

# Treasurer's Report

The finance committee of the Fund's board of directors is responsible for the effective and prudent investment of the endowment, a task essential to assuring a stable source of funds for programs and the foundation's perpetuity. The committee determines the allocation of the endowment among asset classes and hires external managers, who do the actual investing. Day-to-day responsibility for the management of the endowment rests with the Fund's executive vice president and treasurer, who with the assistance of Cambridge Associates consultants is also responsible for researching policy questions and strategic issues to be addressed by the committee. The committee meets at least twice a year with the Fund's principal external investment managers, at which time it

also deliberates current investment issues affecting the management of the endowment and frequently considers new undertakings.

The value of the endowment rose from \$528.3 million on June 30, 1999, to \$557.4 million on June 30, 2000, reflecting a return of 11.9 percent on the investment portfolio during the year combined with total spending (including programs, administration, investment management fees, and taxes) of over \$30 million. In the 12-month period ending June 30, 2000, the weighted average return of a portfolio composed simply of the Wilshire 5000 U.S. stocks (70 percent) and Lehman Aggregate index U.S. bonds (30 percent) was 6.3 percent. Very strong returns on the Fund's venture capital (72.2 percent) and hedge fund (31.0 percent) portfolios and significant changes in the management structure of the endowment during the year contributed to the comparatively strong investment performance.

Beginning in the 1980s and more intensively in the 1990s, institutions like the Fund looked to nontraditional forms of investing (real estate, venture capital, specialized equities including hedge funds, and international exposure) in an attempt to outperform conventional U.S. manager strategies and to reduce risk through diversification. Following the 1970s "nifty fifty" growth stock debacle and the emergence of a large number of professional stock analysts devoted to

identifying undervalued stocks, many endowments also tilted toward value managers, both domestically and internationally.

The concentration of recent markets on a small group of large capitalization growth stocks and new technology companies has presented a significant challenge to sophisticated diversification strategies and the bias toward value investing. The concern is particularly acute for mid-size and smaller endowments like the Fund's, whose investment committees and available staff are stretched to stay on top of complicated manager structures.

Thus, the finance committee decided in April 1999 to undertake a complete reexamination of the investment strategy for the endowment. After careful study, the committee decided to restructure the endowment to reduce the risk of performance significantly divergent from that of the overall market and of peer institutions and to streamline the management structure. Briefly, the salient features of the revised strategy are these:

- The Wilshire 5000 index, which is broadly representative of the entire U.S. stock market, has replaced the S&P 500 index as the market bogey for the U.S. marketable equities portion of the portfolio.
- One-quarter of the endowment (or 56 percent of U.S. equities) is to be allocated to an S&P 500 index fund, in which the market share of growth stocks is currently more than 50 percent.
- Allocations to managers specializing in value stocks are to be significantly reduced, and the representation of small capitalization U.S. growth stock managers will be increased in the portfolio.
- Out of concern about the ability of any manager to cover both U.S. and international equities markets well, the Fund's international equities managers have been restricted to investing entirely outside the United States.
- The specialized equities (hedge fund) portion of the endowment is to be reduced from over 20 percent to 5 percent of the total endowment.
- The Fund will maintain a private equity (venture capital, oil and gas, and real estate) allocation — which has been as high as 16 percent — at the 10 percent level.
- Based on experience suggesting that international bonds add volatility to portfolio returns without adding commensurate return, the U.S. Lehman Aggregate Bond index replaced the Salomon World Government Bond index as the fixed income manager's benchmark, although that manager is permitted to invest in international fixed income securities opportunistically, up to a limit of 20 percent of its account.

As indicated in the figure below, the committee established ranges within which the revised target allocations to major asset classes may vary around their long-term targets; in practice, the variation from targeted levels is expected to be limited.

The first and major phase of restructuring the endowment to conform to the revised policies was carried out in December 1999 and January 2000. Additional manager reallocations, scheduled to take place at the end of 2000, will move the asset class profile of the endowment still closer to long-term targets.

The average annual return on the endowment over the almost 19 years since the Fund modernized its investment strategy in 1981 has been 14.3 percent. Even with setbacks in 1998 arising from the financial crisis of that year and a probably too-ambitious investment approach, the Fund's investment strategy has produced long-term returns competitive with those of other well-managed endowments, annual spending that does not fluctuate with the vicissitudes of the market, and annual growth in spending that at least equals inflation.

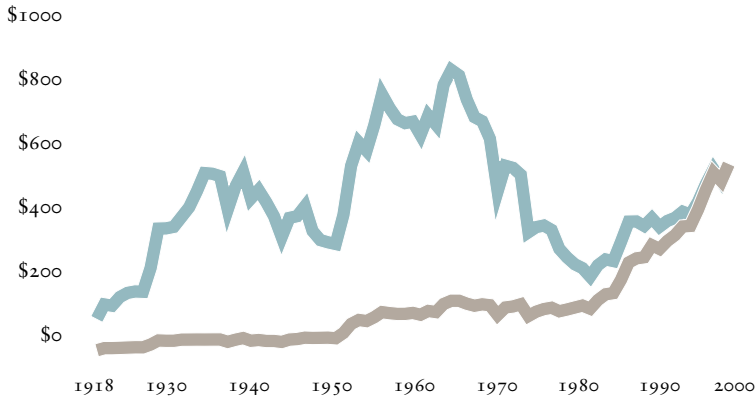
#### **Asset Allocation Targets and Ranges for the Endowment of The Commonwealth Fund**

Asset Class	Long-Term Target	Permissible Range
Fixed Income	30%	20-40%
U.S. Stocks	45%	30-60%
Large Capitalization Value	20%	
Large Capitalization Growth	14%	
Small Capitalization Value	6%	
Small Capitalization Growth	5%	
Foreign Stocks Total	15%	10-20%
Emerging Markets Stocks	4%	0-5%
Private Equity (Venture Capital, Real Estate, and Oil & Gas)	10%	0-15%
Total Endowment	100%	
Specialized Equities (Hedge Funds)	5%	0-7%
U.S. Stock Index (S&P 500) Fund	25%	20-30%

**The Commonwealth Fund's endowment, 1918–2000**

- Constant 2000 dollars
- Current dollars

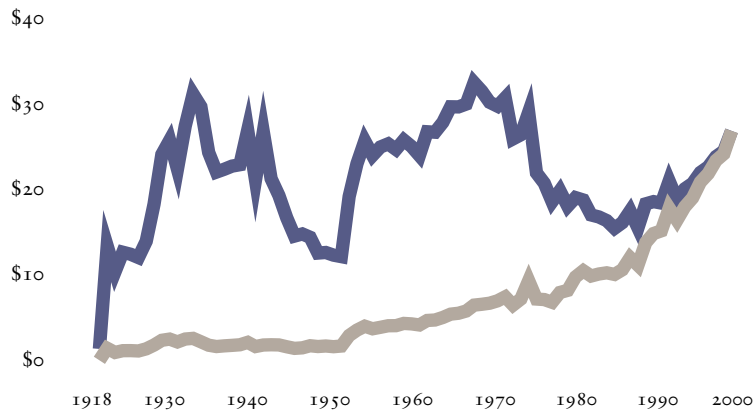
Market value of endowment at the end of fiscal year, in millions



**The Commonwealth Fund's annual spending, 1919–2000**  
**Total spending of \$542.9 million over 81 years, or \$1.8 billion in constant 2000 dollars**

- Constant 2000 dollars
- Current dollars

Annual spending, in millions



Since 1980, the Fund's real (inflation-adjusted) average annual return has been 8.0 percent. Looking at the 30-year period since 1970, however, the real return on the endowment has averaged 5.0 percent. The Fund's current spending policy is predicated on preserving the real value of the endowment and meeting the annual spending requirement mandated by the Internal Revenue Service. Under IRS regulations, the Fund should distribute 5.0 percent of its endowment for charitable purposes, on average, each year, and an additional .6 percent is required to cover investment expenses not counted as part of charitable distributions. The average spending rate is therefore targeted at 5.6 percent. The 30-year long-term historical record, encompassing periods of both good and poor market returns, indicates the wisdom of maintaining the spending rate at this level, in order to preserve the purchasing power of the endowment.

Since its founding in 1918, the Fund has expended \$542.9 million (\$1.8 billion in 2000 dollars) on programs to advance its mission. The Fund's investment and spending policies should assure a continued flow of funds of this magnitude to improve the health and productivity of Americans.

## The Commonwealth Fund

## Independent Auditors' Report

We have audited the accompanying statements of financial position of The Commonwealth Fund as of June 30, 2000 and 1999, and the related statements of activities and of cash flows for the years 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 audits.

We conducted our audits 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 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 audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Fund at June 30, 2000 and 1999, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Deloitte & Touche LLP*

September 13, 2000

**Statements of Financial Position**  
**June 30, 2000 and 1999**

	2000	1999
<b>ASSETS</b>		
Cash	\$ 337,516	\$ 6,741
Investments — At market value (Notes 1, 2)	557,865,502	526,165,386
Interest and dividends receivable	2,017,466	1,201,516
Prepaid taxes	629,742	311,392
Recoverable grants	2,026,664	2,350,000
Prepaid insurance and other assets	406,739	438,373
Landmark property at 1 East 75th Street (at appraised value during 1953, the date of donation)	275,000	275,000
Furniture, equipment, and building improvements (at cost, net of accumulated depreciation of \$1,446,406 at June 30, 2000 and \$2,296,352 at June 30, 1999) (Note 1)	3,633,343	3,773,400
<b>Total Assets</b>	<b>\$567,191,972</b>	<b>\$534,521,808</b>
<b>LIABILITIES AND NET ASSETS</b>		
<b>Liabilities:</b>		
Accounts payable and accrued expenses	\$ 401,938	\$ 1,109,862
Program authorizations payable (Note 3)	16,152,403	17,270,352
Accrued postretirement benefits (Note 4)	1,445,681	1,379,660
Securities transactions payable	2,133,501	1,305,150
Deferred Federal excise tax payable (Note 5)	816,652	1,264,304
<b>Total liabilities</b>	<b>20,950,175</b>	<b>22,329,328</b>
<b>Net Assets</b>	<b>546,241,797</b>	<b>512,192,480</b>
<b>Total Liabilities and Net Assets</b>	<b>\$567,191,972</b>	<b>\$534,521,808</b>

See notes to financial statements.

**The Commonwealth Fund  
Statements of Activities  
Years Ended June 30, 2000 and 1999**

	2000	1999
Revenues:		
Interest and dividends	\$ 15,498,772	\$ 15,421,082
Rental income from real estate limited partnerships	813,310	718,755
Total revenues	16,312,082	16,139,837
Expenses:		
Program authorizations and operating program expenses	23,069,917	20,391,935
General administration	2,657,021	2,638,444
Investment management	2,883,243	2,431,284
Provision for taxes (Note 5)	370,527	413,590
Unfunded retirement and other postretirement expense (Note 4)	565,644	443,199
Total expenses	29,546,352	26,318,452
Excess of expenses over revenues before net investment gains (losses)	(13,234,270)	(10,178,615)
Net investment gains (losses):		
Net realized gains on investments	69,666,174	27,568,517
Change in unrealized depreciation of investments	(22,382,587)	(29,307,736)
Total net investment gains (losses)	47,283,587	(1,739,219)
Change in net assets	34,049,317	(11,917,834)
Net assets, beginning of year	512,192,480	524,110,314
Net assets, end of year	\$546,241,797	\$512,192,480

See notes to financial statements.

**The Commonwealth Fund  
Statements of Cash Flows  
Years Ended June 30, 2000 and 1999**

	2000	1999
Cash flows from operating activities:		
Change in net assets	\$ 34,049,317	\$ (11,917,834)
Net investment (gains) losses	(47,283,587)	1,739,219
Write-off of fixed assets	553,530	—
In kind forgiveness of recoverable grant	323,336	—
Depreciation expense	473,144	492,557
Other	(46,173)	9,716
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Decrease in recoverable grants	—	1,500,000
Increase in prepaid taxes	(318,350)	(257,842)
Increase in interest and dividends receivable	(815,950)	(274,221)
Decrease in prepaid insurance and other assets	31,634	69,148
(Decrease) increase in accounts payable and accrued expenses	(707,924)	653,414
(Decrease) increase in program authorizations payable	(1,071,776)	247,756
Increase (decrease) in accrued postretirement benefits	66,021	(25,067)
Increase in net securities transactions payable	828,351	1,056,891
Decrease in excise taxes payable	—	(217,932)
Decrease in deferred Federal excise tax payable	(447,652)	(586,155)
Net cash used in operating activities	(14,366,079)	(7,510,350)
Cash flows from investing activities:		
Purchase of furniture, equipment, and building improvements, net	(886,617)	(788,899)
Purchase of investments	(1,031,851,518)	(791,541,045)
Proceeds from the sale of investments	1,047,434,989	799,613,658
Net cash provided by investing activities	14,696,854	7,283,714
Net increase (decrease) in cash	330,775	(226,636)
Cash, beginning of year	6,741	233,377
Cash, end of year	\$ 337,516	\$ 6,741
<b>Supplemental Information</b>		
Taxes paid	\$ 1,164,000	\$ 1,506,825

See notes to financial statements.

## Notes to Financial Statements

Years Ended June 30, 2000 and 1999

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Commonwealth Fund (the “Fund”) is a New York City–based national philanthropy, which undertakes independent research on health and social issues.

- (a) *Investments.* Investments in equity securities with readily determinable fair values and all investments in debt securities are carried at fair value, which approximates market value. Limited marketability investments, such as venture capital and equity partnerships, are stated at the Fund’s equity interest in the underlying net assets of the partnerships, which are stated at fair value as reported by the partnerships. Realized gains and losses on dispositions of investments are determined on the identifiable lot basis.
- (b) *Fixed Assets.* Furniture, equipment, and building improvements are depreciated using the straight-line method over their estimated useful lives.
- (c) *Contributions, Promises to Give, and Net Assets Classifications.* All net assets of the Fund are unrestricted. Contributions made, including unconditional promises to give, are recognized as expenses in the period made. Unconditional promises to give for future periods are presented as program authorizations payable on the statement of financial position at fair values, which includes a discount for the time value of money.
- (d) *Use of Estimates.* The preparation of financial statements in conformity with generally accepted accounting principles requires the Fund’s 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. Estimates also affect the reported amounts of additions to and deductions from the statement of activities. The calculation of the present value of unconditional promises to give, actuarial present value of accumulated benefits, and deferred Federal excise taxes requires the significant use of estimates. Actual results could differ from those estimates.
- (e) *Derivative Financial Instruments.* The Fund’s use of derivative financial instruments is predominantly limited to the use of forward exchange contracts that hedge exposure to changes in foreign exchange related to its investments in foreign fixed income. The Fund does not hold or issue financial instruments for trading purposes. Both realized and unrealized gains or losses are recognized in the Statements of Activities.

In June 1998, the Financial Accounting Standards Board (“FASB”) issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which was effective for the Fund’s fiscal year beginning July 1, 2000. This statement will require a change in accounting for the Fund’s hedging activities. As the Fund anticipates hedging the exposure to changes in the fair value of certain investments, gains/losses on these investments will be recognized in the period of change, offset by the losses/gains on the hedging derivative item. The Fund anticipates that its fair value hedges will be highly effective, and thus will not have a material effect on the Statement of Activities.

### 2. INVESTMENTS

Investments at June 30, 2000 and 1999 comprised the following:

	2000		1999	
	Cost	Market Value	Cost	Market Value
Equities	\$291,567,027	\$328,831,296	\$255,184,578	\$334,190,771
Fixed income	154,403,470	150,431,155	138,978,008	130,754,938
Short-term	12,571,766	12,570,177	7,220,133	7,218,215
Real estate limited partnerships and real estate investment trusts	18,438,557	15,380,485	20,221,381	16,066,831
Venture capital limited partnerships	40,052,041	50,652,389	41,346,058	37,934,631
Total	\$517,032,861	\$557,865,502	\$462,950,158	\$526,165,386

At June 30, 2000, the Fund had total unexpended commitments of approximately \$13.6 million in various venture capital and real estate limited partnership investments.

The Fund's investment managers periodically purchase and sell foreign currencies and foreign exchange forward contracts on behalf of the Fund to minimize the exposure of certain investments to adverse fluctuations in the financial and currency markets. There were two foreign currency contracts outstanding at June 30, 2000.

### 3. PROGRAM AUTHORIZATIONS TO BE PAID IN FUTURE YEARS

At June 30, 2000, gross program authorizations of \$16,596,465 were scheduled for payment at later dates, as follows:

July 1, 2000 through June 30, 2001	\$6,705,785
July 1, 2001 through June 30, 2002	7,997,985
July 1, 2002 through June 30, 2003	1,892,695
Program authorizations scheduled for payment at later date	16,596,465
Less adjustment to present value	444,062
Program authorizations payable	<u>\$16,152,403</u>

A discount rate of 5.79% was used to determine the present value of the program authorizations payable at June 30, 2000.

### 4. PENSION PLAN, UNFUNDED RETIREMENT, AND OTHER POSTRETIREMENT BENEFITS

The Fund has a noncontributory defined contribution retirement plan, covering all employees, under arrangements with Teachers Insurance and Annuity Association of America and College Retirement Equities Fund, and Fidelity Investments. This plan provides for purchases of annuities and/or mutual funds for employees. The Fund's contributions were 15% and 14% of the participants' compensation for the years ended June 30, 2000 and 1999, respectively. Pension expense under this plan approximated \$576,000 and \$443,000 for the years ended June 30, 2000 and 1999, respectively. In addition, the plan allows employees to make voluntary tax-deferred purchases of these same annuities and/or mutual funds within the legal limits provided for under Federal law.

The Fund also has a group of former employees who retired prior to the inauguration of the above plan and certain other former employees to whom pension benefits have been approved, on an individual case basis, by the Board of Directors. Benefits under this program are paid directly by the Fund to these retirees. These pension payments are included in the Fund's unfunded retirement expense and approximated \$188,000 and \$189,000 for the years ended June 30, 2000 and 1999, respectively.

Effective July 1, 1998, the Fund entered into a 3-year deferred compensation agreement with certain senior executives that provides for deferred compensation computed as a percentage of salary. Such deferred compensation expense for the year ended June 30, 2000, is included in unfunded retirement and other postretirement expense and accounts payable and accrued expenses.

Unfunded retirement and other postretirement expense, which includes deferred compensation, retiree pension, retiree health and life insurance, and net periodic postretirement expense, was \$565,644 and \$443,199 for the years ended June 30, 2000 and 1999, respectively.

The Fund provides postretirement medical insurance coverage for retirees who meet the eligibility criteria. The following are disclosures required in accordance with FASB Statement No. 132 for the Fund's postretirement medical plan for the years ended June 30, 2000 and 1999:

	2000	1999
Benefit obligation at June 30	\$ 1,405,271	\$ 1,355,000
Fair value of plan assets at June 30	—	—
Funded Status	<u>\$(1,405,271)</u>	<u>\$(1,355,000)</u>
Accrued benefit cost recognized	\$ 1,445,681	\$ 1,379,660
Net periodic benefit cost	\$ 131,021	\$ 37,081
Employer contribution	\$ 65,000	\$ 62,148

Significant actuarial assumptions related to postretirement benefits as of June 30 were as follows:

	2000	1999
Discount rate	7.5%	7.125%
Health care cost trend rates — Initial	9.5%	9.5%
Health care cost trend rates — Ultimate	5.5%	5.5%

#### 5. TAX STATUS

The Fund is exempt from Federal income taxes under Section 501(c)(3) of the Internal Revenue Code but is subject to a 2% or 1% Federal excise tax, if certain criteria are met, on net investment income. For the years ended June 30, 2000 and 1999, the Fund was subject to a rate of 1% and 2%, respectively. In addition, the Fund is subject to Federal and state taxes on unrelated business income.

The Fund is required to make certain minimum distributions in accordance with a formula specified by the Internal Revenue Service. As of June 30, 2000, distributions approximating \$4.5 million are required by June 30, 2001, to satisfy the minimum requirements for fiscal year 2000.

The Fund recorded a provision for Federal excise taxes to be incurred on the unrealized appreciation of investments. Such amounts are shown as deferred Federal excise taxes. For the years ended June 30, 2000 and 1999, provision for tax expense was as follows:

	2000	1999
Excise — current	\$ 815,807	\$ 989,740
Excise — deferred	(447,652)	(586,155)
Unrelated business income	2,372	10,005
Total	\$ 370,527	\$ 413,590

#### 6. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value amounts have been determined by the Fund, using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Fund could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

*All Financial Instruments Other Than Investments.* The carrying amounts of these items are a reasonable estimate of their fair value.

*Investments.* For marketable securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market price for similar securities. For venture capital and real estate limited partnerships held as investments, fair value is estimated using private valuations of the securities or properties held in these partnerships. The carrying amount of these items is a reasonable estimate of their fair value. For foreign exchange forward contracts, the fair value equals the quoted market price.

#### 7. CONTRIBUTIONS RECEIVED

In fiscal years 1987 and 1988, the Fund received a total of \$15,415,804 as a grant from the James Picker Foundation, with an agreement that a designated portion of the Fund's grants be identified as "Picker Program Grants by the Commonwealth Fund." The Fund fulfills this obligation by making Picker Program Grants devoted to specific themes approved by the Fund's Board of Directors. For the year ended June 30, 2000, the Fund's Picker Program Grants approximated \$2.3 million.

In April 1996, the Fund received The Health Services Improvement Fund, Inc.'s ("HSIF") assets and liabilities, \$1,721,016 and \$57,198, respectively, resulting in a \$1,663,818 increase in net assets. In accordance with the terms of an agreement with HSIF, this contribution enables the Fund to make Commonwealth Fund/HSIF grants to improve health care coverage, access, and quality in the New York City greater metropolitan region.