

# ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

## Financial Statements

MARCH 31, 2006

Auditor's Report	180
Statement of Financial Position	181
Statement of Operations and Net Assets	181
Statement of Cash Flows	182
Notes to the Financial Statements	183
Schedules to the Financial Statements	
A Schedule of Investments in Fixed Income Securities	195
B Schedule of Investments in Canadian Equities	196
C Schedule of Investments in United States Equities	197
D Schedule of Investments in Non-North American Equities	198
E Schedule of Investments in Real Estate	199
F Schedule of Investment Returns	200



## AUDITOR'S REPORT

### To the Minister of Finance

I have audited the statement of financial position of the Alberta Heritage Science and Engineering Research Endowment Fund as at March 31, 2006 and the statements of operations and net assets and cash flows for the year then ended. These financial statements are the responsibility of the Fund's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance 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.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Fund as at March 31, 2006 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

*[Original Signed]*

Fred J. Dunn, FCA  
Auditor General

Edmonton, Alberta  
May 19, 2006

*The official version of this Report of the Auditor General, and the information the Report covers, is in printed form.*

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**STATEMENT OF FINANCIAL POSITION**

March 31, 2006

	2006	2005
	(\$ thousands)	
<b>Assets</b>		
Portfolio investments (Note 3)	\$ 674,048	\$ 538,344
Receivable from sale of investments	3,250	-
Administration expense receivable	-	15
	<u>\$ 677,298</u>	<u>\$ 538,359</u>
<b>Liabilities</b>		
Accounts payable	\$ 1	\$ 940
<b>Net Assets (Note 6)</b>	<u>677,297</u>	<u>537,419</u>
	<u>\$ 677,298</u>	<u>\$ 538,359</u>

**STATEMENT OF OPERATIONS AND NET ASSETS**

For the Year Ended March 31, 2006

	2006		2005
	Budget	Actual	Actual
	(\$ thousands)		
<b>Net investment income (Note 7)</b>	\$ 19,774	\$ 57,853	\$ 29,234
<b>Transfer from the General Revenue Fund (Note 6a)</b>	-	100,000	-
<b>Transfers to the Alberta Heritage Foundation for Science and Engineering Research (Note 6b)</b>	(23,092)	(17,975)	(13,445)
<b>Change in net assets</b>	<u>\$ (3,318)</u>	139,878	15,789
<b>Net assets at beginning of year</b>		537,419	521,630
<b>Net assets at end of year</b>		<u>\$ 677,297</u>	<u>\$ 537,419</u>

The accompanying notes and schedules are part of these financial statements.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**STATEMENT OF CASH FLOWS**

For the Year Ended March 31, 2006

	2006	2005
	(\$ thousands)	
<b>Operating transactions</b>		
Net investment income	\$ 57,853	\$ 29,234
Non-cash items included in net investment income	(3,874)	4,413
	53,979	33,647
Increase in receivables	(3,235)	(1)
(Decrease) increase in payables	(939)	940
Cash provided by operating transactions	49,805	34,586
<b>Investing transactions</b>		
Proceeds from disposals, repayments and redemptions of investments	60,255	136,169
Purchase of investments	(196,068)	(151,461)
Cash applied to investing transactions	(135,813)	(15,292)
<b>Transfers</b>		
Transfers from the General Revenue Fund	100,000	-
Transfers to the Foundation	(17,975)	(13,445)
Cash provided by (applied to) transfers	82,025	(13,445)
<b>(Decrease) increase in cash</b>	(3,983)	5,849
<b>Cash at beginning of year</b>	10,261	4,412
<b>Cash at end of year</b>	\$ 6,278	\$ 10,261
<b>Consisting of Deposit in the Consolidated Cash Investment Trust Fund (Note 3)</b>	\$ 6,278	\$ 10,261

The accompanying notes and schedules are part of these financial statements.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**NOTES TO THE FINANCIAL STATEMENTS**

March 31, 2006 (\$ thousands)

**NOTE 1 AUTHORITY AND PURPOSE**

The Alberta Heritage Science and Engineering Research Endowment Fund ("the Fund") operates under the authority of the *Alberta Heritage Foundation for Science and Engineering Research Act* ("the Act"), Chapter A 22, Revised Statutes of Alberta 2000.

The purpose of the Fund is to invest the endowment made to the Fund. The Fund has been managed with the objectives of providing an annual level of income for transfer to the Alberta Heritage Foundation for Science and Engineering while preserving the capital of the endowment over the long term. The portfolio is comprised of high quality fixed-income securities, equities, real estate, absolute return strategy investments and derivative financial instruments.

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND REPORTING PRACTICES**

The recommendations of the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants are the primary source for the disclosed basis of accounting.

The accounting policies of significance to the Fund are as follows:

**(a) Portfolio Investments**

Fixed-income securities, mortgages, equities, real estate investments, absolute return strategies and timberland investments held directly by the Fund or by pooled investment funds are recorded at cost. Cost includes the amount of applicable amortization of discount or premium using the straight-line method over the life of the investments.

Investments are recorded as of the trade date.

The cost of disposals is determined on the average cost basis.

Where there has been a loss in value of an investment that is other than a temporary decline, the investment is written down to recognize the loss. The written down value is deemed to be the new cost.

**(b) Investment Income**

Investment income is recorded on the accrual basis where there is reasonable assurance as to its measurement and collectability.

Gains and losses arising as a result of disposals of investments are included in the determination of investment income.

Income and expenses from derivative contracts are included in investment income. Certain derivative contracts, which are primarily interest rate swaps and cross-currency interest rate swaps, are designated as hedges of market risks for purposes of hedge accounting. Hedge accounting

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**Note 2 (continued)**

recognizes gains and losses from derivatives in the statement of income in the same period as the gains and losses of the security being hedged. As a result, income and expenses from derivative contracts designated as hedges are recognized in income on an accrual basis with gains and losses recognized in income to the extent realized.

Where a hedge relationship is designated, the hedge is documented at inception. The documentation identifies the specific asset being hedged, the risk that is being hedged, type of derivative used and the matching of critical terms of both the hedged security and the hedging derivative for purposes of measuring effectiveness. The derivative must be highly effective in accomplishing the objective of offsetting either changes in the fair value or cash flows attributable to the risk being hedged both at inception and over the life of the hedge.

Derivative contracts not designated as hedges for purposes of hedge accounting, which are primarily bond index swaps, equity index swaps and equity index futures contracts, forward foreign exchange contracts and credit default swap contracts, are recorded at fair value.

**(c) Foreign Currency**

Foreign currency transactions are translated into Canadian dollars using average rates of exchange, except for hedged foreign currency transactions which are translated at rates of exchange established by the terms of the forward exchange contracts. Exchange differences on unhedged transactions are included in the determination of investment income.

**(d) Investment Valuation**

Portfolio investments are recorded in the financial statements at cost. The fair value of investments is provided for information purposes and is disclosed in Note 3 and Schedules A to E.

Fair value is the amount of consideration agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

Measurement uncertainty exists in the fair values reported for certain investments such as private equities, private income, private real estate, absolute return strategies and timberland investments. The fair values of these investments are based on estimates where quoted market prices are not readily available. Estimated fair values may not reflect amounts that could be realized upon immediate sale, nor amounts that ultimately may be realized. Accordingly, the estimated fair values may differ significantly from the values that would have been used had a ready market existed for these investments.

Fair values of investments held either by the Fund or by pooled investment funds are determined as follows:

- (i) Public fixed-income securities and equities are valued at the year-end closing sale price, or the average of the latest bid and ask prices quoted by an independent securities valuation company.
- (ii) Private fixed-income securities and mortgages are valued based on the net present value of future cash flows. These cash flows are discounted using Government of Canada bond rates adjusted for a risk premium estimated by management.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**Note 2 (continued)**

- (iii) The fair value of private equities is estimated by managers or general partners of private equity funds, pools and limited partnerships. Valuation methods may encompass a broad range of approaches. The cost approach is used to value companies without either profits or cash flows. Established private companies are valued using the fair market value approach reflecting conventional valuation methods including discounted cash flows and multiple analyses.
- (iv) The fair value of real estate investments are reported at their most recent appraised value, net of any liabilities against the real property. Real estate properties are appraised annually by qualified external real estate appraisers. Appraisers use a combination of methods to determine fair value including replacement cost, direct comparison, direct capitalization of earnings and discounted cash flows.
- (v) The fair value of absolute return strategy investments is estimated by external managers.
- (vi) The fair value of timberland investments are appraised annually by independent third party evaluators.
- (vii) The fair values of deposits, receivables, accrued interest and payables are estimated to approximate their book values.
- (viii) The fair value of investments and any other assets and liabilities denominated in a foreign currency are translated at the year-end exchange rate.

**(e) Valuation of Derivative Contracts**

Derivative contracts include equity and bond index swaps, interest rate swaps, cross-currency interest rate swaps, credit default swaps, forward foreign exchange contracts and equity index futures contracts. As disclosed in Note 4, the value of derivative contracts is included in the fair value of pooled investment funds. The estimated fair value of derivative contracts at the reporting date is determined by the following methods:

- (i) Equity and bond index swaps are valued based on changes in the appropriate market based index net of accrued floating rate interest.
- (ii) Interest rate swaps and cross-currency interest rate swaps are valued based on discounted cash flows using current market yields and exchange rates.
- (iii) Credit default swaps are valued based on discounted cash flows using current market yields and calculated default probabilities.
- (iv) Forward foreign exchange contracts and equity index futures contracts are valued based on quoted market prices.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

## NOTE 3 PORTFOLIO INVESTMENTS

	2006			2005		
	Cost	Fair Value	%	Cost	Fair Value	%
	(\$ thousands)			(\$ thousands)		
<b>Fixed-Income Securities (Schedule A)</b>						
Deposit in the Consolidated Cash						
Investment Trust Fund (a)	\$ 6,278	\$ 6,278	0.9	\$ 10,261	\$ 10,261	1.9
Canadian Dollar Public Bond Pool (b)	175,613	177,699	24.9	140,906	145,692	26.5
Private Mortgage Pool (c)	26,096	26,771	3.8	24,005	25,016	4.6
Currency Alpha Pool (d)	674	692	0.1	-	-	-
Tactical Asset Allocation Pool (e)	1,285	1,242	0.2	1,090	1,092	0.2
	209,946	212,682	29.9	176,262	182,061	33.2
<b>Canadian Equities (Schedule B)</b>						
Domestic Passive Equity Pooled Fund (f)	51,829	49,700	7.0	36,838	34,494	6.3
Canadian Pooled Equity Fund (g)	28,529	30,255	4.3	24,136	22,306	4.1
Canadian Equity Enhanced Index Pool (h)	11,618	13,687	1.9	10,628	11,631	2.1
Canadian Large Cap Pool (i)	11,920	10,900	1.5	7,521	7,055	1.3
Growing Equity Income Pool (j)	4,538	6,266	0.9	5,673	6,744	1.2
Canadian Multi-Cap Pool (k)	6,922	6,985	1.0	4,921	4,925	0.9
Tactical Asset Allocation Pool Canadian futures contracts (e)	(6,492)	(6,492)	(1.0)	(5,569)	(5,569)	(1.0)
	108,864	111,301	15.6	84,148	81,586	14.9
<b>United States Equities (Schedule C)</b>						
S&P 500 Index Fund (l)	89,950	95,650	13.4	65,728	67,771	12.3
US Large Cap Equity Pool	-	-	-	5	5	-
US Small/Mid Cap Equity Pool (m)	16,024	18,202	2.5	12,084	12,116	2.2
Portable Alpha United States Equity Pool (n)	18,700	18,608	2.6	15,794	15,407	2.8
Growing Equity Income Pool (j)	2,041	1,941	0.3	1,082	1,074	0.2
Tactical Asset Allocation Pool US futures contracts (e)	6,555	6,555	1.0	5,598	5,598	1.0
	133,270	140,956	19.8	100,291	101,971	18.5
<b>Non-North American Equities (Schedule D)</b>						
EAFE Active Equity Pool (o)	100,278	109,347	15.4	83,845	81,562	14.9
EAFE Passive Equity Pool (p)	10,947	13,435	1.9	17,715	20,548	3.7
Emerging Market Equity Pool (q)	5,342	7,338	1.0	5,657	6,233	1.1
EAFE Structured Equity Pool (p)	15,999	15,615	2.2	-	-	-
	132,566	145,735	20.5	107,217	108,343	19.7
<b>Real Estate (Schedule E)</b>						
Private Real Estate Pool (r)	50,947	63,247	8.8	37,158	42,691	7.8
Foreign Private Real Estate Pool (s)	1,929	1,891	0.3	1,853	1,758	0.3
	52,876	65,138	9.1	39,011	44,449	8.1
<b>Absolute Return Strategies (t)</b>						
	24,073	24,174	3.4	26,015	25,817	4.7
<b>Private Equity Pools (u)</b>						
	6,442	6,597	0.9	2,869	2,708	0.5
<b>Private Income Pools (u)</b>						
	3,341	3,351	0.5	2,531	2,493	0.4
<b>Timberland (v)</b>						
	2,670	2,515	0.3	-	-	-
<b>Total Investments (w)</b>	<b>\$ 674,048</b>	<b>\$ 712,449</b>	<b>100.0</b>	<b>\$ 538,344</b>	<b>\$ 549,428</b>	<b>100.0</b>



## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**Note 3 (continued)**

The Fund's investments are held in pooled investment funds established and administered by Alberta Finance. Pooled investment funds have a market based unit value that is used to allocate income to participants and to value purchases and sales of pool units. As at March 31, 2006, the Fund's percentage ownership, at market, in pooled investment funds is as follows:

	% Ownership	
	2006	2005
Absolute Return Strategy Pool	3.7	3.7
Canadian Dollar Public Bond Pool	1.8	1.6
Canadian Equity Enhanced Index Pool	1.1	2.2
Canadian Large Cap Equity Pool	0.6	0.3
Canadian Multi-Cap Pool	1.9	2.1
Canadian Pooled Equity Fund	2.5	2.1
Currency Alpha Pool	1.2	-
Domestic Passive Equity Pooled Fund	1.9	1.5
EAFE Active Equity Pool	1.9	1.75
EAFE Passive Equity Pool	4.3	4.5
EAFE Structured Equity Pool	1.5	-
Emerging Markets Equity Pool	1.2	1.5
Foreign Private Equity Pool (02)	1.7	1.7
Foreign Private Equity Pool (05)	4.4	-
Foreign Private Real Estate Pool	3.7	3.7
Growing Equity Income Pool	2.3	2.6
Portable Alpha United States Equity Pool	4.3	4.3
Private Equity Pool (02)	1.7	1.8
Private Equity Pool (04)	4.0	4.0
Private Income Pool	1.0	1.1
Private Income Pool 2	3.8	-
Private Mortgage Pool	2.0	2.1
Private Real Estate Pool	1.7	1.5
Standard & Poor's 500 Index Fund	4.2	3.7
Tactical Asset Allocation Pool	3.9	1.6
Timberland Pool	3.9	-
US Small/Mid Cap Equity Pool	1.5	1.3

- (a) The Consolidated Cash Investment Trust Fund is managed with the objective of providing competitive interest income to depositors while maintaining appropriate security and liquidity of depositors' capital. The portfolio is comprised of high-quality short-term and mid-term fixed-income securities with a maximum term-to-maturity of three years. As at March 31, 2006, securities held by the Fund have an average effective market yield of 3.96% per annum (2005: 2.79% per annum).
- (b) The Canadian Dollar Public Bond Pool is managed with the objective of providing above average returns compared to the total return of the Scotia Capital Universe Bond Index over a four-year period while maintaining adequate security and liquidity of participants' capital. The excess return is achieved through management of portfolio duration and sector rotation. The portfolio is comprised of high quality Canadian fixed-income instruments and debt related derivatives. As at March 31, 2006, securities held by the Pool have an average effective market yield of 4.7% per annum (2005: 4.48% per annum) and the following term structure based on principal amount: under 1 year: 2% (2005: 3%); 1 to 5 years: 34% (2005: 38%); 5 to 10 years: 33% (2005: 31%); 10 to 20 years: 12% (2005: 12%); and over 20 years: 19% (2005: 16%).

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**Note 3 (continued)**

- (c) The Private Mortgage Pool is managed with the objective of providing investment returns higher than attainable from the Scotia Capital Universe Bond Index over a four-year period or longer. The portfolio is comprised primarily of high quality commercial mortgage loans (94.5%) and provincial bond residuals (5.5%). To limit investment risk, mortgage loans are restricted to first mortgage loans, diversified by property usage and geographic location, and include a small portion of NHA insured loans. As at March 31, 2006, securities held by the Pool have an average effective market yield of 5.27% per annum (2005: 5.29% per annum) and the following term structure based on principal amount: under 1 year: 2% (2005: 2%); 1 to 5 years: 19% (2005: 22%); 5 to 10 years: 50% (2005: 43%); 10 to 20 years: 10% (2005: 12%); and over 20 years: 19% (2005: 21%).
- (d) The Currency Alpha Pool is managed with the objective of providing a fair return over a four-year moving period while reducing return volatility through multiple manager investment styles and strategies. The return is achieved through active currency management with currency positions established primarily through forward foreign exchange contracts. Participants deposit into the Pool a modest amount of cash to minimize rebalancing of cash flows in or out of the Pool when the forward foreign exchange contracts settle.
- (e) The Tactical Asset Allocation Pool provides participants with a quick, effective and efficient way to earn excess returns, on an opportunistic basis, by altering the portfolio weights of broad asset classes using synthetic instruments. At March 31, 2006, the Pool is comprised of a long position through United States equity index futures contracts and a short position through Canadian equity index futures contracts. Cash and short-term securities held by the Pool support approximately 5% to 10% of the Pool's notional exposure in Canadian and United States equity index futures contracts.
- (f) The Domestic Passive Equity Pooled Fund is managed on a passive approach with the objective of providing investment returns comparable to the Toronto Stock Exchange S&P/TSX Composite Index. The portfolio is comprised of publicly traded Canadian equities and structured investments replicating the S&P/TSX 60 Index. The Pool's investment in units of the Floating Rate Note Pool (FRNP) are used as the underlying securities to support the index swaps of the pool. FRNP is managed with the objective of generating floating rate income needed for the swap obligations in respect of structured investments in foreign equities, domestic equities and domestic bonds. Through the use of interest rate swaps, FRNP provides investment opportunities in high quality floating-rate instruments with remaining term-to-maturity of five years or less.
- (g) The Canadian Pooled Equity Fund is managed with the objective of providing competitive returns comparable to the total return of the S&P/TSX Composite Index while maintaining maximum preservation of participants' capital. The portfolio is comprised of publicly traded equities in Canadian corporations. Risk is reduced by prudent security selection, while remaining sector neutral.
- (h) The Canadian Equity Enhanced Index Pool allows participants the opportunity to gain investment exposure to the Canadian large cap equity market. The performance objective is to provide returns higher than the total return of the S&P/TSX Composite Index over a four-year moving average period. The portfolio is comprised of publicly traded equities in Canadian corporations. The enhanced index generates a consistent level of return above the Index with relatively low risk.
- (i) The Canadian Large Cap Equity Pool consists of multiple portfolios of publicly traded Canadian equities. Each portfolio is actively managed by an external manager with expertise in the Canadian large cap equity market. The performance objective is to provide returns higher than the total return of the S&P/TSX Composite Index over a four-year period. Return volatility is reduced through multiple manager investment style and market capitalization focus.
- (j) The Growing Equity Income Pool is managed with the objective of providing a steady and growing stream of dividend income to client portfolios by investing in mature companies with strong financial characteristics and growing distributions. Risk is reduced by holding established, well-capitalized companies. The performance of the pool is measured against the total return of the S&P/TSX Composite Index.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**Note 3 (continued)**

- (k) The Canadian Multi-Cap Pool allows participants to gain investment exposure to the Canadian equity market through internally managed structured investments replicating the S&P/TSX 60 Index and external actively managed Canadian small and mid cap investments. The performance of the pool is measured against the total return of the S&P/TSX Composite Index over a four-year moving average period. The Pool's investment in units of the FRNP are used as the underlying securities to support the index swaps of the pool (see Note 3(f)).
- (l) Publicly traded U.S. equities held in the S&P 500 Index Fund replicate the Standard & Poor's (S&P) 500 index. The performance objective is to provide returns comparable to the total return of the S&P 500 index over a four-year period. The Pool's investment in units of the FRNP are used as the underlying securities to support the index swaps of the pool (see Note 3(f)).
- (m) The U.S. Small/Mid Cap Equity Pool consists of one portfolio of publicly traded United States equities. The portfolio is actively managed by an external manager with expertise in the small cap and mid cap U.S. equity market. The performance objective is to provide returns higher than the total return of the Russell 2500 Index over a four-year period.
- (n) The Portable Alpha United States Equity Pool consists of futures and swap contracts which provide exposure to the U.S. equity market by replicating the S&P 500 Index and investments in value added absolute return strategies. The performance objective is to provide returns higher than the total return of the S&P 500 Index over a four-year period.
- (o) The Europe, Australasia and Far East (EAFE) Active Equity Pool consists of multiple portfolios of publicly traded non-North American equities. Portfolios are actively managed by external managers with European and Pacific Basin mandates. The performance objective is to provide returns higher than the total return of the Morgan Stanley Capital International (MSCI) EAFE Index over a four-year period.
- (p) The EAFE Passive Equity Pool and the EAFE Structured Equity Pool are managed with the objective to provide returns comparable to the total return of the MSCI EAFE Index over a four-year period. The EAFE Passive Equity Pool consists of one portfolio of non-North American publicly traded equities that replicate the MSCI EAFE Index. The EAFE Structured Equity Pool provides exposure to EAFE markets through the use of structured investments such as foreign equity index swaps. The structured pool also invests in the FRNP to generate the floating rate cash flows needed for its equity swap obligations (see Note 3(f)).
- (q) The Emerging Markets Equity Pool consists of publicly traded equities in emerging markets around the world. The portfolio is actively managed by external managers with expertise in emerging markets. The performance objective is to provide returns higher than the total return of the MSCI Emerging Markets Free (MSCI EMF) Index over a four-year period.
- (r) The Private Real Estate Pool is managed with the objective of providing investment returns higher than the IPD Large Institutional All Property Index. Real estate is held through intermediary companies, which have issued to the Pool common shares and participating debentures secured by a charge on real estate. Risk is reduced by investing in properties that provide diversification by geographic location, by property type and by tenancy. As real estate returns are positively correlated to inflation and negatively correlated to returns from fixed income securities and equities, the Pool provides diversification from the securities market with opportunities for high return.
- (s) The Foreign Private Real Estate Pool is managed with the objective of providing investment returns higher than the IPD Large Institutional All Property Index. The Pool provides diverse exposure to non-domestic real estate by investing in foreign real estate backed securities and assets.
- (t) The Absolute Return Strategy Pool is managed with the objective of providing investment returns higher than the Hedge Fund Research Inc. Global Index. The Pool uses external managers who employ various investment strategies. These strategies are expected to produce absolute positive investment returns with lower volatility.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**Note 3 (continued)**

- (u) Private Equity Pools are managed with the objective of providing investment returns higher than the Consumer Price Index (CPI) plus 8.0%. The Private Equity Portfolio consists of the PEP02, PEP04, the Foreign Private Equity Pool 2002 and the Foreign Private Equity Pool 2005. Private equity investments are held in institutionally sponsored private equity pools. Risk is reduced by avoiding direct investments in private companies and by limiting holdings in any single pool. The Private Income Pool allows unit holders to participate as equity investors in infrastructure related projects that are structured to yield high current income with the objective of providing investment returns higher than the CPI plus 6.0%.
- (v) The Timberland Pool provides high current income and long investment horizons. The timberland investment is a partnership interest in forestry land in British Columbia. The performance objective is to earn a return higher than CPI plus 4.0%.
- (w) Where there has been a loss in value of an investment that is other than a temporary decline, the cost of the investment is written down to recognize the loss (see Note 2 (a)). Where the fair value remains less than cost, after recording a writedown, it is management's best judgement that the decline in value is caused by short term market trends and are temporary in nature.

**NOTE 4 DERIVATIVE CONTRACTS**

Derivative contracts are financial contracts, the value of which is derived from the value of underlying assets, indices, interest rates or currency rates. The Fund uses derivative contracts held indirectly through pooled investment funds to enhance return, manage exposure to interest rate risk and foreign currency risk and for asset mix management purposes. The notional value of a derivative contract represents the amount to which a rate or price is applied in order to calculate the exchange of cash flows.

- (i) A swap is a contractual agreement between two counter-parties to exchange a series of cash flows based on a notional amount. An equity or bond index swap involves the exchange of a floating interest rate cash flow for one based on the performance of a market index. For interest rate swaps, parties generally exchange fixed and floating rate interest cash flows based on a notional amount. Cross-currency interest rate swaps are contractual obligations in which the principal amounts of Canadian fixed-income securities denominated in foreign currency are exchanged for Canadian currency amounts both initially and at maturity. Over the term of the cross-currency swap, counter-parties exchange fixed-to-fixed and fixed-to-floating interest rate cash flows in the swapped currencies. A credit default swap allows counter-parties to buy and sell protection on credit risk inherent in a bond. A premium is paid, based on a notional amount, from one counter party to a second counter party in exchange for a contingent payment should a defined credit event occur with respect to the underlying security. There are underlying securities supporting all swaps. Leveraging is not allowed.
- (ii) Forward foreign exchange contracts are contractual agreements to exchange specified currencies at an agreed upon exchange rate and on an agreed settlement date in the future.
- (iii) An equity index futures contract is an agreement to receive or pay cash based on changes in the level of the specified stock index.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**Note 4 (continued)**

The following is a summary of the Fund's proportionate share of the notional amount and fair value of derivative contracts held by pooled funds at March 31, 2006:

	Maturity			2006		2005	
	Under 1 Year	1 to 3 Years	Over 3 Years	Notional Amount (a)	Fair Value (b)	Notional Amount (a)	Fair Value (b)
	(\$ thousands)						
Equity index swap contracts	75%	25%	-	\$ 123,929	\$ 2,269	\$ 65,884	\$ 89
Forward foreign exchange contracts	100%	-	-	65,058	(70)	41,166	567
Interest rate swap contracts	22%	49%	29%	51,255	(108)	20,154	(499)
Cross-currency interest rate swaps	14%	34%	52%	36,133	2,701	26,140	37
Credit default swap contracts	2%	5%	93%	59,923	142	5,502	64
Bond index swap contracts	100%	-	-	11,639	1,302	2,832	20
Equity index futures contracts	100%	-	-	35,294	755	13,701	287
				<b>\$ 383,231</b>	<b>\$ 6,991</b>	<b>\$ 175,379</b>	<b>\$ 565</b>

(a) The notional amounts, upon which payments are based, are not indicative of the credit risk associated with derivative contracts. Current credit exposure is represented by the current replacement cost of all outstanding contracts in a favourable position (positive fair value). The Fund attempts to limit its credit exposure by dealing with counter-parties believed to have good credit standing (A+ or greater).

(b) The method of determining the fair value of derivative contracts is described in Note 2 (e).

**NOTE 5 INVESTMENT RISK MANAGEMENT**

Income and financial returns of the Fund are exposed to credit risk and price risk. Credit risk relates to the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract. Price risk is comprised of currency risk, interest rate risk and market risk. Currency risk relates to the possibility that the investments will change in value due to future fluctuations in foreign exchange rates. Interest rate risk relates to the possibility that the investments will change in value due to future fluctuations in market interest rates. Market risk relates to the possibility that the investments will change in value due to future fluctuations in market prices.

In order to earn an optimal financial return at an acceptable level of risk, management of the Fund established the following long-term policy asset mix for the 2005-2006 fiscal year:

Fixed-income securities	27.5% to 17.5%
Equities	72.5% to 82.5%

Risk is reduced through asset class diversification, diversification within each asset class, quality constraints on fixed-income instruments, and restrictions on amounts exposed to countries designated as emerging markets. Controls are in place respecting the use of derivatives (see Note 4). Forward foreign exchange contracts may be used to manage currency exposure in connection with securities purchased in foreign currency (see Note 4).

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**NOTE 6 NET ASSETS**

Net assets represents the difference between the carrying value of assets held by the Fund and its liabilities. The following table shows the accumulated investment income and transfers to and from the Fund since its inception in 2000:

	<b>Cumulative since 2000</b>	
	<b>2006</b>	<b>2005</b>
	(\$ thousands)	
Transfers from the General Revenue Fund (a)	\$ 621,430	\$ 521,430
Accumulated investment income	106,153	48,300
Accumulated transfers to the Foundation (b)	(50,286)	(32,311)
<b>Net Assets</b>	<b>\$ 677,297</b>	<b>\$ 537,419</b>

- (a) The total accumulated contributions from the GRF include an initial amount of \$500 million deposited during the 2000-2001 fiscal year, \$21.43 million during the 2003-2004 fiscal year and \$100 million during the current fiscal year, pursuant to Section 8 of the *Access to the Future Act*. Under the *Access to the Future Act*, the Fund shall be increased by \$500 million in amounts considered appropriate by the Minister of Finance.
- (b) In accordance with section 8(1) of the *Alberta Heritage Foundation for Science and Engineering Research Act* (the Act), the Minister of Finance must, at the request of the Foundation, pay from the Endowment Fund to the Foundation, money that, in the opinion of the trustees, is required by the Foundation for the furtherance of its objectives. Section 8 of the Act limits annual payments from the Fund to the Foundation for 2004-2005 and subsequent fiscal years. Payments to the Foundation may not exceed, in a fiscal year, 4.5% of the average of the market values determined on March 31 of the preceding three fiscal years, and any unused portion of the amount permitted to be paid in that fiscal year may be paid in any subsequent fiscal year.

	<b>2006</b>
	(\$ thousands)
Accumulated unused spending limit at March 31, 2005	\$ 7,902
4.5% of average market value on March 31, 2003-05	22,444
Spending limit for the year ended March 31, 2006	30,346
Transfers to Foundation during the year	(17,975)
Accumulated unused spending limit at March 31, 2006	12,371
4.5% of average market value on March 31, 2004-06	26,872
Spending limit for the year ended March 31, 2007	<b>\$ 39,243</b>

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**NOTE 7 NET INVESTMENT INCOME**

	<b>2006</b>	<b>2005</b>
	(\$ thousands)	
Deposits and fixed-income securities	\$ 12,657	\$ 11,445
Canadian equities	20,688	5,607
United States equities	3,392	(2,481)
Non-North American equities	15,930	10,863
Real estate	3,618	2,428
Absolute return strategies	990	1,357
Private equities	279	2
Private income	484	130
Timberland	(48)	-
<b>Investment income</b>	<b>\$ 57,990</b>	<b>\$ 29,351</b>
Direct administration expense (Note 8)	(137)	(117)
<b>Net investment income</b>	<b>\$ 57,853</b>	<b>\$ 29,234</b>

Investment income is comprised of interest, dividends, amortization of discount or premium, swap income, security lending income and realized gains and losses, net of write-downs on investments. The Fund's share of income (loss) earned from externally and internally managed investment pools is net of administrative expenses incurred by the pools (see Note 8).

The investment income for the year ended March 31, 2006 includes writedowns of \$1,851 (2005: \$985).

**NOTE 8 ADMINISTRATIVE EXPENSES**

External management fees and internal management expenses are deducted directly from the income from pooled investment funds. Alberta Finance charges direct fund and internal management expenses on a cost recovery basis. External management fees are based on a percentage of net assets under management at fair value and committed amounts in the case of private equity and private income pools. Comparative figures have been restated to include estimated indirect external management fees deducted directly from income of private equity and private income investments, real estate, timberland and absolute return strategies.

	<b>2006</b>	<b>2005</b>
	(restated)	
	(\$ thousands)	
Direct fund expenses (Note 7)	\$ 137	\$ 117
External management fees	1,590	1,173
Internal management expenses	205	146
<b>Total</b>	<b>\$ 1,932</b>	<b>\$ 1,436</b>
Expenses as a percentage of net assets at fair value	0.271%	0.267%

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**NOTE 9 INVESTMENT PERFORMANCE (SCHEDULE F)**

The following is a summary of the investment performance results attained by the Fund determined on a fair value basis:

	<b>One Year Return</b>	<b>Five Year Compound Annualized Return</b>
<b>Time-weighted rates of return</b>		
Overall actual return	14.4%	6.7%
Benchmark return (1)	13.5%	6.1%

(1) The overall benchmark return for year ended March 31, 2006 is a product of the weighted average policy sector weights and the sector benchmark returns.

**NOTE 10 COMPARATIVE FIGURES**

Certain 2005 figures have been reclassified to conform to 2006 presentation.

**NOTE 11 APPROVAL OF FINANCIAL STATEMENTS**

The Deputy Minister of Finance approved these financial statements.



## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

## SCHEDULES TO THE FINANCIAL STATEMENTS

## SCHEDULE OF INVESTMENTS IN FIXED INCOME SECURITIES

## Schedule A

March 31, 2006

	Fund's share			
	2006		2005	
	Cost	Fair Value	Cost	Fair Value
	(\$ thousands)			
<b>Deposits and short-term securities</b>	\$ 8,333	\$ 8,333	\$ 11,724	\$ 11,724
<b>Fixed income securities (a)</b>				
Corporate, public and private	117,374	117,792	86,418	88,398
Government of Canada, direct and guaranteed	48,963	49,117	42,676	43,615
Provincial, direct and guaranteed:				
Alberta	1,059	1,053	81	89
Other provinces	30,819	32,924	32,464	35,213
Municipal	835	900	1,724	1,847
	199,050	201,786	163,363	169,162
Receivable from sale of investments and accrued investment income	4,339	4,339	2,022	2,022
Accounts payable and accrued liabilities	(1,776)	(1,776)	(847)	(847)
	2,563	2,563	1,175	1,175
	<b>\$ 209,946</b>	<b>\$ 212,682</b>	<b>\$ 176,262</b>	<b>\$ 182,061</b>

(a) Fixed income securities held as at March 31, 2006 have an average effective market yield of 4.77% per annum (2005: 4.59% per annum) and the following term structure based on principal amount:

	2006	2005
	%	%
under 1 year	3	3
1 to 5 years	31	35
5 to 10 years	35	33
10 to 20 years	12	12
over 20 years	19	17
	100	100

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**SCHEDULE OF INVESTMENTS IN CANADIAN EQUITIES****Schedule B**

March 31, 2006

	Fund's share			
	2006		2005	
	Cost	Fair Value	Cost	Fair Value
	(\$ thousands)			
<b>Deposits and short-term securities</b>	\$ 568	\$ 568	\$ 661	\$ 661
<b>Public equities (a) (b)</b>				
Financials	32,037	33,034	26,710	26,177
Energy	28,026	30,889	14,821	16,579
Materials	14,920	16,304	12,291	11,539
Industrials	6,376	6,660	4,503	4,403
Consumer discretionary	7,054	5,775	6,317	5,182
Telecommunication services	5,114	5,181	5,317	5,039
Information technology	5,387	4,491	5,179	4,308
Consumer staples	3,792	3,272	3,629	3,557
Health Care	1,611	1,175	1,592	1,087
Utilities	1,213	1,084	1,240	1,148
	105,530	107,865	81,599	79,019
Small Cap Pooled Fund	2,001	2,103	1,480	1,498
Receivable from sale of investments and accrued investment income	2,566	2,566	1,358	1,358
Accounts payable and accrued liabilities	(1,801)	(1,801)	(950)	(950)
	765	765	408	408
	<b>\$ 108,864</b>	<b>\$ 111,301</b>	<b>\$ 84,148</b>	<b>\$ 81,586</b>

(a) The Fund's effective net investment in Canadian public equities includes the notional amount of Canadian equity index swap contracts and equity index futures contracts totalling \$44,673 (2005: \$32,887).

(b) The sector classification conforms to the Global Industry Classification Standard followed by the Toronto Stock Exchange S&P/TSX Composite Index.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**SCHEDULE OF INVESTMENTS IN UNITED STATES EQUITIES****Schedule C**

March 31, 2006

	Fund's share			
	2006		2005	
	Cost	Fair Value	Cost	Fair Value
	(\$ thousands)			
<b>Deposits and short-term securities</b>	\$ 529	\$ 529	\$ 1,488	\$ 1,488
<b>Public equities (a) (b)</b>				
Financials	28,025	29,418	20,429	20,311
Information technology	20,461	21,595	15,283	15,297
Health care	17,121	17,977	13,250	13,105
Industrials	16,267	17,445	12,293	12,696
Consumer discretionary	14,032	14,766	11,558	11,983
Energy	11,598	13,142	7,994	8,800
Consumer staples	11,695	11,724	9,498	9,483
Materials	4,466	4,968	3,796	3,987
Utilities	4,254	4,402	3,433	3,603
Telecommunication services	3,872	4,040	2,831	2,780
	131,791	139,477	100,365	102,045
Receivable from sale of investments and accrued investment income	4,655	4,655	813	813
Accounts payable and accrued liabilities	(3,705)	(3,705)	(2,375)	(2,375)
	950	950	(1,562)	(1,562)
	<b>\$ 133,270</b>	<b>\$ 140,956</b>	<b>\$ 100,291</b>	<b>\$ 101,971</b>

- (a) The Fund's effective net investment in U.S. public equities includes the notional amount of U.S. equity index swap contracts and equity index futures contracts totalling \$72,011 (2005: \$46,698).
- (b) The sector classification conforms to the Global Industry Classification Standard followed by the Standard & Poor's S&P 500 Index.

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**SCHEDULE OF INVESTMENTS IN NON-NORTH AMERICAN EQUITIES**

Schedule D

March 31, 2006

	Fund's share			
	2006		2005	
	Cost	Fair Value	Cost	Fair Value
	(\$ thousands)			
<b>Deposits and short-term securities</b>	\$ 3,299	\$ 3,299	\$ 2,062	\$ 2,062
<b>Public equities (a) (b)</b>				
Financials	35,236	40,591	26,347	27,513
Industrials	16,006	18,680	12,112	12,599
Consumer discretionary	15,160	16,612	14,285	13,947
Materials	9,619	11,320	8,612	9,173
Energy	9,155	10,435	8,668	9,139
Health care	9,627	9,768	6,857	6,320
Information technology	8,994	9,458	5,577	5,286
Consumer staples	8,626	8,407	6,195	6,090
Telecommunication services	8,526	7,679	9,368	8,886
Utilities	5,626	6,098	4,505	4,553
	126,575	139,048	102,526	103,506
Emerging markets pooled funds	2,150	2,846	2,445	2,591
Receivable from sale of investments and accrued investment income	2,911	2,911	1,317	1,317
Accounts payable and accrued liabilities	(2,369)	(2,369)	(1,133)	(1,133)
	542	542	184	184
	\$ 132,566	\$ 145,735	\$ 107,217	\$ 108,343

(a) The Fund's effective net investment in non-North American public equities includes the notional amount of non-North American equity index swap contracts and equity index futures contracts totalling \$14,916 (2005: \$nil).

(b) The sector classification conforms to the Global Industry Classification Standard followed by Standard & Poor's. Public equities by geographic location are as follows:

	Fund's share			
	2006		2005	
	Cost	Fair Value	Cost	Fair Value
	(\$ thousands)			
Japan	\$ 30,432	\$ 32,649	\$ 19,118	\$ 17,891
United Kingdom	26,628	27,402	23,003	22,372
France	12,863	14,237	9,881	10,234
Germany	8,353	9,525	7,249	7,350
Switzerland	8,689	9,419	6,483	6,534
Netherlands	6,263	7,199	5,606	5,580
Australia	4,811	5,219	4,101	4,660
Italy	3,992	4,468	3,622	3,984
Spain	3,682	3,872	2,856	3,006
Sweden	2,498	2,879	2,644	2,762
Other	18,364	22,179	17,963	19,133
	\$ 126,575	\$ 139,048	\$ 102,526	\$ 103,506

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**SCHEDULE OF INVESTMENTS IN REAL ESTATE**

Schedule E

March 31, 2006

	Fund's share			
	2006		2005	
	Cost	Fair Value	Cost	Fair Value
	(\$ thousands)			
<b>Deposits and short-term securities</b>	\$ 35	\$ 35	\$ 17	\$ 17
<b>Real estate (a)</b>				
Office	24,086	31,268	17,457	19,415
Retail	16,234	20,919	13,890	17,287
Industrial	6,163	6,580	3,051	3,372
Residential	2,831	2,847	2,070	1,927
	49,314	61,614	36,468	42,001
Foreign Private Equity Pool	1,929	1,891	1,853	1,758
Participation units	1,467	1,467	616	616
<b>Accrued income and accounts receivable</b>	131	131	57	57
	<b>\$ 52,876</b>	<b>\$ 65,138</b>	<b>\$ 39,011</b>	<b>\$ 44,449</b>

The following is a summary of real estate investments by geographic location:

	Fund's share			
	2006		2005	
	Cost	Fair Value	Cost	Fair Value
	(\$ thousands)			
Ontario	\$ 30,961	\$ 37,516	\$ 23,342	\$ 27,951
Alberta	11,242	17,247	7,403	8,720
Quebec	6,106	5,634	4,852	4,418
British Columbia	1,005	1,217	871	912
	<b>\$ 49,314</b>	<b>\$ 61,614</b>	<b>\$ 36,468</b>	<b>\$ 42,001</b>

## ALBERTA HERITAGE SCIENCE AND ENGINEERING RESEARCH ENDOWMENT FUND

**SCHEDULE OF INVESTMENT RETURNS****Schedule F**

Year Ended March 31, 2006

The Fund uses a time-weighted rate of return based on market values to measure performance. The measure involves the calculation of the return realized by the Fund over a specified period and is a measure of the total return received from an investment dollar initially invested. Total return includes cash distributions (interest and dividend payments) and capital gains or losses (realized and unrealized).

The time-weighted rate of return measures the compounded rate of growth of the initial investment over the specified period. It is designed to eliminate the effect that the size and timing of cash flows have on the internal rate of return. The investment industry uses time-weighted rates of return calculated using market values when comparing the returns of funds with other funds or indices.

Investment returns for the Fund are as follows:

Time-weighted Rates of Return	One Year Return - %					Five Year Compound Annualized Return
	2006	2005	2004	2003	2002	
<b>Short-term fixed income</b>	<b>2.9</b>	<b>2.7</b>	<b>3.0</b>	<b>2.9</b>	<b>4.0</b>	<b>3.1</b>
<i>Scotia Capital 91-day T-Bill Index</i>	2.8	2.2	3.0	2.7	3.7	2.9
<b>Long-term fixed income</b>	<b>5.7</b>	<b>5.6</b>	<b>11.6</b>	<b>9.6</b>	<b>5.9</b>	<b>7.7</b>
<i>Scotia Capital Universe Bond Index</i>	4.9	5.0	10.8	9.2	5.1	7.0
<b>Canadian equities</b>	<b>29.0</b>	<b>15.5</b>	<b>36.6</b>	<b>(17.1)</b>	<b>4.2</b>	<b>11.9</b>
<i>S&amp;P/TSX Composite Index</i>	28.4	13.9	37.7	(17.6)	4.9	11.7
<b>United States equities</b>	<b>8.5</b>	<b>(1.7)</b>	<b>22.1</b>	<b>(30.4)</b>	<b>1.4</b>	<b>(1.7)</b>
<i>S&amp;P 1500 Index</i>	9.1	(1.0)	20.5	(30.7)	1.6	(1.7)
<b>Non-North American equities</b>	<b>23.9</b>	<b>7.4</b>	<b>40.9</b>	<b>(29.1)</b>	<b>(5.6)</b>	<b>4.6</b>
<i>MSCI EAFE Index</i>	20.0	6.2	40.5	(29.3)	(7.3)	3.3
<b>Real estate</b>	<b>20.7</b>	<b>16.9</b>	<b>7.5</b>	<b>9.8</b>	<b>7.3</b>	<b>12.1</b>
<i>IPD Large Institutional All Property Index</i>	18.1	7.1	5.7	8.9	9.9	9.8
<b>Absolute return strategies</b>	<b>5.2</b>	<b>5.5</b>	<b>10.7</b>	<b>1.6</b>	<b>n/a</b>	<b>n/a</b>
<i>HFRX Global Hedged Index</i>	10.1	8.1	6.7	4.7	n/a	n/a
<b>Private equities</b>	<b>12.3</b>	<b>0.6</b>	<b>1.2</b>	<b>(4.3)</b>	<b>n/a</b>	<b>n/a</b>
<i>Consumer Price Index (CPI) plus 8%</i>	10.2	10.1	8.7	5.7	n/a	n/a
<b>Private income</b>	<b>21.3</b>	<b>5.4</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>
<i>CPI plus 6%</i>	8.2	8.1	n/a	n/a	n/a	n/a
<b>Timberland Investments*</b>	<b>(4.9)</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>
<i>CPI plus 4%*</i>	4.2	n/a	n/a	n/a	n/a	n/a
<b>Overall</b>	<b>14.4</b>	<b>6.7</b>	<b>22.5</b>	<b>(10.2)</b>	<b>3.0</b>	<b>6.7</b>
<b><i>Policy Benchmark</i></b>	<b>13.5</b>	<b>5.4</b>	<b>21.7</b>	<b>(10.6)</b>	<b>3.1</b>	<b>6.1</b>

\* Returns from Timberland Investments are for nine months.