

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 \$544.9 million on June 30, 2001, to \$501.7 million on June 30, 2002, reflecting a return of -2.6 percent on the investment portfolio during the year combined with total spending (including programs, administration, investment management fees, and taxes) of \$29.6 million. In that 12-month period, the return of the

S&P 500 index of large capitalization U.S. stocks was -18.0 percent, while the return of the technology/media/telecommunications sectors was -50.0 percent and of international equities was -9.2 percent. In this context, the Fund's overall investment performance was relatively strong. The Fund uses as its market benchmarks 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 those indexes proportionately to the Fund's weighting of equities and bonds (70 percent: 30 percent) would have returned -8.9 percent in the July 2001-June 2002 period.

The Fund's team of equity (U.S. and international) managers produced a combined 12-month return of -9.8 percent, compared with the Wilshire 5000's -16.6 percent and the median U.S. equity manager's -15.2 percent. The Fund's bond manager slightly outperformed the Lehman Aggregate index (8.8 percent versus 8.6 percent), and its real estate partnership investments produced a strong return of 9.1 percent. Reflecting the sharp downturn in technology and

communications stock valuations, especially of new companies, the foundation's venture capital portfolio returned -1.1 percent. Even so, the long-term average annual return of the venture capital portfolio remains very strong, at 17.7 percent.

The Fund's investment returns during the difficult 2001–02 fiscal year generally benefited from the significant restructuring of the management of the endowment that the foundation's finance committee began in early 2000. 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 75 percent of the portfolio to equities (publicly traded

and private) and 25 percent to fixed income securities; a 30 percent commitment to publicly traded U.S. equities, paired with a 15 percent commitment to international equities; allocation of approximately 10 percent of the endowment to a passive S&P 500 index fund, to help control investment costs and assure adequate tracking of the market; satellite U.S. active large and small capitalization value and growth stock managers, with mandates to outperform their respective market benchmarks; a 10 percent allocation to marketable alternative equity (hedge fund) managers; a 10 percent commitment to non-marketable alternative equity (venture capital and private equity investments); and a 10 percent allocation to inflation hedge investments (mainly 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.

As shown in the table opposite, the Fund's investment managers as a group outperformed the overall portfolio market bogey and the median balanced U.S. manager over the one- and three-year periods ending June 30, 2002, and matched the comparative five-year returns. For the last 10 years and the almost 21 years that the foundation has had a multiple manager system, the portfolio's average annual return has exceeded that of the median U.S. balanced manager but fallen just short of the index benchmark return.

The Commonwealth Fund's endowment management strategy

	Long-term target	Permissible range
Total endowment	100%	
ASSET CLASS		
Total equity	75%	60–80%
U.S. equity marketable securities	30%	30–60%
Non-U.S. equity marketable securities	15%	10–20%
Marketable alternative equity	10%	0–20%
Non-marketable alternative equity	10%	5–10%
Inflation hedge	10%	0–15%
Fixed income	25%	10–40%
MANAGER STYLE		
U.S. stock index (S&P 500) fund	10%	10–15%

The Commonwealth Fund's endowment investment returns
Average annual returns for periods ending on June 30, 2002

	Commonwealth Fund	Weighted market index (equities and fixed income)	U.S. balanced manager median
1-Year	-2.6%	-8.9%	-6.8%
3-Year	4.2%	-3.3%	-0.9%
5-Year	5.5%	5.4%	5.7%
10-Year	10.2%	10.6%	9.7%
21-Year	12.9%	13.6%	12.1%

Three considerations determine the Fund's annual spending policy: (1) the aim of providing a reliable flow of funds for programs and planning; (2) the objective of preserving the real (inflation-adjusted) value of the endowment and funds for programs; and (3) the need to meet the Internal Revenue Service requirement of distributing at least 5 percent of the endowment for charitable purposes each year. Since 1996-97, the Fund's practice has been to increase its total budget by 5.5 percent annually; in the 10 years prior to that, the practice was to increase the budget by 6.0 percent annually. With inflation averaging 3.1 percent annually over the last 20 years, the Fund's budget has increased in real terms. High investment returns over the last 20 years enabled real growth in the endowment as well: between 1982 and 2002, the foundation's endowment more than doubled in value in real terms—an achievement that helped restore some of the loss of purchasing power that occurred in the “stagflation” environment of the 1970s.

While the Fund's endowment has performed comparatively well in the severe equities bear market

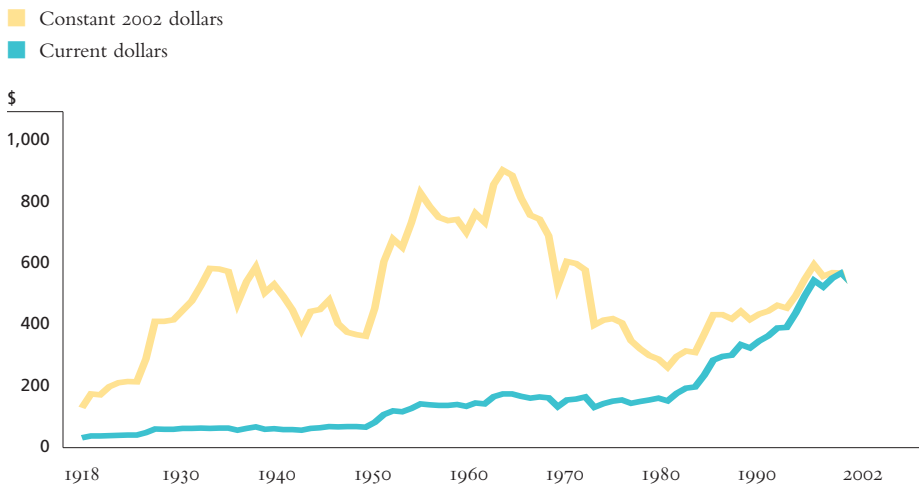
of the last nine quarters, the total return on the endowment has been negative (-9 percent annually). Most market seers predict continued low average returns for at least the next five years, as the market corrects for the excesses that occurred in the final stages of the 1982-2000 bull market in stocks. Like most other institutions whose sole source of income is their endowment, the Fund has found it necessary to reassess its spending plans to adjust to the current market realities. Barring even worse market conditions than now predicted, the foundation plans to maintain its spending at an essentially constant level over the next five years. This plan would accommodate reduced investment return expectations going forward, while not seriously impairing the foundation's programs at a time when it is fulfilling a unique and highly productive role in American society.

The Fund was named the chief beneficiary of the estate of Professor Frances Cooke Macgregor, who had provided a series of annual gifts to the foundation prior to her death in December 2001. Professor Macgregor was a distinguished behavioral scientist and photographer who played a significant role in the development of medical sociology and medical anthropology. In keeping with her bequest, the assets of \$3.0 million received are commingled with the rest of the Fund's endowment, and the Fund will designate approximately \$100,000 of its grants each year as “Frances Cooke Macgregor Grants.” The bequest requires that, for five years following receipt of the

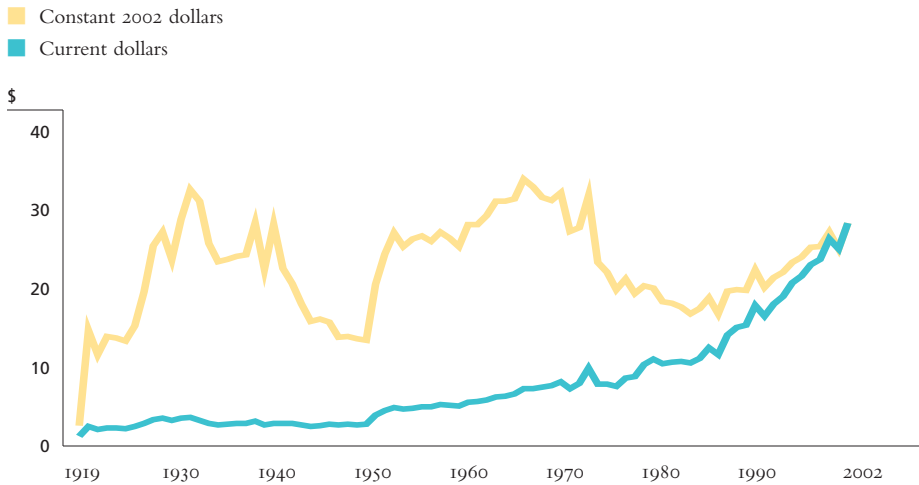
funds, Macgregor grants address iatrogenic medicine issues, the condition of the earlier annual gifts and one that is readily met through the Fund's work on health care quality improvement. The bequest indicates that Macgregor grants should thereafter be used to improve the quality of American health care.

Since its founding in 1918, the Fund has expended \$596.3 million (\$1.9 billion in 2002 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's endowment, 1918–2002
Average fiscal year market value of the endowment, in millions



The Commonwealth Fund's annual spending, 1919–2002
Total spending of \$596.3 million over 83 years, or \$1.9 billion in constant 2002 dollars, in millions



The Commonwealth Fund

Financial Statements

Independent Auditors' Report

We have audited the accompanying statements of financial position of The Commonwealth Fund (the "Fund") as of June 30, 2002 and 2001, 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, 2002 and 2001, 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 4, 2002

Statements of Financial Position

June 30	2002	2001
ASSETS		
Cash	\$ 17,671	\$ 32,599
Investments—at fair value (<i>Notes 1 and 2</i>)	506,879,212	543,833,723
Interest and dividends receivable	1,098,581	1,728,005
Prepaid taxes—net	277,918	75,602
Deferred tax asset (<i>Note 5</i>)	285,942	23,965
Recoverable grants	350,000	350,000
Prepaid insurance and other assets	210,625	344,468
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 \$2,433,304 at June 30, 2002 and \$2,091,524 at June 30, 2001 (<i>Note 1</i>)	3,919,962	4,040,818
Total assets	\$ 513,314,911	\$ 550,704,180
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable and accrued expenses	\$ 2,311,771	\$ 1,710,767
Program authorizations payable (<i>Note 3</i>)	18,270,882	17,171,629
Accrued postretirement benefits (<i>Note 4</i>)	2,052,010	1,558,460
Securities transactions payable—net	5,653,323	140,733
Deferred tax liability (<i>Note 5</i>)	—	319,334
Total liabilities	28,287,986	20,900,923
Net assets:		
Unrestricted	484,474,925	529,803,257
Temporarily restricted (<i>Note 7</i>)	552,000	—
Total net assets	485,026,925	529,803,257
Total liabilities and net assets	\$ 513,314,911	\$ 550,704,180

See notes to financial statements.

Statements of Activities

Years ended June 30	2002	2001
Revenues and support:		
Interest and dividends	\$ 17,132,580	\$ 19,263,079
Contribution from bequest (<i>Note 7</i>)	2,449,124	—
Other revenue	3,149	8,533
Total revenues and support	19,584,853	19,271,612
Expenses:		
Program authorizations and operating program	24,833,062	23,185,660
General administration	2,989,938	2,929,047
Investment management	2,271,948	2,237,133
Tax (benefit) provision—net (<i>Note 5</i>)	(455,338)	330,242
Unfunded retirement and other postretirement (<i>Note 4</i>)	933,642	637,393
Total expenses	30,573,252	29,319,475
Excess of expenses over revenues before net investment losses	(10,988,399)	(10,047,863)
Net investment (losses) gains:		
Net realized (losses) gains on investments	(4,643,263)	18,475,288
Change in unrealized depreciation of investments	(29,696,670)	(24,865,965)
Total net investment losses	(34,339,933)	(6,390,677)
Changes in unrestricted net assets	(45,328,332)	(16,438,540)
Temporarily restricted contribution from bequest (<i>Note 7</i>)	552,000	—
Change in net assets	(44,776,332)	(16,438,540)
Net assets, beginning of year	529,803,257	546,241,797
Net assets, end of year	\$485,026,925	\$529,803,257

See notes to financial statements.

Statements of Cash Flows

Years ended June 30	2002	2001
Cash flows from operating activities:		
Change in net assets	\$ (44,776,332)	\$ (16,438,540)
Net investment losses	34,339,933	6,390,677
Write-off of fixed assets	—	114,257
Forgiveness of recoverable grant	—	1,376,664
Depreciation expense	768,188	530,861
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Decrease in recoverable grants	—	300,000
(Increase) decrease in prepaid taxes—net	(202,316)	554,140
Increase in deferred tax asset	(261,977)	(23,965)
Decrease in interest and dividends receivable	629,424	289,461
Decrease in prepaid insurance and other assets	133,843	62,271
Increase in accounts payable and accrued expenses	601,004	1,308,829
Increase in program authorizations payable	1,099,253	1,019,226
Increase in accrued postretirement benefits	493,550	112,779
Increase (decrease) in securities transactions payable—net	5,512,590	(1,992,768)
Decrease in deferred tax liability	(319,334)	(497,318)
Net cash used in operating activities	(1,982,174)	(6,893,426)
Cash flows from investing activities:		
Purchase of furniture, equipment, and building improvements—net	(647,332)	(1,052,593)
Purchase of investments	(749,241,050)	(476,541,817)
Proceeds from the sale of investments	751,855,628	484,182,919
Net cash provided by investing activities	1,967,246	6,588,509
Net decrease in cash	(14,928)	(304,917)
Cash, beginning of year	32,599	337,516
Cash, end of year	\$ 17,671	\$ 32,599
SUPPLEMENTAL INFORMATION		
Taxes paid	\$ 344,680	\$ 300,000

See notes to financial statements.

Notes to Financial Statements

Years ended June 30, 2002 and 2001

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.

In accordance with Financial Accounting Standards Board Statement No.133, *Accounting for Derivative Instruments and Hedging Activities*, the Fund records derivative instruments 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 and 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. Contributions received and made, including unconditional promises to give, are recognized in the period incurred. The Fund reports contributions as restricted if received with a donor stipulation that limits the use of the donated assets. 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. Reclassifications. Certain prior year's amounts have been reclassified to conform to the current year's presentation.

2. INVESTMENTS

Investments at June 30, 2002 and 2001 comprised the following:

	Cost	Fair Value
2002		
Equities	\$ 311,253,392	\$ 299,010,425
Fixed income	153,198,796	157,628,410
Short-term	18,808,167	18,947,117
Venture capital private equity	28,017,597	22,238,068
Real estate private equity	9,331,254	9,055,192
Total	\$ 520,609,206	\$ 506,879,212
2001		
Equities	\$ 300,193,880	\$ 321,749,684
Fixed income	160,090,111	162,804,013
Short-term	21,460,450	21,349,456
Venture capital private equity	32,970,178	26,644,579
Real estate private equity	13,152,427	11,285,991
Total	\$ 527,867,046	\$ 543,833,723

At June 30, 2002, the Fund had total unexpended commitments of approximately \$12.7 million in various venture capital and real estate limited partnership investments.

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:

	Number of Long (Short) Contracts	Notional Amount
2002		
30-year Treasury Bond	35	\$ 3,500,000
10-year Treasury Note	1	100,000
5-year Treasury Note	1	100,000
S&P 500 Index	—	—
2001		
30-year Treasury Bond	(128)	\$(12,800,000)
10-year Treasury Note	1	100,000
5-year Treasury Note	(7)	(700,000)
S&P 500 Index	(15)	(3,750)

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. There were no foreign currency forward contracts outstanding at June 30, 2002. At June 30, 2001, the Fund had one forward currency contract outstanding with a notional amount of

1,625,000, fair value of approximately \$1,375,000 and an unrealized loss of approximately \$87,000.

Included in short-term investments at June 30, 2002 is a variation amount payable of approximately \$12,000, which represents funds due to broker for additional amounts required to be deposited. At June 30, 2001, short-term investments included a variation amount receivable of approximately \$91,000, which represented funds due from broker for excess amounts on deposit. Also included in short term investments are unrealized gains and unrealized losses on open futures contracts of approximately \$69,000 and \$101,000 at June 30, 2002 and June 30, 2001, respectively.

3. PROGRAM AUTHORIZATIONS TO BE PAID IN FUTURE YEARS

At June 30, 2002, gross program authorizations of \$18,270,882 were scheduled for payment at later dates, as follows:

July 1, 2002 through June 30, 2003	\$15,674,386
July 1, 2003 through June 30, 2004	2,224,474
July 1, 2004 through June 30, 2005	435,489
Gross program authorizations scheduled for payment at a later date	18,334,349
Less adjustment to present value	63,467
Program authorizations payable	\$18,270,882

A discount rate of 2.1% was used to determine the present value of the program authorizations payable at June 30, 2002.

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 17% and 19% of the participants' compensation for the years ended June 30, 2002 and 2001, respectively. Pension expense under this plan approximated \$746,000 and \$733,000 for the years ended June 30, 2002 and 2001, 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 \$107,000 and \$163,000 for the years ended June 30, 2002 and 2001, respectively.

Effective July 1, 1998, the Fund entered into a 3-year deferred compensation agreement with certain senior executives that provides for unfunded deferred compensation computed as a percentage of salary. Such deferred compensation expense for the years ended June 30, 2002 and 2001 are recorded in the financial statements.

Effective July 1, 2001, the Fund established a fully-funded KEYSOP for certain key executives that exchanges deferred compensation benefits for options to purchase mutual funds. The related investments are recorded in the financial statements as of June 30, 2002. In addition, the KEYSOP awarded options to purchase mutual funds to certain employees in exchange for certain pension benefits. This expense and the related investments are recorded in the financial statements as of and for the year ended June 30, 2002.

Unfunded retirement and other postretirement expense, which includes deferred compensation, retiree pension, retiree health and life insurance, and net periodic postretirement expense approximated \$934,000 and \$637,000 for the years ended June 30, 2002 and 2001, 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, 2002 and 2001:

	2002	2001
Benefit obligation at June 30	\$ 1,689,435	\$ 1,936,320
Fair value of plan assets at June 30	—	—
Funded status	\$(1,689,435)	\$(1,936,320)
Accrued benefit cost recognized	\$ 2,052,010	\$ 1,558,460
Net periodic benefit cost	\$ 568,923	\$ 188,688
Employer contribution	\$ 75,373	\$ 75,909

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

	2002	2001
Discount rate	7.00%	7.25%
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, 2002 and 2001, that excise tax rate was 2%. The Fund is also subject to Federal and state taxes on unrelated business income. In addition, the Fund records deferred Federal excise taxes, based upon expected excise tax rates, on the unrealized appreciation or depreciation of investments being reported for financial reporting purposes in different periods than for tax purposes.

The Fund is required to make certain minimum distributions in accordance with a formula specified by the Internal Revenue Service. As of June 30, 2002, distributions approximating \$4,900,000 are required by June 30, 2003, to satisfy the minimum requirements for fiscal year 2002.

In the Statements of Financial Position, the deferred tax assets of \$285,942 at June 30, 2002 and \$23,965 at June 30, 2001 represent a federal excise tax benefit on the unrealized depreciation on investments and unrelated business income tax benefits, respectively. At June 30, 2001, the deferred tax liability of \$319,334 resulted from federal excise taxes on unrealized appreciation on investments.

For the years ended June 30, 2002 and 2001, the tax (benefit) provision, net was as follows:

	2002	2001
Excise taxes—current	\$ 123,838	\$ 851,527
Excise taxes—deferred	(605,276)	(497,320)
Unrelated business		
income taxes—current	2,135	—
Unrelated business		
income taxes—deferred	23,965	(23,965)
	<u>\$(455,338)</u>	<u>\$330,242</u>

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 years ended June 30, 2002 and 2001, the Fund's Picker Program Grants totaled approximately \$1,563,000 and \$950,000, respectively.

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.

At the end of the fiscal year, the Fund received a bequest of \$3,001,124 from the estate of Professor Frances Cooke Macgregor as a contribution to the general endowment, with the amount of annual grants generated by this addition to the endowment to be governed by the Fund's overall annual payout policies. This gift was made with the provisions that in at least the five-year period following its receipt, grants made possible by it will be used to address iatrogenic medicine issues, and that grants made possible by the gift be designated "Frances Cooke Macgregor" grants. In keeping with this bequest, an amount of \$552,000 was recorded as a temporarily restricted net asset as of and for the year ended June 30, 2002.