

**TOBACCO SETTLEMENT
PERMANENT TRUST FUND**

Basic Financial Statements

December 31, 2008

(With Independent Auditors' Report Thereon)

TOBACCO SETTLEMENT PERMANENT TRUST FUND

TABLE OF CONTENTS

	<u>PAGE</u>
INDEPENDENT AUDITORS' REPORT	1
MANAGEMENT'S DISCUSSION AND ANALYSIS	2-10
FINANCIAL STATEMENTS	
Statement of Fiduciary Net Assets	11
Statement of Changes in Fiduciary Net Assets	12
NOTES TO FINANCIAL STATEMENTS	13-19



Padgett Stratemann & Co. LLP

CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

Independent Auditors' Report

Honorable Susan Combs
Comptroller of Public Accounts
State of Texas:

We have audited the accompanying statement of fiduciary net assets of the Tobacco Settlement Permanent Trust Fund (the "Fund"), a private purpose trust fund of the State of Texas, as of December 31, 2008 and the related statement of changes in fiduciary net assets for the year then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our 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 includes consideration of internal control over financial reporting as a basis for designing 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 over financial reporting. Accordingly, we express no such opinion. 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.

As described in note 1, the 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 as of December 31, 2008, 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.

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, 2008 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.

The Management's Discussion and Analysis on pages 2 through 10 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. 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.

Padgett, Stratemann & Co. LLP

Certified Public Accountants
March 11, 2009
Austin, Texas

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TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis

December 31, 2008

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, 2008. Please read this analysis in conjunction with the 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 assets of the Fund decreased \$686 million or 28.2% during the year 2008.
- The Fund provided \$92.3 million to political subdivisions for health care. This was a \$9.6 million increase from the prior year's distribution.

Overview of the Financial Statements and Condensed Financial Information

The 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 Assets 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 Assets reports the additions to, deductions from, and net increases or decreases in net assets.

This annual financial report consists of two parts:

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

The Statement of Fiduciary Net Assets 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 assets. At December 31, 2008 and 2007, Net Assets was calculated as follows:

	2008	2007	Amount of Increase (Decrease)	Percent Change
Investments, at Fair Value	\$ 1,751,054,842	\$ 2,440,399,308	\$(689,344,466)	-28.2%
Other Assets	5,530,666	61,004,259	(55,473,593)	-90.9%
Total Assets	<u>1,756,585,508</u>	<u>2,501,403,567</u>	<u>(744,818,059)</u>	<u>-29.8%</u>
Total Liabilities	<u>5,515,934</u>	<u>63,957,835</u>	<u>(58,441,901)</u>	<u>-91.4%</u>
Net Assets Held in Trust	<u>\$ 1,751,069,574</u>	<u>\$ 2,437,445,732</u>	<u>\$(686,376,158)</u>	<u>-28.2%</u>

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis (Continued)

December 31, 2008

During the period, Other Assets decreased by \$55.5 million dollars while Total Liabilities also decreased by \$58.4 million. These decreases are attributable to the suspension of securities lending activity during the year. See footnote 3 of the financial statements for more information about the security lending program.

The Statement of Changes in Fiduciary Net Assets presents the activity within the Net Asset balance for the year ended. Significant activity accounts include net investment income and distributions to local governments. The change in net assets for the years ended December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>	<u>Amount of Increase (Decrease)</u>	<u>Percent Change</u>
Net Investment Income	\$ (587,713,426)	\$ 179,435,989	\$(767,149,415)	-427.5%
Distributions to Local Governments	92,303,845	82,691,441	9,612,404	11.6%
Expenses	6,358,887	7,286,126	(927,239)	-12.7%
Net Increase (Decrease) in Net Assets	(686,376,158)	89,458,422		
Net Assets Held in Trust, Beginning of Period	2,437,445,732	2,347,987,310		
Net Assets Held in Trust, End of Period	<u>\$1,751,069,574</u>	<u>\$2,437,445,732</u>		

Net Investment Income decreased by \$767.1 million compared to the previous year as a result of the lower investment returns earned by the Fund. During the year ended December 31, 2008, the total rate of return for the Fund was -23.62% while the total rate of return for the previous year was 7.56%. The global equity portfolio was the primary driver of the decrease in investment returns as the return on global equity was -41.88% at year end. The allocation to global equity was 27.94%. The amount distributed to the local governments is based upon a percentage amount of the average market value of the Fund for the most recent twenty calendar quarters. As the market values from five years ago are replaced by more recent market values, the average used in the distribution calculation increases. In addition, the market values for the earlier quarters did not reflect contributions made into the Fund in subsequent years. Finally, the expenses of the Fund decreased by \$927 thousand. These expenses represent the fees paid by the Fund to the Texas Trust which charges the Fund 0.30% of the net asset value of the Fund.

Asset Allocation

During 2007 the Texas Trust conducted an asset allocation study to determine whether the Fund could be invested more efficiently and earn improved risk-adjusted returns. It was determined that the opportunity did exist to improve the efficiency of the portfolio structure and to reduce overall portfolio risk without reducing expected returns. Consequently a structure was adopted wherein assets are allocated in accordance with their investment risk characteristics in lieu of traditional asset classes. This approach is frequently characterized as "risk budgeting." The new allocation structure was adopted on January 1, 2008 and is scheduled to be phased in over the next three years.

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis (Continued)

December 31, 2008

As shown in the chart entitled Phased-In Asset Allocation Targets, the portfolio's asset allocation structure consists of four macro strategy allocations; stable return (low beta), market return (beta), enhanced return and inflation protection (real assets). Stable return (low beta) assets are defined to be strategies that generate relatively consistent returns without dependency on the equity markets. The stable return strategy includes global fixed income and absolute return sub-allocations. Market return (beta) assets are public equities and asset classes that are highly correlated to global equity markets. The market return strategy includes global equity and hedged equity sub-allocations. Enhanced return strategies take advantage of the illiquidity premium and informational inefficient securities. The enhanced return strategy includes private equity and value added/opportunistic real estate sub-allocations. Inflation protection (real assets) serves primarily as inflation hedges and provides benefits of non-correlation. The inflation protected strategy includes stable value real assets, global inflation protected securities and commodities. The chart also defines the target weights to each category over the course of the next three years.

Phased-In Asset Allocation Targets							
Strategy	Prior	Phase 1	Phase 2	Phase 3	Phase 4	Phase 5	Phase 6
	12/31/2007	1/1/2008	4/1/2008	7/1/2008	1/1/2009	1/1/2010	1/1/2011
Stable Return	25.50	25.50	40.50	42.00	39.00	39.00	39.00
Cash	0.50	0.50	0.50	-	-	-	-
US Investment Grade Fixed Income	15.00	15.00	15.00	13.00	-	-	-
Global Investment Grade Fixed Income	-	-	-	4.00	11.00	11.00	11.00
US High Yield Fixed Income	5.00	5.00	5.00	-	-	-	-
Global High Yield Fixed Income	-	-	-	5.00	8.00	8.00	8.00
Absolute Return	5.00	5.00	20.00	20.00	20.00	20.00	20.00
Market Return	70.50	68.50	53.50	49.00	45.50	42.00	38.00
US Small Cap Equity	-	-	-	-	-	-	-
US Mid Cap Equity	-	-	-	-	-	-	-
US Small/Mid Cap Equity	15.00	15.00	-	-	-	-	-
US Large Cap Equity	32.50	32.50	-	-	-	-	-
US All Cap Equity	3.00	1.00	29.50	25.00	21.50	18.00	14.00
Non-US Developed Equity	15.00	15.00	-	-	-	-	-
Non-US Developed Equity	-	-	-	-	-	-	-
Non-US Developed Equity	-	-	9.00	9.00	9.00	9.00	9.00
Emerging Market Equity	-	-	5.00	5.00	5.00	5.00	5.00
Hedged Equity	5.00	5.00	10.00	10.00	10.00	10.00	10.00
Enhanced Return	3.80	4.50	4.50	5.00	9.00	12.00	15.00
Private Equity	2.00	3.00	3.00	3.00	6.00	8.00	10.00
Enhanced Real Estate	1.80	1.50	1.50	2.00	3.00	4.00	5.00
Inflation Protection	0.20	1.50	1.50	4.00	6.50	7.00	8.00
Stable Real Estate	-	1.50	1.50	2.00	2.50	3.00	4.00
Global REITS	0.20	-	-	-	-	-	-
Global Inflation Protected Securities	-	-	-	0.50	1.00	1.00	1.00
Commodities	-	-	-	1.50	3.00	3.00	3.00
	100.00	100.00	100.00	100.00	100.00	100.00	100.00

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis (Continued)

December 31, 2008

The chart entitled Asset Allocation Summary shows the market value and percentage of total portfolio for each macro strategy and sub-strategy as of December 31, 2008.

Asset Allocation Summary								
as of December 31, 2008								
Asset Class	Strategy	Style	Market Value (000's)	VaR	Current %	Long-Term Target (%)	Policy Range (%)	Phase-In Target
STABLE RETURN (Low Beta)			\$789,657	2.9	45.11%	39.0	29 - 49	42
	Investment Grade Fixed Income		335,977		19.19%	11.0		
	High Yield Fixed Income		67,160		3.84%	5.0		
	Emerging Markets		29,205		1.67%	3.0		
	Absolute Return		357,315		20.41%	20.0		
MARKET RETURN (Beta)			\$759,115	10.3	43.34%	38.0	28 - 48	49
	Global Equity		489,481		27.94%	28.0		
		US Equity	316,505		18.07%	14.0		
		Non-US Developed	127,549		7.28%	9.0		
		Emerging Markets	45,427		2.59%	5.0		
	Hedged Equity		269,634		15.40%	10.0		
ENHANCED RETURN			\$151,869	17.9	8.67%	15.0	7 - 23	5
	Private Equity		105,276		6.01%	10.0		
	Real Estate		46,593		2.66%	5.0		
INFLATION PROTECTION (Real Assets)			\$50,429	3.1	2.88%	8.0	3 - 13	4
	Stable Value Real Estate		43,740		2.50%	4.0		
	TIPS		-		0.00%	1.0		
	Commodities		6,689		0.38%	3.0		
<i>Total</i>			<i>\$1,751,070</i>	<i>7.5</i>	<i>100.00%</i>	<i>100.0</i>		

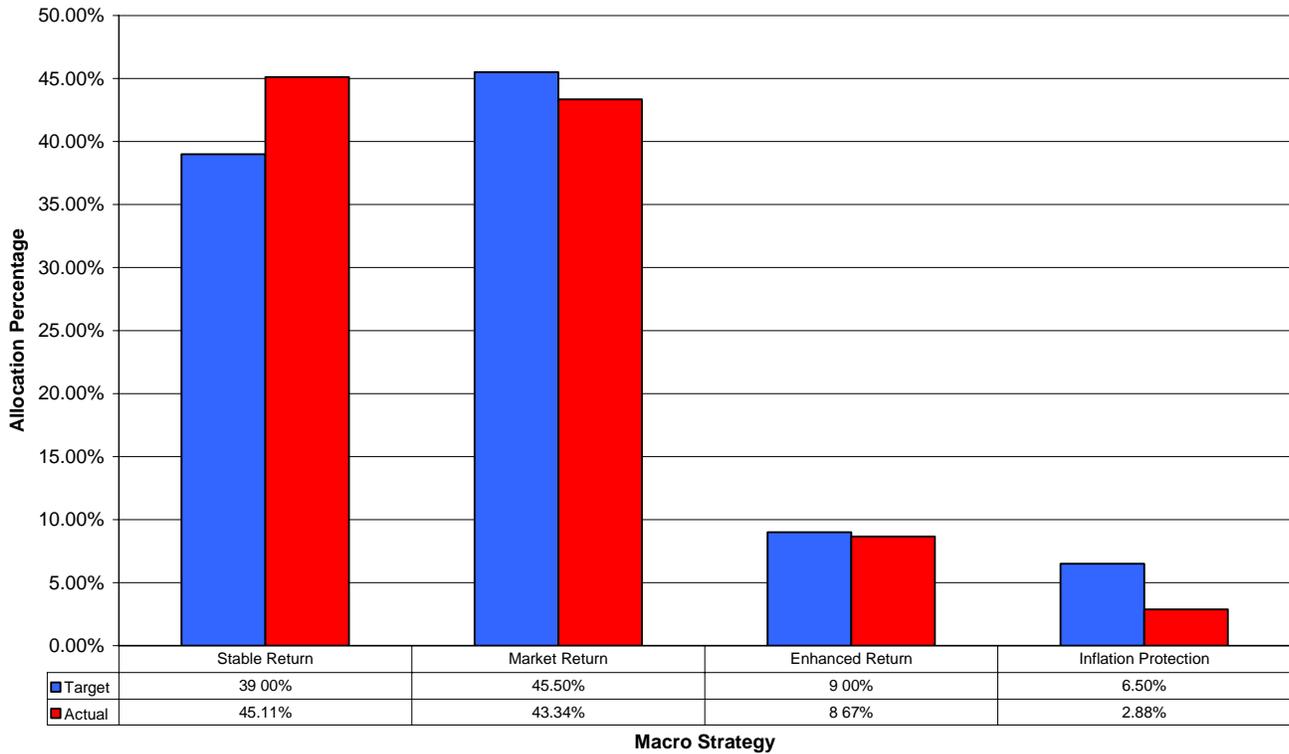
TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management’s Discussion and Analysis
(Continued)

December 31, 2008

The following charts compare the Fund’s macro strategy target asset allocation as of January 1, 2009 with its actual allocation as of December 31, 2008 and the Fund’s sub-strategy asset allocation as of January 1, 2009 with its actual allocation as of December 31, 2008.

**Macro Strategy Allocation
December 31, 2008**

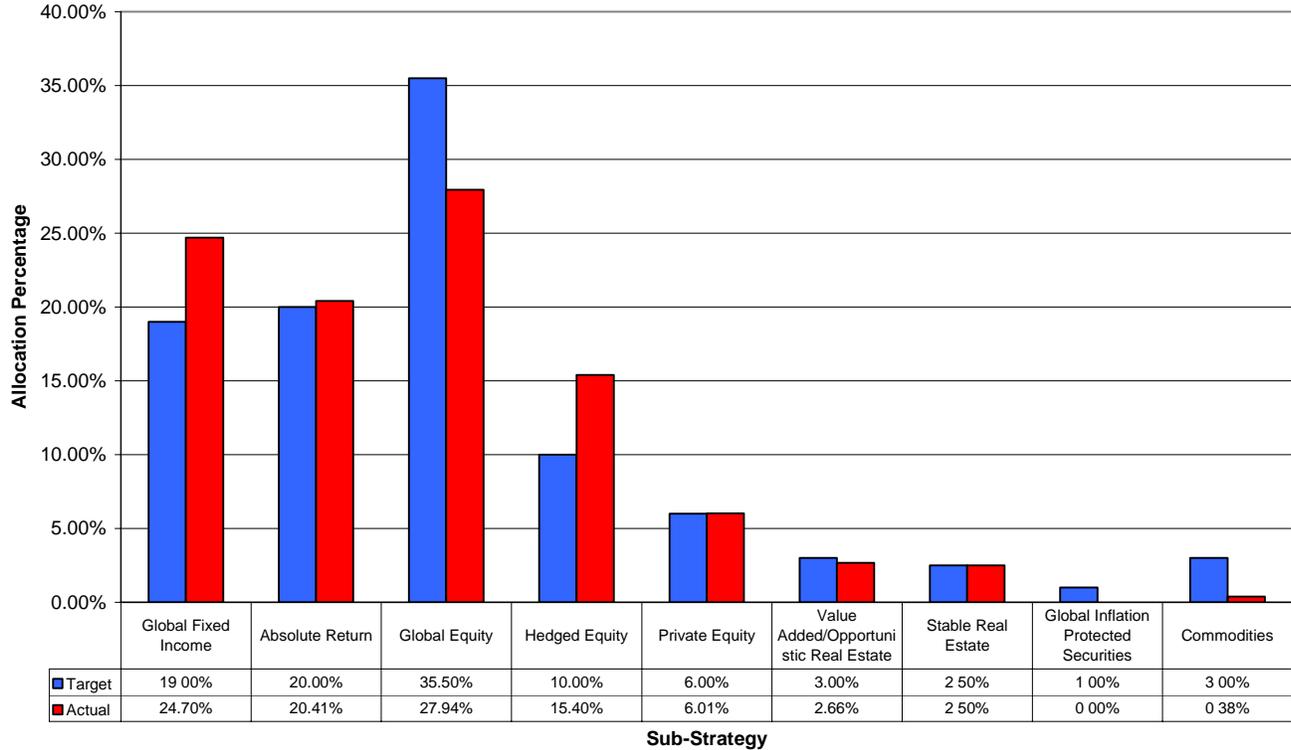


TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis (Continued)

December 31, 2008

Sub-Strategy Allocation December 31, 2008



At year end the Fund's target allocation to Global Fixed Income was 19% and its actual allocation at year end was 24.70%, an overweight of 5.7%. The Fund's target allocation to Global Equity was 35.50% while its actual allocation was 27.94%, an underweight of 7.56%. The Fund was also overweight in the Hedged Equity allocation by 5.4% at year end. The allocations to Global Inflation Protection Securities and to Commodities were also underweight at year end by a combined weight of 3.62%.

Unfunded Commitments

As of December 31, 2008, the Tobacco Fund's outstanding unfunded commitments in the private equity portfolio totaled \$147.7 million. Outstanding unfunded commitments in the real estate allocations totaled \$79.7 million.

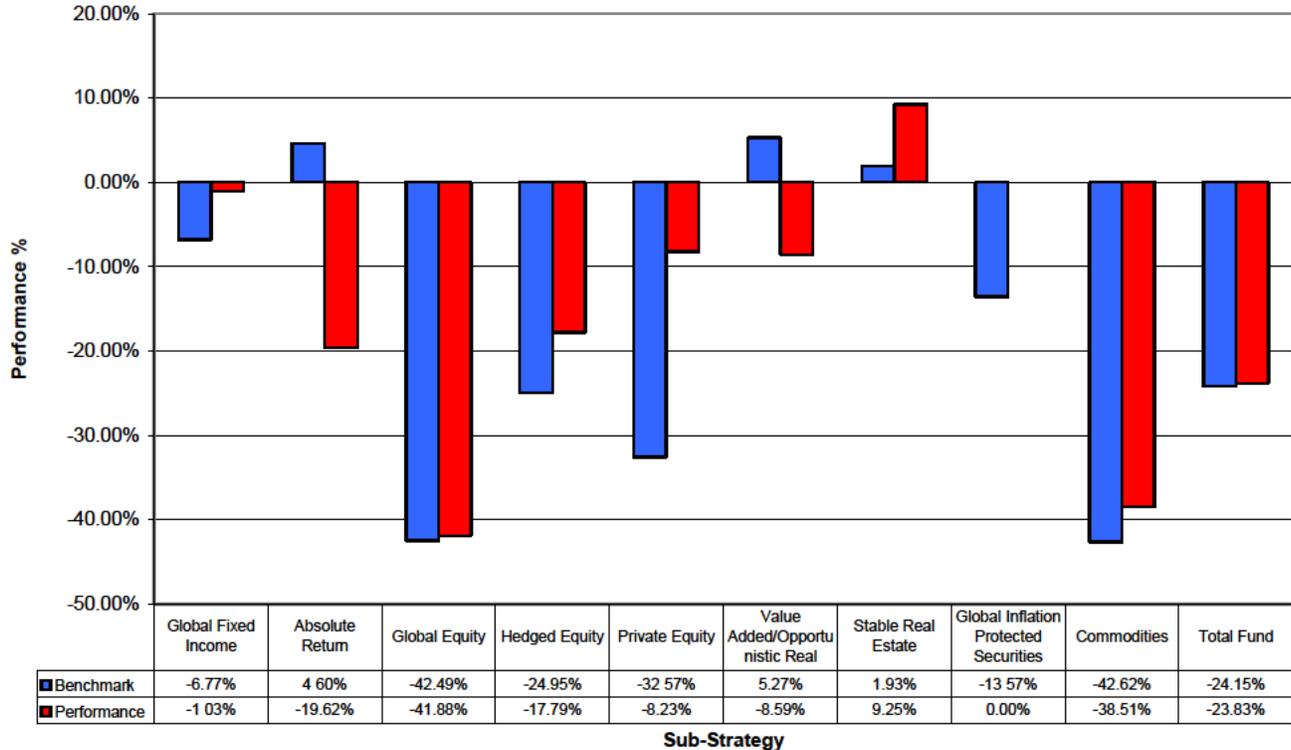
TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis (Continued)

December 31, 2008

Investment Performance

**Investment Performance
December 31, 2008**



The above chart presents the Endowment Pool performance as of December 31, 2008. During the year the Endowment Pool's overall performance was -23.83% while the policy benchmark return was -24.15%. During the year the only asset sub-strategy allocation that provided a positive return was the Stable Real Estate strategy. The Absolute Return Strategy underperformed its benchmark by 24.22% while the Value-added Opportunistic real Estate sub-strategy underperformed its benchmark by 13.86%. All other strategies out-performed their respective benchmarks.

Below is the performance comparison of the Tobacco Trust to the Endowment Pool for the preceding 1 year, 2 year and 3 year periods.

	1 Year	2 Year	3 Year
Total Endowment Pool	-23.83%	-9.44%	-2.03%
Tobacco Trust Fund	-23.62%	-9.36%	-1.91%

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis (Continued)

December 31, 2008

Traditional Asset Managers

The following table displays the performance of the Fund's equity and fixed income asset managers relative to their respective benchmarks for the preceding 1 year, 2 year and 3 year periods.

External Manager Investment Performance				
Asset Class	Manager Name	% Rate of Return		
		1 year	2 year	3 year
Large Cap Core Equity				
	Batterymarch	-36.76%	-17.35%	NA
	Biscayne	-39.59%	-17.85%	-8.40%
	Northern Trust (S&P 500)	-37.00%	-18.47%	-8.36%
	<i>Benchmark (S&P500)</i>	-37.00%	-18.47%	-8.36%
Large Cap Growth Equity				
	Intech	-34.06%	-15.67%	-8.61%
	Northern Trust Russell 1000	-38.46%	-17.06%	-9.10%
	<i>Benchmark (S&P 500 Barra/Citigroup Growth)</i>	-34.92%	-15.73%	-7.62%
Large Cap Value Equity				
	Northern Trust Russell 1000 Value	-36.73%	-20.46%	-8.23%
	<i>Benchmark (Russell 1000 Value)</i>	-36.85%	-20.60%	-8.32%
Mid Cap Core Equity				
	Northern Trust S&P 400	-36.27%	-17.01%	-8.72%
	<i>Benchmark (S&P MidCap 400)</i>	-36.23%	-17.02%	-8.76%
Small Cap Core Equity				
	Northern Trust S&P 600	-31.19%	-17.13%	NA
	<i>Benchmark (S&P 600)</i>	-31.07%	-17.10%	-7.51%
Non US Developed Markets				
	Alliance Berstein	-52.13%	-26.93%	-11.35%
	BGI ACWI ex US Alpha Tilts	-45.02%	-20.74%	-7.18%
	<i>Benchmark (MSCI ACWI ex USA GD)</i>	-45.53%	-20.28%	-6.98%
	<i>BGI International Small Cap Fund*</i>	-47.03%	NA	NA
	<i>MSCI EAFE Small Cap</i>	-46.78%	-26.40%	-13.45%
Emerging Markets				
	BGI Emerging Markets Fund*	-47.13%	NA	NA
	<i>Benchmark MSCI Emerging Markets</i>	-50.34%	NA	NA
Global Investment Grade Fixed Income				
	BGI Core Bond	4.78%	5.16%	4.87%
	<i>Benchmark (Barclays US Aggregate)</i>	5.24%	6.10%	5.51%
Global High Yield Fixed Income				
	Fountain Capital	-20.42%	-8.77%	-3.60%
	<i>Benchmark (LB High Yield Corporate Index)</i>	-26.15%	-13.26%	-5.59%
Emerging Markets Fixed Income				
	Lazard Emerging Income*	7.47%	NA	NA
	<i>Benchmark (Barclays Emerging Market Index)</i>	9.31%	NA	NA

* indicates that the strategy was started during the reported year and that the returns presented are reported since the inception date of the portfolio

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Management's Discussion and Analysis (Continued)

December 31, 2008

Distribution and Contribution History

The Distribution for 2009 is calculated based on the average market value of \$2,140,229,068. The Trust Account uses the most recent twenty (20) calendar quarter end market values to calculate the average market value. Based on these values, the amount eligible for distribution under the rules is \$96,310,308. The following chart reflects the Tobacco Settlement Trust Fund's distribution and contribution history.

Distribution & Contribution History:

Contribution Month	Total	Distribution Month	Total Distribution from Tobacco Fund	Direct Distribution	Total Distribution
		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
Totals:	<u>\$1,682,964,904</u>		<u>\$ 379,972,232</u>	<u>\$ 450,000,000</u>	<u>\$ 829,972,232</u>

Significant Known Facts, Decisions, or Conditions

Subsequent to December 31, 2008, the credit and liquidity crisis in the United States and throughout the global financial system that began in 2008 has continued to result in substantial volatility in the financial markets. These events continue to have adverse impact on the investment portfolio of the Tobacco Settlement Permanent Trust Fund.

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, Frank Zahn at (512) 463-3129.

FINANCIAL STATEMENTS

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Statement of Fiduciary Net Assets

December 31, 2008

Assets	
Trades pending settlement	\$ 3,104,527
Interest and other receivables	2,426,139
Investments (note 3)	<u>1,751,054,842</u>
Total assets	<u>1,756,585,508</u>
Liabilities	
Trades pending settlement	4,627,756
Accounts payable	<u>888,178</u>
Total liabilities	<u>5,515,934</u>
Net Assets	
Held in trust for other governments	<u>\$ 1,751,069,574</u>

SEE ACCOMPANYING NOTES TO FINANCIAL STATEMENTS

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Statement of Changes in Fiduciary Net Assets

Year Ended December 31, 2008

Additions

Investment income:

Net (decrease) in fair value of investments	\$ (608,880,953)
Interest and investment income	<u>21,057,222</u>
Total income from investing activities	<u>(587,823,731)</u>

From securities lending activities:

Securities lending income	981,720
Less borrower rebates and agent fees	<u>871,415</u>
Net income from securities lending	<u>110,305</u>
Total additions	<u>(587,713,426)</u>

Deductions

Professional fees and services	6,358,887
Disbursements to local governments	<u>92,303,845</u>
Total deductions	<u>98,662,732</u>
Change in net assets held in trust for other governments	(686,376,158)
Net assets - beginning of year	<u>2,437,445,732</u>
Net assets - end of year	<u>\$ 1,751,069,574</u>

SEE ACCOMPANYING NOTES TO FINANCIAL STATEMENTS

NOTES TO FINANCIAL STATEMENTS

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Notes to Financial Statements

December 31, 2008

(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 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 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) Basis of Accounting

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.

(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.

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.

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Notes to Financial Statements

December 31, 2008

(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, 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. The type of investments allowed by the Investment Policy includes:

- Common stock
- Derivative securities
- Foreign currency forwards or futures contracts
- Unaffiliated liquid investment funds
- Commercial paper
- Negotiable certificates of deposit
- Bankers Acceptances
- Repurchase agreements and reverse repurchase agreements
- Mortgage backed securities dollar rolls
- Fixed income securities which are components of the Lehman Brothers Aggregate Bond Index (LBAGG)
- U.S. Domestic Bonds
- Floating rate securities
- Medium term notes issued by investment grade corporations
- Zero coupon bonds and stripped treasury and agency securities
- Structured notes and multi-family mortgage-backed securities
- Hedge Funds
- Real Estate
- Private Equity

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Notes to Financial Statements

December 31, 2008

(c) *Investments (Continued)*

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

Strategy	Target %	Range (+/-)
<i>Stable Return (Low Beta)</i>	39%	10%
Global Investment Grade Fixed Income	11%	
Short-term Investment Funds	0%	
US Core	7%	
Non-US Developed	4%	
Global High Yield Fixed Income	8%	
US High Yield	5%	
Emerging Market	3%	
Absolute Return	20%	
<i>Market Return (Beta)</i>	38%	10%
Global Equity	28%	
Domestic	14%	
Non-US Developed	9%	
Emerging Market	5%	
Hedged Equity	10%	
<i>Enhanced Return</i>	15%	8%
Private Equity	10%	
Enhanced Return Real Estate	5%	
<i>Inflation Protection (Real Assets)</i>	8%	5%
Stable Value Real Estate	4%	
Global Inflation Protected Securities	1%	
Commodities	3%	

(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.

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Notes to Financial Statements

December 31, 2008

(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 applies GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This statement requires that governmental entities report investments at fair value on the balance sheet, and that all investment income, including changes in the fair value of investments, should be reported in the operating statement.

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, 2008 are as follows:

Corporate obligations	\$ 55,402,228
International corporate obligations	5,144,098
Exchange traded note-commodities	6,688,944
Equities	111,514,370
International equities	1,149,825
Mutual funds - domestic equities	203,017,183
Mutual funds - global equities	172,975,298
Mutual funds - fixed income	310,637,343
Hedge funds - absolute return	339,068,569
Hedge funds - equities	269,604,392
Alternative Investments Domestic	202,819,218
Alternative Investments International	34,327,976
Investment in Short-Term Investment Fund	38,705,398
Total Endowment Fund Investments	<u><u>\$ 1,751,054,842</u></u>

Consisting of the following:

Fiduciary Funds Investments	1,751,054,842
Total as presented on the Financial Statements	<u><u>\$ 1,751,054,842</u></u>

Credit Risk. Corporate obligations must be rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO") and not rated below investment grade by any NRSRO. Short-term securities must be rated in the highest rating category by an NRSRO. The average quality rating of the high-yield fixed income portfolio shall be B1/B+ or higher. All high-yield securities when purchased must be rated at least CCC. The following schedule lists Standard & Poor's credit rating by investment type for the Fund. The high-yield securities not rated by Standard & Poor's are rated Ba or B by Moody's.

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Notes to Financial Statements

December 31, 2008

(3) Investments (Continued)

Investment Type	AAA	BBB	BB	B	CCC	C	Not Rated
Corporate Obligations		\$ 7,158,441	\$ 23,033,652	\$ 21,487,522	\$ 1,922,008	\$ 249,480	\$ 1,551,125
International Corporate Obligations			4,105,628	1,038,470			
Mutual Funds - Fixed Income							310,637,343
Exchange Traded Note-Commodities							6,688,944
Investments in Short-Term Investment Fund	38,705,398						
Total Endowment Funds	\$ 38,705,398	\$ 7,158,441	\$ 27,139,280	\$ 22,525,992	\$ 1,922,008	\$ 249,480	\$ 318,877,412

Concentration Risk: As of December 31, 2008 no more than 5 percent of the portfolio was invested in securities of one issuer.

Interest Rate Risk: The Fund does not have a formal investment policy that limits 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.

Modified Duration	
Investment Type	(Years)
Corporate obligations	4.21
International corporate obligations	3.71
Mutual funds – fixed income	4.47
Weighted Average Maturity	
	(Days)
Investment in short-term investment fund	47

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	\$34,327,976

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Notes to Financial Statements

December 31, 2008

(3) Investments (Continued)

Securities Lending

Section 404.102 of the Texas Government Code and the Fund's Investment Policy permit the lending of specific endowment fund securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The endowment fund's custodian, as security lending agent, lends securities of the type on loan at year-end for collateral in the form of cash or other securities that exceed the value of the securities on loan.

Types of securities lent include U.S. equities, U.S. government fixed income, U.S. agencies and corporate fixed income.

Collateral includes cash, U.S. government securities and irrevocable letters of credit. U.S. securities are loaned versus collateral valued at 102% of the market value of the securities plus any accrued interest. Non U.S. securities are loaned versus collateral valued at 105% of the market value of the securities plus any accrued interest receivable. At year-end, the Fund has no risk exposure to borrowers because the Fund has no securities loans outstanding. The contract with the Fund's lending agent allows for indemnification where a client's securities are not returned due to insolvency of a borrower and the lending agent has failed to live up to its contractual responsibilities relating to the lending of those securities. The agent's responsibilities include performing appropriate borrower and collateral investment credit analysis, demanding adequate types and levels of collateral, and complying with applicable Federal Financial Institutions Examinations Council regulations concerning securities lending.

All securities loaned can be terminated on demand by either the Texas Trust or the borrower. There are no loans outstanding as of December 31, 2008. Cash collateral is invested in the lending agent's short-term investment fund, which at year-end has a weighted average maturity of 43 days, or in Term Loans, in which case the investments match the loan term. The endowment funds cannot pledge or sell collateral securities received unless the borrower defaults. There were no violations of legal or contractual provisions, no borrower or lending agent default losses known to the securities lending agent.

On September 15, 2008, Lehman Brothers International Europe (LBIE) and, Lehman Brothers Inc. (LBI) were called into default on obligations under the terms of one or more of the Securities Borrowing Agreements. All clients were compensated for any security that was not returned from loan in accordance with the contractual obligations.

On October 6, 2008 the Texas Trust suspended its authorization allowing Northern Trust to act as its agent to lend securities the Texas Trust has in its account. The suspension will remain in effect until revoked by the Texas Trust and the securities lending market has stabilized. The Texas Trust has no securities loaned out as of December 31, 2008.

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

TOBACCO SETTLEMENT PERMANENT TRUST FUND

Notes to Financial Statements

December 31, 2008

(3) Investments (Continued)

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, 2008.

(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 Tobacco Settlement Permanent Trust Account Investment Advisory Committee ("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 financial statements.

The inflation adjusted corpus for the year ending December 31, 2008, was \$2,022,770,316. The Distribution was calculated based on the average market value of the Trust Account using the most recent twenty (20) calendar quarter-end market values of \$2,140,229,068. Based on these values, the amount eligible for distribution in April 2009 under the rules is \$96,310,308. Because the net earnings are less than the calculated distribution amount, the distribution will be funded from the following sources, \$34,816,835 from current earnings less investment expenses and \$61,493,473 from the DSA.

With the current allowed deduction to the DSA, the total DSA reserve is \$39,952,093. This 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 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 \$6,358,887 for the months of January 2008 through December 2008.