

**Tobacco Settlement Permanent Trust Fund**

Basic Financial Statements

December 31, 2012

(With Independent Auditor's Report Thereon)

# **Tobacco Settlement Permanent Trust Fund**

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**Independent Auditor's Report**

The Honorable Susan Combs  
Comptroller of Public Accounts of the State of Texas  
Austin, Texas

**Report on the Financial Statements**

We have audited the accompanying financial statements of the Tobacco Settlement Permanent Trust Fund, a private purpose trust fund of the state of Texas, as of December 31, 2012, 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 of 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 entity'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 entity'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.

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

## **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tobacco Settlement Permanent Trust Fund as of December 31, 2012, 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 Matters*

As described in Note 2, the basic financial statements present only the Tobacco Settlement Permanent Trust Fund and do not purport to, and do not, present fairly the financial position of the state of Texas or the Texas Treasury Safekeeping Trust Company as of December 31, 2012, and the changes in its financial position for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, in 2012 the Fund adopted the new accounting guidance contained in Governmental Accounting Standards Board Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. Our opinion is not modified with respect to this matter.

## **Other Matters**

### *Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 through 10 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.

*Pudgett, Stratemann + Co., LLP*

Certified Public Accountants  
March 8, 2013

# TOBACCO SETTLEMENT PERMANENT TRUST FUND

## Management's Discussion and Analysis

December 31, 2012

The Tobacco Settlement Permanent Trust Fund (the "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, 2012. 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 increased \$139.7 million or 7% during the year 2012.
- The Fund provided \$50 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 management fees (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 Basic Financial Statements

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, 2012 and 2011, Net Position was calculated as follows:

	<u>2012</u>	<u>2011</u>	<u>Amount of Increase (Decrease)</u>	<u>Percent Change</u>
Investments, at Fair Value	\$ 2,138,422,014	\$ 1,960,944,985	\$ 177,477,029	9.05%
Other Assets	3,502,433	41,572,417	(38,069,984)	-91.58%
Total Assets	<u>2,141,924,447</u>	<u>2,002,517,402</u>	<u>139,407,045</u>	<u>6.96%</u>
Total Liabilities	<u>6,939,295</u>	<u>7,192,015</u>	<u>(252,720)</u>	<u>-3.51%</u>
Net Position Held in Trust	<u>\$ 2,134,985,152</u>	<u>\$ 1,995,325,387</u>	<u>\$ 139,659,765</u>	<u>7.00%</u>

## TOBACCO SETTLEMENT PERMANENT TRUST FUND

### Management's Discussion and Analysis (Continued)

December 31, 2012

During the period, other assets decreased by \$38 million dollars while total liabilities decreased by \$250 thousand. The decrease in other assets is attributable to a decrease in trades pending settlement of \$38 million.

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, 2012 and 2011 is as follows:

	<u>2012</u>	<u>2011</u>	<u>Amount of Increase (Decrease)</u>	<u>Percent Change</u>
Net Investment Income	\$ 195,820,891	\$ (39,779,536)	\$ 235,600,427	592.27%
Distributions to Local Governments	50,000,000	51,000,000	(1,000,000)	-1.96%
Expenses	<u>6,161,126</u>	<u>6,207,481</u>	<u>(46,355)</u>	<u>-0.75%</u>
Net Increase (Decrease) in Net Position	139,659,765	(96,987,017)		
Net Position Held in Trust, Beginning of Period	<u>1,995,325,387</u>	<u>2,092,312,404</u>		
Net Position Held in Trust, End of Period	<u><u>\$2,134,985,152</u></u>	<u><u>\$1,995,325,387</u></u>		

Net Investment Income increased by \$235.6 million compared to the previous year as a result of the higher investment returns earned by the Fund. During the year ended December 31, 2012, the total rate of return for the Fund was 9.34% while the total rate of return for the previous year was -1.58%. The total Fund outperformed its benchmark for the year by 1.16%.

## TOBACCO SETTLEMENT PERMANENT TRUST FUND

### Management's Discussion and Analysis (Continued)

December 31, 2012

#### Asset Allocation

The current Texas Trust asset allocation structure as of December 31, 2012 is shown in the chart below.

Asset Class	Strategy	Current Market Value	Weight	Target	Policy Range
<b>Fixed Income</b>		<b>705,924,121</b>	<b>33.1%</b>	<b>35.0%</b>	<b>20-50%</b>
	Global Fixed Income	178,480,543	8.4%	10.0%	
	Cash	49,144,900	2.3%	0.0%	
	Alternative Fixed Income	369,286,903	17.3%	20.0%	
	Private Debt	109,011,775	5.1%	5.0%	
<b>Equity</b>		<b>962,413,320</b>	<b>45.0%</b>	<b>45.0%</b>	<b>30-60%</b>
	Global Public Equity	316,511,381	14.8%	15.0%	
	Hedged Equity	438,056,128	20.5%	20.0%	
	Private Equity	207,845,811	9.7%	10.0%	
<b>Real Assets</b>		<b>367,858,337</b>	<b>17.3%</b>	<b>20.0%</b>	<b>10-30%</b>
	Stable Value Real Assets	70,348,006	3.3%	5.0%	
	Enhanced Real Estate	122,846,909	5.8%	5.0%	
	ILB	20,441,708	1.0%	3.0%	
	Natural Resources	154,221,714	7.2%	7.0%	
<b>Strategic All Asset &amp; Overlays</b>		<b>98,789,374</b>	<b>4.6%</b>	<b>0.0%</b>	<b>0-10%</b>
<b>Total Portfolio</b>		<b>2,134,985,152</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

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 that 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; and,
- 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 return objective of the Fund.

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.

The 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.

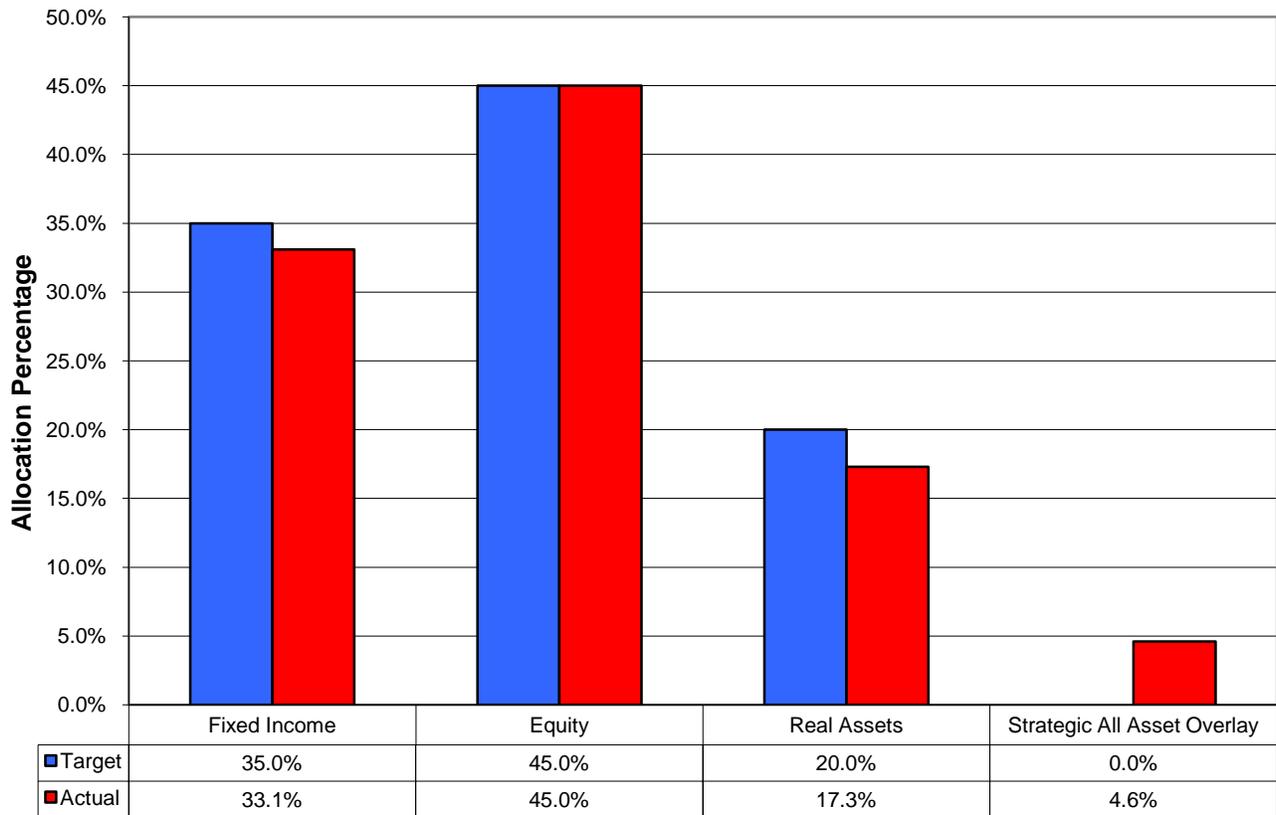
**TOBACCO SETTLEMENT PERMANENT TRUST FUND**

Management’s Discussion and Analysis  
(Continued)

December 31, 2012

The following charts compare the Fund’s macro strategy target asset allocation as of December 31, 2012 with its actual allocation as of December 31, 2012 and the Fund’s sub-strategy asset allocation as of December 31, 2012 with its actual allocation as of December 31, 2012.

**Macro Strategy Allocation  
December 31, 2012**



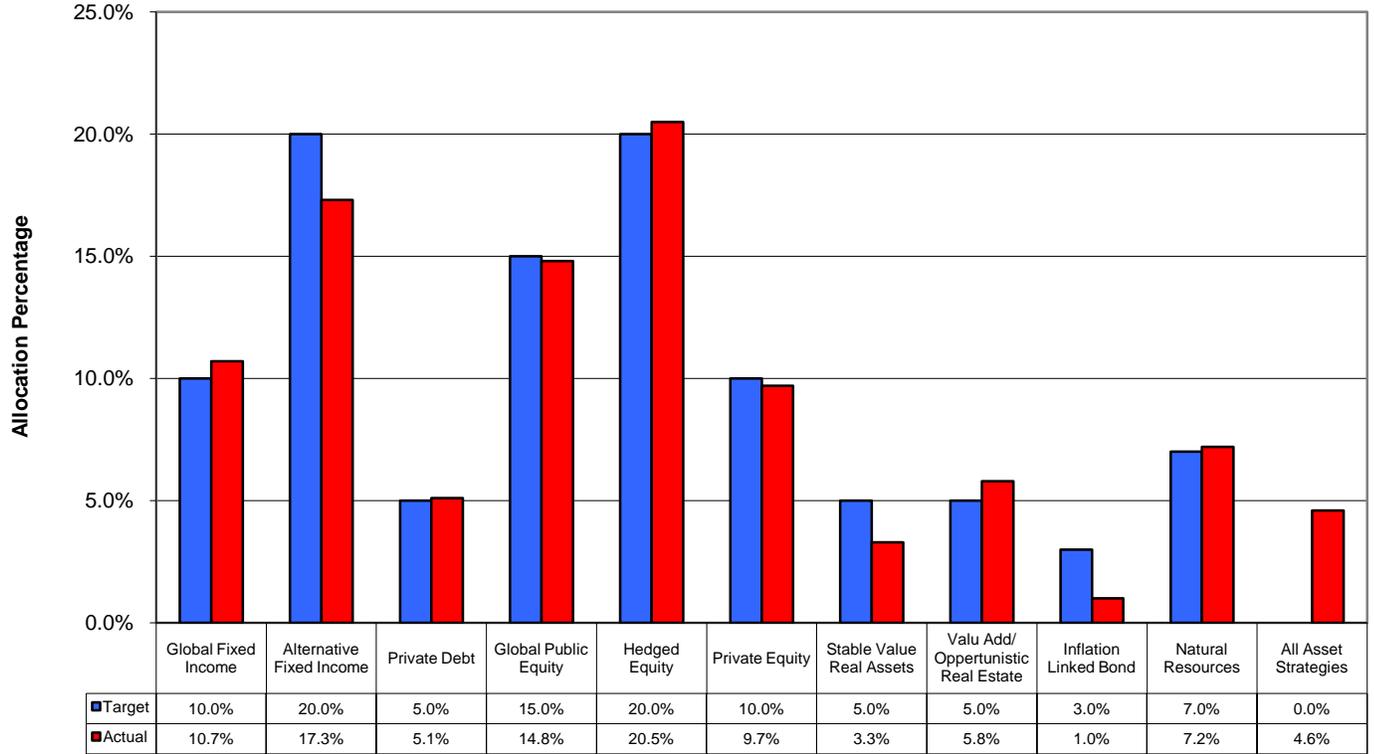
**Macro Strategy**

**TOBACCO SETTLEMENT PERMANENT TRUST FUND**

Management’s Discussion and Analysis  
(Continued)

December 31, 2012

**Sub-Strategy Allocation  
December 31, 2012**



**Sub-Strategy**

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 2.7% underweight in alternative fixed income and a 4.6% overweight in the all asset sub-strategy. Both variances were well within the allowable target ranges for the strategy.

**Unfunded Commitments**

As of December 31, 2012, the Tobacco Fund’s outstanding unfunded commitments totaled \$254.0 million.

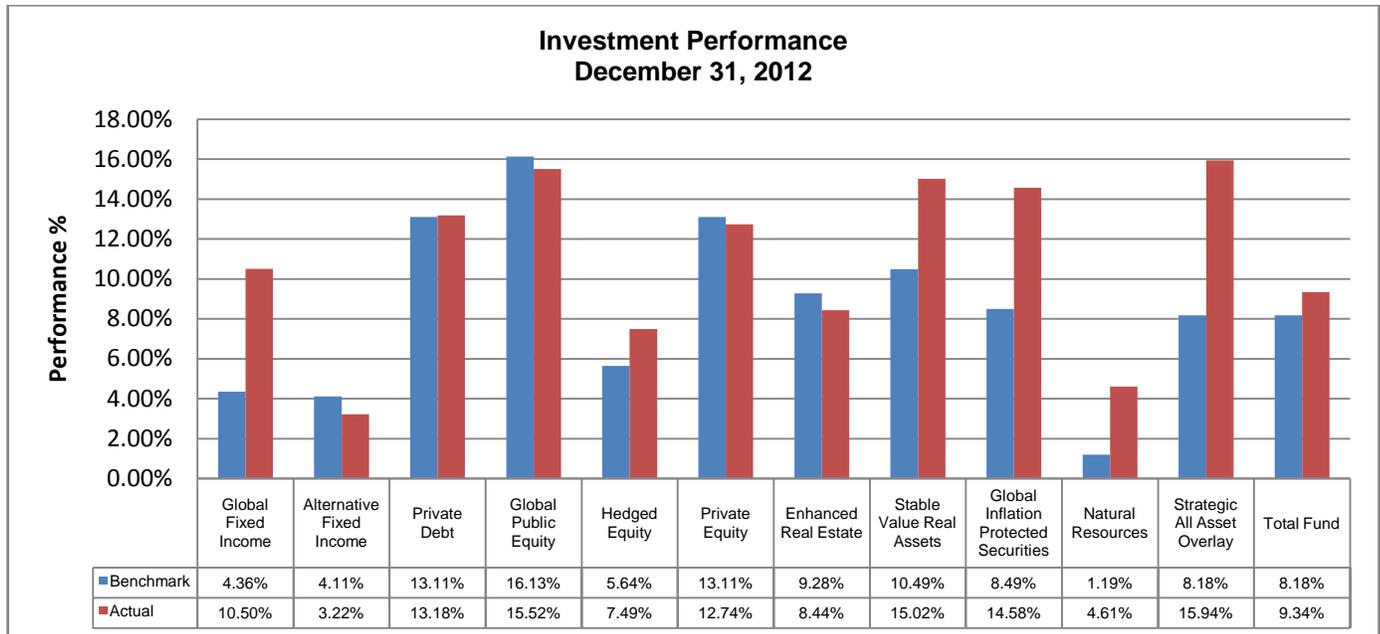
## TOBACCO SETTLEMENT PERMANENT TRUST FUND

### Management's Discussion and Analysis (Continued)

December 31, 2012

#### Investment Performance

The chart below presents the Endowment Pool performance as of December 31, 2012. During the year the Endowment Pool's overall performance was 9.34% while the policy benchmark return was 8.18%. During the year, the Alternative Fixed Income, Global Public Equity, Private Equity and Enhanced Real Estate composite underperformed its benchmark. All other strategies outperformed their respective benchmarks.



The Tobacco Trust is included in the total Endowment Pool. Due to timing differences in contributions and distributions endowments may have a slightly different asset allocations than the total Endowment Pool which may result in slightly different performance results when viewed separately. Below is the performance comparison of the Tobacco Trust to the Endowment Pool for the preceding 1 year, 2 year and 3 year periods.

	<u>1 Year</u>	<u>2 Year</u>	<u>3 Year</u>
<b>Total Endowment Pool</b>	<b>9.34%</b>	<b>3.74%</b>	<b>5.89%</b>
<b>Tobacco Trust Fund</b>	<b>9.41%</b>	<b>3.81%</b>	<b>5.94%</b>

**TOBACCO SETTLEMENT PERMANENT TRUST FUND**

Management's Discussion and Analysis  
(Continued)

December 31, 2012

**Distribution and Contribution History**

The maximum amount eligible for distribution in 2013 under the rules is \$61,018,656. See note 4 for a more detailed explanation of the rules determining the maximum amount to distribute. The following chart reflects the Tobacco Settlement Trust Fund's distribution and contribution history.

<b>Contribution Month</b>	<b>Total</b>	<b>Distribution Month</b>	<b>Total Distribution from Tobacco Fund</b>	<b>Direct Distribution</b>	<b>Total Distribution</b>
		Jan-99	\$ -	\$300,000,000	\$ 300,000,000
Jan-00	\$ 444,581,000	Apr-00	-	100,000,000	100,000,000
Dec-00	433,888,365		-	-	-
Jan-01	67,523,342		-	-	-
Jun-01	43,407,228		-	-	-
Dec-01	491,573,700	Apr-01	14,306,508	50,000,000	64,306,508
May-02	19,317,882	Apr-02	17,760,000	-	17,760,000
Dec-02	26,914,041		-	-	-
Dec-02	148,494,658		-	-	-
Apr-03	7,264,688	Apr-03	22,041,497	-	22,041,497
		Apr-04	28,515,957	-	28,515,957
		Apr-05	50,282,384	-	50,282,384
		Apr-06	72,070,600	-	72,070,600
		Apr-07	82,691,441	-	82,691,441
		Apr-08	92,303,845	-	92,303,845
		Apr-09	92,303,845	-	92,303,845
		Apr-10	46,151,923	-	46,151,923
		Apr-11	51,000,000	-	51,000,000
		Apr-12	50,000,000	-	50,000,000
<b>Totals:</b>	<b>\$ 1,682,964,904</b>		<b>\$ 619,428,000</b>	<b>\$ 450,000,000</b>	<b>\$ 1,069,428,000</b>

## TOBACCO SETTLEMENT PERMANENT TRUST FUND

### Management's Discussion and Analysis (Continued)

December 31, 2012

The following chart reflects the Tobacco Settlement Trust Fund's Distribution Stabilization Account balances since inception.

#### Distribution Stabilization History

<u>Date</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance</u>
Dec-00	\$ 12,841,983	\$ -	\$ 12,841,983
Dec-01	10,186,788	-	23,028,771
Dec-02	10,332,806	-	33,361,577
Dec-03	9,679,918	-	43,041,495
Dec-04	30,952,305	-	73,993,800
Dec-05	8,007,844	-	82,001,644
Dec-06	9,187,938	-	91,189,582
Dec-07	10,255,983	-	101,445,565
Dec-08	-	(57,487,010)	43,958,555
Dec-09	-	-	43,958,555
Dec-10	10,145,226	-	54,103,781
Dec-11	-	(23,877,625)	30,226,156

#### 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 Chief Financial Officer, at (512) 463-3129.

**BASIC FINANCIAL STATEMENTS**

# TOBACCO SETTLEMENT PERMANENT TRUST FUND

## Statement of Fiduciary Net Position

December 31, 2012

### Assets

Trades pending settlement	\$ 2,818,181
Interest and other receivables	684,252
Investments	<u>2,138,422,014</u>
Total assets	<u>2,141,924,447</u>

### Liabilities

Trades pending settlement	5,883,652
Accounts payable	<u>1,055,643</u>
Total liabilities	<u>6,939,295</u>

### Net Position

Held in trust for other governments	<u><u>\$ 2,134,985,152</u></u>
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SEE ACCOMPANYING NOTES TO BASIC FINANCIAL STATEMENTS

**TOBACCO SETTLEMENT PERMANENT TRUST FUND**

Statement of Changes in Fiduciary Net Position

Year Ended December 31, 2012

**Additions**

Investment income:

Net increase in fair value of investments	\$ 168,134,188
Interest and investment income	<u>27,686,703</u>
Total income from investing activities	<u>195,820,891</u>

Total additions 195,820,891

**Deductions**

Professional fees and services	6,161,126
Disbursements to local governments	<u>50,000,000</u>
Total deductions	<u>56,161,126</u>

Change in net position held in trust for other governments 139,659,765

Net Position - beginning of year 1,995,325,387

Net Position - end of year \$ 2,134,985,152

SEE ACCOMPANYING NOTES TO BASIC FINANCIAL STATEMENTS

NOTES TO BASIC FINANCIAL STATEMENTS

# TOBACCO SETTLEMENT PERMANENT TRUST FUND

## Notes to Basic Financial Statements

December 31, 2012

### (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 healthcare 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 (the "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 from the largest governmental units affected by 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 Act requires the Texas Department of Health to collect information regarding the amount of each governmental unit's un-reimbursed health care expenditures, and to certify to the Comptroller the percentage payable from the Fund to each governmental unit.

### (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 time of the related cash flows.

Effective January 1, 2012, the Fund adopted Governmental Accounting Standards Board Standards ("GASB") Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* ("Statement No. 62"), and GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of resources, and Net Position* ("Statement No. 63"). Statement No. 62 incorporates 1) FASB Statements and Interpretations, 2) Accounting Principles Board Opinions, and 3) Accounting Research Bulletins issued on or before November 30, 1989 that do not conflict or contradict GASB pronouncements into GASB's authoritative literature.

Statement No. 63 renames the statement of net assets as the statement of net position and provides guidance for reporting deferred outflows of resources and deferred inflows of resources within the financial statements of governmental entities.

The adoption of these standards did not have a significant impact on the Fund's financial statements.

# TOBACCO SETTLEMENT PERMANENT TRUST FUND

## Notes to Basic Financial Statements

December 31, 2012

### (2) Summary of Significant Accounting Policies (continued)

#### (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. These amounts represent 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 from the Fund, to each eligible political subdivision as provided in the agreement regarding disposition of settlement proceeds.

#### (c) *Investments*

Investments with a readily determinable fair value are reported at fair value based upon quoted market prices, or when quoted market prices are not readily determinable, estimated fair values based on market conditions and information provided by the investment administrators are used. For investments in limited partnerships where no readily determinable fair value exists, the fair value of the investment is based on the most recent capital account balance of each limited partnership as communicated by the investment administrator, adjusted for subsequent contributions, distributions, and withdrawals, or based upon their evaluation of estimated changes in values from the date of the most recent capital account balance. For investments in fund of hedge funds and direct investments in hedge funds, the fair value is based on net asset value information provided by the designated fund administrator. The Texas Treasury Safekeeping Trust Company ("Texas Trust") reviews fair values and makes adjustments as necessary based on their evaluation.

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.

**TOBACCO SETTLEMENT PERMANENT TRUST FUND**

Notes to Basic Financial Statements

December 31, 2012

(2) **Summary of Significant Accounting Policies (continued)**

(c) *Investments (continued)*

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

<b>Strategy Sub-Strategy</b>	<b>Target %</b>	<b>Benchmark(s) Strategy Range</b>
<b><i>Fixed Income</i></b>	<b>35%</b>	<b><i>Allocation Range: 20%-50%</i></b>
Global Fixed Income	10%	9% Barclays Capital Multiverse Bond Index; 1% 90-Day T-bill
Alternative Fixed Income	20%	HFRI FOF: Conservative Index
Private Debt	5%	Thomson Reuters Venture Economics Pooled Average – Custom weighted by vintage year
<b><i>Equity</i></b>	<b>45%</b>	<b><i>Allocation Range: 30%-60%</i></b>
Global Public Equity	15%	MSCI All Country World Index
Hedged Equity	20%	HFRI FOF: Strategic Index
Private Equity	10%	Thomson Reuters Venture Economics Pooled Average – Custom weighted by vintage year
<b><i>Real Assets</i></b>	<b>20%</b>	<b><i>Allocation Range: 10%-30%</i></b>
Stable Value Real Estate	5%	NCREIF Townsend Core Index
Enhanced Real Estate	5%	Index market weighted blend of NCREIF Townsend Value Added & Opportunistic Indices
Global Inflation Protected Securities	3%	Barclays Capital World Inflation Linked Index
Natural Resources	7%	5% Dow Jones UBS Commodity Index; 1% MSCI Energy Index 1% MSCI Materials Index
<b><i>All Asset Strategy</i></b>	<b>0%</b>	<b><i>Allocation Range: 0%-10%</i></b>
Risk Parity, Tactical Asset Allocation, Multi-strategy	0%	Total Endowment Benchmark

# TOBACCO SETTLEMENT PERMANENT TRUST FUND

## Notes to Basic Financial Statements

December 31, 2012

### (2) Summary of Significant Accounting Policies (continued)

#### (d) Custodian

The Fund contracts services to a custodian to discharge 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.

#### (e) Income Tax

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

#### (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 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.

### (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 Texas Trust administers and manages 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 Fund's investments as of December 31, 2012 are as follows:

<b>Investment Type</b>	<b>Fair Value</b>
Mutual funds - global equities	\$ 7,965,335
Mutual funds - domestic fixed income	17,844,970
Mutual funds - global fixed income	215,421,003
Mutual funds - commodities	115,779,579
Hedge funds - fund of funds	153,538,060
Hedge funds - direct funds	1,079,713,810
Alternative investments domestic	433,733,419
Alternative investments international	64,225,590
Investment in short-term investment fund	50,200,248
<b>Total Endowment Fund Investments</b>	<b><u><u>\$ 2,138,422,014</u></u></b>
 <b>Consisting of the following:</b>	
Fiduciary Funds Investments	\$ 2,138,422,014
Total as presented on the Financial Statements	<b><u><u>\$ 2,138,422,014</u></u></b>

**TOBACCO SETTLEMENT PERMANENT TRUST FUND**

Notes to Basic Financial Statements

December 31, 2012

**(3) Investments (continued)**

*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 Ratings	Mutual Funds - domestic fixed income	Mutual Funds - global fixed income	Investments in short-term investment fund
<b>AAA</b>	\$ -	\$ -	\$ 50,200,248
<b>Not Rated</b>	17,844,970	215,421,003	-
<b>Total</b>	\$ 17,844,970	\$ 215,421,003	\$ 50,200,248

*Concentration Risk:* As of December 31, 2012 no more than 5% of the portfolio was invested in securities of one issuer.

*Interest Rate Risk:* The Fund's investment policy does not limit investment maturities. The following schedule reflects the average modified duration of the endowment funds by investment type. The investments in the short-term investment fund use a weighted average maturity to reflect the interest rate risk.

<b>Investment Type</b>	<b>Modified Duration (Years)</b>
Mutual funds – domestic fixed income	3.40
Mutual funds – global fixed income	4.06
	<b>Weighted Average Maturity (Days)</b>
Investment in short-term investment fund	48

# TOBACCO SETTLEMENT PERMANENT TRUST FUND

## Notes to Basic Financial Statements

December 31, 2012

### (3) Investments (continued)

*Foreign Currency Risk:* 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 limited partnerships.

Currency	Investment type	Fair Value
European Euro	Limited Partnership	\$64,225,590

#### *Treasury Pool*

The Fund may participate in the Treasury Pool, which is an internal investment pool. 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 receives allocated earnings based on its percentage share of the Treasury Pool, but its overall value remains the same as the initial deposit into the Treasury Pool plus accrued income. The Fund was not invested in the Treasury Pool at December 31, 2012.

### (4) Annual Distribution from the Fund

The Comptroller is required by Government Code, §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, §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.

A rule revision was adopted by the Comptroller with the advice and approval of the Investment Advisory Committee, and became effective for the actual distribution amount from the Fund for 2006 and for reserving an allocation for the distribution stabilization account ("DSA"), the calculations of which are based on these basic financial statements.

A rule revision was adopted by the Comptroller with the advice and approval of the Investment Advisory Committee, and became effective for the actual distribution amount from the Fund for 2011. If the net earnings of the trust account are less than the calculated actual distribution amount, the actual distribution amount shall not exceed the lesser of: 4.5% of the average market value or 4.5% of the year-end market value. The distribution shall be funded from the sources, until exhausted, in the order provided as follows:

- (1) adjusted current earnings;
- (2) positive net earnings; then
- (3) up to 50% of the balance of the distribution stabilization account.

Any or all positive net earnings, not otherwise distributed may be distributed to the DSA.

## TOBACCO SETTLEMENT PERMANENT TRUST FUND

### Notes to Basic Financial Statements

December 31, 2012

#### **(4) Annual Distribution from the Fund (continued)**

In April 2012 the board elected to distribute \$50,000,000. The distribution was funded from current earnings less investment expenses of \$26,122,375 and \$23,877,625 from the DSA. The current balance in the DSA is \$30,226,156.

The inflation adjusted corpus for the year ending December 31, 2012, was \$2,194,222,021. The average market value of the Trust Account using the most recent twenty (20) calendar quarter-end market values of \$1,996,222,007. The market value at year end is \$2,120,605,594. Based on these values, the maximum amount eligible for distribution in April 2013 under the rules is \$61,018,656. Because the net earnings are less than the calculated distribution amount, the distribution will be funded from the following sources, \$45,905,578 from current earnings less investment expenses and \$15,113,078 from the DSA.

If the maximum amount eligible is distributed, the total DSA reserve would be reduced to \$15,113,078. The reserve is intended to be used to facilitate the objectives of providing a predictable, stable stream of distributions over time and to ensure that the inflation-adjusted value of the distributions is maintained over the long-term.

#### **(5) Related Parties**

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.

Beginning September 1, 2005, the 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 \$6,161,126 for the months of January 2012 through December 2012.