

Tobacco Settlement Permanent Trust Fund

Basic Financial Statements
December 31, 2018

Contents

Independent auditor's report	1-2
Management's discussion and analysis	3-9
Basic financial statements	
Statement of fiduciary net position	10
Statement of changes in fiduciary net position	11
Notes to the financial statements	12-19



RSM US LLP

Independent Auditor's Report

To the Honorable Glenn Hegar
Comptroller of Public Accounts of the State of Texas
Tobacco Settlement Permanent Trust Fund

Report on the Financial Statements

We have audited the accompanying financial statements of the Tobacco Settlement Permanent Trust Fund (the Fund), a private-purpose trust fund of the state of Texas, as of and for the year ended December 31, 2018, and the related notes to the financial statements, which collectively comprise the Fund's basic financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Fund's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of December 31, 2018, and the changes in its financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As described in Note 2 to the financial statements, these financial statements present only the financial statements of the Fund, a private-purpose trust fund of the state of Texas, and do not purport to, and do not, present fairly the financial position of the state of Texas as of December 31, 2018, or the changes in its financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matter—Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis, as listed in the table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

RSM US LLP

Austin, Texas
March 7, 2019

Tobacco Settlement Permanent Trust Fund

Management's Discussion and Analysis December 31, 2018

The Tobacco Settlement Permanent Trust Fund (Fund) management's discussion and analysis is designed to assist the reader in focusing on significant financial issues and provide a performance overview of the Fund's operations for the year ended December 31, 2018. Please read this analysis in conjunction with the basic financial statements which follow this section. The Texas Treasury Safekeeping Trust Company (Texas Trust) administers and manages the assets of the Fund.

Financial Highlights

- The total net position of the Fund decreased by \$62.0 million, or 2.40 percent during the year 2018.
- The Fund distributed \$69.7 million to political subdivisions for health care.

Overview of the Basic Financial Statements and Condensed Financial Information

The management's discussion and analysis is an introduction to the Fund's basic financial statements. The Fund has only one fund and, therefore, the government-wide and fund financial statements are the same since the Fund reports all of its activity as a fiduciary fund, which uses the same measurement focus for all statements.

The Statement of Fiduciary Net Position provides information about the nature and amounts of the Fund's cash, investments and receivables (assets) and their payables (liabilities). The Statement of Changes in Fiduciary Net Position reports the additions to, deductions from and net increases or decreases in net position.

This annual financial report consists of two parts:

- Management's discussion and analysis
- Basic financial statements
 - Statement of Fiduciary Net Position
 - Statement of Changes in Fiduciary Net Position
 - Notes to the Financial Statements

Tobacco Settlement Permanent Trust Fund

Management's Discussion and Analysis December 31, 2018

The Statement of Fiduciary Net Position presents the financial position of the Fund at the end of the fiscal year and includes all assets and liabilities of the Fund. The difference between total assets and total liabilities equals the Fund's net position. At December 31, 2018 and 2017, net position was calculated as follows:

	2018	2017	Variance	Percent Change
Cash and cash equivalents	\$ 120,975	\$ 824,996	\$ (704,021)	(85.34%)
Trades pending settlement	-	222,348	(222,348)	N/A
Other assets	363,077	235,059	128,018	54.46%
Investments at fair value	2,527,307,368	2,587,652,840	(60,345,472)	(2.33%)
Total assets	2,527,791,420	2,588,935,243	(61,143,823)	(2.36%)
Total liabilities	2,164,357	1,283,110	881,247	68.68%
Net position held in trust	\$ 2,525,627,063	\$ 2,587,652,133	\$ (62,025,070)	(2.40%)

During the year, investments decreased by \$60.3 million due to lower investment returns as compared to 2017 and distributions paid of \$69.7 million. Other assets increased by \$128.0 thousand while total liabilities increased by \$881.2 thousand. The increase in other assets is attributable to an increase in interest and other receivables. The increase in liabilities is due to the interest payable related to derivative investments.

The Statement of Changes in Fiduciary Net Position presents the activity within the Net Position balance for the year ended. Significant activity accounts include net investment income and distributions to local governments. The change in net position for the years ended December 31, 2018 and 2017, is as follows:

	2018	2017	Variance	Percent Change
Net investment income	\$ 14,731,918	\$ 264,590,798	\$ (249,858,880)	(94.43%)
Distributions to local governments	69,689,880	67,155,876	2,534,004	3.77%
Expenses	7,067,108	7,053,248	13,860	0.20%
Net increase(decrease) in net position	(62,025,070)	190,381,674		
Net position held in trust at beginning of year	2,587,652,133	2,397,270,459		
Net position held in trust at end of year	\$ 2,525,627,063	\$ 2,587,652,133		

Net Investment Income decreased by \$250.0 million compared to the previous year as a result of the lower investment returns earned by the Fund. During the year ended December 31, 2018, the total rate of return for the Fund was 0.97 percent, while the total rate of return for the previous year was 11.57 percent. The total Fund outperformed its benchmark for the year by 0.31 percent. Distributions to local governments vary from year to year and are based on the amount approved for distribution by the Tobacco Settlement Permanent Trust Account Investment Advisory Committee.

Tobacco Settlement Permanent Trust Fund

Management's Discussion and Analysis December 31, 2018

Asset Allocation

The current Texas Trust asset allocation structure as of December 31, 2018, is shown in the chart below:

Asset Class	Current Market Value	Weight	Target	Policy Range
Fixed Income	\$ 940,397,588	37.2%	35.0%	20-50%
Global Fixed Income	195,394,008	7.7%	10.0%	
Cash	112,956,817	4.5%	0.0%	
Alternative Fixed Income	369,438,761	14.6%	15.0%	
Private Debt	262,608,002	10.4%	10.0%	
Equity	1,062,572,090	42.0%	45.0%	30-60%
Global Public Equity	186,673,513	7.4%	15.0%	
Hedged Equity	569,532,773	22.5%	20.0%	
Private Equity	306,365,804	12.1%	10.0%	
Real Assets	357,960,158	14.2%	20.0%	10-30%
Stable Value Real Assets	238,042,313	9.5%	10.0%	
Enhanced Real Estate	119,917,845	4.7%	10.0%	
Strategic All Asset and Overlays	166,861,584	6.6%	0.0%	0-15%
Total Assets	\$ 2,527,791,420	100%	100%	100%

The current structure represents the ongoing effort by the Texas Trust to achieve its investment objective to earn an annual total return that:

- Provides a predictable, stable stream of distributions.
- Ensures the inflation-adjusted value of distributions is maintained over the long-term.
- Ensures that the inflation-adjusted value of the corpus, after distributions and fund expenses, is maintained over the long-term.
- Achieves the desired portfolio volatility and minimizes downside risk through diversification and risk management.

The Fixed Income strategies are expected to generate relatively consistent positive returns with lower correlation to the public equity markets. Strategies selected are intended to provide positive returns during most economic and capital market environments.

The Equity strategies include public and private equities and asset classes that are correlated to global equity markets. Historically, global equity investments have provided returns in excess of the total Fund return objective.

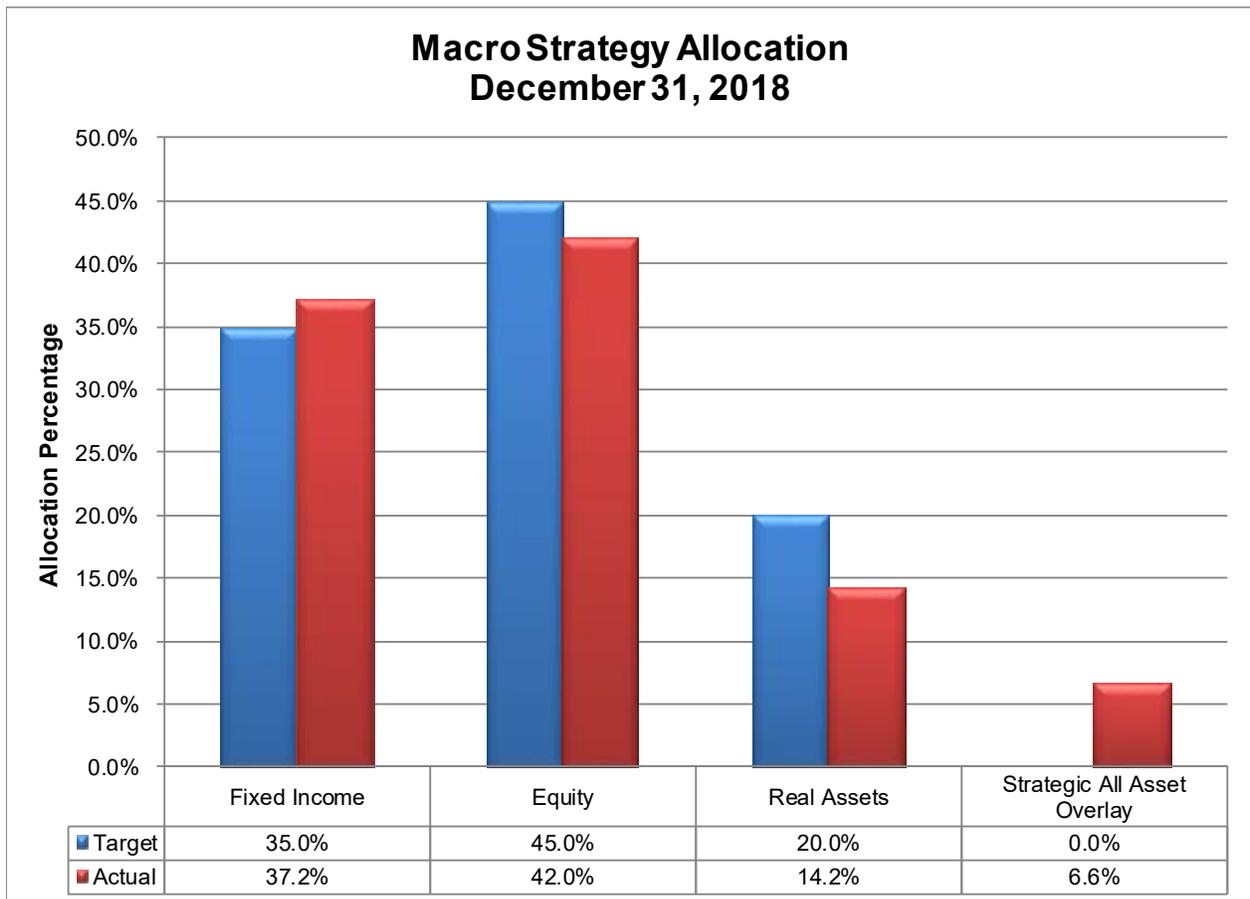
The Real Asset strategies are intended to serve primarily as inflation hedges and provide diversification benefits of low correlation with other investment strategies. A significant majority of the portfolio will be exposed to Real Assets such as high quality real estate, timber, infrastructure assets, industrial and precious metals, energy, livestock, and grains.

Tobacco Settlement Permanent Trust Fund

**Management’s Discussion and Analysis
December 31, 2018**

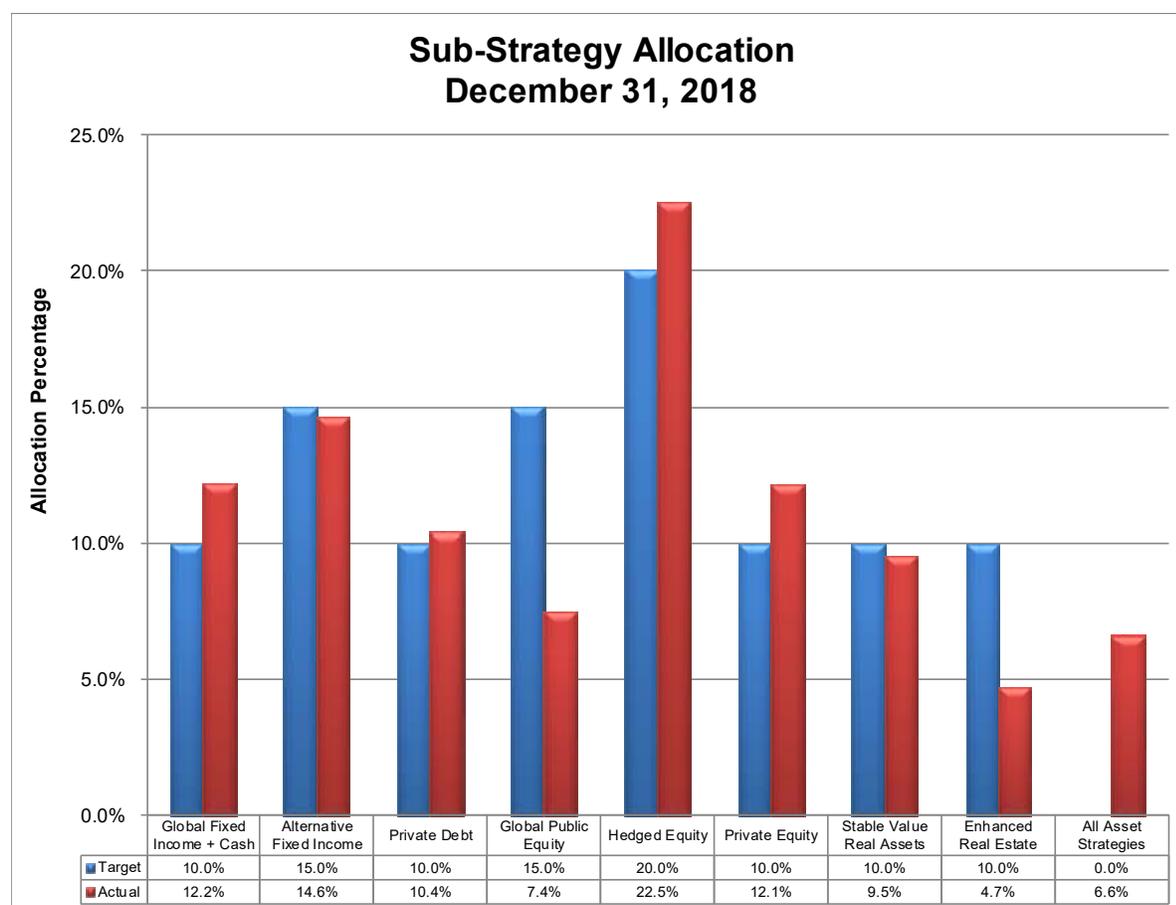
The Strategic All Asset strategies include exposures across equity, fixed income and real estate classes. This portfolio may consist of long-only, hedged and private strategies whose portfolios are diversified across a broad range of asset types.

The following charts compare the Fund’s macro strategy target asset allocation as of December 31, 2018, with its actual allocation as of December 31, 2018, and the Fund’s sub-strategy asset allocation as of December 31, 2018, with its actual allocation as of December 31, 2018:



Tobacco Settlement Permanent Trust Fund

**Management’s Discussion and Analysis
December 31, 2018**



The above chart compares the year-end actual allocation with its target allocation for each sub-strategy. The largest variations at year-end were a 7.6 percent underweight in global public equity and a 6.6 percent overweight in all asset strategies. Both variances were well within the allowable target ranges for the strategy.

Unfunded Commitments

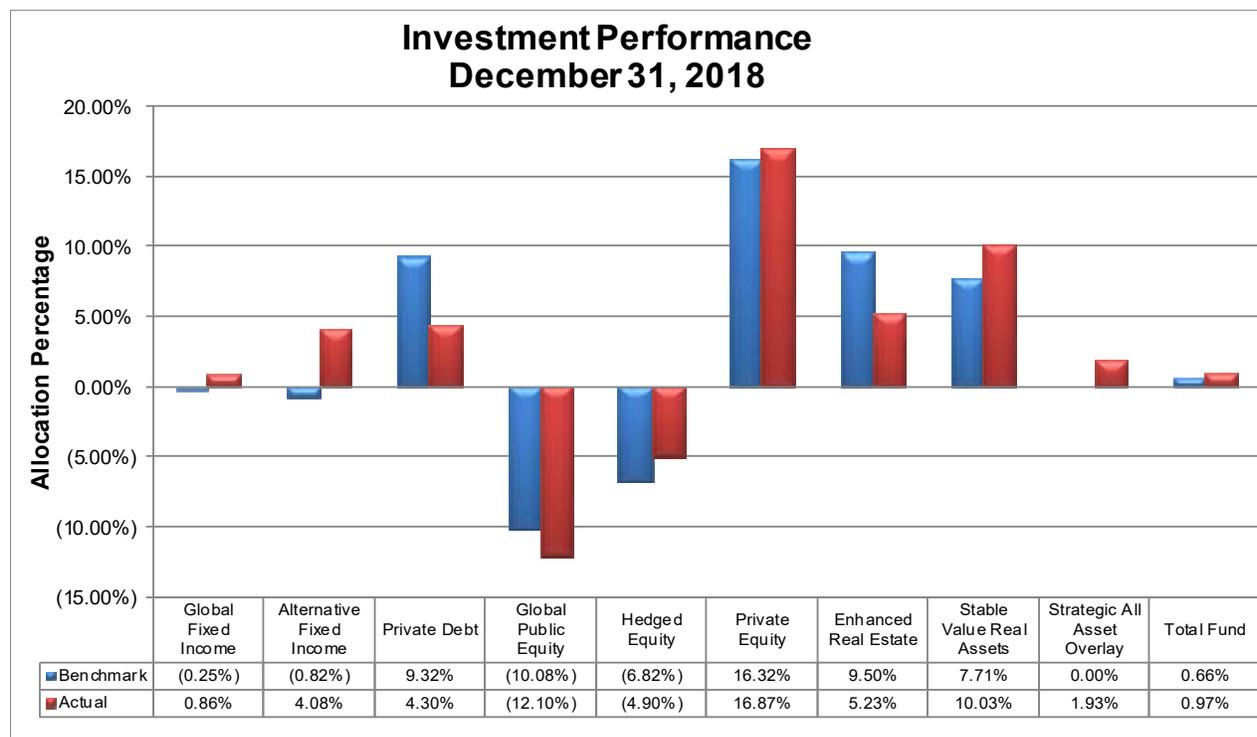
As of December 31, 2018, the Fund’s outstanding unfunded commitments totaled \$698.8 million.

Tobacco Settlement Permanent Trust Fund

**Management’s Discussion and Analysis
December 31, 2018**

Investment Performance

The chart below presents the Fund’s performance as of December 31, 2018. During the year, the Fund’s overall performance was 0.97 percent, while the policy benchmark return was 0.66 percent. During the year, the Private Debt, the Global Public Equity, and the Enhanced Real Estate strategies underperformed their respective benchmark. All other strategies outperformed their benchmarks.



Below is the Fund’s performance for the preceding 1 year, 3 year and 5 year periods.

	1 Year	3 Year	5 Year
The Fund	0.97%	6.60%	4.86%

Tobacco Settlement Permanent Trust Fund

Management's Discussion and Analysis December 31, 2018

Annual Distribution From the Fund

The annual distribution is calculated in accordance with the Trust Account Distribution Policy as set forth in the Investment Policy Statement as authorized in Texas Administrative Code, Title 34, Part 1, Chapter 18, Rules 18.1 and 18.2 (Code).

Under the Code, the calculated actual distribution amount for consideration by the Investment Advisory Committee in April 2019 is \$71,912,881. This amount is based on an average market value of the Trust Account of \$2,397,096,017 as of December 31, 2018, using the most recent 20 calendar quarter-end market values.

See Note 4 for more information.

The following chart reflects the Fund's distribution and contribution history in the Trust Account:

Contribution Month	Total	Distribution Month	Total Distribution From Tobacco Fund	Direct Distribution	Total Distributions
		January 15, 1999	\$ -	\$ 300,000,000	\$ 300,000,000
January 3, 2000	\$ 444,581,000	April 1, 2000	-	100,000,000	100,000,000
December 29, 2000	433,888,365		-	-	-
January 2, 2001	67,523,342		-	-	-
June 12, 2001	43,407,228		-	-	-
December 31, 2001	491,573,700	April 12, 2001	14,306,508	50,000,000	64,306,508
May 1, 2002	19,317,882	April 12, 2002	17,760,000	-	17,760,000
December 30, 2002	26,914,041		-	-	-
December 31, 2002	148,494,658		-	-	-
April 30, 2003	7,264,688	April 17, 2003	22,041,497	-	22,041,497
	-	April 16, 2004	28,515,957	-	28,515,957
	-	April 18, 2005	50,282,384	-	50,282,384
	-	April 18, 2006	72,070,600	-	72,070,600
	-	April 20, 2007	82,691,441	-	82,691,441
	-	April 15, 2008	92,303,845	-	92,303,845
	-	April 15, 2009	92,303,845	-	92,303,845
	-	April 20, 2010	46,151,923	-	46,151,923
	-	April 18, 2011	51,000,000	-	51,000,000
	-	April 18, 2012	50,000,000	-	50,000,000
	-	April 16, 2013	50,000,000	-	50,000,000
	-	April 15, 2014	50,000,000	-	50,000,000
	-	April 15, 2015	55,000,000	-	55,000,000
	-	April 15, 2016	46,761,489	-	46,761,489
	-	April 15, 2017	67,155,876	-	67,155,876
	-	April 15, 2018	69,689,880	-	69,689,880
Total	<u>\$ 1,682,964,904</u>		<u>\$ 958,035,245</u>	<u>\$ 450,000,000</u>	<u>\$ 1,408,035,245</u>

Contacting Texas Trust's Financial Management

This financial report is designed to provide the Fund's beneficiaries, business partners and creditors with a general overview of its finances. Questions about this report can be directed to Texas Trust's Finance Department at (512) 463-4300.

Basic Financial Statements

Tobacco Settlement Permanent Trust Fund

**Statement of Fiduciary Net Position
December 31, 2018**

Assets	
Cash and cash equivalents	\$ 120,975
Interest and other receivables	363,077
Investments	<u>2,527,307,368</u>
Total assets	<u>2,527,791,420</u>
Liabilities	
Accounts payable	1,271,537
Interest payable	<u>892,820</u>
Total liabilities	<u>2,164,357</u>
Net Position	
Held in trust for other governments	<u>\$ 2,525,627,063</u>

See notes to financial statements.

Tobacco Settlement Permanent Trust Fund

**Statement of Changes in Fiduciary Net Position
Year Ended December 31, 2018**

Additions:

Investment income:

Net decrease in fair value of investments

\$ (20,678,132)

Interest and investment income

35,410,050

Total income from investing activities

14,731,918

Total additions

14,731,918

Deductions:

Professional fees and services

7,067,108

Disbursements to local governments

69,689,880

Total deductions

76,756,988

Change in net position held in trust for other governments

(62,025,070)

Net position held in trust for other governments at beginning of year

2,587,652,133

Net position held in trust for other governments at end of year

\$ 2,525,627,063

See notes to financial statements.

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 1. Reporting Entity

The Tobacco Settlement Permanent Trust Fund (the Fund) was established under the authority of House Bill 1161 (the Act) enacted by the 76th Regular Session of the 1999 Texas Legislature. The purpose of the Fund is to collect monies from the tobacco companies, and distribute the funds to eligible local governmental units for reimbursement of previous health care costs associated with tobacco-related illness. The Fund was organized on July 24, 1998, and commenced operations on December 31, 1998.

The Act establishes the Fund with the Texas Comptroller of Public Accounts (Comptroller), who is required to administer and manage the assets of the Fund with the advice of, and in consultation with, the appointed Tobacco Settlement Permanent Trust Account Investment Advisory Committee (Investment Advisory Committee). The Comptroller is also required to make annual distributions to eligible governmental units and to prepare and distribute annual reports regarding the Fund's assets and investments. The Investment Advisory Committee consists of 11 members appointed in accordance with the Act. The Comptroller, with the advice of, and in consultation with, the Investment Advisory Committee, has developed an Investment Policy which guides the investments of the Fund.

The Comptroller has delegated day-to-day investment management of the Fund to the Texas Treasury Safekeeping Trust Company (Texas Trust). In 1986, the 69th Texas Legislature authorized the incorporation of the Texas Trust to give the Treasurer of the State of Texas access to the Federal Reserve System. The 77th Legislature amended the Texas Trust statute and the Texas Trust began operations as a separate state entity on September 1, 2001. Prior to September 1, 2001, the Comptroller provided financial and staff support to conduct and administer the day-to-day operations of the Texas Trust, including the Fund. Those expenses were neither recorded nor allocated to the Fund's basic financial statements and were paid through the General Fund of the Comptroller's Office. The Comptroller is the single shareholder of the Texas Trust and is charged with managing the Texas Trust.

The Act requires the Texas Department of Health to collect information regarding the amount of each governmental unit's unreimbursed health care expenditures, and to certify to the Comptroller the percentage payable from the Fund to each governmental unit.

Note 2. Summary of Significant Accounting Policies

(a) Measurement focus, basis of accounting and financial statement presentation: The state of Texas reports the Fund as a private-purpose trust fund in its basic financial statements. Private-purpose trust funds are accounted for using the economic resources measurement focus and the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when the liability is incurred regardless of the timing of the related cash flows. Security transactions are recorded on a trade date basis.

(b) Restrictions: In accordance with the Act, the Fund is composed of money paid to the Fund in accordance with the Tobacco Settlement Agreement, assets purchased with that money, earnings of the Fund and any other contributions made to the Fund. The cumulative value of all contributions to the Fund represents the corpus of the Fund and shall remain in the Fund and may not be distributed for any purpose that is not in accordance with the approved spending policy. The money and other assets contained in the Fund are not a part of the general funds of the state of Texas.

The Comptroller, with the advice and consultation of the Investment Advisory Committee, may use the earnings of the Fund for investment expense. Upon certification in accordance with the Health and Safety Code, Subchapter J, Chapter 12, the Comptroller shall make an annual distribution from the net earnings of the Fund, to each eligible political subdivision as provided in the agreement regarding disposition of settlement proceeds.

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 2. Summary of Significant Accounting Policies (Continued)

(c) **Investments:** Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Investments are reported at fair value based upon quoted market prices, or when quoted market prices are not readily determinable, other observable significant inputs including net asset values (NAV) of underlying securities.

According to the Act, the Comptroller is to administer and manage the assets of the Fund using the specified fiduciary standard of care and with the advice of, and in consultation with, the Investment Advisory Committee. The Fund is authorized to invest its funds according to the approved Investment Policy.

The following table reflects the Fund's asset class target percentage and the allocation range per the Fund's Investment Policy:

Strategy—Sub-Strategy	Target Percentage	Benchmark(s) Strategy Range
Fixed Income	35%	<i>Allocation Range: 20%-50%</i>
Global Fixed Income	10%	9% Bloomberg Barclays US Universal Bond Index; 1% 3-Month T-Bill
Alternative Fixed Income	15%	HFRI FOF: Conservative Index
Private Debt	10%	Cambridge Associates—Custom Private Debt Index
Equity	45%	<i>Allocation Range: 30%-60%</i>
Global Public Equity	15%	MSCI ACWI IMI Net Index
Hedged Equity	20%	HFRI FOF: Strategic Index
Private Equity	10%	Cambridge Associates—Custom Private Equity Index
Real Assets	20%	<i>Allocation Range: 10%-30%</i>
Stable Value Real Estate	10%	NCREIF NFI—ODCE
Enhanced Real Estate	10%	Cambridge Associates Real Estate Fund Index
Strategic All Asset Strategy and Overlay	0%	<i>Allocation Range: 0%-15%</i>
All Asset Strategies	0%	Total Endowment Benchmark
Overlay Strategies	0%	3-Month T-Bill

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 2. Summary of Significant Accounting Policies (Continued)

(d) Income tax: The Fund is exempt from federal income tax on its operations in accordance with Internal Revenue Code Section 115.

(e) Use of estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ significantly from these estimates.

(f) Distributions: In July 2016, the Comptroller adopted a modification to the Trust Account Distribution Policy as outlined in Texas Administrative Code, Title 34, Part 1, Chapter 18, Rules 18.1 and 18.2 (Code) for calculating the annual distribution, beginning with the 2016 calculation. The revised rules are designed to achieve a conservative but flexible spending policy that will smooth distributions while allowing the Trust Account to maintain its purchasing power over the long-term. In accordance with the Fund's Investment Policy, the calculated actual distribution amount shall be 3 percent of the average market value of the Trust Account calculated as of the end of the calendar year immediately preceding the distribution. The average market value of the Trust Account is calculated using the most recent twenty (20) calendar quarter-end market values. In addition, the distribution stabilization account was eliminated as it is no longer necessary.

(g) Pending trades: Security transactions are recorded on a trade date basis. Pending trades at year-end represent those trades that were executed prior to year-end, but settled after year-end.

Note 3. Investments

The Fund reports investments at fair value on the Statement of Fiduciary Net Position, and all investment income, including changes in the fair value of investments, are reported in the Statement of Changes in Fiduciary Net Position.

The Fund contracts services with a custodian to assist with certain of its responsibilities. The custodian performs the duties involving the acquisition, sale and holding of fixed income and equity investments in the Fund's name.

The Fund categorizes its fair value measurement disclosures within the fair value hierarchy established by generally accepted accounting principles. The hierarchy prioritizes valuation inputs used to measure the fair value of the asset or liability in three broad categories. Levels 1, 2 and 3 (lowest priority level) of the fair value hierarchy are defined as follow:

Level 1: Inputs using unadjusted quoted prices in active markets or exchanges for identical assets or liabilities.

Level 2: Significant other observable inputs, which may include, quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in non-active markets; and inputs other than quoted prices that are observable for the assets or liabilities, either directly or indirectly.

Level 3: Valuations for which one or more significant inputs are unobservable and may include situations where there is minimal, if any, market activity for the asset or liability.

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 3. Investments (Continued)

If the fair value is measured using inputs from different levels in the fair value hierarchy, the measurement is categorized based on the lowest priority level input that is significant to the valuation. The Fund's assessment of significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the investment. Investments measured at fair value using NAV per share (or equivalent) as a practical expedient to fair value are not classified in the fair value hierarchy.

The Fund's investments as of December 31, 2018, are as follows:

Investments by Fair Value Level	Carrying Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market mutual funds	\$ 216,905,938	\$ 216,905,938	\$ -	\$ -
Mutual funds—global fixed income	144,373,287	144,373,287	-	-
Mutual funds—global equities	4,957,320	4,957,320	-	-
Futures—real assets	(460,539)	(460,539)	-	-
Total return swap—fixed income	1,563,732	-	1,563,732	-
Total return swap—equity	(11,904,923)	-	(11,904,923)	-
	<u>\$ 355,434,815</u>	<u>\$ 365,776,006</u>	<u>\$ (10,341,191)</u>	<u>\$ -</u>

Investments Measured at NAV	Carrying Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Hedge funds—fund of funds	81,184,476	N/A	Daily, Monthly, Quarterly, Annually	1-95 days
Hedge funds—direct funds - fixed income	420,766,178	N/A	Daily, Monthly, Quarterly, Annually	2-92 days
Hedge funds—direct funds - equities	671,047,190	N/A	Daily, Monthly, Quarterly, Annually	1-120 days
Hedge funds—direct funds - all asset strategies	22,217,851	N/A	Annually	45 days
Hedge funds—direct funds - real assets	26,373,477	N/A	Monthly	30 days
Domestic alternative - private debt	278,280,091	\$ 153,847,537	N/A	N/A
Domestic alternative - private equity	279,914,118	211,981,814	N/A	N/A
Domestic alternative - real assets	346,837,898	301,291,111	N/A	N/A
International alternative - private debt	42,352	577,793	N/A	N/A
International alternative - private equity	28,857,506	8,855,202	N/A	N/A
International alternative - real assets	16,351,416	22,268,486	N/A	N/A
Total investments at NAV	<u>\$ 2,171,872,553</u>	<u>\$ 698,821,943</u>		
Total Investments	<u>\$ 2,527,307,368</u>			

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 3. Investments (Continued)

Through the use of derivatives such as futures and total return swaps, the risks that are bound together in traditional cash market investments can be separated and managed independently. The primary intent of the Fund's investment in derivative instruments is to manage and implement investment strategies more effectively and at a lower cost than would be possible in the cash market. All of the Fund's derivative instruments are considered investment derivatives and therefore are measured and reported at fair value. Fair value of total return swaps that the Fund entered with counterparties is determined based on the percentage changes in the value of underlying indexes (such as bond index or equity index) over a specified time period. For example, since the Fund is typically a buyer of total bond return swaps, if the underlying bond index goes up, the value of the swap will be higher, and vice versa. The fair value of the Fund's derivatives is measured on a daily basis, by a third-party service provider, but is reported on a monthly basis.

Hedge Funds are valued monthly at NAV using the current monthly account statements from the funds. If a current monthly account statement is unavailable, the value is calculated by the custodian using the estimated monthly return from the fund. Once a statement is received, the value is adjusted to reflect the NAV from the statement adjusted for cash flows that occur after the statement date.

Domestic and international alternative investments are valued monthly at NAV using the latest account statements from the funds. NAV is adjusted for cash flows that occur after the date of the statements through the month-end date.

Fixed Income strategies are expected to generate relatively consistent positive returns with lower correlation to the public equity markets. Strategies selected are intended to provide positive returns during most economic and capital market environments.

Private Debt strategies are primarily focused on debt and credit oriented strategies ranging from senior secured credit to distressed credit, but at times may include exposures across the entire corporate capital structure. Private debt strategies are intended to take advantage of illiquidity premiums available in the debt markets. Portfolios may take an extended period to be realized.

Equity strategies include public and private equities and asset classes that are correlated to global equity markets. Historically, global equity investments have provided returns in excess of the total fund return objective. The equity portfolio consists of traditional long-only, hedged and private strategies whose portfolios are predominantly invested in the equity of corporations.

Real asset strategies are intended to serve primarily as inflation hedges and provide diversification benefits of low correlation with other investment strategies. A significant majority of the portfolio will be exposed to real assets such as high quality real estate, timber, infrastructure assets, industrial and precious metals, energy, livestock and grains.

Strategic All Asset strategies include exposures across equity, fixed income and real estate classes. This portfolio may consist of long-only, hedged and private strategies whose portfolios are diversified across a broad range of asset types.

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 3. Investments (Continued)

Credit risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. The Fund's Investment Policy does not limit credit risk. The following schedule lists Standard & Poor's credit rating by investment type for those investments subject to credit risk:

Standard & Poor's Credit Rating	Mutual Funds—Global Fixed Income	Money Market Funds
AAA	\$ -	\$ 216,905,938
Not rated	144,373,287	-
Total	<u>\$ 144,373,287</u>	<u>\$ 216,905,938</u>

Deposits—custodial credit risk: Custodial credit risk for deposits is the risk that, in the event of failure of a depository financial institution, the Fund will not be able to recover its deposits or will not be able to recover its collateral securities that are in the possession of an outside party. The Fund's cash and cash equivalents represents cash held in the Fund's investment account by the investment custodian. Deposits made in any single financial institution, which are in excess of the Federal Deposit Insurance Corporation (FDIC) level, may be made only if fully collateralized in accordance with the State Depository Handbook.

Investments—custodial credit risk: For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Fund would not be able to recover the loss of its investments or collateral securities that are in possession of an outside entity. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not held in the name of the Texas Trust and are held by the counterparty, its trust or agent, but not in the name of the Texas Trust. The Fund's investments are not exposed to custodial credit risk since they are insured or registered or the securities are held by the Texas Trust or its agent in the Texas Trust's name.

Concentration risk: Concentration of credit risk is the risk of loss attributable to the magnitude of the investment in a single issuer. Excluding passive strategies, exposure to any investment firm will generally be limited to no more than 10 percent of Fund assets. Fund investments will generally not exceed more than 25 percent of any firm's assets under management. As of December 31, 2018, no more than 5 percent of the portfolio was invested in securities of one issuer.

Interest rate risk: Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Fund's Investment Policy does not limit investment maturities. The following schedule reflects the average effective duration of the funds by investment type. The investments in the short-term investment fund use a weighted-average maturity to reflect the interest rate risk.

Investment Type	Amount	Modified Duration
Mutual funds:		
Global Fixed Income	\$ 144,373,287	2.83 years
		<u>Weighted Average Maturity</u>
Investment in short-term investment fund	\$ 216,905,938	18 days

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 3. Investments (Continued)

Foreign currency risk: Foreign currency risk is a financial risk that exists when a financial transaction is denominated in a currency other than that of the base currency of the Fund. The Fund's Investment Policy does not limit investments in any single foreign currency. The Fund's exposure to foreign currency risk derives from its position in foreign currency-denominated investments in alternative investments.

Currency	Cash	Alternative Investment	Total
Euro	\$ 120,975	\$ 45,251,274	\$ 45,372,249

Derivatives: The Fund uses derivatives as part of the hedging and overlays program. The objective of the program is to facilitate risk management and provide efficiency in the implementation of various investment strategies. Permitted applications of the portfolio hedging and overlays program include implementations of strategies in a low cost and efficient manner; to hedge and control risks; to alter the Funds' market (systemic) exposure without trading the underlying cash market securities; to construct portfolios with risk and return characteristics that could not be created with cash market securities or to facilitate transition trading.

The fair value, changes in fair value and notional value of the Funds' investments, classified by derivative type, are displayed in the following table as of December 31, 2018:

	Fair Value	Changes in Fair Value	Notional Value
Futures			
Futures—commodities	\$ (460,539)	\$ (1,838,096)	\$ -
Futures—equity	-	(534,475)	-
Total futures	\$ (460,539)	\$ (2,372,571)	\$ -
Swaps			
Total Return Swap - fixed income	\$ 1,563,732	\$ 795,054	\$ 93,509,349
Total Return Swap - equity	(11,904,923)	(18,529,505)	166,243,883
Total swaps	\$ (10,341,191)	\$ (17,734,451)	\$ 259,753,233
Total derivatives	\$ (10,801,730)	\$ (20,107,021)	\$ 259,753,233

Treasury pool: The Fund may participate in the Treasury Pool, which is an internal investment pool of the state of Texas. The Comptroller maintains oversight responsibility for the Treasury Pool. This responsibility includes the ability to influence operations, designation of management and accountability for fiscal matters. The Treasury Pool operates in accordance with the Comptroller's Investment Policy. The Fund may make withdrawals at any time and has no commitment to add additional funds to the Treasury Pool. The Fund receives allocated earnings based on its percentage share of the Treasury Pool, but its overall value remains the same as the initial deposit, cost, into the Treasury Pool plus accrued income. The Fund was not invested in the Treasury Pool at December 31, 2018.

Tobacco Settlement Permanent Trust Fund

Notes to the Financial Statements December 31, 2018

Note 4. Annual Distribution from the Fund

The Comptroller is required by Government Code, Section 403.1041, to administer the Tobacco Settlement Permanent Trust Account (Trust Account) and manage the assets of the Trust Account with the advice of, and in consultation with, the Investment Advisory Committee. The Comptroller is also required to adopt rules necessary to implement the Comptroller's duties under Government Code, Section 403.1041, including rules distinguishing the net earnings of the Trust Account that may be distributed from earnings used for investment expenses and from the money and assets that are the corpus of the Trust Account.

The amount eligible for annual distribution is calculated in accordance with the Trust Account Distribution Policy as outlined in Texas Administrative Code, Title 34, Part 1, Chapter 18, Rules 18.1 and 18.2 (Code).

Under the Code, the calculated eligible distribution amount for consideration by the Investment Advisory Committee in April 2019 is \$71,912,881. This amount is based on an average market value of the Trust Account of \$2,397,096,017 as of December 31, 2018, using the most recent 20 calendar quarter-end market values. The actual amount to be distributed by the Fund in 2019 is required to be approved by the Investment Advisory Committee.

The corpus of the Trust Account is defined in the Code as the cumulative value of all contributions to the Trust Account. As of December 31, 2018, the value of the corpus is \$1,682,964,904.

Note 5. Related Parties

Upon creation of the Texas Trust as a separate legal entity by the 77th Legislature, as referenced in Note 1, the Texas Trust and the Comptroller's office entered into an inter-agency agreement to recover cost for services provided. The current contract and agreement between the Comptroller and the Texas Trust allows the Texas Trust to charge a flat fee of 30 basis points to recover all costs associated with the management of the Fund. The Fund was charged \$7,067,108 for the year ended December 31, 2018.

