

June 2007

Trust Fund for the People of the Federated States of Micronesia

Annual Report

Fiscal Year 2006

The Trust Fund made significant progress during the Fiscal Year ended September 30, 2006, and during the succeeding quarter.

Performance of Trust Fund Assets in Fiscal Year 2006: (see Annex 1)

The market value of the Trust Fund's net assets stood at \$86.5 million as of September 30, 2006, compared to \$64.2 million on September 30, 2005. The increase was accounted for by the United States contribution of \$16.4 million on October 6, 2005 and investment earnings of \$5.9 million. These earnings represented a total return on assets for the Fiscal Year of 6.8 percent.

Performance and Transactions during the September to December Quarter of 2006:

The Trust Fund's total assets stood at \$111.4 million as of December 31, 2006, including the United States contribution of \$17.7 million on October 6, 2006. In the October-December 2006 quarter alone (the first quarter of Fiscal Year 2007), the return was 6.3 percent, as assets were deployed according the Trust Fund's investment strategy. This strong quarter boosted the return for Calendar Year 2006 to 12.3 percent. The Trust Fund made the following transactions from October through December 2006 (excluding payments for services):

Oct. 2: Receipt of United States subscription: \$17,688,605
Oct. 6: Purchase State Street Russell 3000 Index Fund: \$17,688,605
Oct. 16: Purchase Portfolio Advisors Private Equity Fund: \$2,049,698
Oct. 18: Liquidate State Street MSCI (International) Index Fund: \$36,551,965
Oct. 23: Purchase GMO International Equity Fund: \$24,000,000
Nov. 2: Purchase Newton International Equity Fund: \$6,000,000
Nov. 10: Purchase HarbourVest Buyout Fund: \$317,136
Nov. 10: Purchase HarbourVest Venture Fund: \$45,366
Nov. 20: Purchase Portfolio Advisors Private Equity Fund: \$731,020
Nov. 22: Purchase HarbourVest Buyout Fund: \$90,000
Dec. 1: Purchase HarbourVest Buyout Fund: \$45,000
Dec. 8: Purchase HarbourVest Mezzanine Fund: \$30,000
Dec. 13: Purchase Portfolio Advisors Private Equity Fund: \$517,806
Dec. 22: Purchase HarbourVest International Fund: 288,000 euros

Fees:

During Fiscal Year 2006, the Trust Fund paid \$94,000 in management fees to the Investment Adviser, Mercer Investment Consulting, and paid no other fees in Fiscal Year 2006. At the end of the Fiscal Year, approximately \$7,000 in invoices from Counsel DLA Piper remained outstanding, and JPMorgan Chase later billed \$2,486 for the last quarter of Fiscal Year 2006. DLA Piper also previously billed the Embassy of the Federated States of Micronesia (FSM) in Washington, D.C., for search services covered by grants from the U.S. Department of the Interior. The fee schedules for service providers are as follows:

DLA Piper, Counsel, charges on an hourly basis (\$330 per hour to \$530 per hour, plus expenses); the Trust Fund made no payments to DLA Piper in Fiscal Year 2006, but about \$7,000 was outstanding in invoices for that Fiscal Year;

Mercer Investment Consulting charges \$125,000 annually, billed quarterly, indexed to the U.S. Consumer Product Index; the Trust Fund made a payment of \$94,000 to Mercer in Fiscal Year 2006.

JP Morgan Chase, Trustee, charges 1 basis points (.01 percent) on balances up to \$200 million, plus transaction fees; the Trust Fund made no payments to JP Morgan in Fiscal Year 2006, but JP Morgan subsequently billed \$2,486 for that Fiscal Year. (This amount is to be revised downward, as it was erroneously billed at 1.25 basis points.)

The fee schedules for money managers appear in the attached Managers' Fee Schedules. These fees vary between approximately 0.5 percent and 1.0 percent of managed assets.

As a percent of assets, the Trust Fund expended slightly over 10 basis points, or 0.1 percent. Beginning in Fiscal Year 2007, based on the attached schedule and other fees, the total management expenditures are likely to be slightly less than 100 basis points, or one percent of assets.

The Trust Fund pays no general administrative fees.¹

Organization:

Pursuant to the provisions of the Compact of Free Association and its subsidiary Trust Fund Agreement, the Trust Fund for the People of the Federated States of Micronesia was incorporated in Washington, D.C. on August 17, 2004. The Trust Fund Agreement

¹ The Department of the Interior estimates its contribution--mainly in staff time, but also including equipment use and incidental expenses--at about \$100,000 annually.

established the organization and structure of the Trust Fund, including a Joint Trust Fund Committee (TFC), which exercises all the powers of the Trust Fund.

The Trust Fund Agreement provides for the TFC to be composed of three members who represent the United States and two members who represent the FSM.

The Trust Fund Agreement also provides for the appointment by the TFC of a Trustee and Investment Adviser. The Agreement provides that “The Trustee shall follow the written directions of the Joint Trust Fund Committee with respect to the retention, purchase, sale or encumbrance of trust property and the investment and reinvestment of Principal and Income held hereunder. . .”

Contributions:

The following is a history of contributions made to the Fund’s A Account:

Date	Amount	Contributor
October 1, 2004	\$30,258,383	FSM
October 5, 2004	16,000,000	United States
October 5, 2004	16,188,000	United States
October 6, 2005	16,441,694	United States
October 6, 2006	17,688,605	United States
Total Contributions:	\$96,576,682	

Engagement of Counsel, Investment Adviser, Trustee and Auditor:

The TFC developed Requests for Proposals (RFPs) for Investment Adviser and Trustee with the assistance of DLA Piper Rudnick Gray Cary US LLP (DLA Piper) of Washington, D.C., hired by the FSM Government with a grant from the U.S. Department of the Interior. At its meeting of March 23, 2006 in San Francisco, California, the TFC, by resolution, selected DLA Piper as its legal counsel.

Public Resources Advisory Group (PRAG) coordinated the search for Investment Adviser and Trustee under contract to the FSM Government and the Trust Fund. The search resulted in the engagement of Mercer Investment Consulting as Investment Adviser on October 15, 2005. Mercer presented its investment strategy and asset-allocation analysis on December 14, 2005, and the TFC officially adopted the strategy on March 6, 2006.

PRAG submitted its recommendation for Trustee to the TFC on December 14, 2005, which selected JPMorgan Chase Bank, N.A., as Trustee on March 23, 2006. After contract negotiations and approvals, the TFC officially engaged JPMorgan Chase on July 6, 2006.

The TFC also selected State Street Global Advisors on March 23, 2006, to manage the Trust Fund's investment in domestic and international index funds. After contract negotiation and approval by the TFC, on August 10, 2006, the Trust Fund placed most of its assets with State Street's index funds, as noted above.

In August 2006, TFC subcommittees met to interview candidates recommended by Mercer Investment Consulting to manage international-equity and private-equity portfolios. At a meeting on August 30, 2006, in Honolulu, Hawai'i, the TFC selected Newton Investment Management and Grantham Mayo Van Otterloo (GMO) as international-equity managers and HarbourVest Partners (\$15 million commitment) and Portfolio Advisors (\$10 million commitment) as private-equity managers. In September and October 2006, the Trust Fund entered into agreements with the selected international money managers and private-equity funds, after review by Counsel.

A TFC subcommittee selected a fixed-income manager in December 2006, the final step in the short-term phase of the Mercer strategy. The TFC recently approved a resolution to select the proposed manager.

An auditor for the Trust Fund was recommended by a joint FSM-RMI subcommittee in December 2006 after interviews of three finalists, but the TFC decided to reissue the RFPs to obtain additional responses. On March 8, 2007, after reissue, the TFC approved the selection of Beard Miller Company (BMC) to audit the fund for Fiscal Years 2004 to 2006, and 2007.

Management:

The Trust Fund Agreement gives the Trust Fund juridical personality and the capacity to contract, acquire and dispose of property; institute legal proceedings; and take other action to protect the Fund.

The Trust Fund Agreement assigns these specific responsibilities to the TFC:

- select Investment Advisers, and negotiate and execute management agreements with such Investment Advisers;
- direct the Trustee to pay the compensation costs of such Investment Advisers;
- enter into such contracts, agreements or other arrangements as the Trust Fund Committee deems appropriate;
- direct the Trustee, in writing, to pay the compensation and costs of brokers, from Fund assets;
- establish and revise from time to time, an investment and distribution policy consistent with this Agreement;

-select and appoint an independent Auditor who shall submit a report to the TFC;
and

-within six months of the end of each Fiscal Year, publish and submit to the Governments an *Annual Report* on the activities and management of the Fund, and on the effectiveness of the Fund to accomplish its purpose (to contribute to the economic advancement and long-term budgetary self-reliance of the Federated States of Micronesia by providing an annual source of revenue, after Fiscal Year 2023...”); which annual report may include recommendations regarding improving the effectiveness of the Fund to accomplish that purpose.

Effectiveness of the Fund to Provide an Annual Source of Revenue after FY 2023:

The market value of the Trust Fund’s assets was \$86.4 million as of September 30, 2006 and \$111.4 million on December 31, 2006. The total return for Fiscal Year 2006 was 6.8 percent and for Calendar Year 2006 was 12.3 percent. Returns are on a course to fulfill the purpose of the Fund to provide an annual source of revenue after fiscal year 2023.

Reports on Trust Fund Investment and Performance:

The Trustee, JPMorgan Chase, provides monthly and cumulative reports on Trust Fund Assets. The Investment Advisor also issues quarterly reports on performance. Summaries of performance for Fiscal Year 2006 and Calendar Year 2006 appear as attachments to this *Annual Report*.