# Trust Fund for the People of the Republic of the Marshall Islands

Financial Statements

September 30, 2012 and 2011

ParenteBeard

CONFIDENCE THROUGH CLARITY

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September 30, 2012 and 2011

The following represents the Trust Fund Committee's management discussion and analysis of the Trust Fund for the People of the Republic of the Marshall Islands' (Trust Fund) financial performance for the years ended September 30, 2012 and 2011. Please read it in conjunction with the Trust Fund's financial statements, which follow this section.

**Summary of FY12 Financial Highlights**

- The total Net Asset Value of the Trust Fund increased 32.3% to $165.7 million in fiscal year 2012 from $125.3 million in fiscal year 2011. The increase was mainly due to increased earnings on investments and slightly increased contributions. The Trust Fund experienced an investment gain of $25.5 million primarily due to improved equity and other capital market performance periodically throughout the fiscal year.

- The Trust Fund's overall fiscal year 2012 dollar weighed rate of return on investment was 16.9%. The rate is the highest since inception and compares to a -1.5% loss in fiscal year 2011. In terms of performance measurement (not discounting for fees and expenses), the Fund gained 19.3%, which is almost equal to the Total Trust Benchmark of 19.4% and significantly outperformed the Foundations Median of 14.5%.[1]

- Since inception the Trust Fund has grown an average of 4.7% per annum. The growth rate is slightly below the Total Trust Benchmark of 4.8% and the Foundations Median of 5.1%.

- Contributions totaled $14.9 million for fiscal year 2012 and were received from the Government of the United States ($12.5 million) and Taiwan ($2.4 million). FY11 contributions amounted to $14.3 million.

- A total of $16.5 million was transferred to the C account bringing the total to $27.9 million at the end of fiscal year 2012.[2]

- Investment expenses increased 16.3% to $373,900 in fiscal year 2012 from $321,523 in fiscal year 2011. The increase is mainly due to the increased amount of assets being managed by the Investment Advisor and administered by the Custodian. As a percent of net assets, investment expenses were reduced to 0.23% for fiscal year 2012 from 0.26% for fiscal year 2011.

- Administrative expenses increased by 3.8% to $129,442 in fiscal year 2012 from $124,701 in fiscal year 2011. As a percent of net assets, administrative expenses were reduced to 0.08% for fiscal year 2012 from 0.10% for fiscal year 2011.

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[1] As of September 2010 the Total Trust Benchmark is comprised of 43% Russell 3000, 26% MCSI EAFE (net dividend), 26% Barclays Capital Aggregate and 5% Dow Jones Wilshire REIT.

[2] The C account contains any annual income on the Fund over 6%. The C account shall contain no more than three times the estimated equivalent of the fiscal year 2023 annual grant assistance, including the estimated inflation adjustment provided in the amended Compact of Free Association (Section 218). After fiscal year 2023 the C account may be drawn on, to the extent it has sufficient funds, to address any shortfall if Fund income from the previous year falls below the previous year's distribution adjusted for inflation. Income was also provided to the C account in fiscal years 2006, 2007 and 2010- the years with over 6% annual income.

**The Trust Fund for the People of the Republic of the Marshall Islands**
**Net Assets Summary**

| | September 30, 2012 | September 30, 2011 |
|---|---|---|
| Assets | | |
| Cash and investments | $ 165,668,410 | $ 125,258,589 |
| Total assets | 165,668,410 | 125,258,589 |
| Liabilities | | |
| Accrued expenses | 100,026 | 81,469 |
| Total liabilities | 100,026 | 81,469 |
| Restricted net assets | $ 165,568,384 | $ 125,177,120 |

**Financial Highlights - Net Assets at September 30, 2012**

The fair value of the Trust Fund's net assets was $165.6 million as of September 30, 2012, compared to $125.2 million at September 30, 2011. The 32.3% increase in net assets of $40.4 million is mainly attributable to contributions from member governments that totaled $14.9 million and, given positive equity and capital market performance periodically throughout the year, an investment gain of $26 million. After subtracting the cost of investment fees of $373,930 and administrative expenses of $129,442, the investment gain totals $25.5 million. The total dollar weighted rate of return on investment for the year was 16.9%- the highest rate since Fund inception. Given the investment gain, a transfer was made to the Trust Fund's C account in the amount of $16.5 million.

At September 30, 2012, the Trust Fund's assets consisted of commingled funds invested in domestic equities (34.7%), international equities (33.5%), fixed income (26.2%), and real estate (5.5%). The Trust Fund Committee agreed by resolution to adjust the Investment Policy Statement in August, 2012. The adjustment included adopting an active investment strategy from the former passive approach, adjusting the asset allocations and adding a hedge fund and private equity asset allocation. The adjustments, including the hedge fund investment and private equity, were made at the beginning of fiscal year 2013.

Accrued expenses represent amounts payable for accounting, investment advisor and custodian services incurred during the fiscal year.

### Financial Highlights - Net Assets at September 30, 2011

The fair value of the Trust Fund's net assets was $125.2 million as of September 30, 2011, compared to $112.8 million at September 30, 2010. The increase was attributable to contributions from member governments. There was a net investment loss of $1.8 million mainly attributable to domestic and international public equity losses. Given the investment loss, there was no transfer to the C account. The increase in net assets was $12.4 million for the year ended September 30, 2011 after adding in contributions from the Governments of the United States and Taiwan. At September 30, 2011, the Trust Fund's assets consisted of exchange traded funds invested in domestic and international equities and exchange traded funds invested in fixed income securities. Accrued expenses represented amounts payable for accounting and the investment advisor incurred during the fiscal year.

**The Trust Fund for the People of the Republic of the Marshall Islands**
**Changes in Net Assets Summary**

| | Year ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Contributions | $ 14,874,000 | $ 14,317,347 |
| Net investment income (loss) | 25,646,706 | (1,810,070) |
| Total additions | 40,520,706 | 12,507,277 |
| Administrative expenses | 129,442 | 124,701 |
| Change in net assets | 40,391,264 | 12,382,576 |
| Restricted net assets, beginning | 125,177,120 | 112,794,544 |
| Restricted net assets, ending | $ 165,568,384 | $ 125,177,120 |

### Financial Highlights - Changes in Net Assets for Fiscal Year Ended September 30, 2012

The following contributions were received: scheduled annual contribution of $12.5 million inclusive of a base amount of $10.5 million, a $0.5 million increment plus a cumulative partial inflation adjustment from the Government of the United States on October 14, 2011 and a scheduled annual contribution of $2.4 million from Taiwan on May 24, 2012.

The net investment income gain of $25.6 million was due to a gain in dividends ($0.8 million), realized gains ($18.8 million) and unrealized gains ($6.2 million) during the fiscal year ended September 30, 2011, net of investment expenses of $373,930.

Investment expenses increased by 16.3% from the fiscal year 2011 amount of $321,523. The investment expense increase was partially due to an increase in the amount of assets held given that the Investment Advisor and Custodian fees are based on the amount of assets held. In addition, the Investment Advisor fee slightly increased in September given the Trust Fund Committee's decision to move to active management, while the Custodian's fee slightly increased based on a rate increase. Though the dollar amount increased, the percentage of investment expenses was reduced to 0.23% of restricted net assets for the fiscal year ending September 30, 2012 from 0.26% in the fiscal year ending September 30, 2011. For the fiscal year ended September 30, 2012, the Trust Fund incurred Investment Advisor fees of $338,819 and Custodian fees of $35,111.

Administrative expenses amounted to $129,443, an increase of 3.8% from the fiscal year 2011 amount of $124,701. Though the dollar amount increased, the percentage of administrative expenses was reduced to 0.08% of restricted net assets for the fiscal year ending September 30, 2012 from 0.10% in the fiscal year ending September 30, 2011.

The U.S. Departments of the Interior, State, Education and Commerce contributed staff time, equipment usage and incidental expenses during the fiscal year ended September 30, 2012. No amounts have been recorded in the accompanying financial statements.

### Financial Highlights - Changes in Net Assets for Fiscal Year Ended September 30, 2011

Contributions for fiscal year 2011 amounted to $14.3 million. The following contributions were received: scheduled annual contribution of $11.8 million from the Government of the United States on October 14, 2010; a scheduled annual contribution of $2.4 million from Taiwan on May 9, 2011; and an additional contribution from the RMI government of $119,197 on September 20, 2011. A net investment loss of $1.8 million occurred, net of investment expenses of $321,523. The Trust Fund incurred $291,393 of fees from the Investment Advisor in fiscal year 2011, and Custodian fees of $30,130, which together comprise investment expenses. Administrative expenses amounted to $124,700 consisting of accounting, audit, legal and administrative fees.

The dollar weighted rate of return on investment was -1.5%.

The U.S. Departments of the Interior, State and Education contributed staff time, equipment usage and incidental expenses during the fiscal year ended September 30, 2011. No amounts have been recorded in the accompanying financial statements.

### Future Prospects Beyond Financial September 30, 2012

As stated in the Trust Fund Agreement between the United States and the Republic of the Marshall Islands, the purpose of the Trust Fund is "*to contribute to the economic development and long-term budgetary self-reliance of the RMI by providing an annual source of revenue, after FY23, for assistance in education, health care, the environment, public sector capacity building, private sector development, and public infrastructure 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.*"

The investment objective as set forth in the Investment Policy Statement of September, 2010 states:

*"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. Over shorter periods, outperformance will be sought relative to the notional return on a benchmark portfolio designed to reflect the risk profile according to which the assets are invested at the time."*

The Trust Fund's dollar weighted rate of return on investment, after discounting for contributions, was 16.9% for the fiscal year compared to a rate of -1.5% for fiscal year 2011. The fiscal year 2012 rate is the highest experienced by the Trust Fund since inception, with the previous high experienced in fiscal year 2007 at 14.2%, prior to significant U.S. domestic and international equity and other capital market declines experienced in fiscal years 2008 and 2009. In terms of performance measurement (not discounting for fees and expenses), the Trust Fund gained 19.3%. The gain is almost equal to the Total Trust Benchmark of 19.4% and significantly more than the Foundations Median of 14.5%.

Each asset class, gross of fees, also equaled or was near its benchmark. Domestic equities posted a 30.2% gain (benchmark gain 30.2%), international equities 13.8% (benchmark 13.8%), fixed income 5.1% (benchmark 5.2%) and real estate 31.5% (benchmark 32.1%).

The strong fiscal year 2012 performance resulted in a transfer to the C account. A total of $16.5 million was provided to the C account bringing its total at the end of fiscal year 2012 to $27.9 million. This transfer to the C account increases its value to just over the estimated annual grant assistance to be provided to the Republic of the Marshall Islands through the Amended Compact of Free Association in fiscal year 2023.

Since inception the Trust Fund's average annual net rate of return on investments is 4.7%. The growth rate is slightly below the Total Trust Benchmark of 4.8% and the Foundations Median of 5.1%.

An analysis by the Investment Adviser estimates that, assuming a 6% payout from the Trust Fund, if the Trust Fund manages an average 5% return annually from fiscal year 2012 to fiscal year 2023, the distribution from the estimated assets in fiscal year 2024 would probably provide revenue equivalent to the fiscal year 2023 Compact of Free Association, as Amended, Section 211 sector grant level, inflation adjusted, to fiscal year 2023 but not inflation adjusted beyond.

If the Trust Fund were to achieve an average 8% return annually, the Trust Fund would probably provide fiscal year 2024 revenue equivalent to inflation adjusted fiscal year 2023 grant assistance and allow for 2% future inflation adjustments beyond fiscal year 2023. There would also be a build-up of the C account but probably not at the level to fund that account fully according to the terms of the Trust Fund Agreement. The Trust Fund has achieved 8% or more return in four out of its 9 years of existence- for fiscal years 2006, 2007, 2010 and 2012.

If the Trust Fund were to achieve an average 10% return annually, the Trust Fund would probably provide fiscal year 2024 revenue equivalent to inflation adjusted fiscal year 2023 grant assistance, allow for 2% future inflation adjustments beyond fiscal year 2023, and fully fund the C account. However, achieving such growth annually for the remainder of the build-up period (to fiscal year 2023) is not expected.

Achieving an 8% annual growth is possible but not certain given the potential for market volatility to fiscal year 2023. In addition to potential earnings on investment, analysis shows that additional contributions will improve the possibility to achieve such a rate.

The Trust Fund Committee has taken actions in FY12 to help attract other contributions to the Trust Fund. Activities included applying to foundations and endowments for contributory grants and discussions with multilateral and bilateral donors.

# Independent Auditors' Report

Joint Trust Fund Committee
Trust Fund for the People of the Republic of the Marshall Islands

We have audited the accompanying statement of net assets of Trust Fund for the People of the Republic of the Marshall Islands (a District of Columbia not for profit corporation) as of September 30, 2012 and 2011, and the related statement of changes in net assets for the years then ended. These financial statements are the responsibility of Trust Fund for the People of the Republic of the Marshall Islands' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities and net assets of Trust Fund for the People of the Republic of the Marshall Islands as of September 30, 2012 and 2011 and the changes in its net assets for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 22, 2013, on our consideration of Trust Fund for the People of the Republic of the Marshall Islands' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 1 through 6, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

ParenteBeard LLC

Philadelphia, Pennsylvania
March 22, 2013

# Trust Fund for the People of the Republic of the Marshall Islands

Statement of Net Assets
September 30, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Assets** | | |
| Cash equivalents | $ 994 | $ 119,197 |
| Investments, at fair value | 165,667,416 | 125,139,392 |
| Total assets | $ 165,668,410 | $ 125,258,589 |
| **Liabilities and Restricted Net Assets** | | |
| **Liabilities** | | |
| Accrued expenses | $ 100,026 | $ 81,469 |
| Total liabilities | 100,026 | 81,469 |
| **Restricted Net Assets** | 165,568,384 | 125,177,120 |
| Total liabilities and restricted net assets | $ 165,668,410 | $ 125,258,589 |

*See notes to financial statements*

# Trust Fund for the People of the Republic of the Marshall Islands

Statement of Changes in Net Assets
Year Ended September 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Additions** | | |
| Contributions: | | |
| Government of the United States of America | $ 12,474,000 | $ 11,798,150 |
| Government of Taiwan | 2,400,000 | 2,400,000 |
| Government of the Republic of the Marshall Islands | - | 119,197 |
| Total contributions | 14,874,000 | 14,317,347 |
| Investment income: | | |
| Interest and dividends | 889,784 | 3,572,443 |
| Net increase (decrease) in the fair value of investments | 25,130,852 | (5,060,990) |
| Gross investment income (loss) | 26,020,636 | (1,488,547) |
| Less: investment expenses | 373,930 | 321,523 |
| Net investment income (loss) | 25,646,706 | (1,810,070) |
| Total additions | 40,520,706 | 12,507,277 |
| **Deduction** | | |
| Administrative expenses | 129,442 | 124,701 |
| Change in net assets | 40,391,264 | 12,382,576 |
| **Restricted Net Assets, Beginning** | 125,177,120 | 112,794,544 |
| **Restricted Net Assets, Ending** | $ 165,568,384 | $ 125,177,120 |

*See notes to financial statements*

## 1. Summary of Significant Accounting Policies

### Overview of the Trust Fund:

#### Compact

The Compact of Free Association between the Governments of the United States of America (United States) and the Federated States of Micronesia and the Republic of the Marshall Islands was approved by the United States Congress in Section 201 of Public Law 99-239 (January 14, 1986) and went into effect with respect to the Republic of the Marshall Islands on October 21, 1986 as amended by Public Law 108-188 approved December 17, 2003 (Compact) and provided legislation to establish The Trust Fund for the People of the Republic of the Marshall Islands (Trust Fund).

#### Trust Fund

The Compact provides for the establishment of the Trust Fund. Pursuant to the provisions of the Compact and its subsidiary *Agreement Between the Government of the United States of America and the Government of the Republic of the Marshall Islands* (Original Parties) *Implementing Section 216 and Section 217 of the Compact, as Amended, regarding a Trust Fund* (Trust Fund Agreement), the *Trust Fund for the People of the Republic of the Marshall Islands* was incorporated in Washington, D.C. on April 28, 2004, as a nonprofit corporation. The purpose of the Trust Fund is to contribute to the economic advancement and long-term budgetary self-reliance of the Republic of the Marshall Islands by providing an annual source of revenue through fiscal year 2023. After fiscal year 2023, the Trust Fund will provide an annual source of revenue for assistance in specific sectors described in Section 211 of the Compact, or other sectors as mutually agreed by the Original Parties, with priorities in education and health care. In accordance with the agreement, the situs of the Trust Fund was established within the United States. The Original Parties are committed to contribute to the Trust Fund amounts described in the Compact, subsequent contributors may contribute to the Trust Fund if first approved by all Joint Trust Fund Committee (Committee) voting members. By a majority vote of the Committee, other voting or non-voting members may be appointed from Subsequent Contributors that contribute to the Trust Fund from time to time, provided that the United States maintains the majority vote in the Committee.

After the initial twenty (20) years, beginning October 1, 2023, the Original Parties will consult regarding the future composition of the Committee. The Committee shall remain the same, unless otherwise agreed by the Original Parties.

The composition of the Committee consists of four voting members from the United States appointed by the Government of the United States, which include the Chairman of the Joint Trust Fund Committee, two voting members appointed by and for the Government of the Republic of the Marshall Islands, and one voting member appointed by and for the Government of Taiwan. The Committee has the authority to make decisions, appoint administrators and managers, and significantly influence operations. It also has primary accountability for fiscal matters.

The Government of the United States may unilaterally withdraw the accumulated market value of its contributions from the Trust Fund, plus any undistributed income under certain circumstances which include the Government of the Republic of the Marshall Islands' gross misuse of the Trust Fund's financial resources. The Trust Fund's operations may be terminated by written agreement of the Original Parties.

On May 2, 2005 the Trust Fund entered into a Subsequent Contributor Accession Agreement between the Government of the United States and the Government of the Republic of the Marshall Islands in accordance with Section 216 and Section 217 of the Compact of Free Association Act of 2003, as amended, and the Government of Taiwan. The Government of Taiwan has agreed to contribute to the Trust Fund during the Trust Fund period as described in more detail in Note 2. As provided by the Subsidiary Agreement to the Compact, the "D" Account Trust was set up as a separate trust to be funded by contributions of the Government of Taiwan in accordance with the schedule of payments prescribed by the Accession Agreement. Income from the "D" Account Trust may be utilized by the Government of the Republic of the Marshall Islands at any time after the "D" Account Trust has a corpus of $10,000,000 and proper prior consultation has been made by the Government of the Republic of the Marshall Islands with the Government of Taiwan. The funds held in the "D" Account Trust are not under the control of the Joint Trust Fund Committee, and the corpus of the "D" Account Trust is not a component of the Trust Fund for the People of the Marshall Islands.

**Tax Exempt Status**

As provided by the terms of the Compact, the Trust Fund is exempt from income tax.

**Trust Fund Financial Statements**

The statement of net assets and the statement of changes in net assets are private purpose trust financial statements. They report information on all of the Trust Fund's assets, liabilities, net assets, and activities. The Trust Fund's activities are supported primarily by contributions by the Original Parties and Taiwan, and investment income. The Trust Fund has no business or proprietary type activities that rely on fees or charges for support.

Contributions represent amounts paid by the Original Parties and Taiwan to help meet the operational requirements of the Trust Fund; such contributions represent principal.

The financial statements provide information on the net assets and changes in net assets of the Trust. The Trust Fund is designed to contribute to the long-term budgetary self-reliance of the Republic of the Marshall Islands by establishing a trust fund to provide the Government of the Republic of the Marshall Islands with an ongoing source of revenue after Fiscal Year 2023; recognizing that it is the mutual intention of the Governments of the United States and the Republic of the Marshall Islands that the Government of the United States discontinue annual grant assistance beyond fiscal year 2023. The Trust Fund consists of three accounts the "A" Account, the "B" Account, and the "C" Account, respectively (collectively, the Accounts). Each account has a specific purpose with respect to the use of contributions and income derived from investments as specified by the Trust Fund Agreement in accordance with the special purpose of the Trust Fund.

### Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The Trust Fund's financial statements use the economic resources measurement focus and are prepared using the accrual basis of accounting. Contributions are recorded when due and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows. Additional contributions are recognized as revenue as soon as all eligibility requirements imposed by the Compact have been met. Investment earnings are recorded as earned, since they are both measurable and available.

The Trust Fund has adopted applicable Government Accounting Standards Board (GASB) pronouncements. With this measurement focus, all assets and all liabilities associated with the operation of the Trust Fund are included in the accompanying statement of net assets. The Trust Fund's net assets are restricted for future use after fiscal year 2023.

### Cash Equivalents - Money Market Funds Credit Risk

The Trust Fund's policy is to report cash equivalents at cost which approximates fair value. Cash equivalents consist of money market investments in the SSgA Money Market Fund. This portfolio invests in short term, highly liquid certificates of deposit and notes issued by international banks and finance companies, and repurchase agreements with domestic banks collateralized by debt securities issued or guaranteed by the U.S. government or its agencies. Investments in money market funds are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the funds seek to preserve the value of the investment at $1.00 per share, it is possible to lose money investing in this type of fund.

### Investments

Investments are reported at fair value unless a legal contract exists which guarantees a higher value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. The fair value of real estate assets within REITs are based on estimates and assumptions from information and representations provided by the respective general partners, in the absence of readily ascertainable market values and may be reported at fair value utilizing an income approach to valuation. Investment income consists of interest, dividends and net investment gains or losses resulting from changes in the fair value of investments. Amounts due to broker represent purchases of securities as of the fiscal year end which have not settled and for which payment has not yet been transferred to the broker.

The investment policy adopted by the Trust Fund Committee on September 1, 2012 requires the Trust Fund to allocate its managed investment portfolios among domestic and foreign equity, fixed income securities, and hedge funds. All or a portion of the Trust Fund may be invested in exchange traded funds (ETFs), mutual funds, real estate investment trusts (REITs), common trust funds (commingled vehicles), and other pooled investment vehicles (pooled vehicles). Equity securities issued by ETFs, mutual funds, REITs, commingled and pooled vehicles which invest exclusively in fixed income securities are considered to be fixed income securities. The fair values of ETFs, mutual funds, commingled and pooled vehicles are generally determined by the fair value of the underlying marketable equity and debt securities owned, which are principally common stocks and bonds, respectively. The fair value of REITs is generally based upon the quoted market value of underlying REIT units owned. Publicly traded ETFs, mutual funds, REITs, and similar vehicles may trade at prices above or below the fair values of the underlying investments owned; therefore the fair value of such investments may differ from the sum of the fair values of the underlying investments owned.

The core fixed income portfolios may be invested in securities issued by the U.S. government and government agencies, foreign governments, domestic and international corporate securities, including asset-backed and mortgage-backed obligations. The fixed income portfolio may invest in high yield securities; however the average quality of the fixed income portfolio must be rated "investment grade" by at least one nationally recognized rating agency at the time of purchase.

Derivatives, options and futures are permitted investments for the purpose of reducing risk and efficient portfolio management. Derivatives, options and futures may not be used for speculative purposes.

**Restricted Net Assets**

Restricted net assets consist of the “A”, “B”, and “C” Accounts as described below are subject to legal, regulatory, budgetary, or other restrictions in accordance with the Compact.

1. The “A” Account:

    a. The “A” Account, which established upon the effective date of the Compact, as amended, shall form the Corpus and consist of contributions from the Original Parties and subsequent contributors. Except as otherwise provided in the Trust Fund Agreement, it also consists of the income from the investments made from contributions (principal), and transfers from the “B” Account and “C” Account in accordance with the Trust Fund Agreement.

    b. Through September 30, 2022, payment of allowable expenses of the Trust Fund shall be made from the “A” Account. During this period, the amount, if any, of income in each fiscal year which remains after such payment of expenses shall be reinvested into the “A” Account. Except as provided in the Trust Fund Agreement, or upon termination of the Trust Fund, no funds may be removed from the “A” Account.

   Total amounts included in the “A” Account as of September 30, 2012 and 2011, were \$137,632,385 and \$113,711,615, respectively.

2. The "B" Account:

   a. On October 1, 2022, the "B" Account shall be created.

   b. During fiscal year 2023, all income earned in fiscal year 2023 shall be deposited into the "B" Account for disbursement in fiscal year 2024.

   c. For fiscal year 2024 and thereafter, the "B" Account shall consist of the prior year's income from investment of funds in the "A" Account.

3. The "C" Account:

   a. Shall be created at the same time as the "A" Account, and beginning in fiscal year 2004 through fiscal year 2022, any annual income on the Trust Fund over six percent (6%) shall be deposited in the "C" Account, up to the limit specified in (b) below. Beginning in fiscal year 2023, the "C" Account shall be replenished from the "B" Account in accordance with paragraph 6 below;

   b. Shall contain no more than three times the estimated equivalent of the fiscal year 2023 annual grant assistance, including estimated inflation calculated in accordance with Section 218 of the Compact. Any excess above the estimated amount shall return to the "A" Account; and

   c. May be drawn on, to the extent it contains sufficient funds, to address any shortfall in the "B" Account after fiscal year 2023, if income on the "A" Account falls below the previous year's distribution (not including any amount distributed that year for special needs) adjusted for inflation to the Government of the Republic of the Marshall Islands and for special needs agreed to by the Committee.

   The "C" Account is maintained as a memorandum account within the Trust Fund, and is not separately invested.

   Additions to the "C" Account during the years ended September 30, 2012 and 2011 were $16,470,494 and $-0-, respectively. The actual amount that is ultimately transferred to the "C" Account will be determined by the Joint Trust Fund Committee based on actual cumulative investment performance through the date of the transfer. The balance of the "C" Account as of September 30, 2012 and 2011 was $27,935,999 and $11,465,505.

4. After fiscal year 2023, if the income in the "B" Account is less than the previous year's distribution to the Government of the Republic of the Marshall Islands, and the "C" Account cannot cover the shortfall in the "B" Account, then the principal and reinvested income not available for distribution (corpus) shall not be accessed to compensate for the shortfall.

5. The Committee may disburse to the Government of the Republic of the Marshall Islands from the "B" Account (supplemented from the "C" Account if the "B" Account is insufficient):

a. In fiscal year 2024, an amount equal to the annual grant assistance provided by the Government of the United States to the Government of the Republic of the Marshall Islands in fiscal year 2023, plus an inflation adjustment; and

b. Beginning in fiscal year 2025 and thereafter, an amount of funds no more than the amount equal to the United States annual financial assistance to the Republic of the Marshall Islands in fiscal year 2023 plus a cumulative inflation adjustment thereon, plus any additional amounts for special needs as approved above.

6. Beginning in fiscal year 2023, the Committee shall transfer to the “A” Account any funds in the “B” Account in excess of the amount approved for disbursement in the following fiscal year, in accordance with paragraph 5 above, unless such excess funds are needed to bring the “C” Account to its maximum permitted level.

7. A special account (the “D” Account Trust), was established to allow contribution by the Republic of the Marshall Islands for revenues or income from unanticipated sources. This account may not be commingled with the Trust Fund, and must have a separate account number. The Republic of the Marshall Islands shall have access to funds in this account for unanticipated shortfalls or other purposes. Funds in this account are not part of the Trust Fund corpus and are not under the control of the Joint Trust Fund Committee. Taiwan has been the sole contributor to the “D” Account Trust.

### Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

## 2. Contributions

The Government of the United States will contribute to the Trust Fund annually for twenty years from the effective date of the Compact, amounts set forth in Section 216 of the Compact. Upon termination of the annual financial assistance under Section 211 of the Compact, the proceeds of the Trust Fund shall thereafter be used for the purposes described in Section 211 of the Compact or as otherwise mutually agreed by the Original Parties.

The Government of the United States contributions to the Trust Fund were conditioned on the Government of the Republic of the Marshall Islands contributing at least $25 million to the Trust Fund, prior to October 1, 2003, $2,500,000 prior to October 1, 2004, and $2,500,000 prior to October 1, 2005. Any funds received by the Republic of the Marshall Islands under Section 111 (d) of Public Law 99-239 (January 14, 1986), or successor provisions, would be contributed to the Trust Fund as a Government of the Republic of the Marshall Islands contribution.

Section 108 of U.S. Public Law 108-188 allowed the Republic of the Marshall Islands (RMI) to request compensatory adjustments for the loss of certain tax and trade provisions of the original Compact of Free Association (PL 99-239). Under Section 216(b) of the Compact, as amended, any amount granted by Congress for this purpose must be contributed to the Trust Fund. During 2009, the RMI government submitted a report to Congress claiming compensatory adjustments, and Congress asked for the U.S. government's interagency review of RMI's submission.

The interagency group concluded that RMI "reasonably demonstrated net adverse impacts based on the loss of Title II benefits in making their request for $20 million in further compensation;" and further notes that under Section 216(b) of the Compact, as amended, "any funds received by the Republic of the Marshall Islands under Section of 111(d) of Public Law 99-239 (January 14, 1986), or successor provisions, would be contributed to the Trust Fund as a Republic of the Marshall Islands' contribution." As of March 22, 2013, no compensation had been received.

Contributions to the Trust Fund's "A" Account from inception are as follows:

| Date | Amount (Millions) | Contributor |
|---|---|---|
| June 1, 2004 | $ 25.00 | Republic of the Marshall Islands |
| June 3, 2004 | 7.00 | United States |
| October 5, 2004 | 7.59 | United States |
| February 17, 2005 | 1.50 | Republic of the Marshall Islands |
| May 19, 2005 | 1.00 | Republic of the Marshall Islands |
| May 19, 2005 | 1.75 | Taiwan |
| October 6, 2005 | 2.50 | Republic of the Marshall Islands |
| October 18, 2005 | 8.22 | United States |
| May 15, 2006 | 0.75 | Taiwan |
| October 6, 2006 | 8.95 | United States |
| May 3, 2007 | 0.75 | Taiwan |
| October 9, 2007 | 9.71 | United States |
| October 6, 2008 | 10.78 | United States |
| May 5, 2009 | 0.75 | Taiwan |
| June 5, 2009 | 2.40 | Taiwan |
| October 2, 2009 | 11.13 | United States |
| April 8, 2010 | 2.40 | Taiwan |
| October 14, 2010 | 11.80 | United States |
| May 9, 2011 | 2.40 | Taiwan |
| September 20, 2011 | 0.12 | Republic of the Marshall Islands |
| October 14, 2011 | 12.47 | United States |
| May 24, 2012 | 2.40 | Taiwan |
| Total contributions from inception through September 30, 2012 | $ 131.37 | |

Past received and future scheduled contributions to the Trust Fund "A" Account by the Government of the United States during the Trust Fund period are as follows:

| Fiscal Year | Contribution (Millions) |
|---|---|
| 2004 | $ 7.00 |
| 2005 | 7.59 |
| 2006 | 8.22 |
| 2007 | 8.95 |
| 2008 | 9.71 |
| 2009 | 10.78 |
| 2010 | 11.13 |
| 2011 | 11.80 |
| 2012 | 11.00 |
| 2013 | 11.50 |
| 2014 | 12.00 |
| 2015 | 12.50 |
| 2016 | 13.00 |
| 2017 | 13.50 |
| 2018 | 14.00 |
| 2019 | 14.50 |
| 2020 | 15.00 |
| 2021 | 15.50 |
| 2022 | 16.00 |
| 2023 | 16.50 |

The amounts of scheduled contributions as shown are subject to an inflation adjustment for each United States fiscal year by the percent that equals two-thirds of the percent change in the United States Gross Domestic Product Implicit Price Deflator, or 5 percent, whichever is less in any one year, using the beginning of fiscal period 2004 as a base.

Past received and future scheduled contributions to the Trust Fund "A" Account by the Government of Taiwan during the Trust Fund period are as follows:

| Fiscal Year | Contribution (Millions) |
|---|---|
| 2004 | $ 1.00 |
| 2005 | 0.75 |
| 2006 | 0.75 |
| 2007 | 0.75 |
| 2008 | 0.75 |
| 2009 | 2.40 |
| 2010-2023 | 2.40 |

Contributions to the "D" Account Trust are not reflected in the accompanying financial statements. As described in Note 1, the "D" Account Trust was set up to allow for additional income to the Trust Fund from unanticipated sources. These contributions may not be commingled with assets of the Trust Fund and are required to have a separate account number. The Government of the Republic of the Marshall Islands has access to funds in this account for unanticipated shortfalls or other purposes. Funds in the "D" Account Trust are not part of the corpus of the Trust Fund for the People of the Marshall Islands.

Fair value of invested assets included in the "D" Account Trust as of September 30, 2012 and 2011 were $9,797,130 and $466,323, respectively.

## 3. Investments

During the fiscal years ended September 30, 2012 and 2011, the Trust Fund realized net gains from the sale of investments of $18,857,411 and $2,118,935, respectively. The calculation of net realized investment gains and losses is independent of the calculation of the net increase (decrease) in the fair values of investments. Realized gains and losses on investments that had been held in more than one fiscal year and sold in the current year may have been recognized as an increase or decrease in the fair value of investments reported in the prior year. The net increase (decrease) in the fair value of investments during the fiscal years ended September 30, 2012 and 2011 was $25,130,852 and $(5,060,990), respectively. These amounts take into account the changes in fair value of invested assets (including purchases and sales) that occurred during each year. The cumulative net unrealized gain (loss) on investments held at September 30, 2012 and 2011 was $(673,600) and $(6,947,042), respectively.

The cost and fair values of cash equivalents, investments and related activity for the years ended September 30, 2012 and 2011 are as follows:

| | Fair Value (In Thousands) | | | | | | |
|---|---|---|---|---|---|---|---|
| **Investment Security** | **Cost** | **Beginning Fair Value 10/1/11** | **Purchases** | **Sales** | **Subtotal** | **Ending Fair Value 9/30/12** | **Change in Fair Value** |
| **2012** | | | | | | | |
| Cash equivalents | $ 1 | $ 119 | $ 20,905 | $ 21,023 | $ 1 | $ 1 | $ - |
| Common trust funds: | | | | | | | |
| Fixed Income - domestic | 43,389 | 35,116 | 46,007 | 39,330 | 41,793 | 43,389 | 1,596 |
| Equity - domestic | 57,615 | 59,907 | 68,317 | 89,648 | 38,576 | 57,540 | 18,964 |
| Equity - international | 56,149 | 30,116 | 20,864 | - | 50,980 | 55,551 | 4,571 |
| Real estate funds: | | | | | | | |
| Prepaid subscriptions | 9,187 | - | 9,187 | - | 9,187 | 9,187 | - |
| | $ 166,341 | $ 125,258 | $ 165,280 | $ 150,001 | $ 140,537 | $ 165,668 | $ 25,131 |

| Investment Security | Cost | Beginning Fair Value 10/1/10 | Purchases | Sales | Subtotal | Ending Fair Value 9/30/11 | Change in Fair Value |
|---|---|---|---|---|---|---|---|
| | Fair Value (In Thousands) | | | | | | |
| **2011** | | | | | | | |
| Cash equivalents | $ 119 | $ 917 | $ 17,220 | $ 18,018 | $ 119 | $ 119 | $ - |
| Common trust funds: | | | | | | | |
| Fixed Income - domestic | 34,664 | 24,583 | 37,139 | 27,078 | 34,644 | 35,116 | 472 |
| Equity - domestic | 55,604 | 46,675 | 55,824 | 47,672 | 54,827 | 53,620 | (1,207) |
| Equity - international | 35,286 | 35,393 | 35,285 | 36,334 | 34,344 | 30,116 | (4,228) |
| REIT | 6,533 | 5,252 | 6,533 | 5,399 | 6,386 | 6,288 | (98) |
| | $ 132,206 | $ 112,820 | $ 152,001 | $ 134,501 | $ 130,320 | $ 125,259 | $ (5,061) |

The Trust Fund operates under an investment policy adopted by the Trust Fund Committee. The investment policy has been established to reflect the growth objectives and risk tolerance of the Committee. The Investment Policy Statement was adjusted in August 2012 per resolution RMI 2012-5 Asset Allocation Revision. Asset allocations are targets and will be dictated by current and anticipated market conditions, and may be amended by the Trust Fund Committee from time to time. Tactical ranges anticipate fluctuation and provide flexibility for each investment manager's portfolio to vary within the range without the need for immediate rebalancing.

The asset allocation of the Trust Fund's invested assets as of each fiscal year end is as follows:

| Investment Class | % of Fund Strategic | % of Fund Tactical Range | % Allocation at 9/30/12 |
|---|---|---|---|
| Fixed Income | 20.0 % | 15.0 - 25.0 % | 26.2 % |
| Domestic Equity | 30.0 | 25.0 - 35.0 | 34.7 |
| International Equity | 30.0 | 25.0 - 35.0 | 33.5 |
| Alternative Investments | 15.0 | 10.0 - 20.0 | 0.0 |
| Real Estate | 5.0 | 0.0 - 10.0 | 5.6 |
| Cash | 0.0 | 0.0 - 03.0 | 0.0 |
| | 100.00 % | | 100.00 % |

| Investment Class | % of Fund Strategic | % of Fund Tactical Range | % Allocation at 9/30/11 |
|---|---|---|---|
| Fixed Income | 26.0 % | 21.0 - 31.0 % | 28.0 % |
| Domestic Equity | 43.0 | 38.0 - 48.0 | 42.8 |
| International Equity | 26.0 | 21.0 - 31.0 | 24.1 |
| Alternative Investments | 5.0 | 00.0 - 10.0 | 5.0 |
| Cash | 0.0 | 00.0 - 03.0 | 0.1 |
| | 100.00 % | | 100.00 % |

At September 30, 2012 all fixed income investments were held in ETFs. At September 30, 2011 substantially all fixed income investments were held in common trust funds and ETFs used to closely replicate the performance of recognized bond indices.

As of September 30, 2012, the Trust's fixed income allocation consists of an MGI Collective Trust U.S. Core Opportunistic Fund. As of September 30, 2012, the Trust's fixed income allocation consists of an SSgA Passive Bond Market common trust fund (SSgA); the performance is expected to closely replicate the performance of the Barclays Capital U.S. Aggregate Bond Index. The bonds held by SSgA vary in credit quality, with an average overall rating of "AA2" as rated by Moody's as of September 30, 2012. High yield debt receiving a credit rating below "A" comprises approximately 10% of the fixed income portfolio as rated by Moody's at September 30, 2012. At September 30, 2012, the weighted average maturity of the bonds comprising the SSgA is 6.69 years.

As of September 30, 2011, the Trust's fixed income allocation consists of an SSgA Passive Bond Market common trust fund (SSgA); the performance is expected to closely replicate the performance of the Barclays Capital U.S. Aggregate Bond Index. The bonds held by SSgA vary in credit quality, with an average overall rating of "AA2" as rated by Moody's as of September 30, 2011. High yield debt receiving a credit rating below "A" comprises approximately 9% of the fixed income portfolio as rated by Moody's at September 30, 2011. At September 30, 2011, the weighted average maturity of the bonds comprising the SSgA is 6.92 years.

The Trust Fund's investment policy does not require direct investment in fixed maturity securities (bonds) as a means of managing its exposure to loss of principal due to increasing interest rates. The Trust Fund's investment policy requires the performance of each investment class to be periodically compared with an associated benchmark. Bonds and bond funds generally decrease in value in response to rising interest rates. Bonds, however, have a fixed date of maturity and do not have exposure to loss of principal from rising interest rates, whereas shares of a common trust fund, ETF, or similar investment vehicle have no maturity date.

The Trust Fund's exposure to foreign currency risk is derived from its investment in common trust funds, ETFs and REITs that hold investments in securities of foreign issuers and sovereigns.

At September 30, 2012, the Trust Fund was subscribed to buy shares of a REIT mutual fund in the amount of $9,187,265 such shares to be issued with an effective date of October 1, 2012.

The Trust Fund's exposure to foreign currencies at September 30 is as follows:

| Currency | $USD Fair Value<br>Securities of Foreign Issuers Held by Common Trust Funds<br>(In Thousands) |
|---|---|
| **2012** | |
| Australian Dollar | $ 3,818 |
| Bermudian Dollar | 102 |
| Brazilian Real | 1,372 |
| British Pound | 10,572 |
| Cayman Islands Dollars | 622 |
| Chilean Peso | 305 |
| Chinese Yuan | 930 |
| Colombian Peso | 216 |
| Czech Koruna | 38 |
| Danish Krone | 501 |
| European Euro | 11,965 |
| Hong Kong Dollar | 1,964 |
| Hungarian Forint | 13 |
| Indian Rupee | 737 |
| Indonesian Rupiah | 267 |
| Israeli New Shekel | 253 |
| Japanese Yen | 8,660 |
| Malaysian Ringgit | 559 |
| Mexican Peso | 864 |
| New Zealand Dollar | 60 |
| Norwegian Krone | 416 |
| Peruvian Nuevo Sol | 64 |
| Philippine Peso | 102 |
| Polish Zloty | 152 |
| Russian Ruble | 381 |
| Singapore Dollar | 823 |
| South African Rand | 686 |
| South Korean Won | 991 |
| Swedish Krona | 1,375 |
| Swiss Franc | 3,685 |
| New Taiwan Dollar | 1,042 |
| Thai Baht | 216 |
| Turkish Lira | 165 |
| | $ 53,916 |

| Currency | $USD Fair Value Securities of Foreign Issuers Held by Exchange Traded Funds |
|---|---|
| | (In Thousands) |
| **2011** | |
| Australian Dollar | $ 2,532 |
| British Pound | 6,412 |
| Danish Krone | 287 |
| European Euro | 8,762 |
| Hong Kong Dollar | 809 |
| Israeli New Shekel | 194 |
| Japanese Yen | 6,852 |
| New Zealand Dollar | 39 |
| Norwegian Krone | 269 |
| Singapore Dollar | 522 |
| Swedish Krona | 835 |
| Swiss Franc | 2,603 |
| | $ 30,116 |

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# Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

Joint Trust Fund Committee
Trust Fund for the People of the Republic of the Marshall Islands

We have audited the accompanying statement of net assets of the Trust Fund for the People of the Republic of the Marshall Islands (a District of Columbia not for profit corporation herein referred to as Trust Fund) as of September 30, 2012, and the related statement of changes in net assets for the year then ended, and have issued our report thereon dated March 22, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control over Financial Reporting**

Management of Trust Fund is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered Trust Fund's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Trust Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Trust Fund's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether Trust Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Joint Trust Fund Committee, its respective governments, and the Trust Fund's management and is not intended to be and should not be used by anyone other than these specified parties.

ParenteBeard LLC

Philadelphia, Pennsylvania
March 22, 2013