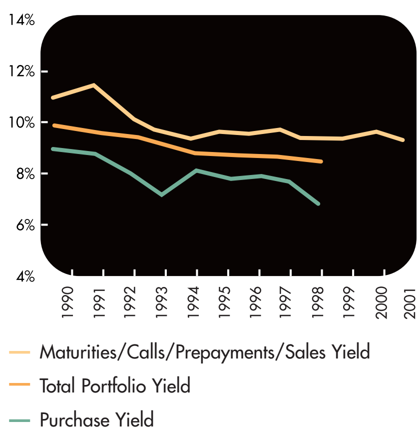
## Fixed Income Investments

The role of fixed income investments is to provide income for distributions. Fixed income investments are managed for yield and minimization of income volatility, primarily using a buy and hold strategy. This strategy is employed because constitutional constraints substantially inhibit the ability to sell fixed income investments for gain without creating income volatility. During periods of declining interest rates, the sale of appreciated fixed income securities to realize gains will reduce distributable income upon reinvestment of proceeds. The realized gains may not be distributed to the AUF to offset the loss in yield. The loss in purchasing power of the annual distributions to the AUF is attributable to the inability of the Fund to replace yields on maturing fixed income securities as presented in the chart to the left.

The fixed income portfolio generated a total return of 12.9% for the year versus 10.6% for its benchmark, the Lehman Brothers Aggregate Index. The outperformance of the portfolio versus its benchmark was primarily attributable to the fact that it had a higher income component with a longer average life than the benchmark.

At fiscal year end, the average quality rating of the fixed income portfolio was Aa2. Only 1.8% of the portfolio was below investment grade or not rated by Moody's Investors Services.

**Fixed Income Portfolio Yields**






**Fixed Income Investments-Performance**

| | 1 yr | 2 yrs | 3 yrs | 5 yrs | 7 yrs |
|---|---|---|---|---|---|
| Fixed Income Portfolio | 12.9% | 12.1% | 9.3% | 8.0% | 9.5% |
| Benchmark:Lehman Brothers Aggregate Index | 10.6% | 10.3% | 8.2% | 6.8% | 8.3% |

## Innovation

Innovation in the securities markets has increased exponentially over the last twenty-five years. PUF investments are distributed across multiple asset classes ranging from highly efficient listed securities to less efficient unlisted securities traded in private markets.

## Equity Investments

The U.S. equity markets generated below average rates of returns over this reporting cycle. The return of PUF's U.S. equities portfolios for the year was (.8)%. The PUF's U.S. equities totaled $3,106.7 million and represented 47.7% of the PUF's investment assets at fiscal year end. The composition of the U.S. equity investments was the following:

**U.S. Equity Investment Portfolios**

| | |
|---|---|
| S&P Index Fund | 31.8% |
| Large Cap Growth | 18.7% |
| REIT's | 7.5% |
| Equity Income/Value | 13.6% |
| Mid-Cap Index | 18.2% |
| Small Cap Growth and Value | 10.2% |
| Total | 100.0% |

## Non-U.S. Equities

Non-U.S. equities also generated below average returns over this reporting cycle. The PUF's total return attributable to non-U.S. equities for the year was 4.4%. The PUF's non-U.S. equity portfolios totaled $424.6 million and represented 6.5% of the PUF's investment assets at year end.

## Alternative Equities

The alternative equities portfolio return reflects the relatively large amount of capital invested in this asset class during the year. As explained in the following paragraph, it takes several years before the alternative equity portfolio will realize returns from new investments. The PUF's alternative equities totaled $494.1 million and represented 7.6% of the PUF's investment assets at year end.

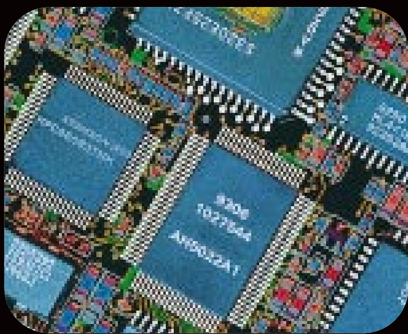
Alternative equities consist of illiquid investments held directly or through limited partnerships. They include private equity, leveraged buy-outs, mezzanine debt, oil and gas, and venture capital investments that are privately held and not traded on public exchanges. These investments require a commitment of capital for extended periods of time with no liquidity. The advantage of alternative assets is that they offer higher long term returns through investment in inefficient and complex markets. They also offer lower correlation of returns with traditional equities and reduced volatility of investment values. The disadvantage of this asset class is that it is illiquid, and is dependent upon the quality of external managers.



| U.S. Equities-Performance | 1 yr | 2 yrs | 3 yrs | 5 yrs | 7 yrs |
|---|---|---|---|---|---|
| **Total U.S. Equities** | (0.8)% | 17.2% | 17.2% | 15.3% | 13.8% |
| Benchmark: Russell 3000 Index | 3.5% | 19.7% | 18.9% | 16.5% | 15.6% |
| Benchmark: S&P 500 Index | 8.1% | 23.3% | 21.8% | 18.2% | 16.3% |

| Non-U.S. Equities-Performance | 1 yr | 2 yrs | 3 yrs | 5 yrs | 7 yrs |
|---|---|---|---|---|---|
| **Total Non-U.S. Equities** | 4.4% | 8.4% | 8.8% | 7.7% | – |
| Benchmark: F.T. Actuaries World (ex. U.S.) Index | (5.0)% | 1.8% | 3.9% | 4.4% | 6.7% |

| Alternative Equities-Performance | 1 yr | 2 yrs | 3 yrs | 5 yrs | 7 yrs |
|---|---|---|---|---|---|
| **Total Alternative Equities** | 8.7% | 12.9% | 17.1% | 22.9% | 16.9% |
| Benchmark: S&P 500 Index +5% | 13.6% | 29.5% | 27.9% | 24.2% | 22.1% |



## Diversification

Information technology and telecommunications have led to increased integration of world financial markets and greater opportunities for diversification of PUF investments.

# THE UNIVERSITY OF TEXAS SYSTEM

## Board of Regents

### Officers

**Donald L. Evans,** Chairman

**Tom Loeffler,** Vice-Chairman

**Rita Crocker Clements,** Vice-Chairman

**Francie A. Frederick,** Executive Secretary

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**Martha E. Smiley,** Austin

### Members (Terms Expire February 1, 2001)

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### Members (Terms Expire February 1, 2003)

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**A.W. "Dub" Riter, Jr.,** Tyler

**A.R. (Tony) Sanchez, Jr.,** Laredo

## University Lands

### West Texas Operations

**Stephen Hartmann,** Executive Director

**Bryce C. Bales,** Manager, University Lands Accounting Office

**James L. Benson,** Manager of Surface Interests

**Wallace V. Gravitt,** Manager of University Lands - Oil, Gas and Mineral Interests

## System Administration

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**Charles B. Mullins, M.D.,** Executive Vice Chancellor for Health Affairs

**R.D. (Dan) Burck,** Executive Vice Chancellor for Business Affairs

**Edwin R. Sharpe,** Vice Chancellor for Academic Affairs

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**Joyce Moos,** Executive Associate to the Chancellor

**Lewis W. Wright,** Associate Vice Chancellor for Business Affairs and Assistant Vice Chancellor for Governmental Relations

**Dale Klein,** Associate Vice Chancellor for Special Engineering Programs

**Thomas G. Ricks,** President and Chief Executive Officer, UTIMCO

**Francie A. Frederick,** Executive Secretary to the Board of Regents



# THE UNIVERSITY OF TEXAS INVESTMENT MANAGEMENT COMPANY

## Officers

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**Thomas G. Ricks,** President and Chief Executive Officer

**Austin M. Long, III,** Managing Director-Private Markets

**David H. Russ,** Managing Director-Public Markets

**Cathy A. Iberg,** Vice President, Secretary-Treasurer

## Legal Counsel

**Vinson & Elkins, LLP,** Austin, Texas

## Independent Auditors

**Deloitte & Touche, LLP,** Houston, Texas

## Thomas O. Hicks

**Chairman of the Board and Chief Executive Officer,** Hicks, Muse, Tate & Furst Incorporated, **Chairman of the Board,** The University of Texas Investment Management Company, **Regent,** The University of Texas System, **Chairman of the Board and Owner,** Dallas Stars Hockey Club, **Chairman of the Board and Owner,** Texas Rangers Baseball Club, **Chairman of the Board,** Chancellor Media Corporation, **Director,** CCI Holdings, **Director,** CEI Citicorp Holdings, **Director,** CorpGroup Limited, **Director,** Home Interiors & Gifts, Inc., **Director,** International Home Foods, **Director,** MVS Corporation, **Director,** Olympus Real Estate Corporation, **Director,** Regal Cinemas, Inc., **Director,** Stratford Capital Partners, **Director,** Sybron International Corporation

## Robert H. Allen

**Regent,** The Texas A&M University System, **Managing Partner,** Challenge Investment Partners, **Director,** FDX Corporation, **Director,** Gulf Canada Resources, Limited, **Chairman of the Board,** Gulf Indonesia Resources, Ltd., **Trustee,** Baylor College of Medicine

## Susan M. Byrne

**Founder, President and Chief Executive Officer,** Westwood Management Corporation, **President,** Westwood Funds, **Director,** Dallas Forum, **Director,** Dallas Institute of Humanities, **Director,** Dallas Theater Center, **Director,** Texas International Theatrical Arts Society, **Trustee,** City of Dallas Employee Retirement Fund, **Member,** Texas Governor's Business Council

## William H. Cunningham

**Chancellor,** The University of Texas System, **Director,** John Hancock Funds, **Director,** Jefferson-Pilot Corporation



## J. Luther King, Jr.

**Principal,** Luther King Capital Management, **Owner and Director,** 4K Land and Cattle Company, **Co-Owner,** Reyrosa Ranch, **Trustee,** Texas Christian University, **Director and Treasurer,** Texas and Southwestern Cattle Raisers Foundation, **Director,** Nature Conservancy of Texas, **Director,** Cross Timbers Oil Company, **Director,** 1998 Southwestern Exposition and Livestock Show, **Director,** several privately held companies, **Board of Governors,** Investment Counsel Association of America, **Member of Investment Advisory Committee** to Board of Trustees of the Employees Retirement System of Texas, **Chartered Financial Analyst**

## Tom Loeffler

**Vice-Chairman, Regent,** The University of Texas System, **Partner,** Arter and Hadden, **Director,** Billing Concepts Corporation, **Director,** Introgen Therapeutics, Inc., **Director,** Boone and Crockett Club, **Director,** Clove Valley Rod & Gun Club, **Co-Chairman,** Team 100 Republican National Committee, **Trustee,** U. T. Law School Foundation

## Homer L. Luther, Jr.

**Principal,** Homer Luther Interests, **Member,** College of Business Administration Foundation Advisory Council of The University of Texas, **Director,** Grand Teton National Park Foundation, **Director,** Mesa Verde Foundation, **Director,** The Yellowstone Park Foundation, **Chairman,** National Park Foundation Alumni Council, **Trustee Emeritus,** National Park Foundation, **Chairman Emeritus,** Board of Trustees of The National Outdoor Leadership School

## A. W. "Dub" Riter, Jr.

**Regent,** The University of Texas System, **Director,** TCA Cable TV, Inc., **Managing Partner,** Pinstripe Investments, **Director,** Texas Taxpayers and Research Association, **Member,** Executive Committee of the Governor's Business Council, **Member,** Executive Committee of the Chancellor's Council for The University of Texas System, **Chairman,** The University of Texas Health Center at Tyler Development Board, **Chairman,** The University of Texas at Tyler Development Board, **Chairman & President,** Texas Chest Foundation

Deloitte & Touche LLP

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statement of investment assets and liabilities of the Permanent University Fund (the "PUF") as of August 31, 1998, the comparison summary of investment in securities as of August 31, 1998 and 1997, and the related statement of investment income, the statement of changes in net investment assets, and the schedule of changes in cost of investments for the year ended August 31, 1998. These financial statements are the responsibility of the PUF's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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. Our procedures included confirmation of securities owned as of August 31, 1998, 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 statement of investment assets and liabilities, the comparison summary of investment in securities, the statement of investment income, the statement of changes in net investment assets, and the schedule of changes in cost of investments referred to above present fairly, in all material respects, the financial position of the PUF as of August 31, 1998, the comparative investment in



Deloitte Touche
Tohmatsu
International

securities as of August 31, 1998 and 1997, and its investment income, the changes in its net investment assets, and the changes in cost of its investments for the year ended August 31, 1998 in conformity with generally accepted accounting principles.

The financial statements referred to above include only the assets and liabilities and investment income related to the investments of the PUF which are managed by The University of Texas Investment Management Company. The PUF's 2.1 million acres of West Texas land is not included in this report.

Deloitte & Touche LLP

October 30, 1998



Suite 2300
333 Clay Street
Houston, Texas 77002-4196
Telephone 713.756.2000
Fax 713.756.2001

## Statement of Investment Assets and Liabilities

**August 31, 1998** (in thousands)

| Assets | |
|---|---|
| Investment in Securities, at Value (cost $5,405,896) | $ 6,401,385 |
| Receivable for Investments Sold | 104,705 |
| Collateral for Securities Loaned, at Value | 326,534 |
| Accrued Income Receivable | 44,644 |
| **Total Investment Assets** | **6,877,268** |

| Liabilities | |
|---|---|
| Payable for Investments Purchased | 12,391 |
| Payable to the Available University Fund | 21,256 |
| Payable Upon Return of Securities Loaned | 326,534 |
| **Total Liabilities** | 360,181 |
| **Net Investment Assets** | **$ 6,517,087** |



## Statement of Changes in Net Investment Assets

**Year Ended August 31, 1998** (in thousands)

| Beginning Net Investment Assets | $ 6,368,278 |
|---|---|
| Contributions from PUF Lands | 79,534 |
| Investment Income | 259,978 |
| Investment Income Distributed | (259,978) |
| Net Realized Gains | 467,553 |
| Net Unrealized Depreciation | (398,278) |
| **Ending Net Investment Assets** | **$ 6,517,087** |

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

## Comparison Summary of Investment in Securities

**August 31, 1998 and 1997** (in thousands)

| | 1998 | | 1997 | |
|---|---|---|---|---|
| | Value | Cost | Value | Cost |
| **Debt Securities** | | | | |
| U.S. Government Obligations (Direct and Guaranteed) | $ 439,655 | $ 385,865 | $ 429,130 | $ 403,141 |
| U.S. Government Agencies (Non-Guaranteed) | 418,900 | 378,981 | 340,927 | 321,813 |
| Foreign Government Obligations | 111,200 | 98,475 | 104,275 | 98,413 |
| Municipal and County Bonds | 122,344 | 109,289 | 112,072 | 108,984 |
| Corporate Bonds | 1,304,751 | 1,197,547 | 1,321,371 | 1,265,584 |
| Other | 4,993 | 4,993 | – | – |
| **Total Debt Securities** | 2,401,843 | 2,175,150 | 2,307,775 | 2,197,935 |
| **Preferred Stocks** | 3,156 | 3,072 | 3,933 | 2,696 |
| **Equity Securities** | | | | |
| Domestic Common Stocks | 1,522,491 | 1,178,931 | 1,591,139 | 997,406 |
| Limited Partnerships | 454,445 | 448,376 | 331,116 | 292,906 |
| Index Funds | 1,866,082 | 1,449,485 | 1,961,372 | 1,327,294 |
| Rights and Warrants | 13 | 15 | 3 | – |
| Other | 9,872 | 7,384 | 25,118 | 8,457 |
| **Total Equity Securities** | 3,852,903 | 3,084,191 | 3,908,748 | 2,626,063 |
| **Cash and Cash Equivalents** | | | | |
| Money Markets and Cash Held at State Treasury | 143,483 | 143,483 | 47,657 | 47,657 |
| Commercial Paper | – | – | 100,000 | 100,000 |
| **Total Cash and Cash Equivalents** | 143,483 | 143,483 | 147,657 | 147,657 |
| **Total Investment in Securities** | **$ 6,401,385** | **$ 5,405,896** | **$ 6,368,113** | **$ 4,974,351** |



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

## Statement of Investment Income
**Year Ended August 31, 1998** (in thousands)

| | |
|---|---|
| **Debt Securities** | |
| U.S. Government Obligations (Direct and Guaranteed) | $ 30,247 |
| U.S. Government Agencies (Non-Guaranteed) | 29,418 |
| Foreign Government Obligations | 7,533 |
| Municipal and County Bonds | 8,258 |
| Corporate Bonds | 96,884 |
| **Total Debt Securities** | 172,340 |
| **Preferred Stocks** | 230 |
| **Equity Securities** | |
| Domestic Common Stocks | 36,445 |
| Limited Partnerships | 6,159 |
| Index Funds | 32,162 |
| Other | 2,576 |
| **Total Equity Securities** | 77,342 |
| **Cash and Cash Equivalents** | |
| Money Markets and Cash Held at State Treasury | 8,598 |
| Commercial Paper | 173 |
| **Total Cash and Cash Equivalents** | 8,771 |
| **Other Investment Income** | |
| Securities Lending | 1,295 |
| **Total Other Investment Income** | 1,295 |
| **Total Investment Income** | **$ 259,978** |

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

## Schedule of Changes in Cost of Investments
**Year Ended August 31, 1998** (in thousands)

| Type of Investment | Beginning Cost | Purchases | Sales, Maturities & Redemptions | Gains (Losses) | Reclass & Amortization | Ending Cost |
|---|---|---|---|---|---|---|
| **Debt Securities** | | | | | | |
| U.S. Government Obligations (Direct and Guaranteed) | $ 403,141 | $ 143,245 | $ (161,753) | $ 121 | $1,111 | $ 385,865 |
| U.S. Government Agencies (Non-Guaranteed) | 321,813 | 93,752 | (38,495) | 149 | 1,762 | 378,981 |
| Foreign Government Obligations | 98,413 | – | – | – | 62 | 98,475 |
| Municipal and County Bonds | 108,984 | – | (235) | – | 540 | 109,289 |
| Corporate Bonds | 1,265,584 | 26 | (69,922) | 411 | 1,448 | 1,197,547 |
| Other | – | 4,993 | – | – | – | 4,993 |
| **Total Debt Securities** | 2,197,935 | 242,016 | (270,405) | 681 | 4,923 | 2,175,150 |
| **Preferred Stocks** | 2,696 | 2,694 | (5,100) | 2,782 | – | 3,072 |
| **Equity Securities** | | | | | | |
| Domestic Common Stocks | 997,406 | 844,529 | (845,855) | 159,975 | 22,876 | 1,178,931 |
| Limited Partnerships | 292,906 | 211,952 | (115,357) | 81,766 | (22,891) | 448,376 |
| Index Funds | 1,327,294 | 300,030 | (400,287) | 222,448 | – | 1,449,485 |
| Rights and Warrants | – | – | – | – | 15 | 15 |
| Other | 8,457 | 437 | (1,510) | – | – | 7,384 |
| **Total Equity Securities** | 2,626,063 | 1,356,948 | (1,363,009) | 464,189 | – | 3,084,191 |
| **Cash and Cash Equivalents** | | | | | | |
| Money Markets and Cash Held at State Treasury | 47,657 | 95,925 (1) | – | (99) | – | 143,483 |
| Commercial Paper | 100,000 | – | (100,000) | – | – | – |
| **Total Cash and Cash Equivalents** | 147,657 | 95,925 | (100,000) | (99) | – | 143,483 |
| **Total Investment In Securities** | **$4,974,351** | **$1,697,583** | **$(1,738,514)** | **$467,553** | **$4,923** | **$ 5,405,896** |

(1) Net increase/decrease in cash and money markets during the year



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

**Note 1 - Organization**

**A**

The Permanent University Fund ("PUF") is a public endowment contributing to the support of eligible institutions of The University of Texas System ("U. T. System") and The Texas A&M University System ("TAMU System"). The PUF was established in the Texas Constitution of 1876 through the appropriation of land grants previously given to the University of Texas plus one million acres. Additional land grants to the PUF were completed in 1883 with the contribution of another one million acres. Today, the PUF contains 2,109,190 acres located in 24 counties primarily in West Texas.

The PUF's 2.1 million acres of West Texas land produce two streams of income: mineral and surface. Mineral income is retained forever as part of the PUF; however, surface income is distributed to the Available University Fund ("AUF"). Funds held in the PUF are invested primarily in corporate and government securities.

The investments of the PUF are managed by The University of Texas Investment Management Company ("UTIMCO"). Investment management fees are charged directly to the AUF.

The accompanying financial statements include only the assets and liabilities and investment income related to the investments of the PUF which are managed by UTIMCO. The PUF's 2.1 million acres of West Texas land is not included in this report.

**B**

The constitutional provisions governing the PUF prohibit the expenditure of corpus and consequently, gains and losses on sales of securities remain in the PUF. Conversely, the Constitution of Texas mandates that all dividend and interest income be distributed to the AUF.

**C**

The audited financial statements and schedules have been prepared for the purpose of complying with the reporting requirements of Section 66.05 and 66.08(f) of the Texas Education Code and for the purpose of presenting the statement of investment income. Section 66.02 of the Texas Education Code was amended to require the distribution of investment income to the AUF on an accrual basis of accounting effective for the fiscal year beginning September 1, 1997.

**Note 2 - Significant Accounting Policies**

**A**

*Cash and Cash Equivalents* - Cash and cash equivalents consist of cash held at the State Treasury, commercial paper and money market instruments.

**B**

*Security Valuation* - Investments are primarily valued on the basis of market valuations provided by independent pricing services.

Fixed income securities directly held are valued based upon prices supplied by Merrill Lynch Securities Pricing Service and other major fixed income pricing services, external broker quotes and internal pricing matrices. Equity investment market values are based on the New York Stock Exchange composite closing prices, if available. If not available, the market value is based on the closing price on the primary exchange on which the security is traded (if a closing price is not available, the average of the last reported bid and ask price is used).

Limited partnerships and Other are valued based on a fair valuation determined as specified by policies established by the UTIMCO Board of Directors.

Securities held in index funds are generally valued as follows:

Stocks traded on security exchanges are valued at closing market prices on the valuation date.

Stocks traded on the over-the-counter market are valued at the last reported bid price, except for National Market System OTC stocks which are valued at their closing market prices.

Fixed income securities are valued based upon bid quotations obtained from major market makers or security exchanges.

**C**

*Foreign Currency Translation* - The accounting records of the PUF are maintained in U.S. dollars. Purchases and sales of securities of foreign entities and their related income receipts are translated into U.S. dollars at the exchange rate on the dates of the transactions. The portion of currency gains and losses resulting from changes in foreign exchange rates on purchases and sales of securities is included with net realized and unrealized gain or loss from investments. The currency gains and losses on dividend and interest payments resulting from changes in foreign exchange rates between the accrual date and the payment date are included in investment income.

**D**

*Investment Income* - Interest income is accrued as earned. Dividend income is recorded on the ex-dividend date. Dividend and interest income is recorded net of foreign taxes where recovery of such taxes is not assured. Bonds are amortized over the life of the security using the interest method, which is a method of amortizing discounts or premiums that result in constant rates of interest. Distributions of income to the AUF are based on an accrual basis of accounting as provided by a statutory amendment effective September 1, 1997.

**E**

*Security Transactions* - Security transactions are accounted for on a trade date basis for most securities. International index fund transactions are recorded on a settle date basis due to trading practices which impose restrictions in acquiring per unit information on trade date. Gains and losses on securities sold are determined on the basis of average cost. A loss is recognized if there is an impairment in the value of the security that is determined to be other than temporary.

**F**

*Use of Estimates* - The preparation of financial statements in conformity with generally accepted accounting principles 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.

## Note 3 - Investment Activity

During the year ended August 31, 1998, the cost of purchases and proceeds from sales and maturities of investments (excluding cash and cash equivalents) were $1,601,657,450 and $1,638,513,583, respectively. Such transactions were made at current market prices on the dates of the transactions.

## Note 4 - Securities Lending

The PUF loaned securities to certain brokers who paid the PUF negotiated lenders' fees. These fees are included in investment income. The PUF 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 United States issuers and a market value of 105% for loaned securities of non-United States issuers. If the market value of the collateral held in connection with loans of securities of United States 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-United States issuers, the collateral should remain 105% of the market value of the loaned securities at the close of any business day. If it falls below the 105%, the borrower must deliver additional collateral by the close of the following business day.

The value of securities loaned and the value of collateral held as of August 31, 1998 are as follows:

| Securities on Loan | Value |
|---|---|
| U.S. Government | $ 293,735,448 |
| Corporate Bonds | 21,030,198 |
| Common Stock | 5,327,432 |
| Total | $ 320,093,078 |
| U.S. Government | $ 12,434,830 |
| Corporate Bonds | 5,971,625 |
| Total | $ 18,406,455 |

| Type of Collateral | Value of Collateral |
|---|---|
| Cash | $ 298,296,499 |
| Cash | 22,034,870 |
| Cash | 6,202,169 |
| Total Cash Collateral | $ 326,533,538 |
| Non-Cash | $ 12,851,250 |
| Non-Cash | 6,125,000 |
| Total Non-Cash Collateral | $ 18,976,250 |

Cash received as collateral for all securities lending activities is recorded as an asset with an equal and offsetting liability to return the collateral. 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.

**Note 5 - Investment Commitments**

Unfunded contractual commitments for limited partnerships and other assets were $783,919,361 at August 31, 1998.

**Note 6 - Reclassification**

The Comparison Summary of Investment in Securities has been reclassified for the year ended August 31, 1997 to conform with the 1998 presentation.

**Note 7 - Index Funds**

The index funds consist of the Equity Index Fund B Lendable, which is majority-owned by the PUF and The University of Texas System's Long Term Fund, and the Mid Cap Index Fund B Lendable, which is majority-owned by the PUF. Also included in the index funds are twenty-one MSCI Equity Index Fund B international funds which are invested in Europe, Australia and the Far East.

The values of the funds, as of August 31, 1998 & 1997 are as follows:

| August 31, | 1998 | 1997 |
|---|---|---|
| Equity Index Fund B Lendable | $ 936,699,381 | $ 927,137,853 |
| Mid Cap Index Fund B Lendable | 513,003,187 | 628,277,048 |
| MSCI Equity Index Fund B | 416,379,542 | 405,956,907 |
| | $1,866,082,110 | $1,961,371,808 |

**Note 8 - Year 2000 (Unaudited)**

The PUF could be adversely affected if the computer systems it uses and those used by the PUF's managers, custodian and other major service providers, do not properly process and calculate date-related information and data from and after January 1, 2000. This is commonly known as the Year 2000 problem. UTIMCO, as the investment manager for the PUF, embarked on an active Year 2000 program during the fall of 1996. All internal processes and programs, hardware and software products, and external interfaces have been carefully analyzed both for Year 2000 compliance and for their impact on the PUF's ability to continue normal operations beyond January 1, 2000.

UTIMCO began monitoring the efforts of other key external vendors during the fall of 1997. Mellon Trust, the custodian and the major service provider for the PUF, has met with UTIMCO every two months to review and report its progress regarding the Year 2000 plan. As of August 31, 1998, Mellon is on target to remediate its systems and to complete integration testing by January 1999.

Based on the information available to UTIMCO management, the PUF's managers and other key service providers are taking steps that they believe are reasonable in addressing the Year 2000 issues. At this time, however, there can be no assurance that these steps will be sufficient, and the failure of a timely completion of all necessary procedures could have a material adverse effect on the PUF's operations. Management will continue to monitor the status of and the PUF's exposure to this issue.

The PUF's constitutional mandate to serve as a perpetual source of funding for The University of Texas System and The Texas A&M University System academic and health care programs remains unchanged. The fulfillment of this mandate in future years will depend progressively on the Fund's ability to add value through investment return.

1998

return
on
investment

# future value

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The University of Texas Investment Management Company