

PERMANENT UNIVERSITY FUND

FINANCIAL STATEMENTS

Years Ended August 31, 2003 and 2002

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

Our discussion and analysis of the Permanent University Fund's (PUF) financial performance provides an overview of its activities for the fiscal year ended August 31, 2003. This discussion was prepared by The University of Texas Investment Management Company "UTIMCO" and should be read in conjunction with the PUF's financial statements and notes. The PUF is a public endowment contributing to the support of 18 institutions and 6 agencies in The University of Texas System (UT System) and The Texas A&M University System (TAMU 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.

The purpose of the MD&A is to provide an objective and easily readable analysis of the PUF's financial statements based upon currently known facts, decisions or conditions.

Financial Highlights

- The PUF's net asset value after distributions increased by \$506.5 million from \$6,738.3 million to \$7,244.8 million, or approximately 7.5% during the year.
- Fiscal year 2003 contributions of PUF Lands mineral income increased by 26.8% from \$80.5 million to \$102.1 million and represented 1.5% of the average value of the PUF investments during the year. PUF Lands consist of more than 2.1 million acres in 24 counties primarily in West Texas.
- The PUF posted a net investment return of 12.02% for the fiscal year ended August 31, 2003, compared to a net investment return of negative 7.35% for the prior fiscal year.
- The PUF's annual distribution to the Available University Fund (AUF) increased by 7.3% in fiscal year 2003.

Market Commentary

The fiscal year ended August 31, 2003 was 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. The table on the next page outlines the dramatic contrast in results between these two periods:

PERMANENT UNIVERSITY FUND

<u>Index</u>	<u>Equity Description</u>	<u>9/1/02 - 3/11/03</u>	<u>3/11/03 - 8/31/03</u>
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%

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 PUF was able to preserve capital during the dramatic negative results of the first six months. In addition, positive performance by many of the PUF's active managers added to returns. Finally, decisions to tactically reallocate capital during the spring and summer months away from defensive assets, including fixed income, and towards more economically sensitive instruments, such as small cap and emerging markets equities, enabled the PUF to participate in the financial markets' eventual anticipation of a strong global recovery, which resulted in superior investment returns.

Use of Financial Statements and Notes

The PUF's financial statements were prepared in accordance with standards issued by the Governmental Accounting Standards Board (GASB). Three financial statements are typically required under GASB: the Statement of Net Investment Assets, the Statement of Operations and Changes in Net Investment Assets, and the Statement of Cash Flows.

In compliance with the reporting requirements of Section 66.05 of the Texas Education Code, we have included a Schedule of Changes in Cost of Investments and Investment Income. Because this required schedule presents the majority of the cash flows of the PUF, a separate Statement of Cash Flows is not presented. We have also included a Comparison Summary of Investment in Securities, at Fair Value.

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

Statement of Net Investment Assets

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

The PUF 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 PUF investment assets to internally and externally managed portfolios in accordance with approved asset allocation policies, and attempts to supplement the original endowment corpus by

PERMANENT UNIVERSITY FUND

increasing purchasing power over time. In doing so, UTIMCO increases the PUF resources available to fund the debt service on bonds issued by the UT Board and the Texas A&M System Board of Regents to fund capital expenditures and to fund academic excellence programs at The University of Texas at Austin, Texas A&M University, and Prairie View A&M.

Net assets consist of contributions from PUF Lands mineral income and accumulated undistributed realized and unrealized gains on investments.

Statement of Operations and Changes in Net Investment Assets

Changes in net assets as presented on the Statement of Operations and Changes in Net Investment Assets are based on activity of the PUF investments. The purpose of this statement is to present the results of operations, the changes in value of the investments of the PUF, the contributions from PUF Lands mineral income, and the distributions to the AUF.

PUF investments earned realized and unrealized investment gains of \$638.8 million during the year compared to realized and unrealized losses of \$676.0 million for the year ended August 31, 2002. Expenses totaled \$20.2 million in fiscal year 2003 and \$21.0 million in fiscal year 2002.

The net increase in net investment assets resulting from operations totaled \$767.5 million for the fiscal year ended August 31, 2003, compared to a net decrease in net investment assets resulting from operations of \$544.0 million for the fiscal year ended August 31, 2002.

Distributions to the AUF increased from \$338.4 million in fiscal year 2002 to \$363.0 million in fiscal year 2003.

The PUF'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.

PUF distributions are controlled by a spending policy approved by the UT Board as directed by the Texas Constitution, which directs the UT Board to establish a distribution policy that provides stable, inflation-adjusted distributions to the AUF and preserves the real value of the PUF investments over the long term. To achieve this, the annual distribution is currently established at 4.75% of the prior twelve quarters' average net asset value of the PUF investments, as determined each February 28 for the following fiscal year.

PERMANENT UNIVERSITY FUND

The distributions to the AUF are subject to the following overriding conditions:

1. Distributions must be at least equal to the amount needed to pay debt service on PUF Bonds;
2. Distributions may not increase from the preceding year (except as necessary to pay debt service on PUF Bonds) unless the purchasing power of PUF Investments for any rolling 10-year period has been preserved;
3. Distributions may not exceed 7 percent of the average net fair market value of PUF investments in any fiscal year, except as necessary to pay debt service on PUF Bonds.

Schedule of Changes in Cost of Investments and Investment Income

The Schedule of Changes in Cost of Investments and Investment Income is prepared for the purpose of complying with the reporting requirement of Section 66.05 of the Texas Education Code, and provides relevant information about the purchases and sales of PUF investments for the fiscal year ended August 31, 2003. Purchases of PUF investments during the fiscal year totaled \$6,629.1 million, and sales, maturities and redemptions totaled \$6,755.5 million.

Schedule of Investment in Securities, at Fair Value

The Schedule of Investment in Securities, at Fair Value provides a comparative listing of investments by type of security. The total investment in securities increased from \$6,834.4 million to \$7,352.3 million during the year.

Contacting UTIMCO

The above financial highlights are designed to provide a general overview of the PUF's investment results and insight into the following financial statements. Additional information may be found on our website and inquiries may be directed to UTIMCO via www.utimco.org.

Report of Independent Auditors

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

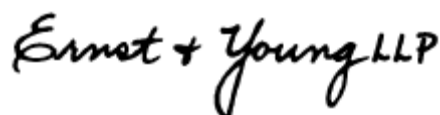
We have audited the accompanying statements of net investment assets and the summary of investment in securities of the Permanent University Fund (PUF) as of August 31, 2003, the related statements of operations and changes in net investment assets, and the schedule of changes in cost of investments and investment income for the year then ended. 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 audit. The financial statements of the PUF for the year ended August 31, 2002, were audited by other auditors whose report dated October 18, 2002 included an explanatory paragraph and a qualified opinion regarding the exclusion of 2.1 million acres of land from those statements.

We conducted our audit 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 audit provides a reasonable basis for our opinion.

The financial statements referred to above include only the investment assets and liabilities and changes therein related to the investments of the PUF which are managed by The University of Texas Investment Management Company (UTIMCO) and are not intended to be a complete presentation of the PUF's assets, liabilities, income, and expenses. The PUF's 2.1 million acres of land are not included in this report. (See Note 1).

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 the Governmental Accounting Standards Board. 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.

In our opinion, the 2003 financial statements referred to above present fairly, in all material respects, the financial position and summary of investment in securities of the PUF managed by UTIMCO as of August 31, 2003, the results of its operations and its cash flows managed by UTIMCO, the changes in its net investment assets managed by UTIMCO, and the changes in cost of its investments and investment income managed by UTIMCO for the year then ended, in conformity with accounting principles generally accepted in the United States.



October 17, 2003

PERMANENT UNIVERSITY FUND

Statements of Net Investment Assets

August 31, 2003 and 2002

(in thousands)

Investment Assets	2003	2002
Investment in Securities, at Fair Value (Cost \$7,249,708 and \$7,416,247, respectively)	\$ 7,352,310	\$ 6,834,428
Collateral for Securities Loaned, at Fair Value	159,065	127,482
Deposit with Broker for Futures Contracts	54,591	43,810
Unrealized Gains on Foreign Currency Exchange Contracts	12,938	14,878
Receivables		
Investment Securities Sold	143,690	119,664
Accrued Income	12,289	15,410
Other	<u>3,419</u>	<u>551</u>
Total Investment Assets	<u>7,738,302</u>	<u>7,156,223</u>
Liabilities		
Payable Upon Return of Securities Loaned	159,065	127,482
Unrealized Losses on Foreign Currency Exchange Contracts	8,774	4,529
Payables		
Investment Securities Purchased	323,058	283,507
Other	<u>2,577</u>	<u>2,430</u>
Total Liabilities	<u>493,474</u>	<u>417,948</u>
Net Investment Assets	<u>\$ 7,244,828</u>	<u>\$ 6,738,275</u>
Supplementary Disclosure:		
Net Investment Assets Consist Of:		
Contributions from PUF Lands	\$ 3,581,374	\$ 3,479,267
Accumulated Undistributed Net Realized Gain on Investments including Foreign Currency Transactions	3,556,188	3,830,585
Net Unrealized Appreciation (Depreciation) of Investments including Translation of Assets and Liabilities in Foreign Currencies	<u>107,266</u>	<u>(571,577)</u>
Net Investment Assets	<u>\$ 7,244,828</u>	<u>\$ 6,738,275</u>

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

PERMANENT UNIVERSITY FUND

Statements of Operations and Changes in Net Investment Assets

Years Ended August 31, 2003 and 2002

(in thousands)

	<u>2003</u>	<u>2002</u>
Investment Income		
Interest	\$ 66,216	\$ 78,204
Dividends	63,899	62,752
Income Distributions from Limited Partnerships	15,158	8,998
Other	<u>3,673</u>	<u>3,162</u>
Total Investment Income	<u>148,946</u>	<u>153,116</u>
Expenses		
Investment Management and Consulting Fees	8,792	11,252
UTIMCO Management Fee	5,187	3,275
PUF Lands Expense	5,061	5,221
Custodial Fees and Expenses	675	726
Other Expenses	<u>529</u>	<u>573</u>
Total Expenses	<u>20,244</u>	<u>21,047</u>
Net Investment Income	<u>128,702</u>	<u>132,069</u>
Realized and Unrealized (Gain) Loss on Investments		
Net Realized Loss on Investment Securities and Foreign Currency Related Transactions	(40,077)	(308,061)
Net Unrealized Appreciation (Depreciation) on Investment Securities and Foreign Currency Related Transactions	<u>678,843</u>	<u>(367,958)</u>
Net Gain (Loss) on Investments	<u>638,766</u>	<u>(676,019)</u>
Net Increase (Decrease) in Net Investment Assets Resulting from Operations	\$ 767,468	\$ (543,950)
Net Investment Assets		
Beginning of Period	6,738,275	7,540,148
Contributions from PUF Lands	102,107	80,511
Distributions to Available University Fund	<u>(363,022)</u>	<u>(338,434)</u>
End of Period	<u>\$ 7,244,828</u>	<u>\$ 6,738,275</u>

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

PERMANENT UNIVERSITY FUND

Schedule of Changes in Cost of Investments and Investment Income

Year ended August 31, 2003

(in thousands)

	Beginning Cost	Purchases	Sales, Maturities & Redemptions	Gains (Losses)	Reclass	Ending Cost	Investment Income
Equity Securities							
Commingled Investments	\$ 1,171,767	\$ 525,704	\$ (22,130)	\$ (25,051)	\$ -	\$ 1,650,290	\$ 5,960
Index Funds	1,631,133	664,051	(746,778)	(177,514)	-	1,370,892	23,053
Domestic Common Stock	964,036	851,145	(924,717)	(2,515)	798	888,747	29,889
Limited Partnerships	1,088,065	154,958	(134,640)	55,949	(585)	1,163,747	15,158
Foreign Common Stock	240,169	228,817	(189,034)	(22,420)	(213)	257,319	4,899
Other	1,076	-	(194)	2	-	884	1,227
Total Equity Securities	<u>5,096,246</u>	<u>2,424,675</u>	<u>(2,017,493)</u>	<u>(171,549)</u>	<u>-</u>	<u>5,331,879</u>	<u>80,186</u>
Debt Securities							
U.S. Government Obligations (Direct and Guaranteed)	172,696	1,291,967	(1,351,319)	4,448	-	117,792	8,374
U.S. Government Agencies (Non-Guaranteed)	334,421	1,580,156	(1,480,020)	6,155	-	440,712	16,595
U.S. Government Agencies (Non-Guaranteed) (Non-U.S. \$)	1,448	467	(1,388)	373	-	900	101
Foreign Government and Provincial Obligations (U.S. \$)	8,982	11,733	(10,650)	377	-	10,442	961
Foreign Government and Provincial Obligations (Non-U.S. \$)	95,166	570,703	(558,606)	12,969	-	120,232	4,283
Municipal and County Bonds	14,443	3,997	(6,564)	392	-	12,268	846
Corporate Bonds	427,885	256,581	(426,992)	10,624	(85)	268,013	21,515
Foreign Corporate Bonds	19,212	5,338	(7,953)	672	-	17,269	903
Commingled Investment	20,777	1,729	(2,343)	(294)	-	19,869	1,729
Commercial Paper	-	141,929	(141,098)	69	-	900	53
Repurchase Agreements	-	322,400	(322,400)	-	-	-	22
Other	8,300	24	-	-	(553)	7,771	12
Total Debt Securities	<u>1,103,330</u>	<u>4,187,024</u>	<u>(4,309,333)</u>	<u>35,785</u>	<u>(638)</u>	<u>1,016,168</u>	<u>55,394</u>
Purchased Options	<u>-</u>	<u>11,255</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>11,255</u>	<u>-</u>
Preferred Stock							
Domestic Preferred Stock	6,918	5,256	-	-	3,245	15,419	93
Foreign Preferred Stock	1,060	429	(1,327)	61	-	223	-
Total Preferred Stock	<u>7,978</u>	<u>5,685</u>	<u>(1,327)</u>	<u>61</u>	<u>3,245</u>	<u>15,642</u>	<u>93</u>
Convertible Securities	<u>10,734</u>	<u>422</u>	<u>(116)</u>	<u>(254)</u>	<u>(2,607)</u>	<u>8,179</u>	<u>5</u>
Cash and Cash Equivalents							
Money Markets Funds and Cash Held at State Treasury	1,197,959	-	(427,254)*	95,880**	-	866,585	12,188
Securities Lending	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,080</u>
Total Investment in Securities	<u>\$ 7,416,247</u>	<u>\$ 6,629,061</u>	<u>\$ (6,755,523)</u>	<u>\$ (40,077)</u>	<u>\$ -</u>	<u>\$ 7,249,708</u>	<u>\$ 148,946</u>

* Net decrease in cash and money markets during the year.

** Includes net realized gains on futures contracts and foreign currency contracts.

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

PERMANENT UNIVERSITY FUND

Comparison Summary of Investment in Securities, at Fair Value

August 31, 2003 and 2002

(in thousands)

	<u>2003</u>	<u>2002</u>
Equity Securities		
Commingled Investments	\$ 1,848,446	\$ 1,125,861
Index Funds	1,399,273	1,281,021
Domestic Common Stock	1,093,492	1,008,546
Limited Partnerships	828,392	886,013
Foreign Common Stock	257,202	192,579
Other	7,135	5,053
Total Equity Securities	<u>5,433,940</u>	<u>4,499,073</u>
Debt Securities		
U.S. Government Obligations (Direct and Guaranteed)	119,002	180,180
U.S. Government Agencies (Non-Guaranteed)	446,193	353,554
U.S. Government Agencies (Non-Guaranteed) (Non-U.S. Dollar Denominated)	1,133	1,599
Foreign Government and Provincial Obligations (U.S. Dollar Denominated)	10,937	9,099
Foreign Government and Provincial Obligations (Non-U.S. Dollar Denominated)	126,874	100,015
Municipal and County Bonds	12,681	15,743
Corporate Bonds	271,516	430,147
Foreign Corporate Bonds	19,376	20,425
Commingled Investment	18,920	17,307
Commercial Paper	900	-
Other	2,421	2,949
Total Debt Securities	<u>1,029,953</u>	<u>1,131,018</u>
Preferred Stock		
Domestic Preferred Stock	9,238	2,472
Foreign Preferred Stock	227	1,202
Total Preferred Stock	<u>9,465</u>	<u>3,674</u>
Purchased Options	<u>11,147</u>	<u>-</u>
Convertible Securities	<u>1,203</u>	<u>2,719</u>
Cash and Cash Equivalents		
Money Market Funds Maintained to Back Futures Contracts	578,373	604,130
Other Money Market Funds and Cash Held at State Treasury	288,229	593,814
Total Cash and Cash Equivalents	<u>866,602</u>	<u>1,197,944</u>
Total Investment in Securities	<u>\$ 7,352,310</u>	<u>\$ 6,834,428</u>

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

PERMANENT UNIVERSITY FUND

Notes to Financial Statements

Note 1 – Organization and Basis of Presentation

(A) The Permanent University Fund (PUF) is a state endowment contributing to the support of eligible institutions of The University of Texas System (UT 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, as well as an additional 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 over 2.1 million acres of land located in 24 counties primarily in West Texas (PUF Lands).

PUF Lands are managed by UT System administration and produce two streams of income: mineral and surface. UT System administration remits mineral income to the PUF, and distributes surface income to the Available University Fund (AUF). The mineral income retained by the PUF is invested and managed by The University of Texas Investment Management Company (UTIMCO).

(B) The accompanying financial statements report the investment in securities of the PUF, including the assets, liabilities, mineral contributions and investment income. Expenses related to the PUF's security investments and PUF Lands, as well as distributions from the PUF to the AUF, are also included. The PUF Lands asset values are not included in the accompanying financial statements.

The Schedule of Changes in Cost of Investments and Investment Income has been prepared for the purpose of complying with the reporting requirement of Section 66.05 of the Texas Education Code.

The PUF uses the accrual method of accounting, recognizing income when such items are earned and expenses when such items are incurred. The PUF is subject to the pronouncements of the Governmental Accounting Standards Board (GASB) and accounts for its activities as a proprietary enterprise fund. The PUF also applies all applicable pronouncements of the Financial Accounting Standards Board that do not conflict with pronouncements of the 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 PUF. The accompanying financial statements may differ in presentation from the Texas Comptroller of Public Accounts' Annual Financial Reporting Requirements.

Note 2 – Significant Accounting Policies

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

Fixed income securities held directly by the PUF 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 security 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).

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

Limited partnerships and other equity securities are valued based on a fair valuation determined as specified by policies established by the UTIMCO Board of Directors. Limited partnerships are valued using the partnership's capital account balance at the closest available reporting period (usually June 30), as communicated by the general partner, adjusted for contributions and withdrawals subsequent to the latest available reporting period. In the rare case when no ascertainable value is available, the limited partnership is valued at cost.

Securities held by the PUF 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.

Commingled investments are valued based on net asset value information provided by the investment company.

(B) ***Foreign Currency Translation*** -- The accounting records of the PUF are maintained in U.S. dollars. Investments in securities are valued at the daily rates of exchange on the valuation date. Purchases and sales of securities of foreign entities and the related income receipts and expense payments are translated into U.S. dollars at the exchange rate on the dates of the transactions. The PUF does not isolate that portion of the results of operations resulting from changes in foreign exchange rates on investments from fluctuations arising from changes in market prices of securities held. Such fluctuations are included with the net realized and unrealized gain or loss from investments. Security classifications, as domestic or foreign, on the comparison summary of investment in securities, at fair value are based on currency.

(C) ***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. Investment income includes net realized and unrealized currency gains and losses recognized between accrual and payment dates on dividend and interest transactions. Premiums and discounts on bonds are not amortized.

(D) ***Security Transactions*** -- Security transactions are recorded on a trade date basis for most securities. International index fund transactions are recorded on a settlement date basis due to trading practices which impose restrictions in acquiring per unit information on the 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.

(E) ***Federal Income Taxes*** -- The PUF is not subject to federal income tax.

(F) ***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

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

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

(G) ***Foreign Currency Contracts*** -- The PUF enters into forward foreign currency exchange contracts to hedge against foreign currency exchange rate risks on its non-U.S. dollar denominated investment securities and to facilitate trading strategies primarily as a tool to increase or decrease market exposure to various foreign currencies. When entering into a forward currency contract, the PUF agrees to receive or deliver a fixed quantity of foreign currency for an agreed-upon price on an agreed future date. These contracts are valued daily and the PUF's net equity therein, representing unrealized gain or loss on the contracts as measured by the difference between the forward foreign exchange rates at the dates of entry into the contracts and the forward rates at the reporting date, is included in the statements of assets and liabilities. Realized and unrealized gains and losses are included in the statements of operations. These instruments involve market and/or credit risk in excess of the amount recognized in the statement of investment assets and liabilities. Risks arise from the possible inability of counterparties to meet the terms of their contracts and from movement in currency and securities values and interest rates.

(H) ***Cash and Cash Equivalents*** -- Cash and cash equivalents consist of money markets, cash held at the State Treasury, foreign currencies and other overnight funds. A portion of the PUF's cash and cash equivalents are maintained to support the notional value of future contracts held (see Note 9). Cash and cash equivalents are an integral part of the PUF's investment activities, and as such are included in the investment in securities balance on the statement of net investment assets.

(I) ***Recently Issued Accounting Standards*** -- In March 2003, GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3*, which modifies and expands disclosures regarding deposits and investments. This statement is not effective for the PUF until the fiscal year ending 2005. Management does not anticipate that the implementation of the new statement will have a material impact on the PUF's financial statement balances.

(J) ***Contributions from PUF Lands*** -- The mineral income earned from PUF Lands is recorded on a cash basis as remitted by UT System administration and presented on the accompanying statements of operations and changes in net investment assets as an increase in net investment assets, styled "Contributions from PUF Lands."

(K) ***Reclassifications*** -- Certain items in the 2002 financial statements and related notes have been reclassified to conform with 2003 classification.

Note 3 – Investments

Under provisions of the Texas Constitution and certain state statutes, the PUF may invest in a wide variety of investments subject to the investment policy adopted by the UT System Board of Regents.

The PUF's investments have been categorized as defined by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements) and Reverse Repurchase Agreements*, to give an indication of the level of credit risk assumed by the PUF at August 31, 2003 and 2002. All of the securities shown in the comparison summary of investment in securities, at fair value are considered credit risk category 1 investments except for commingled equity investments,

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

index funds, limited partnerships, other equity securities, commingled debt investments, purchased options and cash and cash equivalents. Credit risk category 1 investments are investments that are insured or registered held by the PUF or its agent in the PUF's name. All of the exceptions are not categorized by credit risk category because they are not evidenced by securities that exist in physical or book entry form. The amounts identified as securities on loan that have cash held as collateral (see Note 7) would also be considered not categorized.

Note 4 – Commingled Investments

The commingled investments consist of investments in other entities in which the PUF has an ownership percentage, shares or limited partnership interest. The international equity fund is majority owned by the PUF and The University of Texas System General Endowment Fund. The market values of the commingled investments consist of the following:

	August 31,	
	2003	2002
Equity Commingled Investments:		
Merger Arbitrage and Special Situation Funds	\$ 581,755,897	\$ 477,940,743
Hedge Funds	561,770,382	324,619,273
Emerging Market Mutual Funds	319,038,238	222,499,570
International Equity Fund	135,691,424	-
Small Capitalization International Stock Fund	123,428,656	100,801,027
Fund of Hedge Funds	88,127,748	-
Opportunistic Small Cap Value Fund	37,621,494	-
Energy Sector Index Fund	<u>1,011,800</u>	<u>-</u>
Total Equity Commingled Investments	<u>\$ 1,848,445,639</u>	<u>\$ 1,125,860,613</u>
Debt Commingled Investment:		
High Yield Bond Fund	<u>\$ 18,920,153</u>	<u>\$ 17,306,568</u>

The merger arbitrage and special situation funds invest in securities of companies facing a major corporate event. These events might include mergers, tender offers, recapitalizations, spin-offs, liquidations and substantial corporate self-tenders. In addition, these funds may invest in distressed companies that are subject to reorganizations, bankruptcies, or other special situations that can create arbitrage opportunities through the exploitation of inefficiencies in the pricing of related securities. The research-intensive investments within these funds are typically uncorrelated with the overall market and dependent on the occurrence of specific "investment events" to realize the return.

Hedge funds invest in global equity securities both long and short. Investment return is expected to be realized from long and short security selection, and only modestly by the direction of the overall equity markets.

The emerging market funds utilize a long and short investment strategy and invest primarily in emerging and developed markets in Asia and the Pacific region and emerging markets in Latin America, Eastern Europe, the Middle East, and Russia.

The international equity fund invests in non-U.S. equity assets, cash equivalents, currencies and

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

currency forwards.

The fund of hedge funds invest in other hedge funds including merger arbitrage and special situation funds, hedge funds, and other relative value hedge funds and absolute return strategies.

The opportunistic small cap value fund makes active strategic-block value investments in a limited number of small-capitalization public companies.

Note 5 – Index Funds

The index funds, managed by the same investment manager, consist of several funds with different investment objectives, as follows:

The Mid-Cap Index Fund B Lendable is a portfolio of common stocks with the objective of approximating as closely as practicable the capitalization weighted total rate of return of the segment of the U.S. and Canadian markets for publicly traded common stocks represented by the medium capitalized companies. The fund tracks the S&P Mid-Cap 400 Index.

The EAFE Equity Index Fund B is managed to replicate the Morgan Stanley Capital International Europe, Australia and Far East Index (EAFE). Individual index funds are established to represent each country within the EAFE Index. The fund is a commingled ‘superfund’ comprised from the individual EAFE Index country funds managed in their appropriate capitalization weights.

The Emerging Markets Structured Tiered Fund B attempts to approximate the capitalization weighted total rates of return of the equity securities in the Morgan Stanley Capital International Emerging Markets Free Index for selected countries. The fund adopts a structured tier weighting approach across the countries.

The Russell 2000 Alpha Tilts Fund B’s objective is approximating the capitalization weighted total rate of return of the Russell 2000 Index. The fund is selected and maintained in accordance with a formula designed to select stocks through optimized tilts toward particular stock characteristics. The formula is designed to provide systematic exposure to such characteristics with the objective of producing long-term returns in excess of the total rate of return of the Russell 2000 Index.

The Equity Index Fund B Lendable is a portfolio of common stocks with the objective of approximating as closely as practicable the capitalization weighted total return of that segment of the U.S. market for publicly traded common stocks represented by the larger capitalized markets. The fund tracks the S&P 500 Index.

The Russell 3000 Alpha Tilts Fund B’s objective is approximating the capitalization weighted total rate of return of the Russell 3000 Index. The

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

fund is selected and maintained in accordance with a quantitative formula designed to select stocks through optimized tilts toward particular stock characteristics. The formula is designed to provide systematic exposure to such characteristics with the objective of producing long-term returns in excess of the total rate of return of the Russell 3000 Index.

The Russell 2000 Equity Index Fund B's objective is approximating as closely as practicable the capitalization weighted total return of the segment of the U.S. market for publicly traded common stocks represented by the Russell 2000 Index.

The EAFE Equity Index Transition Fund is a temporary fund established to accommodate the transition of existing investments into an existing index fund. The EAFE Equity Index Transition Fund will be folded into the EAFE Equity Index Fund B upon completion of the transition.

The Russell 2000 Equity Index Transition Fund is a temporary fund established to accommodate the transition of existing investments into an existing index fund. The Russell 2000 Equity Index Transition Fund will be folded into the Russell 2000 Index Fund B upon completion of the transition.

When deemed appropriate, a portion of the index funds may be invested in futures contracts for the purpose of acting as a temporary substitute for investment in common stocks.

The Mid-Cap Index Fund B Lendable is majority owned by the PUF and The University of Texas System General Endowment Fund. The market values of the PUF's interests in these index funds are as follows:

	August 31,	
	2003	2002
Mid-Cap Index Fund B Lendable	\$ 468,330,163	\$ 570,464,012
EAFE Equity Index Fund B	281,251,540	382,334,592
Emerging Markets Structured Tiered Fund B	218,705,253	56,132,542
Russell 2000 Alpha Tilts Fund B	212,154,484	74,462,698
Equity Index Fund B Lendable	108,695,766	197,627,598
Russell 3000 Alpha Tilts Fund B	104,377,981	-
Russell 2000 Equity Index Fund B	5,323,981	-
EAFE Equity Index Transition Fund	412,619	-
Russell 2000 Equity Index Transition Fund	21,032	-
	<u>\$ 1,399,272,819</u>	<u>\$ 1,281,021,442</u>

Note 6 – Limited Partnerships

The limited partnerships consist of interests in privately held investments that are not registered for sale on public exchanges. The market values of the limited partnerships consist of the following:

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

	August 31,	
	2003	2002
U.S. Private Equity	\$ 427,450,782	\$ 452,802,148
Non-U.S. Private Equity	125,483,673	107,306,281
Venture Capital	114,657,694	168,636,160
Opportunistic	83,445,458	71,492,831
Mezzanine	64,670,130	73,693,410
Oil and Gas	8,583,765	3,797,496
Direct Investments	4,100,659	8,284,913
	<u>\$ 828,392,161</u>	<u>\$ 886,013,239</u>

The U.S. private equity interests consist of investments in private equity partnerships which primarily invest in the equity securities of private businesses that are considered to be in the post-start-up phase and that are profitable and generating income.

Venture capital consists of interests in partnerships that provide capital to companies that are in the early stages of development.

Non-U.S. private equity interests consist of investments in private equity and venture capital partnerships that are based outside of the U.S. These partnerships focus on making investments in companies that have operations in countries other than the U.S.

The opportunistic category consists of interests in private equity partnerships that invest in distressed debt, specialized sectors or that purchase limited partnership interests in private equity partnerships on a secondary basis.

Mezzanine interests consist of investments in partnerships that make subordinated debt or minority equity investments in private companies.

Oil and Gas consists of interests in private partnerships that hold royalty interests and other non-working interests in oil and gas properties. These properties create an income stream over the life of the partnership.

Direct investments represent the PUF's direct interests in private companies.

Note 7 – Securities Lending

The PUF loans securities to certain brokers who pay 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 U.S. issuers and a market value of 105% for loaned securities of non-U.S. issuers. If the market value of the collateral held in connection with loans of securities of U.S. issuers is less than 100% at the close of trading on any business day, the borrower is required to deliver additional collateral by the close of the next business day to equal 102% of the market value. For non-U.S. issuers, the collateral should remain at 105% of the market value of the loaned securities at the close

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

of any business day. If it falls below 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 are as follows at August 31, 2003 and 2002:

Securities on Loan	2003 Value	2002 Value	Type of Collateral	2003 Value of Collateral	2002 Value of Collateral
U.S. Government	\$ 62,899,948	\$ 55,425,205	Cash	\$ 63,659,881	\$ 55,914,798
Foreign Government	8,723,945	832,596	Cash	9,147,671	873,180
Corporate Bonds	33,253,536	49,909,136	Cash	34,353,149	51,699,500
Common Stock	<u>49,684,339</u>	<u>18,068,081</u>	Cash	<u>51,904,234</u>	<u>18,994,692</u>
Total	<u>\$ 154,561,768</u>	<u>\$ 124,235,018</u>	Total	<u>\$ 159,064,935</u>	<u>\$ 127,482,170</u>
U.S. Government	<u>\$ 510,071</u>	<u>\$ 4,502,822</u>	Non-Cash	<u>\$ 684,927</u>	<u>\$ 4,794,959</u>

Cash received as collateral for 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 8 – Commitments

The PUF had unfunded contractual commitments for Limited Partnerships and Other assets of \$489,452,054 as of August 31, 2003.

Note 9 – Futures Contracts

The PUF's activities include trading in derivatives such as futures contracts. During the years ended August 31, 2003 and 2002, the futures contracts were used to facilitate various trading strategies, primarily as a tool to increase or decrease market exposure to various asset classes of the PUF. The asset classes that used futures include domestic and foreign equities, domestic and foreign debt, and commodities. Commodity index exposure was obtained through the Goldman Sachs Commodity Index (GSCI). The GSCI is a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The PUF had \$54,591,354 and \$43,809,926 on deposit with a broker for collateral as margin for the futures contracts as of August 31, 2003 and 2002, respectively. It is the intention of the PUF not to utilize leverage when entering into these contracts and to maintain cash balances that when combined with the collateral deposited with a broker exceed the notional value of the futures contracts held. Short futures may be used by a limited number of external managers for the PUF to hedge the PUF's interest rate or country risk associated with security positions.

Futures contracts are marked to market daily; that is, they are valued at the close of business each day, and a gain or loss is recorded between the value of the contracts that day and on the previous day. The daily gain or loss is referred to as the daily variation margin which is settled in cash with the broker each morning for the amount of the previous day's mark to market. The amount that is settled in cash with the broker each morning is the carrying and fair value of the futures contracts. Such carrying value at August 31, 2003 and 2002, is included in "Receivables Other" on the accompanying statements of net investment assets. The amount of net realized gain on the futures contracts was \$71,537,611 for the year ended August 31, 2003. The amount of net realized loss on

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

the futures contracts was \$46,185,245 for the year ended August 31, 2002. The PUF executes such contracts either on major exchanges or with major international financial institutions and minimizes market and credit risk associated with these contracts through the managers' various trading and credit monitoring techniques.

The following discloses the notional, carrying and fair values at August 31, 2003, and the average carrying and fair values for the year ended August 31, 2003, for futures contracts:

	Notional Value at August 31, 2003		Carrying and Fair Value at August 31, 2003		Average Carrying and Fair Value for the Year Ended August 31, 2003	
	Long	Short	Assets	Liabilities	Assets	Liabilities
Domestic Equity Futures	\$ 498,416,150	\$ 29,917,400	\$ 3,248,850	\$ -	\$ 2,113,484	\$ 1,919,095
International Equity Futures	30,172,888	75,085,078	539,866	655,046	475,728	506,187
Commodity Futures	97,123,062	-	-	100,437	898,146	799,359
Domestic Fixed Income Futures	128,208,531	146,563,172	178,983	134,816	334,752	336,348
International Fixed Income Futures	161,667,949	43,797,837	546,654	205,850	406,436	381,633

The following discloses the notional, carrying and fair values at August 31, 2002, and the average carrying and fair values for the year ended August 31, 2002, for futures contracts:

	Notional Value at August 31, 2002		Carrying and Fair Value at August 31, 2002		Average Carrying and Fair Value for the Year Ended August 31, 2002	
	Long	Short	Assets	Liabilities	Assets	Liabilities
Domestic Equity Futures	\$ 417,191,940	\$ 10,362,825	\$ 102,030	\$ 1,457	\$ 1,455,612	\$ 1,703,571
International Equity Futures	25,621,117	19,465,687	399,959	337,130	498,235	487,316
Commodity Futures	178,767,300	-	83,225	-	738,662	624,036
Domestic Fixed Income Futures	76,192,172	155,464,891	151,170	245,101	480,304	483,656
International Fixed Income Futures	215,443,016	86,895,459	491,971	52,938	256,972	247,346

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

Note 10 – Foreign Currency Exchange Contracts

The tables below summarize by currency the contractual amounts of the PUF’s foreign currency exchange contracts at August 31, 2003 and 2002. Foreign currency amounts are translated at exchange rates as of August 31, 2003 and 2002. The “Net Buy” amounts represent the U.S. dollar equivalent of net commitments to purchase foreign currencies, and the “Net Sell” amounts represent the U.S. dollar equivalent of net commitments to sell foreign currencies.

Currency	Net Buy August 31, 2003	Net Sell August 31, 2003	Unrealized Gains on Foreign Currency Exchange Contracts August 31, 2003	Unrealized Losses on Foreign Currency Exchange Contracts August 31, 2003
Australian Dollar	\$ 27,268,134	\$ -	\$ 318,910	\$ 1,001,991
Canadian Dollar	-	44,951,328	553,914	559,836
Danish Krone	1,952,391	-	2,975	104,676
Euro	56,906,152	-	1,337,203	953,241
Hong Kong Dollar	261,499	-	2	72,401
Japanese Yen	123,325,998	-	2,025,842	1,142,503
Mexican New Peso	-	-	60,830	-
New Zealand Dollar	127,638	-	370,793	80,315
Norwegian Krone	-	4,407,362	2,631,780	116,033
Polish Zloty	1,412,058	-	35,287	94,712
Singapore Dollar	16,736,061	-	460,630	44,154
Swedish Krona	36,030,307	-	1,757,478	1,643,149
Swiss Franc	-	35,629,719	2,794,515	1,934,028
UK Pound	30,794,872	-	587,935	1,026,856
	<u>\$ 294,815,110</u>	<u>\$ 84,988,409</u>	<u>\$ 12,938,094</u>	<u>\$ 8,773,895</u>

Currency	Net Buy August 31, 2002	Net Sell August 31, 2002	Unrealized Gains on Foreign Currency Exchange Contracts August 31, 2002	Unrealized Losses on Foreign Currency Exchange Contracts August 31, 2002
Australian Dollar	\$ 7,251,442	\$ -	\$ 727,279	\$ 4,646
Canadian Dollar	-	16,575,827	677,196	251,973
Danish Krone	351,521	-	15,564	-
Euro	78,868,365	-	1,511,226	32,209
Japanese Yen	118,038,269	-	6,453,112	716,428
New Zealand Dollar	9,977,266	-	69,062	39,420
Norwegian Krone	9,798,409	-	4,740,335	582,652
Singapore Dollar	2,177,766	-	241	197,202
Swedish Krona	41,612,454	-	207,427	151,793
Swiss Franc	-	44,041,740	302,488	1,925,110
UK Pound	24,614,254	-	173,873	627,618
	<u>\$ 292,689,746</u>	<u>\$ 60,617,567</u>	<u>\$ 14,877,803</u>	<u>\$ 4,529,051</u>

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

Note 11 – Note Purchase Commitment

During the fiscal year 2003, the PUF entered into note purchase agreements with the UT System Board of Regents and the Texas A&M System Board of Regents. These agreements commit the PUF to acquire up to \$400,000,000 of UT System flexible rate notes and \$80,000,000 of Texas A&M System flexible rate notes in the event of a failed remarketing of such notes.

The PUF receives an annual commitment fee equal to 0.1% of the commitment amount. The commitment fees earned by the PUF were \$356,658 for the year ended August 31, 2003.

Note 12 – Distributions to the Available University Fund

The Texas Constitution allows for (a) distributions to the AUF from the “total return” on PUF investments, including income return as well as capital gains (realized and unrealized) and (b) the payment of PUF expenses from PUF assets. The Texas Constitution directs the Board of Regents of UT System to establish a distribution policy that provides stable, inflation adjusted annual distributions to the AUF and preserves the real value of the PUF investments over the long term. Accordingly, distributions to the AUF in any given fiscal year are subject to the following: (1) A minimum amount equal to the amount needed to pay debt service on PUF bonds; (2) No increase from the preceding year (except as necessary to pay debt service on PUF bonds) unless the purchasing power of PUF investments for any rolling 10-year period has been preserved; (3) A maximum amount equal to seven percent of the average net fair market value of PUF assets in any fiscal year, except as necessary to pay debt service on PUF bonds. The PUF distribution to the AUF for the year ending August 31, 2004, in the amount of \$348,033,578 will be paid quarterly. The first payment of \$87,008,395 was made on September 2, 2003.

Note 13 – Fees and Expenses

The PUF incurs investment management fees from various external managers of the PUF. The fees, generally assessed quarterly, are based on a percentage of the market value of investments held by each individual investment manager and currently range from 0.01% to 1.0%. In addition to quarterly investment management fees, the PUF may pay annual performance-based management fees for investment performance in excess of certain defined benchmarks as provided for in the managers’ contracts. In addition, the PUF incurs consulting fees for investment planning and oversight services with regard to limited partnerships and hedge funds.

UTIMCO assesses the PUF a management fee to cover the costs of managing the PUF investments and providing day-to-day operations. The fee assessed for the years ended August 31, 2003 and 2002, was \$5,187,122 and \$3,274,506, respectively.

The PUF is assessed a fee to cover expenses related to the management of the PUF Lands. The fee assessed for the years ended August 31, 2003 and 2002, was \$5,061,283 and \$5,220,999, respectively.

PERMANENT UNIVERSITY FUND

Notes to Financial Statements (cont.)

Custodial fees and expenses are assessed by the financial institution which holds the PUF's assets. Fees are based on the number of accounts, market value of the PUF, and transaction activity in accordance with the contractual agreement with the institution. Additional fees are assessed for performance measurement, risk measurement and on-line communication services per the contractual agreement.

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