

# **Tobacco Settlement Permanent Trust Fund**

Annual Financial Report  
December 31, 2020

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## Independent Auditor's Report

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, 2020, 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 and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. 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 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.

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

### 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, 2020, 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 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, 2020, 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.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated March 15, 2021, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Fund's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund's internal control over financial reporting and compliance.

*RSM US LLP*

Austin, Texas  
March 15, 2021

## **Tobacco Settlement Permanent Trust Fund**

### **Management's Discussion and Analysis December 31, 2020**

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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, 2020. 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 by \$169.8 million, or 6.2% during the year 2020.
- The Fund distributed \$73.8 million to political subdivisions for health care in the year 2020.

#### **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 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, 2020

The Statement of Fiduciary Net Position presents the financial position of the Fund at the end of each 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, 2020 and 2019, net position was calculated as follows:

	2020	2019	Variance	Percent Change
Cash and cash equivalents	\$ -	\$ 464,617	\$ (464,617)	(100.00%)
Trades pending settlement	6,224,799	3,154,215	3,070,584	97.35%
Other assets	6,596	285,503	(278,907)	(97.69%)
Investments at fair value	2,943,394,157	2,765,322,178	178,071,979	6.44%
Total assets	2,949,625,552	2,769,226,513	180,399,039	6.51%
Total liabilities	26,623,258	15,990,590	10,632,668	66.49%
Net position held in trust	\$ 2,923,002,294	\$ 2,753,235,923	\$ 169,766,371	6.17%

After distributing \$73.8 million during 2020, the value of investments still increased by \$178.1 million due to positive investment returns during the year. Other assets decreased by \$278.9 thousand while total liabilities increased by \$10.6 million. The decrease in other assets is attributable to a decrease in interest and other receivables. The increase in liabilities is due to the timing of payables at year-end.

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, 2020 and 2019, is as follows:

	2020	2019	Variance	Percent Change
Net investment income	\$ 248,130,807	\$ 304,916,524	\$ (56,785,717)	(18.62%)
Distributions to local governments	73,831,824	71,912,881	1,918,943	2.67%
Expenses	4,532,612	5,394,783	(862,171)	(15.98%)
Net increase(decrease) in net position	169,766,371	227,608,860		
Net position held in trust at beginning of year	2,753,235,923	2,525,627,063		
Net position held in trust at end of year	\$ 2,923,002,294	\$ 2,753,235,923		

Net investment income decreased by \$56.8 million compared to the previous year, as a result of the lower investment returns earned by the Fund. During the year ended December 31, 2020, the total rate of return for the Fund was 7.70%, while the total rate of return for the previous year was 11.75%. The total Fund underperformed its benchmark for the year by 2.31%. 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, 2020

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#### Asset Allocation

The current Texas Trust asset allocation structure as of December 31, 2020, is shown in the chart below:

Asset Class	Current Market Value	Weight	Target	Policy Range
<b>Fixed Income</b>	<b>\$ 1,011,969,321</b>	<b>34.3%</b>	<b>35.0%</b>	<b>20-50%</b>
Global Fixed Income	19,971,666	0.7%	10.0%	
Cash	300,314,168	10.1%	0.0%	
Alternative Fixed Income	372,669,022	12.7%	15.0%	
Private Debt	319,014,465	10.8%	10.0%	
<b>Equity</b>	<b>1,277,758,340</b>	<b>43.4%</b>	<b>50.0%</b>	<b>30-60%</b>
Global Public Equity	192,391,221	6.5%	15.0%	
Hedged Equity	608,405,949	20.7%	20.0%	
Private Equity	476,961,170	16.2%	15.0%	
<b>Real Assets</b>	<b>532,179,908</b>	<b>18.0%</b>	<b>15.0%</b>	<b>10-30%</b>
Stable Value Real Assets	350,982,811	11.9%	7.5%	
Enhanced Real Estate	181,197,097	6.1%	7.5%	
<b>All Asset and Overlays</b>	<b>127,717,983</b>	<b>4.3%</b>	<b>0.0%</b>	<b>0-15%</b>
<b>Total Assets</b>	<b>\$ 2,949,625,552</b>	<b>100.0%</b>	<b>100%</b>	<b>100%</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 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.

Alternative Fixed Income strategies are intended to preserve investment capital by achieving consistent positive real returns and maximizing long-term total returns, within prudent levels of risk, through the use of diversified portfolios of complementary strategies.

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.

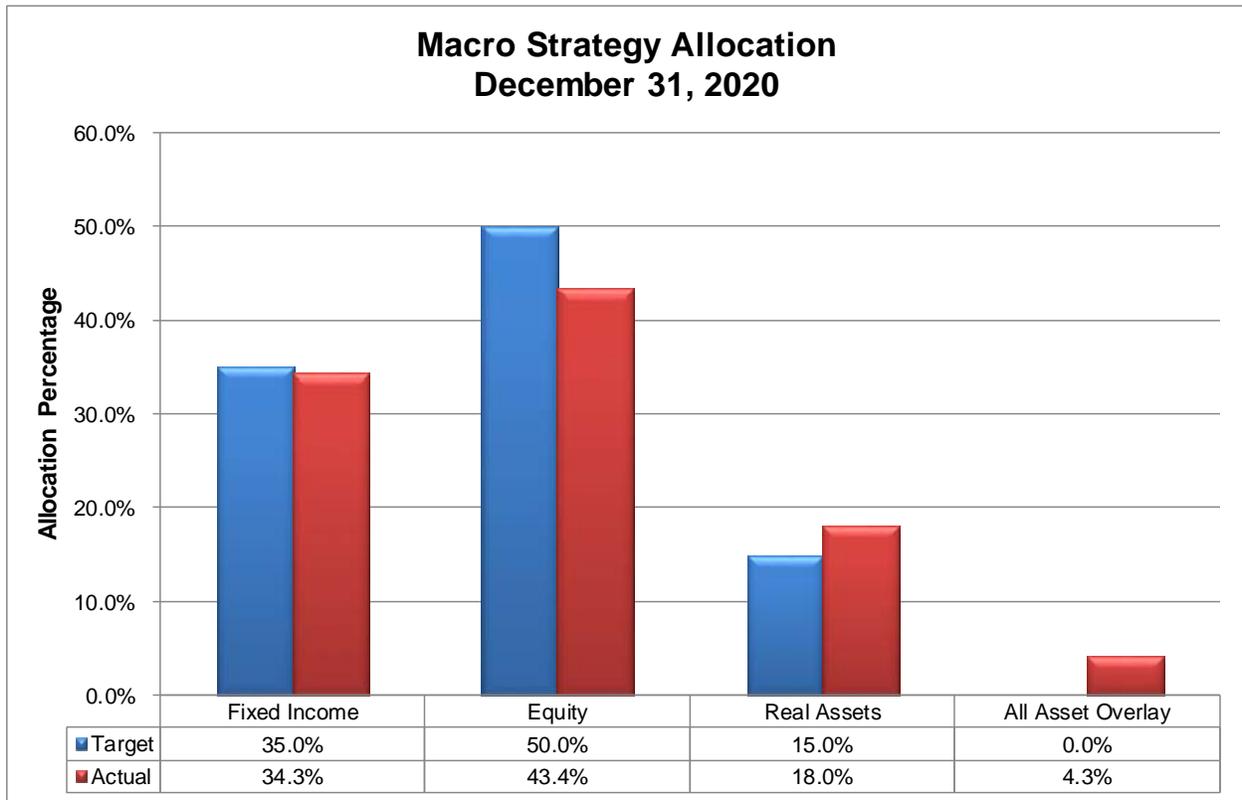
**Tobacco Settlement Permanent Trust Fund**

**Management’s Discussion and Analysis  
December 31, 2020**

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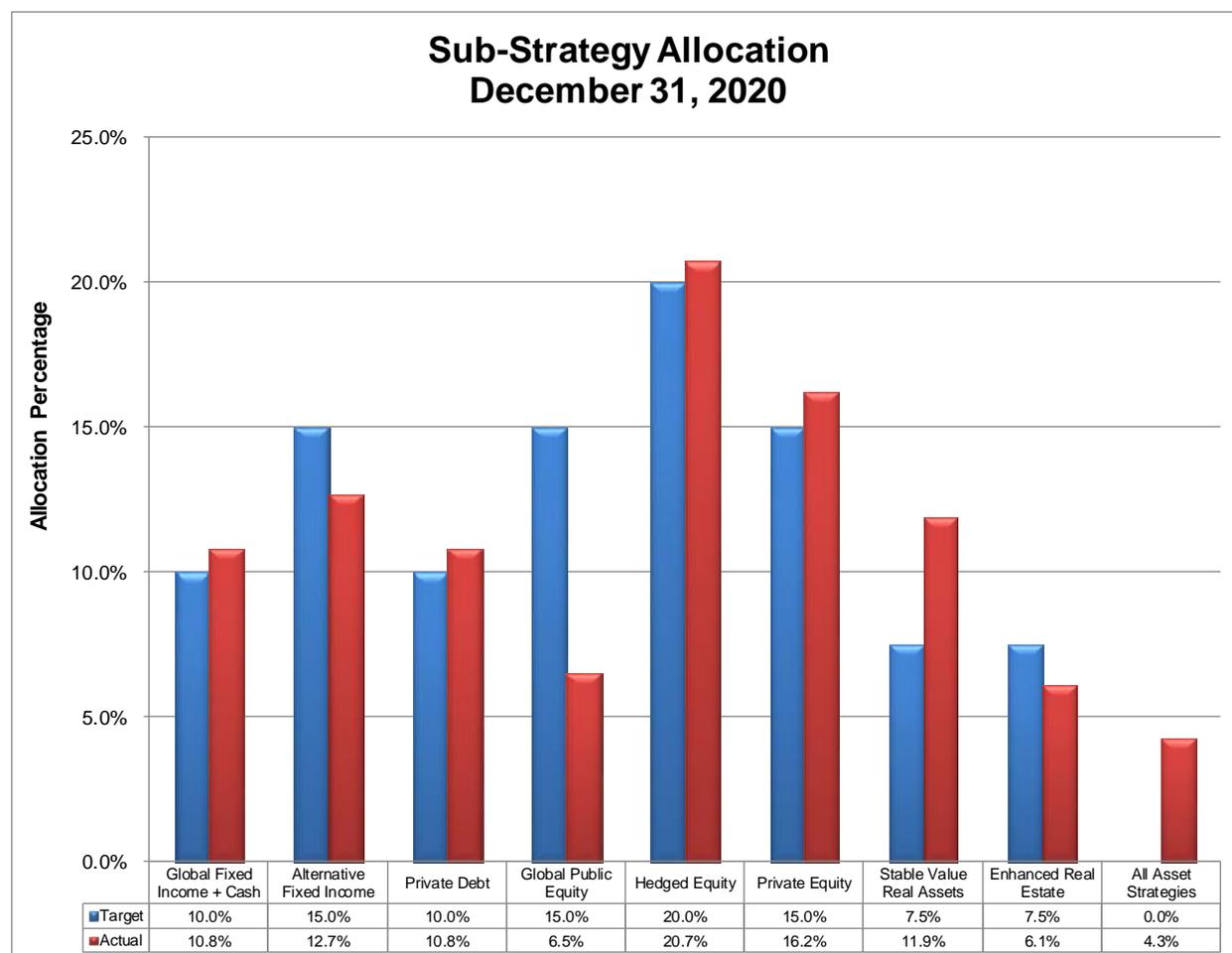
The All Asset strategies include exposures across equity, fixed income and real estate classes. This portfolio may consist of long-only, hedged and private strategies whose portfolios are diversified across a broad range of asset types.

The following charts compare the Fund’s macro strategy target asset allocation as of December 31, 2020, with its actual allocation as of December 31, 2020, and the Fund’s sub-strategy asset allocation as of December 31, 2020, with its actual allocation as of December 31, 2020:



**Tobacco Settlement Permanent Trust Fund**

**Management’s Discussion and Analysis  
December 31, 2020**



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 8.5% underweight in global public equity and a 4.3% overweight in all asset strategies. Both variances were well within the allowable target ranges for the strategy.

**Unfunded Commitments**

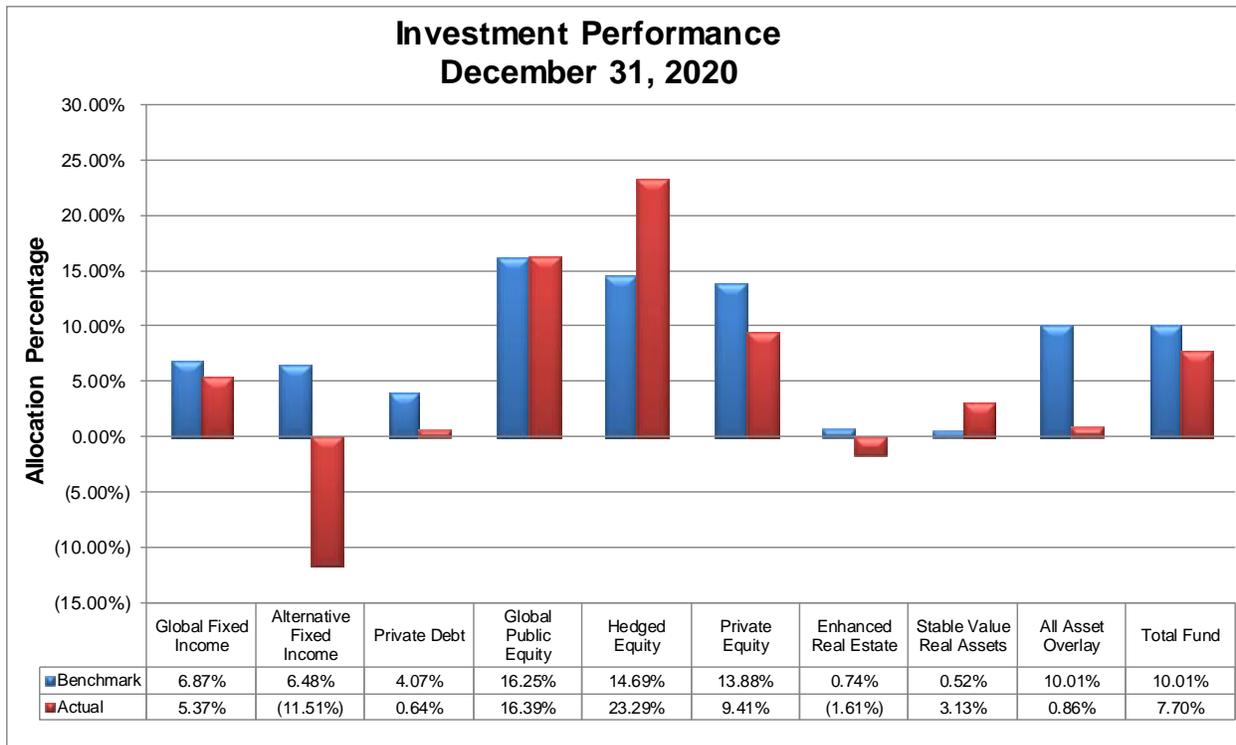
As of December 31, 2020, the Fund’s outstanding unfunded commitments totaled \$732.4 million.

**Tobacco Settlement Permanent Trust Fund**

**Management’s Discussion and Analysis  
December 31, 2020**

**Investment Performance**

The chart below presents the Fund’s performance as of December 31, 2020. During the year, the Fund’s overall performance was 7.70%, while the policy benchmark return was 10.01%. During the year, Global Public Equity, Hedged Equity and Stable Value Real Assets strategies outperformed their respective benchmarks. All other strategies underperformed 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	7.70%	6.71%	7.83%

## Tobacco Settlement Permanent Trust Fund

### Management's Discussion and Analysis December 31, 2020

#### 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 2021 is \$75,630,577. This amount is based on an average market value of the Trust Account of \$2,521,019,243 as of December 31, 2020, 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		Total Distributions
			From Tobacco Fund	Direct Distribution	
		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
	-	April 15, 2019	71,912,881	-	71,912,881
	-	April 15, 2020	73,831,824	-	73,831,824
<b>Total</b>	<b>\$ 1,682,964,904</b>		<b>\$ 1,103,779,950</b>	<b>\$ 450,000,000</b>	<b>\$ 1,553,779,950</b>

**Tobacco Settlement Permanent Trust Fund**

**Management's Discussion and Analysis  
December 31, 2020**

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**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, 2020**

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**Assets**

Other assets	\$	6,596
Trade pending settlement		6,224,799
Investments		<u>2,943,394,157</u>
<b>Total assets</b>		<u><u>2,949,625,552</u></u>

**Liabilities**

Accounts payable		26,471,170
Interest payable		<u>152,088</u>
<b>Total liabilities</b>		<u><u>26,623,258</u></u>

Net Position

**Held in trust for other governments** \$ 2,923,002,294

See notes to financial statements.

## Tobacco Settlement Permanent Trust Fund

### Statement of Changes in Fiduciary Net Position Year Ended December 31, 2020

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**Additions:**

Investment income:

Net increase in fair value of investments

\$ 223,825,106

Interest and investment income

24,305,701

**Total income from investing activities**248,130,807**Total additions**248,130,807**Deductions:**

Professional fees and services

4,532,612

Disbursements to local governments

73,831,824

**Total deductions**78,364,436

Change in net position held in trust for other governments

169,766,371

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

2,753,235,923

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

\$ 2,923,002,294

See notes to financial statements.

## Tobacco Settlement Permanent Trust Fund

### Notes to the Financial Statements December 31, 2020

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#### 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 invest the monies collected from the tobacco companies, and distribute the income 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 (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 (the 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 overseeing the management of 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:** During the year ended August 31, 2020, the Fund adopted new accounting guidance by implementing the provisions of Governmental Accounting Standards Board (GASB) Statement No. 84, *Fiduciary Activities*, which establishes criteria for identifying and reporting fiduciary activities. The implementation of this statement did not materially change the presentation of the financial statements of the Fund.

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.

These financial statements include only the operations of the Fund and do not purport to, and do not, present the financial position of the State of Texas as of December 31, 2020 and the changes in its financial position for the year then ended.

## Tobacco Settlement Permanent Trust Fund

### Notes to the Financial Statements December 31, 2020

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#### Note 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. 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 distribution 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.

**(c) Investments:** The Fund reports its investments at fair value and 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.

## Tobacco Settlement Permanent Trust Fund

### Notes to the Financial Statements December 31, 2020

#### Note 2. Summary of Significant Accounting Policies (Continued)

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

Strategy—Sub-Strategy	Target Percentage	Benchmark(s) Strategy Range
<b>Fixed Income</b>	<b>35%</b>	<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
<b>Equity</b>	<b>50%</b>	<i>Allocation Range: 30%-60%</i>
Global Public Equity	15%	MSCI ACWI IMI Net Index
Hedged Equity	20%	HFRI FOF: Strategic Index
Private Equity	15%	Cambridge Associates—Custom Private Equity Index
<b>Real Assets</b>	<b>15%</b>	<i>Allocation Range: 10%-30%</i>
Stable Value Real Estate	7.5%	NCREIF NFI—ODCE
Enhanced Real Estate	7.5%	Cambridge Associates Real Estate Fund Index
<b>Strategic All Asset Strategy and Overlays</b>	<b>0%</b>	<i>Allocation Range: 0%-15%</i>
All Asset Strategies	0%	Total Endowment Benchmark
Overlay Strategies	0%	3-Month T-Bill

**(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.

## Tobacco Settlement Permanent Trust Fund

### Notes to the Financial Statements December 31, 2020

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#### Note 2. Summary of Significant Accounting Policies (Continued)

**(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% 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 accounting principles generally accepted in the United States of America. 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, 2020

#### 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, 2020, are as follows:

Investments by Fair Value Level	Fair 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)
<b>Debt securities:</b>				
Money market funds	\$ 294,082,772	\$ 294,082,772	\$ -	\$ -
Mutual funds—global fixed income	6,403,388	6,403,388	-	-
Mutual funds—global equities	1,310,241	1,310,241	-	-
<b>Derivative securities:</b>				
Total return swap—fixed income	665,449	-	665,449	-
Total return swap—equity	20,335,975	-	20,335,975	-
Total investments at fair value	<u>\$ 322,797,825</u>	<u>\$ 301,796,401</u>	<u>\$ 21,001,424</u>	<u>\$ -</u>

Investments Measured at NAV	Investment Strategy	Fair Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Hedge funds—fund of funds	Equity	\$ 100,774,168	N/A	Daily, Monthly, Quarterly, Annually	1-95 days
Hedge funds—direct funds—fixed income	Alternative fixed income	428,336,284	N/A	Daily, Monthly, Quarterly, Annually	2-92 days
Hedge funds—direct funds—equities	Equity	679,080,188	N/A	Daily, Monthly, Quarterly, Annually	1-120 days
Hedge funds—direct funds—all asset	All asset	27,404,387	N/A	Annually	45 days
Hedge funds—direct funds—real assets	Real asset	30,980,035	N/A	Monthly	30 days
Domestic alternative—private debt	Private debt	318,993,055	\$ 243,888,436	N/A	N/A
Domestic alternative—private equity	Equity	442,394,304	220,744,858	N/A	N/A
Domestic alternative—real assets	Real assets	527,377,116	236,292,088	N/A	N/A
International alternative—private debt	Private debt	21,410	612,932	N/A	N/A
International alternative—private equity	Equity	38,415,169	14,193,371	N/A	N/A
International alternative—real assets	Real assets	26,820,215	16,691,599	N/A	N/A
Total investments at NAV		<u>\$ 2,620,596,331</u>	<u>\$ 732,423,284</u>		
Total Investments		<u>\$ 2,943,394,157</u>			

## **Tobacco Settlement Permanent Trust Fund**

### **Notes to the Financial Statements December 31, 2020**

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#### **Note 3. Investments (Continued)**

Equity securities classified as Level 1 of the fair value hierarchy are valued using a published price.

Mutual Funds are valued daily or monthly, as appropriate, at a published NAV per share.

Through the use of derivatives, including 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.

Alternative Fixed Income strategies are intended to preserve investment capital by achieving consistent positive real returns and maximizing long-term total returns, within prudent levels of risk, through the use of diversified portfolios of complementary strategies.

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.

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, 2020

#### 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 Mutual Funds
AAA	\$ -	\$ 294,082,772
Not rated	6,403,388	-
Total	<u>\$ 6,403,388</u>	<u>\$ 294,082,772</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 represent 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 level, may be made only if fully collateralized in accordance with the State Depository Handbook. No cash and cash equivalents were reported as of December 31, 2020.

**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 Fund and are held by the counterparty, its trust or agent, but not in the name of the Fund. The Fund's investments are not exposed to custodial credit risk since they are insured or registered or the securities are held by the Fund or its agent in the Fund'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% of Fund assets. Fund investments will generally not exceed more than 25% of any firm's assets under management. As of December 31, 2020, no more than 5% 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	\$ 6,403,388	5.96 years
		<u>Weighted Average Maturity</u>
Investment in short-term investment fund	\$ 294,082,772	47 days

## Tobacco Settlement Permanent Trust Fund

### Notes to the Financial Statements December 31, 2020

#### 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	\$ -	\$ 65,256,794	\$ 65,256,794

**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, 2020:

	Fair Value	Changes in Fair Value	Notional Value
Swaps			
Total Return Swap—fixed income	\$ 665,449	\$ 5,413,106	\$ 166,267,371
Total Return Swap—equity	20,335,975	60,117,274	271,165,137
Total swaps	\$ 21,001,424	\$ 65,530,380	\$ 437,432,508
Total derivatives	\$ 21,001,424	\$ 65,530,380	\$ 437,432,508

**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, 2020.

## Tobacco Settlement Permanent Trust Fund

### Notes to the Financial Statements December 31, 2020

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#### 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 2021 is \$75,630,577. This amount is based on an average market value of the Trust Account of \$2,521,019,243 as of December 31, 2020, using the most recent 20 calendar quarter-end market values. The actual amount to be distributed by the Fund in 2020 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, 2020, the value of the corpus is \$1,682,964,904.

#### Note 5. Related Party Transactions

Upon creation of the Texas Trust as a separate legal entity by the 77<sup>th</sup> 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 28 basis points to recover all costs associated with the management of the Fund. The Fund was charged \$4,532,612 for the year ended December 31, 2020. As of December 31, 2020, management fee payable of \$1,308,716 was outstanding and included in accounts payable on the accompanying statement of fiduciary net position.

#### Note 6. Impact of COVID-19

On January 30, 2020, the World Health Organization declared the coronavirus outbreak a "Public Health Emergency of International Concern" and on March 11, 2020, declared it to be a pandemic. Actions taken around the world to help mitigate the spread of the coronavirus include restrictions on travel, and quarantines in certain areas, and forced closures for certain types of public places and businesses. The coronavirus and actions taken to mitigate the spread of it have had and are expected to continue to have an adverse impact on the economies and financial markets of many countries, including the geographical area in which the Fund operates. On March 27, 2020, the *Coronavirus Aid, Relief, and Economic Security Act* was enacted to amongst other provisions, provide emergency assistance for individuals, families and businesses affected by the coronavirus pandemic.

It is unknown how long the adverse conditions associated with the coronavirus will last and what the complete financial effect will be. To date, the Fund has not experienced any significant changes in the fair value of assets or liabilities as a result of the pandemic.

**Report on Internal Control Over Financial Reporting and on Compliance  
and Other Matters Based on an Audit of Financial Statements Performed  
in Accordance With *Government Auditing Standards***

**Independent Auditor's Report**

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

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the 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, 2020, and the related notes to the financial statements, which collectively comprise the Fund's basic financial statements, and have issued our report thereon dated March 15, 2021.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Fund's financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the financial statements. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

**Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Fund's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

*RSM US LLP*

Austin, Texas  
March 15, 2021