

Trust Fund for the People of the Federated States of Micronesia

Annual Report Fiscal Year 2010

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1. Purpose and Organization:

Purpose of the Trust Fund:

The Trust Fund was incorporated in the District of Columbia on August 17, 2004 pursuant to an *Agreement Between the Government of the United States of America and the Government of the Federated States of Micronesia Implementing Section 215 and Section 216 of the Compact, as Amended Regarding a Trust Fund*.

The purpose of the Fund is 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, for assistance in the sectors described in Section 211 of the Compact, as amended, or other sectors as mutually agreed by the Original Parties, with priorities in education and health care.

Organization:

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

Alcy Frelick was a member representing the United States during Fiscal Year 2010. She was represented by Mark Bezner during the second half of the year and was replaced by Christopher Marut at the end of Fiscal Year 2010.

Members of the Trust Fund Committee as of September 30, 2010, were the following:

Representing the United States:

Nikolao Pula, Chairman, Director, Office of Insular Affairs, U. S. Department of the Interior

James Kulikowski, Deputy Director for Policy, Office of Global Health Affairs, Office of the Secretary, U.S. Department of Health and Human Services

Christopher Marut, Director, Office for Australia, New Zealand and Pacific Island Affairs, U.S. Department of State

Representing the Federated States of Micronesia:

Fabian Nimea, Director, Office of Statistics, Budget and Economic Management, Overseas Development Assistance, and Compact Management, FSM

Aren Palik, President and CEO, Pacific Islands Development Bank

2. Administration:

Executive Administrator:

Richard Miller has been Executive Administrator of the Trust Fund since FY 2007. The Executive Administrator reports to the Chairman and is responsible for all administrative and management functions of the Trust Fund.

During FY 2010, the Executive Administrator managed the evaluation of responses to RFPs for Investment Adviser and Trustee posted during FY 2009. He also prepared and posted an RFP for the Executive Administrator position, dated September 15, 2010 with proposals due October 31, 2010. Responses were evaluated by the TFC in FY 2011.

Service Providers:

Investment Adviser:

Mercer Investment Consulting has provided investment advice since they were engaged by the Trust Fund in 2005. As advised by Mercer, the Trust Fund invested in a mix of active and passive investments. The mix of investments required the contracting of several money managers by the Trust Fund.

After the FY 2010 selection process, Mercer Global Investments (MGI) was engaged to manage the portfolio. In accordance with the Mercer recommendation, the Trust Fund liquidated previous Mercer Investment Consulting investments and transferred the funds to MGI pooled investment funds. The Trust Fund continues with separate money managers in real estate, private equity, hedge fund, convertible bonds and emerging market debt. MGI plays an active role in coordinating with the managers. Mercer's fees and money managers' fees total approximately 68 basis points (0.68 of assets). Detailed information on managers is contained in the MGI Quarterly Investment Summaries.

Custodian:

State Street Bank and Trust was chosen as custodian during FY 2010. State Street will perform all the duties required by the Trust Fund Agreement as a "trustee," although the TFC agreed that State Street can be referred to as the "custodian." Their fee is approximately 3 basis points, including all services. State Street provides plan accounting, which will track the values of each contributor's balance and the A and C Account. It can also pay invoices directly, based on a repetitive instruction from the Committee, as well as making payments based on individual instructions.

As of September 30, 2010, the Trust Fund had contracts or agreements with the following additional service providers:

Auditor:	ParenteBeard, LLC
Bookkeeper:	Bookminders
Legal Counsel:	DLA Piper, LLP

Expenses:

The Trust Fund paid investment fees to the investment adviser, custodian and money managers in FY 2010 totaling \$939,224. Administrative expenses, including the Executive Administrator and Auditor, were \$152,679 during the year.

Table 1. FSM Investment and Administrative Expenses, FY06 to FY10

	FY05	FY06	FY07	FY08	FY09	FY10
	(\$ thousand)					
Investment Expenses:		139.1	686.4	955.7	1049.2	939.2
Custodian		2.0	12.9	42.1	16.3	23.5
Investment Adviser		125.4	142.4	126.8	187.8	319.7
Money Managers		4.7	531.1	786.8	845.1	596.0
Administrative Expenses:	13.4	9.5	39.7	93.6	134.0	152.7
Executive Administrator				70.7	85.7	91.9
Audit fees			33.9	15.3	39.7	45.1
Legal fees	13.4	9.5	5.8	4.5	0.2	4.3
Bookkeeping fees				3.4	5.9	6.3
Miscellaneous fees				(0.3)	2.5	5.1

(There were no expenses in FY2005, other than legal fees for contract review.)

Resolutions Approved in Fiscal Year 2010:**FSM 2010-1: November 13, 2009: Asset Allocation:**

-approved the asset allocation recommended by Mercer and related asset transfers.

FSM 2010-2: December 7, 2009: Approval of PRAG Engagement:

-approved an expenditure of up to \$10,000 to pay Public Resources Advisory Group to review proposals for investment adviser and trustee.

FSM 2010-3: March 12, 2010: Engagement Agreement with ParenteBeard LLC:

-approved agreements with ParenteBeard to audit the accounts for Fiscal Years 2009 and 2010.

FSM 2010-4: March 12, 2010: Engagement of Evaluation Associates:

-approved a letter of engagement with Evaluation Associates in an amount not to exceed \$10,000 to advise the Trust Fund on selection of an investment adviser and trustee, and on administration of the Trust Fund.

FSM 2010-5: March 26, 2010: FSM Annual Report, FY 2009:

-approved the Annual Report for Fiscal Year 2009 and transmission of the report and audited financial statements to the Governments of the United States and FSM.

FSM 2010-6: March 15, 2010: Asset Allocation:

-approved asset rebalancing recommendations by Mercer.

FSM 2010-7: June 1, 2010: Approval of Investment Adviser:

-authorized the Chairman to reach an agreement with Mercer Investment Consulting as Investment Adviser.

FSM-2010-8: Engagement of Evaluation Associates:

-authorized the Chairman to sign a letter of engagement in an amount not to exceed \$10,000 with Evaluation Associates to prepare a study and advise on administrative structures and evaluate responses to the RFP for Executive Administrator. (This expenditure was not made.)

FSM 2010-9: June 1, 2010: Extension of Executive Administrator Contract:

-approved the extension of the contract with Richard Miller as Executive Administrator to Sept. 30, 2010, pending evaluation of responses to an RFP.

FSM 2010-10: June 1, 2010: Engagement of Custodian:

-authorized the Chairman to reach agreement with State Street as Custodian of Trust Fund assets and to submit the agreement to the Committee for approval.

FSM 2010-11: September 3, 2010: Approval of Contract with State Street:

-approved the custodian contract between the Trust Fund and State Street Bank and Trust dated September 3, 2010.

FSM 2010-12: September 3, 2010: Approval of Agreement with MGI:

-approved the Investment Management and Consulting Services Agreement with MGI, dated September 3, 2010.

FSM 2010-13: September 3, 2010: Contracting of Executive Administrator:

-approved a position description and authorized the Chairman to post and circulate an announcement of the position; directed the Chairman to transmit responses to the Committee members and present finalists for review at the November 2010 meeting.

-authorized the Chairman to expend up to \$5,000 for costs of posting the announcement and reviewing responses.

-authorized the Chairman to extend the contract with Richard Miller until 10 business days after the position is filled, not later than December 31, 2010.

3. **Account Balances and Performance:**

Summary of FY 2010 Financial Performance:

The Trust Fund had net investment income of \$17,757,642 in FY 2010 and ended the year with net assets of \$177,198,362. (Source: Audited Financial Statements, September 30, 2010 and 2009.)

Table 2. Net Assets, Oct. 1, 2009:	\$138,075,219
U. S. Government Contribution	21,518,180
Investment Earnings and Unrealized Gain:	18,696,866
Less investment fees	(939,224)
Net Investment Income:	17,757,642
Total Income:	39,275,822
Less administrative expenses:	(152,679)
Change in Net Assets:	39,123,143
Net Assets, Sept. 30, 2010:	\$177,198,362

Asset Performance and Allocation:

Net Investment income of \$17,757,642 during FY 2010 was about 12.9 percent of net assets at the start of the fiscal year. The weighted average return on assets, net of fees, was 11.2 percent for FY 2010. The asset value, performance, allocation and target allocation by asset class as of Sept. 30, 2010 are shown below:

The C Account:

The Trust Fund Agreement requires that annual income over six percent in any fiscal year be deposited in C Account. The C Account is to be drawn on after 2023 to address any shortfall in the amount available for distribution. The C Account was not established as a separate accounting entity until after the close of FY 2010, although it accumulated balances in Fiscal Years 2006, 2007 and 2010. As of the close of FY 2010, the C Account balance was \$20,216,922, leaving a balance of \$156,981.440 in the A Account.

Table 3. Assets by Value, Performance v. Benchmark, Allocation v. Target

	Value	Growth	Benchmark	Allocation	Target
Domestic Equity:	\$48.3	11.2%	11.0%	27.3%	28.0%
International Equity:	\$53.6	11.9%	7.6%	30.2%	29.0%
Fixed Income:	\$45.5	13.4%	8.2%	25.7%	23.5%
Private Real Estate:	\$6.1	7.2%	7.0%	3.5%	7.5%
Hedge Fund:	\$8.8	(partial year)		5.0%	5.0%
Private Equity:	\$14.8	15.4%	13.2%	8.3%	7.0%
Cash:	\$0.1	0.0%	-	0.8%	0%

Table 4. FSM Accounts, FY 2005 to FY 2010

	FY05-10	FY05	FY06	FY07	FY08	FY09	FY10
	\$ millions						
Opening Assets:		64.2	86.5	122.8	117.5	138.1	
Contribution Income:	158.0	62.5	16.4	17.7	19.0	20.9	21.5
United States	123.7	32.2	16.4	17.7	19.0	20.9	21.5
FSM	30.3	30.3					
Net Investment Income:	19.7	1.8	5.8	18.7	(24.2)	(0.2)	17.8
Earnings	23.4	1.8	5.9	19.4	(23.2)	0.8	18.7
Investment Expenses:	3.7		(0.1)	(0.7)	(1.0)	(1.0)	(0.9)
Administrative Expenses:				0.1	0.1	0.1	0.2
Closing Assets:		64.2	86.5	122.8	117.5	138.1	177.2

Table 5. Performance since FY 2006 v. Benchmark and Foundations Median

	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10
Asset Growth (net of fees)	2.9%	6.8%	17.4%	-16.6%	-2.1%	11.1%
FSM Custom Benchmark	2.1%	8.4%	19.2%	-19.9%	1.4%	10.1%
<i>Foundations Universe Median</i>			16.3%	-14.6%	-1.1%	10.0%

The Custom benchmark represents the underlying benchmarks for each asset class, weighted by their target percentage allocation. The Foundations Universe Median is one indicator provided by Mellon Analytical Solutions and used by MGI to represent similar investment pools to the Trust Funds.

4. Effectiveness and Recommendations

Effectiveness of the Trust Fund in Accomplishing its Purpose:

The purpose of the Trust Fund as cited above is *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.*

Thus the original approved investment strategy as stated by Mercer Investment Consulting in 2005 was a long-term one. It stated:

The broad investment objective will be to maximize investment returns, subject to constraints aimed at containing fluctuations in returns over shorter periods within acceptable limits.

In September 2010, when it was engaged as MGI to manage, as well as advise on, the investment portfolio, Mercer restated this strategy:

The broad investment objective will be to maximize investment returns, subject to constraints aimed at containing fluctuations in returns over shorter periods within acceptable limits.

MGI then recommended, and the Committee approved, an asset allocation designed to meet this objective, including that assets should be substantially fully invested because cash holding will reduce long-term rates of return. MGI recommendations included: an allocation to foreign equities, a portion of assets allocated to active mandates, a component of passive indexed management to provide greater diversification and lower cost, and more than one investment manager to lower risk.

MGI's analysis shows that this "aggressive" asset allocation could be expected to provide a return somewhat in excess of 8 percent during the period from inception up to 2024. This would result in a level of assets that would provide a source of income after 2023 nearly equal to the level of U.S. grants in 2023. However, as of the close of FY 2010, performance was short of a growth path that would result in this level of assets. MGI will include an analysis of progress toward investment objectives in future quarterly reports.

The FSM Economic Review of the Compact for FY 2008 and for FY 2009 by the Graduate School demonstrated that the Trust Fund was well short of a growth path to reach a level that would provide a source of income equal to Compact grants after 2023. A June 2007 U.S. Government Accountability Office assessment came up with a similar conclusion. Their analysis showed that the level of Trust Fund balances in 2023 would likely not reach a level that would provide distributions equal to the level of 2023 Compact grants plus full inflation correction after 2023, as permitted by the Trust Fund Agreement.

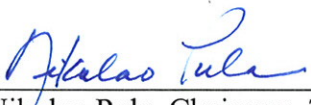
Recommendations Regarding Improving Effectiveness

MGI has suggested a series of asset allocation alternatives that could slightly increase expected returns. These suggestions have included adjusting the allocation toward more volatile investment classes, which would increase risk. And MGI has suggested increasing the proportion of assets in actively managed funds, which would increase investment costs.

The FY 2009 Compact Review by the USDA Graduate School recommends that the Trust Fund Committee revisit its investment strategy, as it is now in the process of doing, and mobilize additional contributions.

Administratively, significant efficiency increases were implemented during and at the end of FY 2010, including MGI's assumption of the administrator responsibility for managed assets and State Street's agreement to pay invoices and meet capital calls without requiring written instructions for each transaction.

There is a remaining deficiency noted by the auditors in regard to the Trust Fund's inability to prepare full disclosure financial statements. The auditor recommends use of an accounting firm or part-time controller. This may save time and money in the preparation of the annual audit and would improve accountability for Trust Fund resources. Further research and actions is needed so that the audit is done efficiently and in compliance with U.S. Government accounting standards.


Nikolao Pula, Chairman, Trust Fund Committee 6/28/11
Date

