

# 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 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 investment issues affecting the management of the endowment and considers new undertakings.

The value of the endowment fell from \$557.4 million on June 30, 2000, to \$544.9 million on June 30, 2001, reflecting a return of 2.5 percent on the investment portfolio during the year combined with total spending (including programs,

administration, investment management fees, and taxes) of almost \$27 million. In this 12-month period, the return of the S&P 500 index of large capitalization U.S. stocks was -14.8 percent, while the return of the especially hard-hit technology sector was -50.4 percent, and that of international equities was -23.2 percent. In this context the Fund's overall investment performance was relatively strong. The Fund uses as its market bogeys the Wilshire 5000 U.S. equities index and the Lehman Aggregate Bond index (broad market indexes for, respectively, U.S. equities and bonds), and a portfolio invested in these indexes proportionately to the Fund's weighting of equities and bonds (70 percent:30 percent) would have returned -7.5 percent in the July 2000-June 2001 period.

The Fund's team of equity (U.S. and international) managers produced a combined 12-month return of -1.5 percent, compared with the Wilshire 5000's -15.3 percent and the median U.S. equity manager's -10.2 percent. The Fund's bond manager outperformed the Lehman Aggregate index, 12.9 percent versus 11.2 percent, and its real estate partnership investments produced a strong return of 18.1 percent. Reflecting the sharp downturn in technology and communications stock valuations, especially of new companies, the foundation's venture capital portfolio returned -12.7 percent. Even so, the long-term average annual return of the venture capital portfolio remains very strong, at 17.8 percent.

The Fund's investment returns during the difficult 2000-01 fiscal year generally benefited from the significant restructuring

of the management of the endowment that the foundation's finance committee began in early 2000 and completed in early 2001. The restructuring was aimed at reducing the risk of performance significantly divergent from that of the overall market or peer institutions and at streamlining the management structure.

The salient features of the Fund's current investment strategy are summarized in the table below. Key among these are an overall target commitment of 70 percent of the portfolio to equities (publicly traded and private) and 30 percent to fixed income securities; a 45 percent commitment to publicly traded U.S. equities, paired with a 15 percent commitment to international equities; allocation of approximately 25 percent of the endowment to a passive S&P 500 index fund, to assure adequate representation of large capitalization growth

stocks in a portfolio that is otherwise heavily value-oriented; a modest commitment to small capitalization U.S. growth stock managers, to further assure adequate exposure to growth stocks; limited use of specialized equities (hedge fund) managers; and a 10 percent commitment to private equities (principally venture capital, with some real estate and energy-related investments).

The finance committee periodically reviews asset class allocation targets and the permissible ranges of variation around them; except in very unusual circumstances, the portfolio is rebalanced when market forces or manager performance cause an allocation to substantially diverge from its target.

The average annual return on the endowment over the almost 20 years since the Fund modernized its investment strategy in 1981 has been 14.0 percent. Even with setbacks in 1998 arising from the financial crisis of that year and a probably too-ambitious investment approach encompassing a large commitment to specialized equities managers, 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.

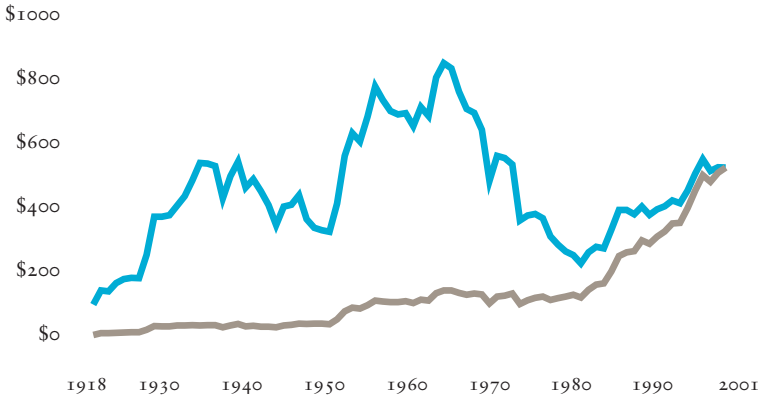
### The Commonwealth Fund's endowment management strategy

	Allocation on June 30, 2001	Long-term target	Permissible range
Total endowment	100%	100%	
<b>ASSET CLASS</b>			
Fixed income	35%	30%	20-40%
U.S. stocks total	44%	45%	30-60%
Large capitalization value	21%	20%	
Large capitalization growth	10%	14%	
Small capitalization value	9%	6%	
Small capitalization growth	4%	5%	
Foreign stocks total	12%	15%	10-20%
Emerging markets stocks	2%	4%	0-5%
Private equity (venture capital, real estate, and oil & gas)	9%	10%	0-15%
<b>MANAGER STYLE</b>			
Specialized equities (hedge funds)	8%	5%	0-8%
U.S. stock index (S&P 500) fund	19%	25%	20-30%

**The Commonwealth Fund's endowment, 1918–2001**

- Constant 2001 dollars
- Current dollars

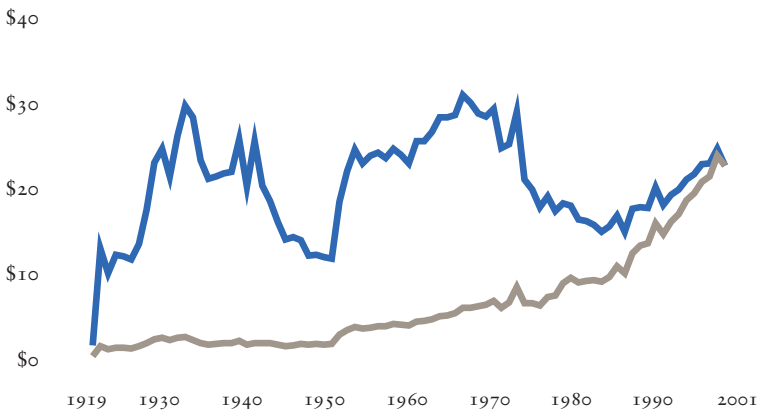
Average fiscal year market value of endowment, in millions



**The Commonwealth Fund's annual spending, 1919–2001**  
**Total spending of \$567.9 million over 82 years, or \$1.9 billion**  
**in constant 2001 dollars**

- Constant 2001 dollars
- Current dollars

Annual spending, in millions



Since 1980, the Fund's real (inflation-adjusted) average annual return has been 7.7 percent. Looking at the 30-year period since 1970, however, the real return on the endowment has averaged 4.9 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 \$567.9 million (\$1.87 billion in 2001 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 (the "Fund") as of June 30, 2001 and 2000, 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, 2001 and 2000, 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.

October 2, 2001

*Deloitte & Touche LLP*

**Statements of Financial Position**  
**June 30, 2001 and 2000**

	2001	2000
<b>ASSETS</b>		
Cash	\$ 32,599	\$ 337,516
Investments — At fair value (Notes 1 and 2)	543,833,723	557,865,502
Interest and dividends receivable	1,728,005	2,017,466
Prepaid taxes	75,602	629,742
Recoverable grants	350,000	2,026,664
Prepaid insurance and other assets	344,468	406,739
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 \$2,091,524 at June 30, 2001 and \$1,446,406 at June 30, 2000) (Note 1)	4,040,818	3,633,343
<b>Total Assets</b>	<b>\$550,680,215</b>	<b>\$567,191,972</b>
<b>LIABILITIES AND NET ASSETS</b>		
Liabilities:		
Accounts payable and accrued expenses	\$ 1,710,767	\$ 401,938
Program authorizations payable (Note 3)	17,171,629	16,152,403
Accrued postretirement benefits (Note 4)	1,558,460	1,445,681
Securities transactions payable, net	140,733	2,133,501
Deferred Federal excise tax payable (Note 5)	295,369	816,652
<b>Total liabilities</b>	<b>20,876,958</b>	<b>20,950,175</b>
<b>Net Assets</b>	<b>529,803,257</b>	<b>546,241,797</b>
<b>Total Liabilities and Net Assets</b>	<b>\$550,680,215</b>	<b>\$567,191,972</b>

See notes to financial statements.

**The Commonwealth Fund  
Statements of Activities  
Years Ended June 30, 2001 and 2000**

	2001	2000
Revenues:		
Interest and dividends	\$ 18,017,868	\$ 15,498,772
Rental income from real estate limited partnerships	1,253,744	813,310
Total revenues	19,271,612	16,312,082
Expenses:		
Program authorizations and operating program expenses	23,185,660	23,069,917
General administration	2,929,047	2,657,021
Investment management	2,237,133	2,883,243
Provision for taxes (Note 5)	330,242	370,527
Unfunded retirement and other postretirement expense (Note 4)	637,393	565,644
Total expenses	29,319,475	29,546,352
Excess of expenses over revenues before net investment (losses) gains	(10,047,863)	(13,234,270)
Net investment (losses) gains:		
Net realized gains on investments	18,475,288	69,666,174
Change in unrealized appreciation of investments	(24,865,965)	(22,382,587)
Total net investment (losses) gains	(6,390,677)	47,283,587
Change in net assets	(16,438,540)	34,049,317
Net assets, beginning of year	546,241,797	512,192,480
Net assets, end of year	\$529,803,257	\$546,241,797

See notes to financial statements.

**The Commonwealth Fund  
Statements of Cash Flows  
Years Ended June 30, 2001 and 2000**

	2001	2000
Cash flows from operating activities:		
Change in net assets	\$ (16,438,540)	\$ 34,049,317
Net investment losses (gains)	6,390,677	(47,283,587)
Write-off of fixed assets	114,257	553,530
Forgiveness of recoverable grant	1,376,664	323,336
Depreciation expense	530,861	473,144
Other	—	(46,173)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Decrease in recoverable grants	300,000	—
Decrease (increase) in prepaid taxes	554,140	(318,350)
Decrease (increase) in interest and dividends receivable	289,461	(815,950)
Decrease in prepaid insurance and other assets	62,271	31,634
Increase (decrease) in accounts payable and accrued expenses	1,308,829	(707,924)
Increase (decrease) in program authorizations payable	1,019,226	(1,071,776)
Increase in accrued postretirement benefits	112,779	66,021
(Decrease) increase in securities transactions payable, net	(1,992,768)	828,351
Decrease in deferred Federal excise tax payable	(521,283)	(447,652)
Net cash used in operating activities	(6,893,426)	(14,366,079)
Cash flows from investing activities:		
Purchase of furniture, equipment, and building improvements, net	(1,052,593)	(886,617)
Purchase of investments	(476,541,817)	(1,031,851,518)
Proceeds from the sale of investments	484,182,919	1,047,434,989
Net cash provided by investing activities	6,588,509	14,696,854
Net (decrease) increase in cash	(304,917)	330,775
Cash, beginning of year	337,516	6,741
Cash, end of year	\$ 32,599	\$ 337,516
<b>Supplemental Information</b>		
Taxes paid	\$ 300,000	\$ 1,164,000

See notes to financial statements.

## Notes to Financial Statements

Years Ended June 30, 2001 and 2000

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Commonwealth Fund (the "Fund") is a private foundation supporting 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. Effective July 1, 2000, the Fund adopted Financial Accounting Standards Board issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (amended by Statement No. 138). This statement requires derivative instruments to be recorded in the statements of financial position at their fair value, with such changes in fair value being recorded in the statement of activities. The Fund does not hold or issue financial instruments, including derivatives, for trading purposes. Both realized and unrealized gains or losses are recognized in the statements of activities.
- (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 present value.
- (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 program authorizations payable, actuarial present value of accumulated benefits, deferred Federal excise taxes, and the depreciable lives of fixed assets requires the significant use of estimates. Actual results could differ from those estimates.
- (e) *Reclassification.* Certain prior year's amounts have been reclassified to conform to the current year's presentation.

### 2. INVESTMENTS

Investments at June 30, 2001 and 2000 comprised the following:

	2001		2000	
	Cost	Fair Value	Cost	Fair Value
Equities	\$300,193,880	\$321,749,684	\$295,850,015	\$332,306,953
Fixed income	160,090,111	162,804,013	154,402,886	150,432,354
Short-term	21,460,450	21,349,456	12,572,351	12,568,978
Venture capital private equity	32,970,178	26,644,579	40,052,039	50,652,389
Real estate private equity	13,152,427	11,285,991	14,155,570	11,904,828
Total	\$527,867,046	\$543,833,723	\$517,032,861	\$557,865,502

At June 30, 2001, the Fund had total unexpended commitments of approximately \$13.8 million in various venture capital and real estate limited partnership investments.

The Fund's investment managers periodically purchase and sell 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. At June 30, 2001, the Fund had one forward currency contract outstanding, with a notional amount of \$1.625 million, fair value of approximately \$1,375,000, and an unrealized loss of approximately \$87,000. There were no foreign currency forward contracts outstanding at June 30, 2000.

Included in short-term investments at June 30, 2001 is a net variation margin receivable of approximately \$91,000, which represents funds due from broker for excess amounts deposited on margin. Also included are unrealized losses on forward and futures contracts of approximately \$101,000 and \$123,000 at June 30, 2001 and 2000, respectively.

The Fund's investment managers use futures contracts to manage asset allocation and to adjust the duration of the fixed income portfolio. The table below summarizes the Fund's positions in long and short futures at June 30:

Futures Contracts	2001		2000	
	Number of Long (Short) Contracts	Notional Amount	Number of Long (Short) Contracts	Notional Amount
S&P 500 Index	(15)	(3,750)	—	—
30-year Treasury Bond	(128)	(12,800,000)	(74)	(7,400,000)
10-year Treasury Note	1	100,000	(52)	(5,200,000)
5-year Treasury Note	(7)	(700,000)	—	—
2-year Treasury Note	—	—	28	5,600,000

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

At June 30, 2001, gross program authorizations of \$17,327,800 were scheduled for payment at later dates, as follows:

July 1, 2001 through June 30, 2002	\$13,336,679
July 1, 2002 through June 30, 2003	3,180,931
July 1, 2003 through June 30, 2004	810,190
Program authorizations scheduled for payment at later date	17,327,800
Less adjustment to present value	156,171
Program authorizations payable	\$17,171,629

A discount rate of 3.38% was used to determine the present value of the program authorizations payable at June 30, 2001.

### 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 approximated 14% and 15% of the participants' compensation for the years ended June 30, 2001 and 2000, respectively. Pension expense under this plan approximated \$574,000 and \$576,000 for the years ended June 30, 2001 and 2000, 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. This pension expense is included in the Fund's unfunded retirement and other postretirement expense and approximated \$163,000 and \$189,000 for the years ended June 30, 2001 and 2000, 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 years ended June 30, 2001 and 2000 is included in unfunded retirement and other postretirement expense and accounts payable and accrued expenses (see Note 8).

Unfunded retirement and other postretirement expense, which includes deferred compensation, retiree pension, retiree health and life insurance, and net periodic postretirement expense approximated \$637,000 and \$566,000 for the years ended June 30, 2001 and 2000, respectively.

The Fund provides postretirement medical insurance coverage for retirees who meet the eligibility criteria. The following are disclosures required in accordance with SFAS 132 for the Fund's postretirement medical plan for the years ended June 30, 2001 and 2000:

	2001	2000
Benefit obligation at June 30	\$ 1,936,320	\$ 1,405,271
Fair value of plan assets at June 30	—	—
Funded Status	\$(1,936,320)	\$(1,405,271)
Accrued benefit cost recognized	\$ 1,558,460	\$ 1,445,681
Net periodic benefit cost	\$ 188,688	\$ 131,021
Employer contribution	\$ 75,909	\$ 65,000

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

	2001	2000
Discount rate	7.25%	7.50%
Health care cost trend rates — initial	9.50%	9.50%
Health care cost trend rates — ultimate	5.50%	5.50%

#### 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, 2001 and 2000, the Fund was subject to a rate of 2% and 1%, 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, 2001, distributions approximating \$5.3 million are required by June 30, 2002, to satisfy the minimum requirements for fiscal year 2001.

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, 2001 and 2000, provision for tax expense was as follows:

	2001	2000
Excise — current	\$ 851,527	\$ 815,807
Excise — deferred	(497,320)	(447,652)
Unrelated business income	(23,965)	2,372
Total	\$ 330,242	\$ 370,527

#### 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, 2001, the Fund's Picker program grants totaled approximately \$950,000.

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.

#### 8. SUBSEQUENT EVENT

Effective July 1, 2001, the Fund established an employee stock option plan for certain key executives which exchanges certain pension and deferred compensation benefits (see Note 4) for options to purchase securities.