2003 Permanent Health Fund

PHF

Ownership of Permanent Health Fund

August 31, 2003	Value (in millions)
Permanent Health Fund for Higher Education	$ 318.0
UT Health Science Center at San Antonio	181.7
UT M. D. Anderson Cancer Center	90.9
UT Southwestern Medical Center at Dallas	45.4
UT Medical Branch at Galveston	22.7
UT Health Science Center at Houston	22.7
UT Health Center at Tyler	22.7
UT El Paso	22.7
Regional Academic Health Center	18.2
Total	**$ 745.0**

Financial Highlights

(in millions)

Years Ended August 31,	1999	2000	2001	2002	2003
Beginning Net Asset Value	$ -	$ 890.3	$ 1,016.6	$ 881.4	$ 698.2
Contributions (Withdrawals)	890.0	25.0	-	(88.2)	-
Net Investment Return	0.3	141.9	(93.2)	(53.2)	85.3
Distributions (Payout)	-	(40.6)	(42.0)	(41.8)	(38.5)
Ending Net Asset Value	**$ 890.3**	**$ 1,016.6**	**$ 881.4**	**$ 698.2**	**$ 745.0**

Overview

Totaling $745.0 million, the Permanent Health Fund (PHF) is an internal UT System mutual fund for the pooled investment of state endowment funds for health-related institutions of higher education. The UT Board of Regents established the PHF in August 1999 with proceeds from state tobacco litigation.

In order to take advantage of lower unit costs, attractive investment opportunities, and broader diversification benefits available from a larger investment fund, the funds in the PHF are invested in The University of Texas System General Endowment Fund (GEF), a broadly diversified mutual fund managed by UTIMCO, which was created by the UT Board of Regents in March, 2001. The PHF currently owns 20.8% of the GEF's $3.6 billion net asset value. The other GEF unit holder is The University of Texas System Long Term Fund (LTF.)

Investment Policy

The primary investment objective is to preserve the purchasing power of PHF assets by earning an average annual real return of 5.5% over rolling ten year periods or longer. Earning an average annual real return of 5.5% permits two primary objectives:

- Provide for current beneficiaries by increasing the annual distribution at a rate at least equal to the current 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.

Since the PHF's investment return is dependent on the GEF return, the operations and results of the GEF must be examined to determine the results of the PHF's activities for the year. The design of the GEF's portfolio is based on a combination of quantitative analysis and market judgment employed by UTIMCO's investment staff. Sophisticated statistical techniques are combined with the judgment of investment professionals to test many asset allocation alternatives, including the sensitivity of potential future results to changes in assumptions in order to make portfolio construction decisions. Investment management involves as much art as science and qualitative considerations often play an extremely important role in successful portfolio management decisions. Art and science were used to develop the target and current GEF portfolios.

Asset Allocation

Asset Class	Actual	Target
Domestic Public Equities	35.0%	31.0%
International Public Equities	20.9%	19.0%
Absolute Return	10.3%	10.0%
Inflation Hedging	8.6%	10.0%
Fixed Income	15.0%	15.0%
Private Capital	10.7%	15.0%
Cash and Cash Equivalents	(0.5%)	0.0%
Total	**100.0%**	**100.0%**

Investment Return and Market Commentary

The PHF posted an investment return of 12.7% (net of investment management fees) for the year ended August 31, 2003. Returns in the year were driven by very strong absolute and relative performance in the absolute return hedge funds, inflation hedge, and domestic and international active equity management asset categories. The absolute return hedge funds enjoyed a 21.3% return for the year, significantly beyond the 5.5% benchmark return for the asset category. Inflation hedge assets also turned in an outstanding performance of 22.1% versus a benchmark return of 13.6%.

Fiscal 2003 will be remembered as a year of two remarkably contrasting periods. The first was the period leading up to the conclusion of the major conflict in Iraq, where uncertainty and global market weakness prevailed. The second was the subsequent months following the market low registered on March 11, during which risk taking around the world was financially rewarded.

Navigating these two disparate investment environments proved challenging. However, by maintaining a diversified asset exposure—including a meaningful allocation to absolute return strategies (hedge funds)—the GEF was able to preserve capital during the dramatic negative results of the first six months. In addition, UTIMCO's selection of a growing stable of high quality active managers was a strong contributing factor, as those active managers earned high value-added returns. Finally, decisions to tactically reallocate capital during the spring and summer months away from defensive assets, including fixed income, towards more economically sensitive instruments, such as small cap and emerging markets equities, enabled the GEF to participate in the financial markets' eventual anticipation of a strong global recovery.

For the year, UTIMCO's allocation to emerging markets provided a 27.0% return versus the benchmark results of 12.2%. Likewise, the allocation to small capitalization domestic companies produced a 22.5% result, well ahead of the 14.9% benchmark results. In total, the marketable endowment assets enjoyed a return of 15.5% for the fiscal year, well ahead of the 11.6% benchmark, resulting in a net value-added to the GEF of more than $108.8 million.

Results Contrast

Index	Equity Description	9/1/02 - 3/11/03	3/11/03 - 8/31/03
S&P 500	U.S. Large Capitalization	(11.1%)	26.9%
Russell 2000	U.S. Small Capitalization	(10.8%)	44.3%
MSCI EAFE	International Developed Markets	(15.7%)	29.8%
MSCI Emerging Markets Free	International Emerging Markets	(7.6%)	40.9%

Distribution (or Spending) Policy

The distributions of the PHF are based on a distribution policy which balances the needs and interests of current beneficiaries with those of the future. The PHF utilizes what is often called a "constant growth" spending policy in determining annual distributions. Under a constant growth spending policy, distributions in any year are equal to the distributions in the prior year plus an increase to offset actual inflation in the particular year. Thus distributions grow at a steady rate equal to the rate of inflation, providing a stable stream of "real" resources to the beneficiaries of the PHF.

The PHF's distribution policy defines the compromise between the conflicting goals of providing substantial, sustainable support for current operations and preserving purchasing power of the endowment assets. The PHF's distribution policy objectives are an integral element in the success of the PHF preserving its purchasing power. Following are the distribution policy objectives:

- Provide a predictable, stable stream of distributions over time
- Ensure that the inflation adjusted value of distributions is maintained
- Ensure that the inflation adjusted value of PHF assets after distributions is maintained over the long-term

The distribution policy states that distributions are increased annually at the average rate of inflation (twelve quarter average) provided that the distribution rate remains within a range of 3.5% to 5.5%. In 2000, the PHF's first full year of existence, the distribution rate was $.045 per unit, or 4.5% of the initial market value. For the years ended August 31, 2001 and 2002, the distribution rate was increased each year by 2.2%, approximately the average rate of inflation. The rate is currently at $.047 per unit and has remained at that rate since fiscal year 2002 and will remain at $.047 for fiscal year 2004. Although the average distribution rate has not exceeded the upper range of 5.5%, the rate has not been increased by the UT Board because significant negative returns in the global equity markets during 2001 and 2002 has resulted in the PHF's net asset value of $745.0 being less than the original PHF contributions of $820.0 million. The PHF's short time of existence, only four years, coupled with two years of negative performance, has not allowed for the PHF to build and preserve purchasing power.

Expenses

The large asset base under UTIMCO's management allows for economies of scale in management of the endowment funds. The GEF was created as the investment vehicle in which the PHF and LTF could get cost effective exposure to a well diversified investment portfolio. The GEF incurs expenses for external management fees, custody and safekeeping fees, and other fees related to its operations. Both the PHF and LTF pay the same fee for every unit of GEF owned by these funds. However, there are additional expenses which differ for the PHF and LTF. Therefore, the total fee paid by each unit of the PHF includes PHF expenses plus a portion of the GEF expenses. The UTIMCO fee for 2003 fiscal year was .09% of PHF average net assets; fees and expenses paid to external managers and other service providers totaled .26% of PHF average net assets.

Management and Oversight

Since the PHF's inception, The University of Texas Investment Management Company has been responsible for the investment management of the PHF. UTIMCO's sole purpose is the management of investment assets under the fiduciary care of the UT Board of Regents. UTIMCO is governed by a nine-member Board of Directors appointed by the UT Board of Regents. The UTIMCO Board of Directors includes three members of the UT Board of Regents, the Chancellor of UT System, and five independent investment professionals. Annual and quarterly information is available to the public via UTIMCO's website: www.utimco.org, including the audited financial statements of the PHF.