

Financial Statements

The University of Texas System

Long Term Fund

*Years ended August 31, 2004 and 2003*

The University of Texas System Long Term Fund

Financial Statements

Years ended August 31, 2004 and 2003

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)**

Our discussion and analysis of The University of Texas System Long Term Fund's (Fund) financial performance provides an overview of its activities for the fiscal year ended August 31, 2004. This discussion was prepared by The University of Texas Investment Management Company (UTIMCO) and should be read in conjunction with the Fund's financial statements and notes. The Fund is an internal UT System mutual fund for the pooled investment of 6,537 privately raised endowments and other long-term funds of the 15 component institutions of the UT System. The Texas Constitution and various state statutes designate The University of Texas System Board of Regents (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 Permanent Health Fund (PHF), also established by the UT Board. The GEF is organized as a mutual fund in which the Fund and the PHF 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 contributions, withdrawals and distributions, increased by \$553.5 from \$2,839.8 million to \$3,393.3 million or approximately 19.5% during the year.
- Participant contributions to the Fund increased by 178.5% from fiscal year 2003 to 2004. Fiscal year contributions of \$315.1 million represented 9.8% of the average value of the Fund assets during the year. Participant contributions consist of endowment and other long-term funds that have been forwarded to the Fund for management by UTIMCO.
- The Fund posted a net investment return of 14.59% for the fiscal year ended August 31, 2004, compared to a net investment return of 12.78% for the prior fiscal year.
- The Fund's distribution rate per unit was increased by 2.5%, approximately the average rate of inflation, during the year. This equated to an increase in the 2004 rate to \$0.2645 per unit from the 2003 rate of \$0.258 per unit. The fiscal year distributions represented 4.89% of the Fund's average net asset value during the year.

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**Use of Financial Statements and Notes**

The Fund financial statements were prepared in accordance with standards issued by the Governmental Accounting Standards Board (GASB). Two financial statements are required under GASB: the Statement of Fiduciary Net Assets and the Statement of Changes in Fiduciary Net Assets.

The notes to the financial statements contain supplemental information that is essential for the fair presentation of the financial statements.

**Statement of Fiduciary Net Assets**

The Statement of Fiduciary Net Assets presents assets, liabilities, and net assets of the Fund as of the end of the fiscal year. This statement, along with all of the Fund's financial statements, is prepared using the accrual basis of accounting, whereby Fund investment income is recognized when earned and Fund expenses are recognized when incurred.

Since the Fund no longer invests in individual securities except for GEF units and a negligible amount of cash, the majority of the Fund's balance sheet is reflected in its investment in GEF units.

As of August 31, 2004, the Fund owned 28,857,142 GEF units representing an ownership percentage of 80.65%. As of August 31, 2004, the fair value of the GEF units was \$3,393.4 million.

The GEF invests in a broad mix of investments and is actively managed to its benchmark, the Endowment Policy Portfolio. The Endowment Policy Portfolio is the index or benchmark for the endowment funds that UTIMCO manages. The return of the Endowment Policy Portfolio is the sum of the weighted benchmark returns for each asset class that comprise it. UTIMCO allocates GEF's assets to internally and externally managed portfolios in accordance with approved asset allocation policies, and attempts to supplement the original endowment corpus by increasing purchasing power over time. In doing so, UTIMCO increases the endowment resources available to fund the teaching, research, and health care programs specified by the various donors.

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

	<b>2004</b>	<b>2003</b>	<b>Amount of Increase (Decrease)</b>	<b>Percent Change</b>
<b>Assets</b>				
General Endowment Fund Units, at Fair Value	\$ 3,393.4	\$ 2,840.0	\$ 553.4	19%
Other Investments	-	-	-	-
Cash and Cash Equivalents	-	-	-	-
Receivable for Investment Securities Sold	16.0	40.5	(24.5)	(60)
<b>Total Assets</b>	<b>3,409.4</b>	<b>2,880.5</b>	<b>528.9</b>	<b>18</b>
<b>Liabilities</b>				
Payable to Participants	16.0	40.5	(24.5)	(60)
Other Payables	0.1	0.2	(0.1)	(50)
<b>Total Liabilities</b>	<b>16.1</b>	<b>40.7</b>	<b>(24.6)</b>	<b>(60)</b>
<b>Net Assets Held in Trust</b>	<b>\$ 3,393.3</b>	<b>\$ 2,839.8</b>	<b>\$ 553.5</b>	<b>19%</b>

**Statement of Changes in Fiduciary Net Assets**

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

The net increase in fair value of investments of the Fund was \$375.5 million during the year compared to \$275.4 million for the year ended August 31, 2003. Expenses totaled \$6.1 million in fiscal year 2004 and \$6.2 million in fiscal year 2003.

Distributions to participants totaled \$158.1 million and \$143.9 million, respectively, for the years ended August 31, 2004 and 2003. The increase in distributions is a result of the UT Board increasing the distribution rate from \$0.258 to \$0.2645 for fiscal year 2004, and additional contributions into the Fund. The Fund is structured as a mutual fund in which each endowment or account purchases units at the Fund's market value per unit. Cash distributions are paid quarterly, on a per unit basis, directly to the UT System institution of record.

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

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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 statement in the supplemental schedules, the ratio of distributions to average net assets (12-quarter average) has remained between 3.5% to 5.5%.

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

	<b>2004</b>	<b>2003</b>	<b>Amount of Increase (Decrease)</b>	<b>Percent Change</b>
Investment Income	\$ 441.1	\$ 332.1	\$ 109.0	33%
Less Investment Expenses	(3.1)	(0.1)	(3.0)	3000
Net Investment Income	438.0	332.0	106.0	32
Participant Contributions	315.1	113.1	202.0	179
Total Additions	753.1	445.1	308.0	69
Administrative Expenses	3.0	2.9	0.1	3
Participant Withdrawals	38.6	53.5	(14.9)	(28)
Participant Distributions	158.0	143.9	14.1	10
Total Deductions	199.6	200.3	(0.7)	-
Change in Fiduciary Net Assets	553.5	244.8	308.7	126
Net Assets Held in Trust, Beginning of Period	2,839.8	2,595.0	244.8	9
Net Assets Held in Trust, End of Period	\$ 3,393.3	\$ 2,839.8	\$ 553.5	19%

**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).

## Report of Independent Auditors

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

We have audited the accompanying financial statements of The University of Texas System Long Term Fund (the “Fund”) as of and for the years ended August 31, 2004 and 2003, as listed in the table of contents. These financial statements are the responsibility of the Fund’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only The University of Texas System Long Term Fund and do not purport to, and do not, present fairly the fiduciary net assets of The University of Texas Investment Management Company nor The University of Texas System as of August 31, 2004 and 2003 and the changes in its fiduciary net assets for the years then ended in conformity with accounting principles generally accepted in the United States.

In our opinion, the financial statements, referred to above present fairly, in all material respects, the fiduciary net assets of The University of Texas System Long Term Fund as of August 31, 2004 and 2003, and the changes in its fiduciary net assets for the years then ended, in conformity with accounting principles generally accepted in the United States.

Management’s discussion and analysis on pages 1 through 4 is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming opinions on the financial statements of The University of Texas System Long Term Fund. The supplemental schedules are presented for purposes of additional analysis and are not a required part of the basic financial statements. The supplemental schedules as of and for the years ended August 31, 2004 and 2003 have been subjected to the audit procedures applied in the audits of the financial statements and, in our opinion, based on our audits, are fairly stated in relation to the financial statements taken as a whole. The supplemental schedules for the years ended August 31, 2002, 2001 and 2000 were audited by other auditors whose report dated October 18, 2002 included an unqualified opinion.

 Ernst & Young LLP

October 22, 2004



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**Statements of Fiduciary Net Assets**

*August 31, 2004 and 2003*

*(Dollars in thousands, except per unit amounts)*

	<u>2004</u>	<u>2003</u>
<b>Assets</b>		
General Endowment Fund Units, at Fair Value	\$ 3,393,444	\$ 2,839,986
Other Investments	-	1
Cash and Cash Equivalents	1	1
Receivable for Investment Securities Sold	16,005	40,492
<b>Total Assets</b>	<u>3,409,450</u>	<u>2,880,480</u>
<b>Liabilities</b>		
Payable to Participants	16,005	40,492
Other Payables	170	142
<b>Total Liabilities</b>	<u>16,175</u>	<u>40,634</u>
<b>Net Assets Held in Trust (607,622,749 Units and 555,329,487 Units, respectively)</b>	<u>\$ 3,393,275</u>	<u>\$ 2,839,846</u>
<b>Net Asset Value Held in Trust Per Unit</b>	<u>\$5.585</u>	<u>\$5.114</u>

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

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**Statements of Changes in Fiduciary Net Assets**

*Years Ended August 31, 2004 and 2003 (in thousands)*

	<u>2004</u>	<u>2003</u>
<b>Additions</b>		
Investment Income		
Net Increase in Fair Value of Investments	\$ 375,512	\$ 275,413
Allocation of General Endowment Fund Net Investment Income	65,588	56,635
Other	27	8
Total Investment Income	<u>441,127</u>	<u>332,056</u>
Less Investment Expenses		
UTIMCO Management Fee	2,990	3,135
Other Expenses	108	71
Total Investment Expenses	<u>3,098</u>	<u>3,206</u>
Receipt of Funds from UT System for UTIMCO Management Fee	-	3,135
Net Investment Income	<u>438,029</u>	<u>331,985</u>
Participant Contributions	<u>315,113</u>	<u>113,164</u>
<b>Total Additions</b>	<u>753,142</u>	<u>445,149</u>
<b>Deductions</b>		
Administrative Expenses		
Fee for Endowment Compliance	2,381	2,441
Internal Fee for Educational Purposes	666	536
Total Administrative Expenses	<u>3,047</u>	<u>2,977</u>
Participant Withdrawals	38,613	53,537
Participant Distributions	<u>158,053</u>	<u>143,852</u>
<b>Total Deductions</b>	<u>199,713</u>	<u>200,366</u>
<b>Change in Fiduciary Net Assets</b>	553,429	244,783
Net Assets Held in Trust, Beginning of Period	<u>2,839,846</u>	<u>2,595,063</u>
<b>Net Assets Held in Trust, End of Period</b>	<u>\$ 3,393,275</u>	<u>\$ 2,839,846</u>

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

# THE UNIVERSITY OF TEXAS SYSTEM

## LONG TERM FUND

*Notes to Financial Statements*

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### **Note 1 – Organization and Basis of Presentation**

The University of Texas System Long Term Fund (Fund) is a pooled fund established for the collective investment of private endowments and other long-term funds supporting various programs and purposes of the 15 institutions comprising The University of Texas System (UT System). The Fund was formerly known as the Common Trust Fund. The Long Term Fund was established February 9, 1995, by the Board of Regents of The University of Texas System (Board of Regents) to succeed the Common Trust Fund pooled investment fund. Fiduciary responsibility for the Fund rests with the 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 Permanent Health Fund (PHF) also established by the Board of Regents. The GEF is organized as a mutual fund in which the Fund and the PHF 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. This fund is subject to the pronouncements of the Governmental Accounting Standards Board (GASB).

The annual combined financial statements of UT 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. Subsequent participant contributions received by the Fund are also used to purchase GEF units. At August 31, 2004, the Fund is the majority participant in the GEF, with ownership of 28,857,142 units, which represents 80.65% of the GEF. At August 31, 2003, the Fund held 27,696,705 units, which represented 79.22% of the GEF.

The GEF and the Fund have identical investment objectives. Additionally, the GEF's accounting policies follow the Fund's, as described in Note 3, except for the distributions to participants. On a monthly basis for accounting purposes, the GEF 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

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*Notes to Financial Statements (cont.)*

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income and realized gain amounts are considered reinvested as GEF contributions. Any allocated realized losses reduce the cost basis of the units in the GEF. Since the distribution is proportional to the percentage of ownership by the unitholders, no additional units are purchased. The Fund redeems GEF units quarterly to meet its distribution requirements to its unitholders.

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

**Note 3 – Significant Accounting Policies**

- (A) **Security Valuation** -- The Fund's investment in GEF Units is valued at the net asset value per unit reported by the GEF, which is based on fair value.
- (B) **Investment Income** -- Interest income is accrued as earned.
- (C) **Security Transactions** -- A gain or loss is recognized on GEF unit sales on the basis of average cost.
- (D) **Distributions to Participants** -- Cash distributions to participants are paid quarterly based on a per unit payout established by the Board of Regents. For the fiscal year ended August 31, 2004, the quarterly rate was \$.066125 which equates to a yearly rate of \$.2645 per unit. For the fiscal year ended August 31, 2003, the quarterly distribution rate was \$.0645 which equated to a yearly rate of \$.258 per unit. The ratio of distributions to average net assets (12-quarter average) was 4.98% as of August 31, 2004. The investment policy provides that the annual payout will be adjusted by the average consumer price index of the prior 36 months including August 31 subject to a maximum distribution of 5.5% of the Fund's average market value and a minimum distribution of 3.5% of the Fund's average market value.
- (E) **Fund Valuation** -- Valuation of the Fund's units occurs on a quarterly basis. Unit values are determined by dividing the value of the Fund's net assets by the number of units outstanding on the valuation date.
- (F) **Purchases and Redemption of Units** -- The value of participating units, upon admission to the Fund, is based upon the market value of net assets held as of the valuation date. Redemptions from the Fund will also be made at the market value price per unit at the valuation date at the time of the withdrawal. There are no transaction costs incurred by participants for the purchase or redemption of units.
- (G) **Participants' Net Assets** -- All participants in the Fund have a proportionate undivided interest in the Fund's net assets.
- (H) **Federal Income Taxes** -- The Fund is not subject to federal income tax.
- (I) **Use of Estimates** -- The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of

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*Notes to Financial Statements (cont.)*

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revenues and expenses during the reporting period. Actual results could differ from these estimates.

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

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

**Note 4 – Fees and Expenses**

The Fund is assessed a management fee by UTIMCO to cover the costs of managing the Fund and providing day-to-day operations. The fees assessed for the years ended August 31, 2004 and 2003, were \$2,990,222 and \$3,135,100, respectively. The Fund, however, was reimbursed by UT System for the fee in fiscal year 2003, which is shown in the statements of changes in fiduciary net assets as Receipt of Funds from UT System for UTIMCO Management Fee. The fee will no longer be reimbursed by UT System.

The Fund is assessed an annual administrative fee on behalf of UT System component institutions based on 0.08% of the market value of the Fund for the support of enhanced and expanded endowment compliance efforts. The fees assessed for the years ended August 31, 2004 and 2003, were \$2,380,591 and \$2,441,003, respectively.

The Fund is assessed a quarterly internal fee by UT System for educational purposes based on 0.005% of the Fund's net asset value on the last day of each quarter for the years ended August 31, 2004 and 2003. The fees assessed for the years ended August 31, 2004 and 2003, were \$665,745 and \$536,407, respectively.

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

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*Supplemental Schedules*

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**Financial Highlights**  
*Years Ended August 31,*

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
<b>Selected Per Unit Data</b>					
Net Asset Value, Beginning of Period	\$ 5.114	\$ 4.788	\$ 5.412	\$ 6.198	\$ 5.347
Income from Investment Operations					
Net Investment Income	0.099	0.097	0.098	0.140	0.142
Net Realized and Unrealized Gain (Loss) on Investments	0.637	0.487	(0.471)	(0.681)	0.939
Total Income (Loss) from Investment Operations	<u>0.736</u>	<u>0.584</u>	<u>(0.373)</u>	<u>(0.541)</u>	<u>1.081</u>
Less Distributions					
From Net Investment Income	0.099	0.097	0.098	0.140	0.142
From Net Realized Gain	0.166	0.161	0.153	0.105	0.088
Total Distributions	<u>0.265</u>	<u>0.258</u>	<u>0.251</u>	<u>0.245</u>	<u>0.230</u>
Net Asset Value, End of Period	<u>\$ 5.585</u>	<u>\$ 5.114</u>	<u>\$ 4.788</u>	<u>\$ 5.412</u>	<u>\$ 6.198</u>

**Ratios and Supplemental Data**

Net Assets, End of Period (in thousands)	\$3,393,275	\$2,839,846	\$2,595,063	\$2,843,300	\$3,136,229
Ratio of Expenses to Average Net Assets	0.43%	0.40%	0.39%	0.23%	0.33%
Ratio of Net Investment Income to Average Net Assets	1.84%	2.01%	1.89%	2.44%	2.45%
Ratio of Distributions to Average Net Assets (5-quarter average)	4.89%	5.40%	4.86%	4.31%	3.99%
Ratio of Distributions to Average Net Assets (12-quarter average)	4.98%	4.86%	4.38%	4.12%	3.98%