

# THIRD QUARTER UPDATE



**Heritage Fund**

# 2005-06

## Alberta Heritage Savings Trust Fund

For the nine months ended December 31, 2005

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**THIRD QUARTER UPDATE**  
**DECEMBER 31, 2005**

# Alberta Heritage Savings Trust Fund

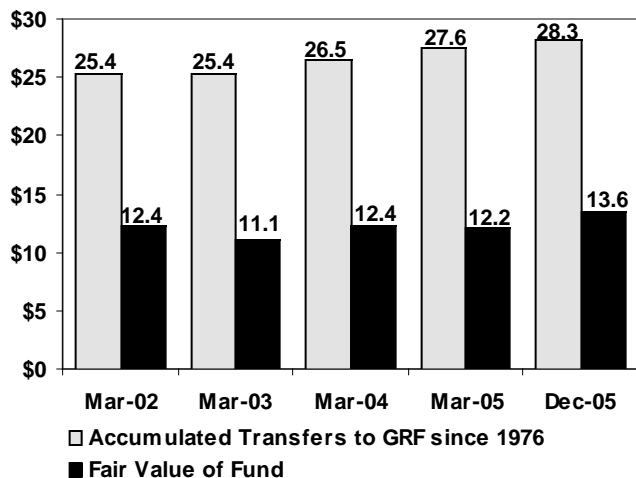
## QUARTER IN REVIEW

The Alberta Heritage Saving Trust Fund (the Fund) earned \$268 million from its investments in the third quarter of 2005-06 compared to \$350 million in the third quarter of last year. The decrease resulted from lower capital gains from equity investments due to an under-performance in world stock markets this quarter compared to the third quarter last year. However, over nine months the Fund has earned \$914 million compared to \$848 million for the same period last year. All of the income is transferred to the General Revenue Fund (GRF) except for an estimated \$258 million which was retained in the Fund for inflation proofing.

Over the past nine months, the total fair value of the Fund increased to \$13.6 billion, up \$1,357 million, from \$12.2 billion at the beginning of the year. During the quarter, \$750 million was transferred into the Fund from the GRF on account of the Access to the Future Fund. Unrealized gains increased by \$349 million during the past nine months. Inflation proofing the Fund and transfers from the GRF related to the Access to the Future Fund are discussed on pages 3 and 8 respectively.

## FUND VALUE AND ACCUMULATED TRANSFERS TO THE GRF

(billions)



Overall, the S&P/TSX Index increased by 2.9% this quarter and 24.1% over one year. As a result of higher oil prices, the energy sector in the S&P/TSX Index increased by 61.7% over one year.

While Canadian dollar declined slightly against the U.S. dollar during the quarter it strengthened against the U.S. dollar over nine months. Federal surpluses, rising oil prices, robust growth forecasts and expectations of higher interest rates helped fuel the increase in value of the Canadian dollar over the past nine months. At December 31, 2005, one U.S. dollar purchased \$1.17 Canadian compared to \$1.16 Canadian at September 30, 2005 and \$1.21 Canadian at March 31, 2005. As a result, the value of the Heritage Fund's United States equity investments decreased over nine months when translated into Canadian dollars, resulting in lower investment returns.

Over the quarter, the U.S. market measured by the S&P 1500 Index increased by 2.1% in U.S. dollars and 2.5% when translated into Canadian dollars.

The non-North American market measured by the MSCI EAFE Index increased by 4.5% this quarter in Canadian dollars.

## MARKET SUMMARY

Benchmark Index Returns

Period Ended December 31, 2005

(percent)

	Three Months	Nine Months	One Year
<b>Stock Markets</b>			
Canadian			
S&P/TSX Composite Index	2.9	18.9	24.1
United States			
S&P 1500 Index (US \$)	2.1	7.8	5.7
S&P 1500 Index (Cdn \$)	2.5	3.9	2.4
Non-North American			
MSCI EAFE Index (Cdn \$)	4.5	9.6	10.0
<b>Canadian Bond Market</b>			
SC Bond Universe Index	0.7	5.3	6.5

## Change in Net Assets

The Fund accounts for its investments using the cost basis of accounting. Investments and income recorded on a cost basis exclude unrealized gains and losses. Investments and income on a fair value basis includes changes in unrealized gains and losses during the period. The investment income on a fair value basis for the three and nine months ended December 31, 2005 was \$421 million (2004: \$628 million) and \$1,263 million (2004: \$661 million) respectively.

### Changes in Net Assets

(millions)

	3 Months ended Dec 31, 2005	9 Months ended Dec 31, 2005	9 Months ended Dec 31, 2004
Fair value, beginning of period	\$ 12,565	\$12,222	\$12,396
Investment income, cost basis (1)	268	914	848
Transfers to GRF (2)	(157)	(656)	(848)
Amount retained for inflation proofing	111	258	-
Transfer from GRF(3)	750	750	-
Change in unrealized gains	153	349	(187)
Fair value, end of period (4)	\$ 13,579	\$13,579	\$12,209

- (1) Includes interest, dividends, realized gains and losses, derivative income and administration expenses.  
 (2) Net of inflation proofing. See financial statements (Note 6).  
 (3) Pursuant to *Access to the Future Act* (see page 8).  
 (4) Includes investments of \$13,490 million plus net current assets of \$89 million.

## INVESTMENT INCOME

The Fund recorded net income of \$914 million over nine months of which interest, dividends, real estate income and security lending income totalled \$349 million net of administrative expenses, compared to \$332 million for the same period last year. Net realized capital gains from sale of securities and gains from derivative transactions totalled \$565 million, compared to \$516 million for the same period last year.

### Net Investment Income (Loss)

(millions)

	Fixed Income	Equity Income	Real Estate	Other Income*	Total
05-06 9 mos.	\$ 234	\$ 574	\$ 67	\$ 39	\$ 914
04-05 year	264	717	68	43	1,092
03-04 year	304	729	54	46	1,133
02-03 year	286	(1,224)	39	5	(894)
01-02 year	444	(276)	38	-	206

\* Includes income from private equities, private income, timberland, and absolute return strategies.

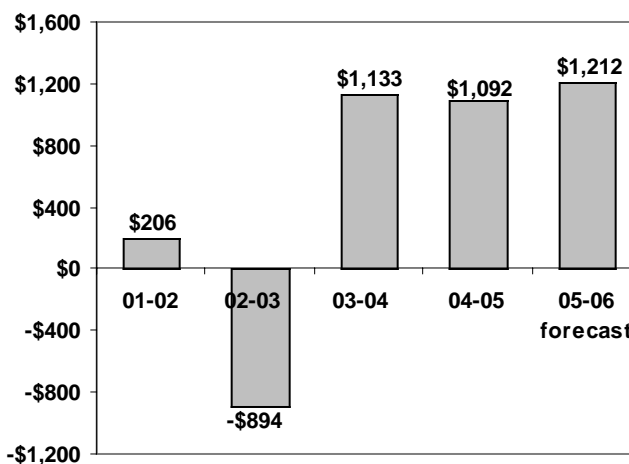
## Forecast Investment Income

The Fund's forecast investment income for fiscal year 2005-06 is \$1,212 million, an increase of \$528 million from the original budget estimate of \$684 million. The increase in forecast income is due to stronger than expected performance from Canadian and non-North American equity markets and fixed income investments. Additional transfers received from the GRF under the *Access to the Future Act* also contributed to the increase.

The Government of Alberta financial statements are prepared on a consolidated basis, which eliminates the income the Fund earns from Alberta provincial corporation securities forecast to be \$15 million for fiscal year 2005-06. On a consolidated basis the Fund forecast investment income is \$1,197 million.

### Heritage Fund Investment Income

(millions)



## Transfers to the General Revenue Fund and Inflation Proofing the Fund

The Fund business plan provides for inflation proofing of the Fund in fiscal year 2005-06. As at December 31, 2005, an estimated \$258.6 million has been accrued as the amount retained from income earned by the Fund during the first nine months of the year. Commencing in 2005-06, net investment income earned by the Fund, less the amount retained in the Fund for inflation proofing is transferred to the Province's main operating fund, the GRF.

At December 31, 2005, a receivable from GRF totalling \$81.7 million is comprised of the following:

Due to (from) GRF at March 31, 2005	\$ 62.4
Add: Net income earned for the nine months ended December 31, 2005	914.5
Less: Amount retained in the Fund for inflation proofing	(258.6)
Less: Payments to GRF during the period	<u>(800.0)</u>
Due to (from) GRF at December 31, 2005	<u><u>\$ (81.7)</u></u>

## INVESTMENTS

### Asset Mix

The investment strategy is to invest in a diversified portfolio to optimize long-term returns at an acceptable level of risk. The long-term policy asset allocation is reported in the Fund's Statement of Investment Policies and Guidelines.

### Asset Mix Policy

(percent of fair value)

ASSET CLASS	Long Term Policy Asset Mix		Actual Asset Mix	
	05-06	04-05	Dec05	Mar05
<b>Fixed income</b>				
Money market	1.0	2.0	0.7	0.8
Fixed income securities	29.0	30.5	30.7	31.9
	<b>30.0</b>	<b>32.5</b>	<b>31.4</b>	<b>32.7</b>
<b>Public equities</b>				
Canadian	15.0	15.0	19.1	18.5
United States	15.0	15.0	15.5	16.2
Non-North American	15.0	15.0	16.4	16.1
	<b>45.0</b>	<b>45.0</b>	<b>51.0</b>	<b>50.8</b>
<b>Real estate</b>	<b>10.0</b>	<b>10.0</b>	<b>10.7</b>	<b>9.7</b>
<b>Absolute return strategies</b>	<b>6.0</b>	<b>7.5</b>	<b>4.3</b>	<b>5.0</b>
<b>Private equities</b>	<b>4.0</b>	<b>5.0</b>	<b>1.6</b>	<b>1.3</b>
<b>Private income</b>	<b>3.0</b>	<b>-</b>	<b>0.6</b>	<b>0.5</b>
<b>Timberland</b>	<b>2.0</b>	<b>-</b>	<b>0.4</b>	<b>-</b>
	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Based on the Heritage Fund Statement of Investment Policies and Guidelines, the long-term policy asset mix for fixed income securities decreases from 32.5% to 30.0%. The long-term policy mix for public equity investments remains the same at 45.0%. The target for real estate investments remains unchanged at 10.0% of total portfolio investments. Absolute return strategy investments decrease from 7.5% to 6.0% of total portfolio investments. Private equity and income investments increase from 5.0% to 7.0% of total investments. Timberland investments were added during the year and represent 2.0% of the total asset mix.

The Fund's long-term objective is to increase alternative investments to 15% of the total asset mix. Alternative investments include absolute return strategies, private equities, private income and timberland. These investments are a relatively illiquid asset class and will require time to build up to their target asset mix.

The actual investment mix for fixed income securities decreased slightly from 32.7% at March 31, 2005 to 31.4% at December 31, 2005. Public equity investments increased from 50.8% to 51.0%. Real estate investments increase from 9.7% to 10.7%. Absolute return strategies decreased from 5.0% to 4.3% of the Fund's investment portfolio. Private equity investments increased from 1.3% to 1.6%. Private income investments increased from 0.5% to 0.6%. Timberland investments comprise 0.4% of the total investment portfolio.

### New Investment Products

There were no new investment products acquired during the third quarter. In the first quarter, new investments were initiated in timberland, currency alpha and EAFE structured equity products (see Note 3 to the financial statements). Timberland investments, responsibly managed, are a renewable and sustainable resource. Demand for timberland products has increased over the past decades, and is expected to continue to grow in the future. Timberland investments, given responsible management and solid demand for products, are expected to be a source of yield and portfolio diversification. Timberland investments have historically provided attractive real rates of return. The currency alpha investment earns returns through active currency management while the EAFE structured equity investment provides exposure to non-North American equity markets primarily through foreign equity index swaps.

### Investment Valuation

Investments and investment income are recorded on the financial statements of the Fund at cost in accordance with government accounting policies. The fair value of the Fund and its investments are provided for information purposes. Management uses fair value to assess the investment performance of the fund against market-based benchmarks.

The Fund's policy is to write-down the cost of those securities where the decline in value below cost is not considered temporary. On a quarterly basis, management reviews the Fund's investment portfolio to identify those securities where the fair value has declined significantly below cost. Based on management's review, write-downs for the three and nine months ended December 31, 2005 totalled \$3.9 million and \$27.2 million.

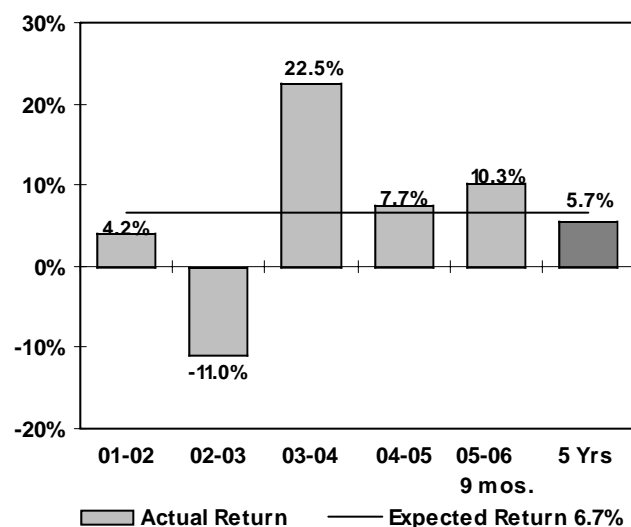
## PERFORMANCE MEASUREMENT

### Heritage Fund Rate of Return

The Fund posted an overall return of 3.2% this quarter, 10 basis points better than the Fund's policy benchmark return of 3.1%.

The performance of the Fund is measured over the long-term. Over the past five-year period, the Fund generated a nominal annualized return of 5.7%. The Fund is expected to generate a real rate of return of 4.5% at an acceptable level of risk over a moving five-year period. Over a five-year period, the annualized inflation rate was 2.2%. Therefore, the Fund is expected to generate a nominal annualized rate of return of 6.7%.

### Heritage Fund Annual Returns at Fair Value



The performance of the Fund investments is also measured against various market-based indices. Value-added by investment management is accomplished through asset mix decisions and security selection. The following sections describe the performance of the Fund's major asset classes in relation to their benchmarks.

### Business Plan Performance Measures

Time Weighted Rates of Return  
(percent)

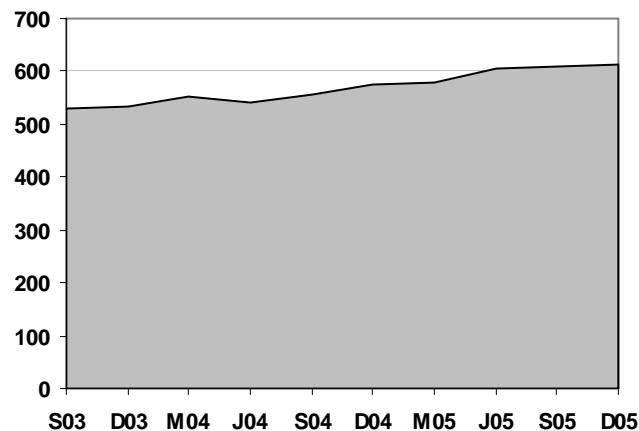
	Current Quarter	Nine Months	One Year	Five Years (2)
<b>OVERALL RETURN (1)</b>	3.2	10.3	12.6	5.7
<b>ENDOWMENT PORTFOLIO</b>				
<b>Short term fixed income</b>	0.7	2.0	2.7	3.1
<i>SC 91-Day T-Bill</i>	0.7	2.0	2.6	3.0
<b>Long term fixed income</b>	0.8	6.1	7.3	8.1
<i>SC Universe Bond Index</i>	0.7	5.3	6.5	7.4
<b>Canadian equities</b>	3.0	19.6	24.9	7.3
<i>S&amp;P/TSX Index</i>	2.9	18.9	24.1	6.6
<b>United States equities</b>	2.3	3.1	1.7	(4.1)
<i>S&amp;P 1500 Index (3)</i>	2.5	3.9	2.4	(4.2)
<b>Non North American equities</b>	4.9	12.3	13.2	0.4
<i>MSCI EAFE Index</i>	4.5	9.6	10.0	(0.6)
<b>Real estate</b>	11.3	18.8	28.9	12.5
<i>IPD Large All Property Index (4)</i>	11.8	17.5	19.1	10.4
<b>Absolute return strategies</b>	0.4	2.5	4.6	n/a
<i>HFRX Global Hedged Index (5)</i>	1.2	6.3	8.0	n/a
<b>Private equities</b>	3.8	11.0	12.0	n/a
<i>CPI Plus 8.0%</i>	2.1	7.8	10.0	n/a
<b>Private income</b>	1.9	20.5	22.5	n/a
<i>CPI plus 6.0%</i>	1.6	6.4	8.0	n/a
<b>Timberland</b>	(1.0)	n/a	n/a	n/a
<i>CPI plus 4.0%</i>	1.1	n/a	n/a	n/a
<b>Total Endowment Portfolio</b>	3.2	10.3	12.6	4.9
<i>Policy Benchmark</i>	3.1	9.6	11.0	4.2

- (1) The overall return includes the Endowment Portfolio and the past returns of the Transition Portfolio which was wound up in the first half of 2002-03.
- (2) Returns for 5 years are annualized.
- (3) Prior to April 1, 2004, the benchmark for US equities was the S&P 500 Index.
- (4) The amounts reported for the IPD Large Institutional All Property Index are estimated and may vary significantly from the actual amounts when received. Prior to June 1, 2005, the benchmark for real estate was CPI plus 5%. Prior to April 1, 2002, the benchmark was the Russell Canadian Property Index.
- (5) Prior to July 1, 2005, the benchmark return was CPI plus 6%

## Fixed Income Investments

The Scotia Capital (SC) Universe Bond Index measures the performance of marketable Canadian bonds with terms to maturity of more than one year. Over the past quarter, the SC Universe Bond Index increased by 0.7% while the short-term SC 91-Day T-Bill Index increased by 0.7%.

### SC Universe Bond Index



	Actual Return %	Benchmark SC Universe Bond Index %	Over (Under) bps(1)
<b>LT Fixed Income</b>			
Current Quarter	0.8	0.7	10
Nine Months	6.1	5.3	80
One Year	7.3	6.5	80
Five Years (annualized)	8.1	7.4	70

(1) One basis point equals 0.01%.

	Actual Return %	Benchmark SC 91-Day T-Bill Index %	Over (Under) bps
<b>ST Fixed Income</b>			
Current Quarter	0.7	0.7	-
Nine Months	2.0	2.0	-
One Year	2.7	2.6	10
Five Years (annualized)	3.1	3.0	10

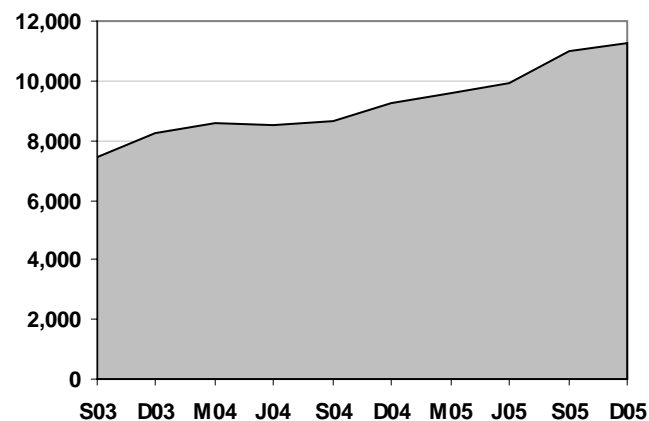
The Fund's actual rate of return over the quarter from long-term Canadian fixed income securities was 0.8%, 10 basis points better than the benchmark SC Universe Bond Index. Over five years, the return from long-term fixed income securities was 8.1% or 70 basis points better than the benchmark of 7.4%. The Fund's return from short-term securities was 0.7% and 3.1% over three months and five years respectively. The Fund's fixed income portfolio is internally managed through various pools and through direct holdings.

At December 31, 2005, investments in deposits, bonds, notes, short-term paper, provincial corporation debentures and loans totalled 31.4% of total portfolio investments or \$4.2 billion compared to 32.7% or \$4.0 billion at March 31, 2005.

## Canadian Equity Investments

The Toronto Stock Exchange S&P/TSX Index, which measures the performance of Canada's top companies, reported a return of 2.9% for the quarter ending December 31, 2005. During the quarter, the materials and financial sectors led all sectors with returns of 9.9% and 7.8% respectively. The consumer staples and telecommunications services finished the quarter with the lowest returns of negative 7.2% and 4.7% respectively.

### S&P/TSX Composite Index



	Actual Return %	Benchmark S&P/TSX Index %	Over (Under) bps
<b>Canadian Public Equities</b>			
Current Quarter	3.0	2.9	10
Nine Months	19.6	18.9	70
One Year	24.9	24.1	80
Five Years (annualized)	7.3	6.6	70

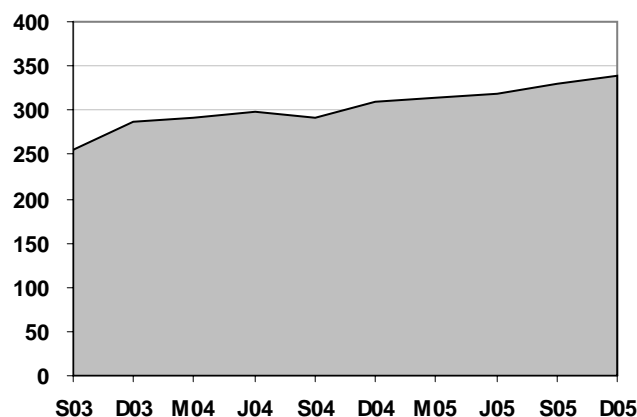
The Fund's Canadian equity portfolio is held in various investment pools, which are managed by internal and external managers. Over the quarter the Fund's actual return from Canadian equities was 3.0%, 10 basis points better than the benchmark return from the S&P/TSX Index. Over five years, the Fund's return from Canadian equities was 7.3%, 70 basis points better than the benchmark return of 6.6%.

At December 31, 2005, investments in Canadian public equities totalled 19.1% or \$2.6 billion of the Fund investment portfolio compared to 18.5% or \$2.3 billion at March 31, 2005.

### United States Equity Investments

The U.S. equity market closed out the quarter posting a positive return. The Standard & Poor's 1500 Index, S&P 1500, which measures the performance of the top 1,500 American companies, increased by 2.1% in U.S. dollars and 2.5% when translated into Canadian dollars due to the weaker Canadian dollar over the quarter.

#### S&P 1500 Index



	Actual Return %	Benchmark S&P 1500 Index (1) %	Over (Under) bps
<b>U.S. Public Equities</b>			
Current Quarter	2.3	2.5	(20)
Nine months	3.1	3.9	(80)
One Year	1.7	2.4	(70)
Five Years (annualized)	(4.1)	(4.2)	10

(1) Prior to April 1, 2004, the benchmark return for U.S. equities was the S&P 500 Index.

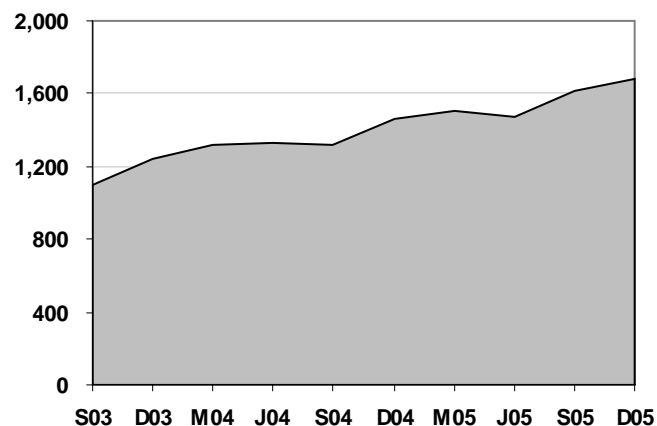
The Fund's actual rate of return over the quarter from U.S. equities was 2.3% in Canadian dollars or 20 basis points less than the S&P 1500 Index. Over five years, the Fund's U.S. equity portfolio returned a negative 4.1%, 10 basis points better than the benchmark.

At December 31, 2005, investments in U.S. equities totalled 15.5% or \$2.1 billion of the Fund investment portfolio compared to 16.2% or \$2.0 billion at March 31, 2005.

### Non-North American Equity Investments

The non-North American equity market recorded a good return this quarter. The Morgan Stanley Capital International Index for Europe, Australasia, and the Far East, MSCI EAFE Index, measures the performance of approximately 1,000 companies on 21 stock exchanges around the world. Over the quarter, the index increased 4.5% in Canadian dollars.

#### MSCI EAFE Index



	Actual Return %	Benchmark MSCI EAFE Index %	Over (Under) bps
<b>Non-North American Public Equities</b>			
Current Quarter	4.9	4.5	40
Nine Months	12.3	9.6	270
One Year	13.2	10.0	320
Five Years (annualized)	0.4	(0.6)	100

The Fund's actual return from non-North American equities was 4.9%, 40 basis points better than the benchmark. Over five years the Fund's non-North American equity portfolio returned a 0.4%, 100 basis points better than the benchmark MSCI EAFE Index.

At December 31, 2005, investments in non-North American equities totalled 16.4% or \$2.2 billion of the Fund investment portfolio compared to 16.1% or \$2.0 billion at March 31, 2005.

### Real Estate Investments

The Fund's real estate investments are held in the internally managed Private Real Estate Pool and the Foreign Private Real Estate Pool. Real estate investments earned 11.3% over the quarter and 12.5% over five years. Over the past year, real estate investments have returned 28.9%.



<b>Real estate</b>	<b>Actual Return</b> %	<b>Benchmark</b>	
		IPD Large Institutional All Property Index (1) %	Over (Under) bps
Current Quarter	11.3	11.8	(50)
Nine Months	18.8	17.5	130
One Year	28.9	19.1	980
Five Years (annualized)	12.5	10.4	210

(1) Amounts shown are estimated and may vary significantly from actual amounts when received. Prior to June 1, 2005, the benchmark for real estate was CPI plus 5%. Prior to April 1, 2002, the benchmark was the Russell Canadian Property Index.

Nearly half of the real estate portfolio is invested in retail, half in office and a small portion in industrial and residential. Approximately 62% of the real estate holdings are located in Ontario, 27% in Alberta, 9% in Quebec and 2% in British Columbia.

At December 31, 2005, investments in real estate totalled 10.7% or \$1.4 billion of the Fund investment portfolio compared to 9.7% or \$1.2 billion at March 31, 2005.

### Absolute Return Strategies

Absolute return strategy investments encompass a wide variety of investments with the objective of realizing positive returns regardless of the overall market direction. A common feature of many of these strategies is buying undervalued securities and selling short overvalued securities. Over the quarter, absolute return strategies generated a return of 0.4%, 80 basis points less than the benchmark Hedge Fund Research Inc. (HFRX) Global Hedged Index.

<b>Absolute Return Strategies</b>	<b>Actual Return</b> %	<b>Benchmark</b>	
		HFRX Global Hedged Index %	Over (Under) bps
Current Quarter	0.4	1.2	(80)
Nine Months	2.5	6.3	(380)
One Year	4.6	8.0	(340)
Five Years (annualized)	n/a	n/a	-

At December 31, 2005, investments in absolute return strategies totalled 4.3% or \$581 million of total Fund investments compared to 5.0% or \$611 million at March 31, 2005.

### Private Equity Investments

At December 31, 2005, the private equity comprised a small portion of the Fund's overall investment portfolio at 1.6% or \$218 million compared to 1.3% or \$153 million at March 31, 2005. During the quarter, private equity investments returned 3.8%, 170 basis points more than the benchmark Consumer Price Index (CPI) plus 8%.

<b>Private Equity</b>	<b>Actual Return</b> %	<b>Benchmark</b>	
		CPI plus 8% %	Over (Under) bps
Current Quarter	3.8	2.1	170
Nine Months	11.0	7.8	320
One Year	12.0	10.0	200
Five Years (annualized)	n/a	n/a	-

### Private Income Investments

Private income investments comprised 0.6% or \$82 million of overall investments compared to 0.5% or \$61 million at March 31, 2005. Private income investments returned 1.9%, 30 basis points better than the benchmark CPI plus 6%.

<b>Private Income</b>	<b>Actual Return</b> %	<b>Benchmark</b>	
		CPI plus 6% %	Over (Under) bps
Current Quarter	1.9	1.6	30
Nine Months	20.5	6.4	1410
One Year	22.5	8.0	1450
Five Years (annualized)	n/a	n/a	-

### Timberland Investments

The timberland product is a new investment this year. At December 31, 2005, timberland investments comprised 0.4% or \$58 million of the Fund's overall investment portfolio. During the quarter, timberland investments returned a negative 1.0%, 210 basis points less than the benchmark CPI plus 4%.

<b>Timberland</b>	<b>Actual Return</b> %	<b>Benchmark</b>	
		CPI plus 4% %	Over (Under) bps
Current Quarter	(1.0)	1.1	(210)
Nine Months	n/a	n/a	-
One Year	n/a	n/a	-
Five Years (annualized)	n/a	n/a	-

## ADMINISTRATIVE EXPENSES

External management fees and internal management expenses are deducted directly from the income of 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.

The Fund's total administrative expenses for the nine months ended December 31, 2005, including amounts deducted from the investment income of the pooled funds, amounted to \$32,390,000 or 0.24% of the Funds net assets at fair value compared to \$27,836,000 or 0.23% of net assets for the same period last year.

### Administrative Expenses Breakdown

Nine months ended December 31, 2005 (thousands)

	Nine Months Ended	
	Dec 31, 2005	Dec 31, 2004
Direct fund expenses	\$ 1,736	\$ 1,980
Externally managed investment pools	27,170	22,980
Internally managed investment pools	3,484	2,876
Total	<u>\$ 32,390</u>	<u>\$ 27,836</u>
Expenses as a percent of net assets at fair value	<u>0.24%</u>	<u>0.23%</u>

Over the past nine months, expenses of direct and internally managed investment pools increased by \$364,000 over the same period last year. Expenses from externally managed investment pools increased by \$4,190,000 over the same period last year. The increase is primarily due to external manager fees associated with new investments in absolute return strategies, private equities and private income pools.

## TRANSFERS FOR ACCESS TO THE FUTURE

The *Access to the Future Act* was proclaimed on October 6, 2005 and provides for the transfer of up to \$3.0 billion from the GRF to the Fund on account of the Access to the Future Fund. An account within the Fund is deemed to be established to which is allocated, as considered appropriate by the Minister of Finance, money transferred to the Fund after April 1, 2005. Transfers are recorded in the Fund when received. On December 1, 2005, \$750 million was transferred from the GRF to the Fund.

# ALBERTA HERITAGE SAVINGS TRUST FUND

## FINANCIAL STATEMENTS

DECEMBER 31, 2005

(unaudited)

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**BALANCE SHEET**December 31, 2005 (unaudited)  
(thousands)

	<u>December 31, 2005</u>	<u>March 31, 2005</u>
<b>Assets</b>		
Portfolio investments (Note 3)	\$ 12,281,826	\$ 11,417,548
Accrued investment income	7,531	7,008
Administration expense receivable	-	281
Due from the General Revenue Fund	81,690	-
	<u>\$ 12,371,047</u>	<u>\$ 11,424,837</u>
<b>Liabilities and Fund Equity</b>		
Liabilities		
Accounts payable	\$ -	\$ 7
Due to the General Revenue Fund	-	62,388
	-	62,395
Fund equity (Note 6)	12,371,047	11,362,442
	<u>\$ 12,371,047</u>	<u>\$ 11,424,837</u>

**STATEMENT OF OPERATIONS**For the Nine Months ended December 31, 2005 (unaudited)  
(thousands)

	Three Months Ended Dec. 31,		Nine Months Ended Dec. 31,	
	2005	2004	2005	2004
<b>Net income (Note 7)</b>	\$ 268,435	\$ 349,699	\$ 914,527	\$ 847,792
<b>Transfers to the General Revenue Fund (Note 6)</b>	(157,435)	(349,699)	(655,922)	(847,792)
<b>Amount retained for inflation-proofing (Note 6)</b>	111,000	-	258,605	-
<b>Transfers from the General Revenue Fund (Note 6)</b>	750,000	-	750,000	-
<b>Net change in fund equity</b>	861,000	-	1,008,605	-
<b>Fund equity at beginning of period</b>	11,510,047	11,362,442	11,362,442	11,362,442
<b>Fund equity at end of period</b>	<u>\$12,371,047</u>	<u>\$11,362,442</u>	<u>\$12,371,047</u>	<u>\$11,362,442</u>

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

## STATEMENT OF CASH FLOWS

for the Nine Months ended December 31, 2005 (unaudited)  
(thousands)

	Three Months Ended Dec. 31,		Nine Months Ended Dec. 31,	
	2005	2004	2005	2004
<b>Operating transactions</b>				
Net income	\$ 268,435	\$ 349,699	\$ 914,527	\$ 847,792
Non-cash items included in net income	(4,537)	(86,089)	(94,490)	(187,519)
	263,898	263,610	820,037	660,273
Decrease (increase) in accounts receivable	13,950	15,683	(242)	(285)
Decrease in accounts payable	(9,006)	-	(7)	(42)
Cash provided by operating transactions	268,842	279,293	819,788	659,946
<b>Investing transactions</b>				
Proceeds from disposals, repayments and redemptions of investments	128,775	835,261	731,813	2,022,827
Purchase of investments	(388,904)	(855,555)	(1,522,619)	(1,833,282)
Cash provided by (applied to) investing transactions	(260,129)	(20,294)	(790,806)	189,545
<b>Transfers</b>				
Transfers from the General Revenue Fund	750,000	-	750,000	-
Transfers to the General Revenue Fund	(157,435)	(349,699)	(655,922)	(847,792)
Increase (decrease) in amounts due to the General Revenue Fund	(642,565)	85,699	(144,078)	5,792
Cash applied to transfers	(50,000)	(264,000)	(50,000)	(842,000)
<b>Increase (decrease) in cash</b>	(41,287)	(5,001)	(21,018)	7,491
<b>Cash at beginning of period</b>	91,628	126,154	71,359	113,662
<b>Cash at end of period</b>	\$ 50,341	\$ 121,153	\$ 50,341	\$ 121,153
<b>Consisting of Deposits in the Consolidated Cash Investment Trust Fund (Note 3)</b>	\$ 50,341	\$ 121,153	\$ 50,341	\$ 121,153

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

# Notes to the Financial Statements

December 31, 2005 (unaudited)

## NOTE 1 AUTHORITY AND MISSION

The Alberta Heritage Savings Trust Fund operates under the authority of the *Alberta Heritage Savings Trust Fund Act (the Act)*, Chapter A-23, Revised Statutes of Alberta 2000, as amended.

The preamble to the Act describes the mission of the Fund as follows:

*"To provide prudent stewardship of the savings from Alberta's non-renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans."*

## 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 in loans are recorded at cost less any allowance for credit loss. Where there is no longer reasonable assurance of timely collection of the full amount of principal and interest of a loan, a specific provision for credit loss is made and the carrying amount of the loan is reduced to its estimated realizable amount.

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 in fixed-income securities, mortgages, equities, real estate, absolute return strategies and timberland investments 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. When a loan becomes impaired, recognition of interest income in accordance with the terms of the original loan agreement ceases. Any subsequent payments received on an impaired loan are applied to reduce the loan's book value.

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

Income and expense 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 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 expense 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.

(unaudited)

**Note 2 (continued)**

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, equity index futures, 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.

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, loans, 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 directly by the Fund or by pooled investment funds are determined as follows:

- (i) Public fixed-income securities and equities are valued at the period-end closing sale price, or the average of the latest bid and ask prices quoted by an independent securities valuation company.
- (ii) Mortgages, provincial corporation debentures and private fixed-income securities are valued based on the net present value of future cash flows. These cash flows are discounted using appropriate interest rate premiums over similar Government of Canada benchmark bonds trading in the market.
- (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 analysis.
- (iv) The fair value of real estate investments is reported at the 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 the discounted cash flows.

*(unaudited)*

**Note 2 (continued)**

- (v) The fair value of Absolute Return Strategy Pool investments are estimated by external managers.
- (vi) The fair value of loans is estimated by management based on the present value of discounted cash flows.
- (vii) The fair value of timberland investments are appraised annually by independent third party evaluators.
- (viii) The fair value of deposits, receivables, accrued interest and payables are estimated to approximate their book values.
- (ix) The fair value of investments and any other assets and liabilities denominated in a foreign currency are translated at the period-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.



(unaudited)

**NOTE 3 PORTFOLIO INVESTMENTS**

	December 31, 2005			March 31, 2005		
	Cost	Fair Value	%	Cost	Fair Value	%
(thousands)						
<b>Fixed-Income Securities</b>						
Deposit in the Consolidated Cash Investment Trust Fund (a)	\$ 50,341	\$ 50,341	0.4	\$ 71,359	\$ 71,359	0.6
Canadian Dollar Public Bond Pool (b)	3,199,089	3,267,057	24.2	3,094,268	3,154,021	25.5
Bonds, notes & short-term paper, directly held (c)	22,504	22,674	0.2	23,067	23,742	0.2
Private Mortgage Pool (d)	585,500	603,593	4.5	518,924	532,357	4.3
Provincial corporation debentures, directly held (e)	83,213	119,158	0.9	88,340	132,261	1.1
Loans, directly held (f)	93,422	93,422	0.7	93,298	93,298	0.8
Currency Alpha Pool (g)	20,698	21,121	0.1	-	-	-
Overlay Pool (h)	50,694	49,885	0.4	24,529	24,555	0.2
	<b>4,105,461</b>	<b>4,227,251</b>	<b>31.4</b>	<b>3,913,785</b>	<b>4,031,593</b>	<b>32.7</b>
<b>Public Equities</b>						
<b>Canadian</b>						
Domestic Passive Equity Pooled Fund (i)	986,741	1,099,963	8.2	868,241	989,240	8.1
Canadian Pooled Equity Fund (j)	506,609	679,301	5.0	491,455	605,425	4.9
Canadian Equity Enhanced Index Pool (k)	285,833	347,808	2.6	292,113	319,695	2.6
Canadian Large Cap Equity Pool (l)	229,023	233,265	1.7	163,796	184,242	1.5
Growing Equity Income Pool (m)	116,979	159,118	1.2	128,558	152,821	1.3
Canadian Multi-Cap Pool (n)	190,569	190,173	1.4	138,847	138,958	1.1
	2,315,754	2,709,628	20.1	2,083,010	2,390,381	19.5
Overlay Pool Canadian futures contracts (h)	(149,317)	(149,317)	(1.0)	(125,308)	(125,308)	(1.0)
	<b>2,166,437</b>	<b>2,560,311</b>	<b>19.1</b>	<b>1,957,702</b>	<b>2,265,073</b>	<b>18.5</b>
<b>United States</b>						
S&P 500 Index Fund (o)	1,161,406	1,288,865	9.5	1,179,505	1,284,273	10.4
US Small/Mid Cap Equity Pool (p)	249,903	266,355	2.0	237,574	240,550	2.0
US Large Cap Equity Pool	-	-	-	77	77	-
Portable Alpha United States Equity Pool (q)	375,225	361,672	2.7	326,700	316,340	2.6
Growing Equity Income Pool (m)	39,633	40,970	0.3	24,513	24,350	0.2
	1,826,167	1,957,862	14.5	1,768,369	1,865,590	15.2
Overlay Pool US futures contracts (h)	136,643	136,643	1.0	125,969	125,969	1.0
	<b>1,962,810</b>	<b>2,094,505</b>	<b>15.5</b>	<b>1,894,338</b>	<b>1,991,559</b>	<b>16.2</b>
<b>Non-North American</b>						
EAFE Active Equity Pool (r)	1,487,842	1,640,438	12.1	1,402,418	1,467,601	12.0
EAFE Passive Equity Pool (s)	167,160	217,509	1.6	267,922	364,905	3.0
Emerging Markets Equity Pool (t)	140,087	181,170	1.3	128,567	141,465	1.1
EAFE Structured Equity Pool (s)	192,914	187,395	1.4	-	-	-
	<b>1,988,003</b>	<b>2,226,512</b>	<b>16.4</b>	<b>1,798,907</b>	<b>1,973,971</b>	<b>16.1</b>
<b>Real Estate</b>						
Private Real Estate Pool (u)	1,039,766	1,381,559	10.2	966,041	1,148,626	9.4
Foreign Private Real Estate Pool (v)	64,273	61,581	0.5	43,161	40,948	0.3
	<b>1,104,039</b>	<b>1,443,140</b>	<b>10.7</b>	<b>1,009,202</b>	<b>1,189,574</b>	<b>9.7</b>
<b>Absolute Return Strategies (w)</b>	<b>591,022</b>	<b>581,123</b>	<b>4.3</b>	<b>615,053</b>	<b>610,593</b>	<b>5.0</b>
<b>Private Equities (x)</b>	<b>219,152</b>	<b>217,619</b>	<b>1.6</b>	<b>166,624</b>	<b>153,374</b>	<b>1.3</b>
<b>Private Income (x)</b>	<b>83,100</b>	<b>81,840</b>	<b>0.6</b>	<b>61,937</b>	<b>61,012</b>	<b>0.5</b>
<b>Timberland (y)</b>	<b>61,802</b>	<b>57,781</b>	<b>0.4</b>	-	-	-
<b>Total Investments (z)</b>	<b>\$ 12,281,826</b>	<b>\$ 13,490,082</b>	<b>100.0</b>	<b>\$ 11,417,548</b>	<b>\$ 12,276,749</b>	<b>100.0</b>

*(unaudited)***Note 3 (continued)**

The majority of 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 December 31, 2005, the Fund's percentage ownership, at market, in pooled investment funds is as follows:

	% Ownership	
	<u>December 31, 2005</u>	<u>March 31, 2005</u>
Absolute Return Strategy Pool	88.5	88.5
Canadian Dollar Public Bond Pool	36.6	35.6
Canadian Equity Enhanced Index Pool	27.8	60.2
Canadian Large Cap Equity Pool	13.1	8.0
Canadian Multi-Cap Pool	56.6	60.2
Canadian Pooled Equity Fund	54.3	56.3
Currency Alpha Pool	28.9	-
Domestic Passive Equity Pooled Fund	40.4	41.7
EAFE Active Equity Pool	30.7	31.5
EAFE Passive Equity Pool	76.5	79.9
EAFE Structured Equity Pool	19.1	-
Emerging Markets Equity Pool	33.6	33.6
Foreign Private Equity Pool (02)	43.8	43.8
Foreign Private Real Estate Pool	87.1	87.1
Growing Equity Income Pool	55.8	59.1
Overlay Pool	35.5	35.5
Portable Alpha United States Equity Pool	87.9	87.9
Private Equity Pool	13.6	13.6
Private Equity Pool (02)	62.1	62.1
Private Equity Pool (04)	77.0	77.0
Private Equity Pool (98)	100.0	100.0
Private Income Pool	25.7	25.7
Private Mortgage Pool	44.9	44.2
Private Real Estate Pool	37.2	40.4
Standard & Poor's 500 Index Fund	68.0	69.3
Timberland Pool	87.6	-
US Small/Mid Cap Equity Pool	24.6	25.5

- (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 December 31, 2005, securities held by the Fund have an average effective market yield of 3.62% per annum (March 31, 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 December 31, 2005, securities held by the Pool have an average effective market yield of 4.47% per annum (March 31, 2005: 4.48% per annum) and the following term structure based on principal amount: under 1 year: 3% (March 31, 2005: 3%); 1 to 5 years: 34% (March 31, 2005: 38%); 5 to 10 years: 31% (March 31, 2005: 31%); 10 to 20 years: 12% (March 31, 2005: 12%); and over 20 years: 20% (March 31, 2005: 16%).
- (c) As at December 31, 2005, fixed-income securities held directly by the Fund have an average effective market yield of 3.76% per annum (March 31, 2005: 3.18% per annum). As at December 31, 2005, fixed-

(unaudited)

**Note 3 (continued)**

income securities have the following term structure based on principal amount: under two years: 100% (March 31, 2005: 100%).

- (d) 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 December 31, 2005, securities held by the Pool have an average effective market yield of 5.05% per annum (March 31, 2005: 5.29% per annum) and the following term structure based on principal amount: under 1 year: 2% (March 31, 2005: 2%); 1 to 5 years: 16% (March 31, 2005: 22%); 5 to 10 years: 53% (March 31, 2005: 43%); 10 to 20 years: 10% (March 31, 2005: 12%); and over 20 years: 19% (March 31, 2005: 21%).
- (e) As at December 31, 2005, Alberta Social Housing Corporation debentures have an average effective market yield of 7.83% per annum (March 31, 2005: 7.51% per annum) and the following term structure based on principal amounts: 5 to 10 years: 100% (March 31, 2005: 100%).
- (f) Investments in loans are recorded at cost. The fair value of loans is estimated by management based on the present value of discounted cash flows. As at December 31, 2005, investment in loans, at cost, include the Ridley Grain loan amounting to \$91,245 (March 31, 2005: \$91,245) and the Vencap loan amounting to \$2,177 (March 31, 2005: \$2,053). The increase in the carrying value of the Vencap loan resulted from amortization of the loan on a constant yield basis.
- Under the terms of the loan to Ridley Grain, 11% Participating First Mortgage Bonds due July 31, 2015, interest is compounded semi-annually and payable annually to the extent of available cash flow and any shortfall is to be deferred and capitalized. The principal of \$91,245 and deferred interest is repayable on or before July 31, 2015. Deferred interest at December 31, 2005 amounted to \$98,916 (March 31, 2005: \$92,517). Grain throughput volumes are the main determinant of profitability of the grain terminal and the value of the loan to the Fund. Due to the uncertainty of forecasting the grain throughput volumes, income from the participating bonds is recognized when it is measurable and collectable.
  - The principal amount of the Vencap loan, amounting to \$52,588, is due July 2046 and bears no interest.
- (g) 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 style 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.
- (h) The Overlay Pool provides participants with a quick, effective and efficient means to achieve tactical asset allocation opportunities without incurring undue transaction costs in the underlying investments. Long or short exposures to respective asset classes are obtained through synthetic instruments on a largely unfunded basis using equity index futures contracts. Approximately 5% to 10% of the Pool's notional exposure in Canadian and U.S. futures contracts is supported by cash and short-term securities. The Overlay Pool is comprised of the "long" position through U.S. futures contracts, the "short" position through Canadian futures contracts, and the "cash securities" position through money market securities. Taken together these three positions reduce exposure to Canadian equities and increase exposure to U.S. equities.

*(unaudited)*

**Note 3 (continued)**

- (i) 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.
- (j) 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.
- (k) 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.
- (l) The Canadian Large Cap Equity Pool consists of multiple portfolios of publicly traded Canadian equities. The portfolios are actively managed by external managers 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.
- (m) The Growing Equity Income Pool is managed with the objective of providing a steady and growing stream of dividend income by investing in mature Canadian and U.S. 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 a custom S&P/TSX Composite Index for dividend paying stocks.
- (n) 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 (i)).
- (o) 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 (i)).
- (p) 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.
- (q) 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

*(unaudited)***Note 3 (continued)**

absolute return strategies. The performance objective is to provide returns higher than the total return of the Standard & Poor's S&P 500 Index over a four-year period.

- (r) The Europe, Australasia and Far East (EAFE) Active 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.
- (s) 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 replicates 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 (i)).
- (t) 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 Morgan Stanley Capital Index Emerging Markets Free (MSCI EMF) Index over a four-year period.
- (u) 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.
- (v) 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.
- (w) 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.
- (x) 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 Private Equity Pool, PEP98, PEP02, PEP04 and the Foreign Private Equity Pool 2002. 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 invests 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%.
- (y) 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%.
- (z) 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 is temporary in nature.

*(unaudited)***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.

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 December 31, 2005:

	Maturity			December 31, 2005		March 31, 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	84%	16%		\$ 2,039,735	\$ 54,636	\$1,534,324	\$ 7,673
Interest rate swap contracts	45%	37%	18%	628,036	15,062	491,031	(12,449)
Forward foreign exchange contracts	100%			1,417,988	11,600	935,430	13,334
Cross-currency interest rate swaps	13%	33%	54%	573,155	48,236	580,540	2,228
Credit default swap contracts	18%	20%	62%	197,195	2,063	128,430	1,384
Bond index swap contracts	100%			154,189	3,065	61,311	428
Equity index futures contracts	100%			697,159	10,195	302,125	5,957
				<u>\$ 5,707,457</u>	<u>\$ 144,857</u>	<u>\$4,033,191</u>	<u>\$ 18,555</u>

- (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).

(unaudited)

## 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.

The Standing Committee on the Alberta Heritage Savings Trust Fund reviews and approves the business plan of the Fund. In order to earn an optimal financial return at an acceptable level of risk, the 2005-2008 Business Plan proposed the following asset mix policy for the Fund:

	<u>2005-06</u>	<u>2006-07</u>	<u>2007-08</u>
Public equities	45.0%	45.0%	45.0%
Fixed income securities	35.0%	32.5%	32.5%
Real estate	10.0%	10.0%	10.0%
Absolute return strategies	5.0%	7.5%	7.5%
Private equities	5.0%	5.0%	5.0%

Subsequent to the release of the 2005-08 Business Plan, the long-term asset mix policy for 2007-08 was amended. Fixed income securities were reduced from 32.5% to 30.0%, absolute return strategies were reduced from 7.5% to 6.0%, private equities are reduced from 5.0% to 4.0%, private income and timberland investments are added at 3.0% and 2.0% respectively.

Risk is reduced through asset class diversification, diversification within each asset class, quality and duration 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).

## NOTE 6 FUND EQUITY

Section 8(2) of the *Alberta Heritage Savings Trust Fund Act* (the Act) states that the net income of the Heritage Fund, less any amount retained in the Fund to maintain its value, shall be transferred to the General Revenue Fund annually in a manner determined by the Minister of Finance.

The estimated amount retained from income of the Fund for the nine months ended December 31, 2005 is determined by multiplying the total equity of the Fund before the amount retained for inflation proofing by the estimated percentage increase in the Canadian gross domestic product price index (GDP Index) for the period.

If the net income of the Heritage Fund is less than the amount required to be retained, the net income, if any, shall be retained. If the percentage increase of the GDP Index is a negative number, the negative number shall be treated as if it were zero.

During the quarter, the Fund received \$750 million from the General Revenue Fund, pursuant to Section 4(5) of the *Access to the Future Act*.

*(unaudited)***NOTE 7 NET INCOME**

	Three Months Ended Dec. 31,		Nine Months Ended Dec. 31,	
	2005	2004	2005	2004
	(thousands)			
Deposit and fixed-income securities	\$ 61,212	\$ 69,955	\$ 234,182	\$ 210,077
Canadian equities	95,547	175,295	369,405	352,483
United States equities	10,451	34,212	27,161	40,108
Non-North American equities	42,935	22,395	179,450	172,975
Real estate	29,060	19,033	67,285	47,314
Absolute return strategies	23,142	21,853	20,208	17,741
Private equities	6,322	7,034	6,201	7,034
Private income	1,486	454	12,824	2,040
Timberland	(1,195)	-	(453)	-
<b>Investment income</b>	<b>268,960</b>	<b>350,231</b>	<b>916,263</b>	<b>849,772</b>
Direct administrative expenses (Note 8)	(525)	(532)	(1,736)	(1,980)
<b>Net income</b>	<b>\$ 268,435</b>	<b>\$ 349,699</b>	<b>\$ 914,527</b>	<b>\$ 847,792</b>

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

The investment income for the nine months ended December 31, 2005 includes writedowns totalling \$27,230 (December 31, 2004: \$23,966).

**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.

	Three Months Ended Dec. 31,		Nine Months Ended Dec. 31,	
	2005	2004	2005	2004
	(restated)			
	(thousands)			
Direct fund expense (Note 7)	\$ 525	\$ 532	\$ 1,736	\$ 1,980
External management fees	9,152	7,564	27,170	22,980
Internal management expenses	1,053	826	3,484	2,876
<b>Total</b>	<b>\$ 10,730</b>	<b>\$ 8,922</b>	<b>\$ 32,390</b>	<b>\$ 27,836</b>
Percent of net assets at fair value	0.08%	0.07%	0.24%	0.23%



*(unaudited)***NOTE 9 INVESTMENT PERFORMANCE**

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

	<u>Three Month Return</u>	<u>Nine Month Return</u>	<u>Five Year Compound Annualized Return</u>
<b>Time-weighted rates of return</b>			
Overall actual return	3.2%	10.3%	5.7%
Benchmark return (1)(2)	3.1%	9.6%	6.7%

(1) The overall benchmark return for the three and nine months ended December 31, 2005 is a product of the weighted average policy sector weights and the sector benchmark returns.

(2) Over a moving five-year period, the Fund is expected to generate a real rate of return of 4.5% based on the Fund's business plan. Over a five-year period, the annualized inflation rate was 2.2%. Therefore, the fund is expected to generate a nominal annualized rate of return of 6.7%.

**NOTE 10 APPROVAL OF FINANCIAL STATEMENTS**

The Deputy Minister of Finance approved these financial statements.



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