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

# Fiscal Year 2012 Annual Report

March 6, 2013

# I. Introduction

The Annual Report for the Trust Fund for the People of the Republic of the Marshall Islands (the Fund) is presented to provide the status of the Fund as of 30 September 2012, the performance during the fiscal year ending 30 September 2012, and a review of the Fund since its inception in April 2004. The Annual Report should be considered together with the audited annual financial statements for Fiscal Year 2012 (FY12).

The Annual Report's information is mainly sourced from the annual financial statements prepared by the Fund's bookkeeper and verified by the Fund's auditor, and quarterly investment reports prepared by the Fund's Investment Adviser, Mercer Investment Consulting, Inc. with information from the Custodian, State Street Bank and Trust Company. The analysis and presentation reflects the views of the Trust Fund Committee (the Committee).

The Annual Report was prepared by the Executive Administrator and approved by the Trust Fund Committee on 6 March 2013. Any questions or comments pertaining to the report should be directed to the Executive Administrator, Anthony Costanzo, at apcostanzo@bgsi.net or at 703-683-3793.

**FY12 Highlights**

- The total Net Asset Value of the Fund increased 32.3% to $165.6 million in FY12 from $125.2 million in FY11. The increase was mainly due to increased earnings on investments and slightly increased contributions. The Fund experienced an investment gain of $25.5 million primarily due to improved public equity and other capital market performance periodically throughout the fiscal year.

- The Fund's overall FY12 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 FY11. In terms of performance measurement (not discounting for fees and expenses), the Fund gained 19.3%. That gain is almost equal to the Total Trust Benchmark of 19.4% and significantly outperformed the Foundations Median of 14.5%.[1]

- Since inception the Fund has grown an average of 4.5% per annum (net of fees)- almost double the annual rate of growth of 2.3% as of the end of FY11. The growth rate is slightly below the Total Trust Benchmark of 4.8% and the Foundations Median of 5.1% for the same time period.[2]

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[1] 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] If the Fund was to average 5% growth annually to FY23, the distribution from estimated assets for FY24 should provide a distribution equivalent to the FY23 Compact of Free Association, as Amended, Section 211 grant level, inflation adjusted to FY23 but not beyond. If the Fund averages 8% growth annually, the Fund should provide FY24 revenue equivalent to the inflation adjusted FY23 Amended Compact grant level, allowing for 2% inflation adjustments beyond FY23 and provide a partial build-up of the C account.

- Contributions totaled $14.9 million for FY12 and were received from the United States government ($12.5 million) and Taiwan ($2.4 million). FY11 contributions amounted to $14.3 million.

- A significant contribution was made to the C account.[3] A total of $16.5 million was provided to the C account bringing the total to $27.9 million at the end of FY12.

- Investment expenses increased 16.3% to $373,900 in FY12 from $321,523 in FY11. The increase is mainly due to the increased amount of the assets being managed by the Investment Advisor and administered by the Custodian. As a percent of restricted net assets, investment expenses were reduced to 0.23% for FY12 from 0.26% for FY11.

- Administrative expenses increased by 3.8% to $129,443 in FY12 from $124,700 in FY11. As a percent of restricted net assets, administrative expenses were reduced to 0.08% for FY12 from 0.10% for FY11.

- The Trust Fund Committee has taken steps to attract additional subsequent contributors to the Fund and continues to take note of the potential for the Fund to receive an additional $20 million resulting from the United States government findings of tax and trade issues from the original Compact of Free Association between the U.S. and RMI governments.

[3] 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 FY23 annual grant assistance, including the estimated inflation adjustment provided in the amended Compact of Free Association (Section 218). After FY23 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 FY06, FY07 and FY10- the years with over 6% annual income.

# II. Trust Fund Purpose, Organization and Commitments

## A. Purpose

The Compact of Free Association, as Amended (the "Amended Compact") -- as codified in the Compact of Free Association Amendments Act of 2003 (U.S. Public Law 108-188, December 17, 2003; "the Amended Compact Act") -- under Title Two: Economic Relations, Section 216, provides for the establishment of a trust fund according to the Trust Fund Agreement negotiated between the Original Parties: the United States government (U.S. government) and the Republic of the Marshall Islands government (RMI government). The Compact's Section 216 and 217 set forth the funding to be contributed by both governments to 2023. The Trust Fund Agreement provides the organizational structures, policies and procedures for most aspects of the Fund's start-up and ongoing operations.

The Fund was incorporated as a non-profit corporation under the laws of the District of Columbia in April 2004. The Trust Fund Agreement is supported by a set of by-laws initially approved by the Committee on 19 August 2005. Resolutions are considered and approved periodically to improve the overall management and operations of the Fund, as determined by the Committee. The Investment Policy Statement provides the Fund's main investment guidance. The latest version of the Investment Policy Statement was approved in September 2010 and was amended in August 2012.

As stated in the Trust Fund Agreement, the purpose of the Fund is to:

> *"contribute to the economic development and long-term budgetary self-reliance of the Republic of the Marshall Islands by providing an annual source of revenue, after Fiscal Year 2023, 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 broad investment objective, as set forth in the Investment Policy Statement, is to:

> *"maximize 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."*

## B. Organization

The Fund's Committee has functions indicated by the Trust Fund Agreement to oversee the:

1. Operation, supervision, and management of the Fund;
2. Investment and distribution of Fund resources; and
3. Conclusion of agreements and arrangements with subsequent contributors and other organizations.

For FY12, the Committee consisted of 7 members. According to the Trust Fund Agreement, the U.S. government maintains a majority of voting members to include the Chairman. The RMI government appoints two voting members. A subsequent contributor may or may not be a voting member. Currently, the U.S. government has 4 members including the Chairman, the RMI government has 2 members including the Vice Chairman, and Taiwan, as a subsequent contributor, has one member.

The FY12 Committee members were:

1. Nikolao Pula, Chairman (Department of the Interior), U.S.
2. Dennis Momotaro, Vice Chairman (Ministry of Finance), RMI
3. Chris Marut, Member (Department of States), U.S.
4. Jeanette Lim, Member (Department of Education), U.S.
5. Craig Allen, Member (Department of Commerce), U.S.
6. Phillip Muller, Member (Ministry of Foreign Affairs), RMI
7. James C.K. Tien, Member (Ministry of Foreign Affairs), Taiwan

Dennis Momotaro replaced Jack Ading as Vice Chairman and RMI member during the second quarter of the fiscal year. Phillip Muller replaced Robert Muller as an RMI member during the second quarter. Craig Allen replaced Joseph McDermott as a U.S. member also during the second quarter.

An Executive Administrator supports the Committee.

During FY12 the Committee met quarterly to review investment performance and conduct Fund business on the following dates. Minutes have been recorded, approved and signed for each meeting.

1. 13 December 2011 (Washington D.C.-based teleconference)
2. 6 March 2012 (Washington D.C.-based teleconference)
3. 16 May 2012 (Washington D.C.-based teleconference)
4. 20 August 2012 (Honolulu)

Minutes have been recorded, approved and signed for each meeting.

Prior to the 20 August 2012 meeting, and for the first time, a seminar was held to educate the Committee members and support staff on several aspects of Fund management and investment vehicles. The seminar included presentations by the Investment Advisor (Mercer Investment Consulting, Inc.), Custodian (State Street Bank and Trust Company) and the Executive Administrator.

A Custodian and Investment Adviser support the Fund. State Street Bank and Trust Company has performed as Custodian since September 2010. Mercer Investment Consulting, Inc., has performed as the Investment Adviser also since September 2010.

### C. Commitments

Contributions to the Fund by the U.S. government and RMI government are governed by the schedule in the Amended Compact. The U.S. government is committed to contribute $7 million annually from FY04 to FY23 plus a cumulative $0.5 million addition annually beginning in FY05, which correlates to the amount of the reductions in direct grant assistance, plus a partial inflation adjustment as indicated in the Amended Compact.[4] The RMI government was to provide $30 million in specific tranches by 1 October 2005. Taiwan has made various contributions annually since FY05 and since FY09 contributes $2.4 million annually to FY23.

For FY12, a total of $14,874,000 was contributed consisting of a scheduled $12,474,000 from the U.S. government and a scheduled $2,400,000 contribution from Taiwan.

The following table indicates total contributions to date and estimated future contributions based on the Trust Fund Agreement and other agreements.

**Figure 1: Contributions to FY12 and Committed Future Contributions**
($s millions)

| Date | United States | RMI | Taiwan | Total |
|---|---|---|---|---|
| FY04 | 7.00 | 25.00 | | 32.00 |
| FY05 | 7.59 | 2.50 | 1.75 | 11.84 |
| FY06 | 8.22 | 2.50 | 0.75 | 11.47 |
| FY07 | 8.95 | | 0.75 | 9.70 |
| FY08 | 9.71 | | 0.75 | 10.46 |
| FY09 | 10.78 | | 2.40 | 13.18 |
| FY10 | 11.13 | | 2.40 | 13.53 |
| FY11 | 11.80 | 0.119 | 2.40 | 14.32 |
| FY12 | 12.50 | | 2.40 | 14.90 |
| *Invested to Date* | *87.68* | *30.12* | *13.60* | *131.40* |
| FY13 | 13.31 | | 2.40 | 15.71 |
| FY14 | 12.00 | | 2.40 | 14.40 |
| FY15 | 12.50 | | 2.40 | 14.90 |
| FY16 | 13.00 | | 2.40 | 15.40 |
| FY17 | 13.50 | | 2.40 | 15.90 |
| FY18 | 14.00 | | 2.40 | 16.40 |
| FY19 | 14.50 | | 2.40 | 16.90 |

[4] As stated in the Amended Compact, "the US government contribution shall be adjusted 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 Year 2004 as the base."

| | | | | |
|---|---|---|---|---|
| FY20 | 15.00 | | 2.40 | 17.40 |
| FY21 | 15.50 | | 2.40 | 17.90 |
| FY22 | 16.00 | | 2.40 | 18.40 |
| FY23 | 16.50 | | 2.40 | 18.90 |
| ***Total*** | ***$243.49*** | ***$30.12*** | ***$40.00*** | ***$313.61*** |

* U.S. numbers as of FY14 do not include the inflation adjustment. The adjustment will be calculated and added each fiscal year. The U.S. FY13 contribution was received in October 2012 but is not included in the Annual Report analysis since it is an FY13 contribution.

# III. Administration and Approved Resolutions

## A. Executive Administrator

The Fund contracts an Executive Administrator who serves in support of the governance, administration and operations of the Committee.

The current Executive Administrator began providing services in April 2011 after the Committee conducted an advertised search for candidates. The former Executive Administrator served in the position from 2005. The Executive Administrator contract was extended to April 2013 with the approval of Resolution RMI 2012-3 Executive Administrator Contract Extension.

The key duties of the Executive Administrator are to maintain all official Committee documents and records; update the Chairman, Vice Chairman, and other members of the Committee on activities of the Fund; coordinate Fund service providers; provide administrative services regarding fund payments, decisions and deliberations; assist in audit preparation and prepare the annual report; and prepare periodic performance and other assessments to inform Committee members and staff.

Key FY12 activities include the following:

- Maintained service agreements with Investment Advisor, Custodian, accountant, auditor, legal counsel and others. Negotiated service agreements or adjustments with Custodian, legal counsel and bookkeeper.
- Organized, conducted and provided follow-up for the four quarterly review meetings including meeting agenda, support documents and meeting minute preparation.
- Prepared or coordinated the preparation and approval of Committee resolutions.
- Actively liaised with the Custodian, Investment adviser, accountant and auditor to conduct Fund business and worked with the entities on improvements, as needed.
- Coordinated updating the Investment Policy Statement and implementing the asset allocation revisions.
- Prepared research on potential subsequent contributor candidates and possible ways forward to attract subsequent contributors to the Fund.
- Coordinated with both U.S. and FSM government members and staff in support of the above.

## B. Service Providers

The Fund maintains contracts with a set of service providers to help conduct Fund business. The following are the key service providers.

**Custodian**
State Street Bank and Trust Company (State Street) serves as Fund Custodian per a contract between State Street and the Committee dated 3 September 2010. State Street, as the

Custodian, provides all the services of the Trust Fund Agreement's Article 13 with the exception of the record keeping and reporting functions. Key services include:

- To collect and receive any and all money and other property of whatever kind or nature due or owing or belonging to the Fund;
- Follow written directions of the Committee with respect to retention, purchase, sale or encumbrance of trust property and the investment and reinvestment of principal and income;
- To disburse income or corpus only pursuant to the conditions set forth in the Trust Fund Agreement;
- Make all payment of liabilities and administrative expenses; and
- Effect all distributions pursuant to the instruction of the Committee.

State Street's fee is 3 basis points of Fund value assessed quarterly. In July 2012 State Street indicated an additional flat fee-a Supplemental Custody and Accounting Fee- to be added to the quarterly assessment. The additional fee resulted from increased regulatory, recordkeeping and technology upgrade costs. The Committee negotiated a fee lower than that initially proposed.

State Street maintains a web site portal for Committee members and key staff access for recordkeeping and reporting. State Street also provides planned accounting that helps to track each contributor's balance and the C account.[5]

**Investment Adviser and Money Manager**
Mercer Investment Consulting, Inc. (Mercer) serves as Fund Investment Adviser and money manager per a contract between Mercer and the Committee. Mercer performs the duties of investment adviser and money manager as specified in Article 14 of the Trust Fund Agreement. Key duties include:

- Advise and recommend to the Committee one or more money managers who will invest the assets of the Fund to produce a diversified portfolio.
- Provide the Committee with data relating to any prospective money manager, indicating performance and relevant comparisons with similar money managers to assist the Committee in evaluating the performance of the prospective money managers.
- Direct trades and manage liquidity, amongst other money manager-type functions.

Per Resolution RMI 2012-5 Asset Allocation Revision, approved on 20 August 2012, the portfolio's management was adjusted to an active management approach from a passive approach for certain fund asset categories. Mercer's fee was adjusted when this approach began to be applied in late September 2012. The fee increased to 54 basis points of Fund assets, assessed quarterly, from the previous 22 basis points.

[5] Planned accounting is a breakdown of the fund by contributor (U.S., RMI and Taiwan governments) and by the A and C account. The breakdown allows the allocation of contributions, investment gains and losses, and expenses to each contributor and helps to calculate the proportions of each contributor of the A and C accounts.

Mercer has provided the Committee with monthly flash reports. The reports provide a snapshot of Fund performance by asset class and by individual asset, inclusive of values and comparisons to agreed upon benchmarks. Mercer also provides detailed quarterly performance reports prior to Committee quarterly meetings. The reports provide information about global, U.S. and comparative fund investment performance and Fund status for the quarter, fiscal year and since inception. Mercer also provides a forecast of potential future performance based on high, medium and low growth scenarios. Mercer representatives present the report at the quarterly meeting and respond to Committee member and staff questions. Mercer also reviewed the September 2010 Investment Policy Statement during the 16 May 2012 Committee meeting and again during the 20 August 2012 meeting to recommend to the Committee any needed changes.

**Accounting**

The Committee has engaged Bookminders since 2008. Bookminders has prepared the Fund's financial records dating back to inception in 2004. The service agreement with Bookminders was extended by one year to June 2013. Bookminders produces quarterly financial statements and the annual financial statements. The auditor reviews the annual financial statements.

**Auditor**

ParenteBeard serves as the Fund's auditor and has conducted the annual audits dating back to FY04. The Committee engaged ParenteBeard in June 2011 to prepare the FY11 audit as well as the FY12 audit. ParenteBeard conducts the audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Both the FY11 and FY12 audits were prepared in a timely manner and completed by the deadline (end of March for each fiscal year).

**Legal Counsel**

DLA Piper LLP served as the Fund's legal counsel up to January 2012. The firm had provided legal advice since the Fund's inception, as needed. After a search, the Committee selected Vorys, Sater, Seymour and Pease LLP as legal counsel. The service agreement was in place in January 2012. As part of the agreement, Vorys also provides a Registered Agent for the Fund, as required by the District of Columbia for registered non-profit corporations.

## C. Approved Resolutions

The Committee approved 7 Resolutions in FY12. The following is the title and brief description of each resolution.

*RMI Resolution 2012-1* *Cash Raising Authority*

Allows the Executive Administrator to raise cash with the Investment Adviser to meet Fund expenses.

*RMI Resolution 2012-2* *Legal Counsel Appointment and Registered Agent Designation*

Appointed Vorys, Sater, Seymour and Pease LLP as the Fund's legal counsel and as Registered Agent.

*RMI Resolution 2012-3 Executive Administrator Contract Extension*
Extended the Executive Administrator's contract one year to April 2013.

*RMI Resolution 2012-4 Annual Report Approval*
Approval of the FY11 Annual Report and the approval of transmission of the Annual Report and Audited Financial Statements to the respective governments and to the public.

*RMI Resolution 2012-5 Asset Allocation Revision*
Approved an adjustment in the Fund's asset allocation to allow active investment in several asset categories, add another asset category (a hedge fund), increase the fee to 54 basis points and, accordingly, adjust the Investment Policy Statement.

*RMI Resolution 2012-6 Engagement Agreement with Bookminders and Accounting Support Services*
Approved a service proposal with Bookminders for accounting services to June 2013.

*RMI Resolution 2012-7 Release of Information*
Authorization to release information to a public source regarding the Fund's A and C account calculations.

# IV. FY12 Account Balances and Performance and Trends Since Inception

## A. Trust Fund Asset Classes and Allocations

The Fund's asset allocations were adjusted during FY12 based on Resolution RMI 2012-5 Asset Allocation Revision agreed to in August 2012. The main adjustment was to allocate resources to actively managed funds from the previous passively managed funds in the areas of U.S. medium and small cap funds, non U.S. Equity funds, fixed income, and real estate. The U.S. large cap fund remains passively managed. A hedge fund was also added to the asset allocation but the investment in that asset category did not take place until early FY13 given fund selection and the subscription and resource allocation process. The real estate fund was selected in September 2012 with monies wired to the fund in September 28 and the investment recorded on October 1 2012.[6] The new Investment Policy Statement Strategic Target Allocations and Permitted Ranges are to be in full effect once the hedge fund investments are made.

The asset allocation change was also due to the Fund's heavy reliance on U.S. public equity performance since this category is the largest portion of the Fund. While this helped the Fund's performance in growth years, such as in FY10 and FY12, it caused more significant downfalls in down years, such as in FY08 and FY11. There was limited protection of Fund assets during market downturns.

The increase in non-U.S. public equity, the second largest portion of the Fund, was due to the need to diversify international holdings and resulted in an emerging market fund being added to the portfolio.

The decision to adjust the portfolio was made after various presentations by the Investment Advisor regarding active versus passive management and the interest of the Committee to seek increased returns compared to previous years as well as to further diversify the portfolio and decrease the risk level.

Figure 2 illustrates these changes and the past and current strategic target allocations, permitted ranges, and allocations as of the end of FY11 and FY12.

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[6] The amount invested in the real estate fund (AEW Real Estate Securities Value Fund) was $9,197,265.33. The amount is identified in the audited annual financial statements as a "prepaid investment."

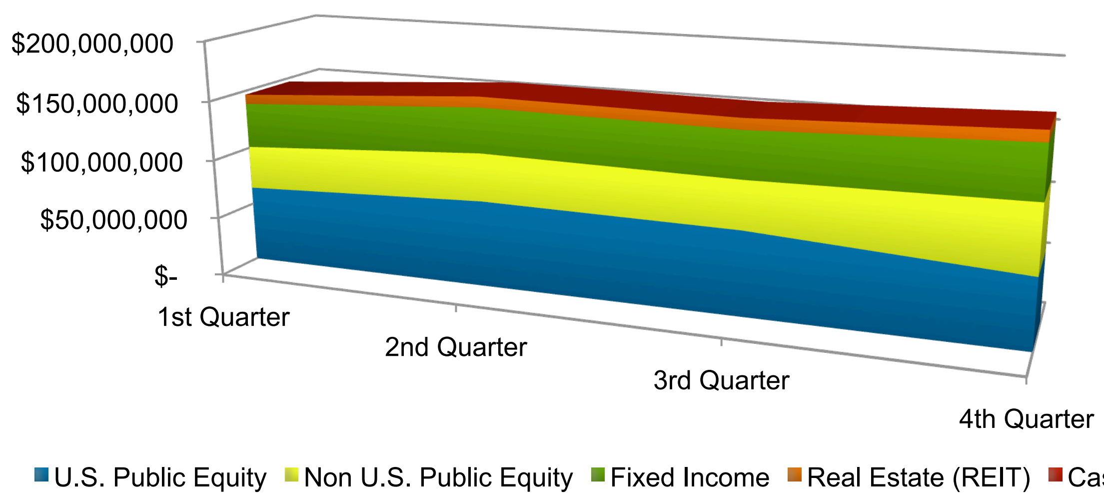
**Figure 2: Asset Classes Per Investment Policy Statement and for FY11 and FY12**
Source: Investment Policy Statement, 9/10 and 8/12 Amendment; Mercer Quarterly Reports- 9/30/11 and 9/30/12

| Asset Class | Strategic Target Allocation & Permitted Range 9/30/11 | Strategic Target Allocation & Permitted Range 9/30/12 | Allocation as of 9/30/11 | Allocation as of 9/30/12 | % Change of Allocation |
|---|---|---|---|---|---|
| **Domestic Equity** | 43%<br>38%-48% | 30%<br>25%-35% | 42.8% | 34.70% | -8.10% |
| **U.S. Large Cap Equity** | 36% | 24% | 36.0% | 27.30% | -8.70% |
| **U.S. Small/Med Cap Equity** | 7% | 6% | 6.6% | 3.70% | -2.90% |
| **Non-U.S. Equity** | 26%<br>21%-31% | 30%<br>25%-35% | 24.0% | 33.50% | 9.50% |
| **Fixed Income** | 26%<br>21%-31% | 20%<br>15%-25% | 28.0% | 26.20% | -1.80% |
| **Real Estate** | 5%<br>0%-10% | 5%<br>0%-10% | 5.0% | 5.50% | 0.50% |
| **Hedge Fund** | 0% | 15%<br>10%-20% | 0.0% | 0.00% | 0.00% |
| **Cash** | 0%<br>0%-3% | 0%<br>0%-3% | 0.1% | 0.00% | -0.10% |
| **Total** | 100% | 100% | 100% | 100% | |

Throughout FY12, the Investment Adviser had adjusted the asset classes within the permitted ranges indicated in the Investment Policy Statement based on market changes. For instance, during times of U.S. domestic public equity market growth in the second and third quarters of the fiscal year, there was heavier weight in those equities. Towards the end of the fiscal year, funds began to be set-aside to adjust the portfolio given the new strategic target allocations. Funds were placed in the U.S. large cap fund and lower risk fixed income investment to eventually be contributed to the hedge fund in early 2013 and funds were placed in the non-U.S. equity category to invest in an emerging market fund.

As shown in Figure 3, the change in asset allocation can be seen in the 4$^{th}$ quarter with a decrease in the allocation to U.S. domestic public equity funds and increases to the non U.S. public equity funds and the fixed income fund. The real estate fund has remained about the same as a proportion of the Fund. The Committee has attempted to keep the cash account at minimal levels to only meet monthly expenditure so that all funds are fully invested.

**Figure 3: Asset Class Changes FY12**
Source: Mercer Quarterly Performance Reports




From a historic perspective, the August FY12 asset allocation change was the most significant since Fund inception. A change was made from the original asset allocation in August 2008 and an adjustment was put in effect in December 2009. The December 2009 change was to reduce the non-U.S. equity asset class by 4% and increase the domestic equity class by 3% and the fixed income class by 1%. In September 2010, the asset allocation indicated in the FY11 Strategic Target Allocation and Permitted Range column of Figure 2 was adopted

The individual assets have changed as the Investment Adviser has adjusted the assets per the Adviser's review of the portfolio in May 2012 and again in August 2012. The previous investment adviser, Goldman Sachs, had the funds primarily passively invested in iShares. Mercer, as the current Investment Adviser, initially invested the assets in funds managed by State Street Global Assets (a corporation distinct from State Street Bank) and now to more actively managed funds and more diverse funds with the FY13 addition of the hedge fund.

The individual asset change is illustrated in Figure 4.

**Figure 4: Asset Change FY10 to FY12**

| Asset Class | Assets Held as of 9/30/11 | Assets Held as of 9/30/12 |
|---|---|---|
| **Domestic Equity** | | |
| **U.S. Large Cap Equity** | SSgA Russell 1000 Index Fund | SSgA S&P 500 Index Fund |
| **U.S. Small/Med Cap Equity** | SSgA Russell 2000 Index Fund | Mercer Small/Mid Cap Growth Equity Fund<br>Mercer Small/Mid Cap Value Equity Fund |
| **Non-U.S. Equity** | SSgA MSCI EAFE Fund | SSGA MSCI EAFE Fund<br>Mercer Emerging Markets Equity Fund |

| Asset Class | Assets Held as of 9/30/11 | Assets Held as of 9/30/12 |
|---|---|---|
| **Fixed Income** | SSgA U.S. Aggregate Fund | Mercer Core Opportunistic Fixed Income Fund |
| **Real Estate** | SSgA U.S. REIT Non-Erisa Fund | AEW Real Estate Securities Value Fund |

Fund performance measurement is conducted according to a set of performance standards established in the Investment Policy Statement. Individual benchmarks are identified in the Statement and the Investment Adviser also measures performance according to its Total Trust Benchmark and Foundation and other medians. Fund performance is measured preliminarily in the monthly Flash Reports and in more detail in the quarterly performance reports.

The following are the key benchmarks. The benchmarks are revised from FY11 given the previously described investment allocation adjustments.

**Figure 5: Performance Standard Benchmarks**

| Asset Class | Benchmarks |
|---|---|
| **Overall** | Total Trust Benchmark[7]<br>Foundations Median |
| **Domestic Equity** | Russell 3000 Index<br>Mercer Institutional U.S. Equity Combined Median |
| **U.S. Large Cap Equity** | S&P 500 Index<br>Mercer Institutional U.S. Equity Large Cap Core Median |
| **U.S. Small/Med Cap Equity** | Russell 2500 Growth Index<br>Mercer Institutional U.S. Equity SMID Growth Median<br>Russell 2500 Value Index<br>Mercer Institutional U.S. Equity SMID Value Median |
| **Non-U.S. Equity** | Mercer Institutional World ex U.S. EAFE Equity Median (adjusted as of 9/12 to include emerging market)<br>MSCI EAFE Index (for SSGA MSCI EAFE fund)<br>MSCI Emerging Markets (for Mercer Emerging Markets Equity Fund)<br>Mercer Institutional Emerging Markets Equity Median |
| **Fixed Income** | Barclays U.S. Aggregate Bond Index<br>Mercer Institutional U.S. Fixed Core Median<br>Mercer Institutional U.S. Fixed Core Opportunistic Median |
| **Real Estate** | Dow Jones U.S. Select REIT<br>Mercer Institutional U.S. Real Estate Public REITS Median<br>Mercer Institutional U.S. Real Estate Open End Median |

The portfolio was reviewed each quarter during Committee meetings. The Investment Advisor also provided a longer-term review of the portfolio during the May and August 2012 meetings. A

[7] The Total Trust Benchmark is comprised of 43% Russell 3000 Index, 26% MSCI EAFE (net dividend), 26% Barclays Capital Aggregate and 5% Dow Jones Wilshire REIT.

more complete annual review for FY11 was provided during the December 2011 quarterly meeting.

## B. Summary of FY12 Performance and Trends Since Inception

The Fund ended FY12 with a net asset value of $165,568,385. The amount is a 32.3% gain from FY10 as shown n Figure 6. The gain is attributable to investment earnings comprised of dividends, realized and unrealized gains, and contributions from the U.S. government and Taiwan. The U.S. contribution increased from the FY11 amount as scheduled with an additional $500,000 plus the cumulative inflation adjustment. The Taiwan amount remained the same as in FY11. While the RMI government had made a contribution in FY11, no contribution was made in FY12.

**Figure 6: Trust Fund Assets FY11 and FY12, Percent Change**
Source: Audited Financial Statements September 30, 2011 and 2010 and September 30, 2012 and 2011

| Category | FY11 | FY12 | % Difference |
|---|---|---|---|
| **Net Assets (Beginning of FY)** | **$112,794,544** | **125,177,121** | 11.0% |
| | | | |
| Contributions | | | |
| U.S. | 11,798,150 | 12,474,000 | 5.7% |
| Taiwan | 2,400,000 | 2,400,000 | 0 |
| RMI | 119,197 | 0 | -100.0% |
| Total Contribution Income | 14,317,347 | 14,874,000 | 3.9% |
| | | | |
| Investment Earnings and Unrealized Gains | -1,488,547 | 26,020,637 | 1848.1% |
| Less Investment Fees | 321,522 | 373,930 | 16.3% |
| Net Investment Income | -1,810,069 | 25,646,707 | 1516.9% |
| | | | |
| Total Income | 12,507,278 | 40,520,707 | 224.0% |
| | | | |
| Less Administrative Expenses | 124,701 | 129,442 | 3.8% |
| | | | |
| Change in Net Assets | 12,382,577 | 40,391,265 | 226.2% |
| | | | |
| **Net Assets (End of Fiscal Year)** | **$125,177,121** | **$165,568,386** | 32.3% |

The Fund's investment earnings, as shown in Figure 7, are a result of public equity and capital market gains in all asset categories for FY12. While the year experienced public equity and capital market ups and downs and periods of uncertainty, gains were made on an annual basis for two of the three each income categories.

**Figure 7: Investment Income FY11 and FY12**
Source: Audited Financial Statements September 30, 2011 and 2010 and September 30, 2012 and 2011

| Category | FY11 | FY12 |
|---|---|---|
| Dividends | 3,572,443 | 889,784 |
| Unrealized Gain (loss) on Investments | -7,179,925 | 6,273,442 |
| Realized Gain (loss) on Investments | 2,118,935 | 18,857,411 |
| Total | $(1,488,547) | $26,020,636 |

Overall, the Fund had a dollar weighted rate of return on investment of 16.92%. The annual return was the best since Fund inception in FY04. The return compares to a rate of return of -1.5% in FY11 and 8.2% in FY10. The FY12 gain allowed for a significant transfer to the C account, further described in Section C, below.

The Fund, while established in FY04, was not fully invested until FY06. Income for FY04 consisted of interest earnings. For FY05, income consisted of interest earnings and some dividend income. FY06 was the first year the Fund had realized and unrealized investment gains.

As shown in Figure 8, investment losses only occurred in FY08 and FY11. The losses during these years were attributable to poor U.S. and international public equity market performance and economic conditions to which the Fund's investment mix was inherently tied given the emphasis on U.S. and international equities.

**Figure 8: Total Contributions, Income, Expenses and Net Assets Since Inception**
Source: Annual Audited Financial Statements since FY04
$s millions

| | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 |
|---|---|---|---|---|---|---|---|---|---|
| **Net Assets (Beginning of Fiscal Year)** | | **$32.16** | **$45.15** | **$63.10** | **$83.81** | **$76.32** | **$90.45** | **$112.79** | **$125.17** |
| | | | | | | | | | |
| Contributions | | | | | | | | | |
| U.S. | 7.00 | 7.59 | $8.22 | $8.95 | $9.71 | $10.78 | $11.13 | $11.80 | $12.47 |
| Taiwan | - | 1.75 | $0.75 | $0.75 | $0.75 | $2.40 | $2.40 | $2.40 | $2.40 |
| RMI | 25.00 | 2.50 | $2.50 | $0.00 | $0.00 | $0.00 | $0.00 | $0.12 | $0.00 |
| Total | 32.00 | 11.84 | $11.47 | $9.70 | $10.46 | $13.18 | $13.53 | $14.32 | $14.87 |
| | | | | | | | | | |
| Net Investment Income | | | | | | | | | |
| Earnings | 0.16 | 1.21 | $6.62 | $11.25 | -$17.54 | $1.59 | $9.58 | -$1.49 | $26.02 |
| Fees and Expenses | - | 0.05 | $0.14 | $0.23 | $0.41 | $0.65 | $0.77 | $0.45 | $0.50 |
| Total | 0.16 | 1.15 | $6.48 | $11.01 | -$17.95 | $0.94 | $8.81 | -$1.93 | $25.52 |
| | | | | | | | | | |
| **Net Assets (End of Fiscal Year)** | **$32.16** | **45.15** | **$63.10** | **$83.81** | **$76.32** | **$90.45** | **$112.79** | **$125.17** | **$165.56** |

Total Fund expenses increased in FY12 compared to FY11, as illustrated in Figure 9. Overall investment and administrative expenses increased by 12.8%. While total expenses increased, they were still below most prior year totals and were reduced as a share of the total Fund- to 0.30% of total net asset value from 0.36% in FY11.

Investment expenses increased by 16.3% compared to FY11. The Custodian’s fee increased by 16.5% mainly due to the increased value of the Fund since its fee is based on total Fund value. Also, the Custodian added an additional fee at fiscal year’s end based on increased costs due to meeting regulatory and reporting requirements, and technology upgrades. The Investment Advisers fee increased by 16.3% also mainly due to the increase in the value of the assets managed. The fee structure was also adjusted upward (to 54 basis points from 22 basis points) at the end of FY12 since the Committee decided to adopt an active management approach and add a new asset category. While costs increased for the fiscal year compared to FY11, it should be noted that investment expenses were substantially reduced in FY11 from previous years, as shown in Figure 9. Overall for FY12, investment expenses were actually reduced as a share of the Fund’s total net asset value- to 0.23% in FY12 from 0.26% in FY11. This percentage remains the lowest since FY06

Administrative expenses increased by 3.8% compared to FY11. As shown in Figure 9, the increase is due to increased costs for the Executive Administrator position and an increase for Miscellaneous Expenses. The audit fee was the same as in FY11. Legal and accounting fees were reduced. Despite the slight increase, administrative costs were also reduced as a percentage of the net asset value- to .08% in FY12 from .10% in FY11. This percentage remains the lowest since FY07.

Historically, fees were non-existent during the Fund's initiation in FY04, but, as the Committee contracted service providers to meet the Fund's legal, administrative and investment obligations, expenses steadily increased to FY10. As a percent of net assets, expenses increased to a high point of 0.88% of net assets in FY08. Part of the high percentage for that year was due to costs incurred the previous year. The FY12 percentage is the lowest since FY07. The current percentage is expected to increase next year given the more than doubling of the Investor Advisor's fee at the end of FY12. However, increased earnings are supposed to result from the Investment Advisor's active management approach and more diversified asset mix.

**Figure 9: Investment and Administrative Expenses Since Inception and Differences Between FY10 and FY12**
Source: Annual Audited Financial Statements since FY04

| | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | Diff FY11-FY12 |
|---|---|---|---|---|---|---|---|---|---|
| **Investment Expenses** | **$38,716** | **$139,073** | **$224,483** | **$599,963** | **$524,070** | **$651,141** | **$321,523** | **$373,930** | 16.3% |
| Custodian | 12,859 | 139,073 | 169,461 | 175,761 | 165,825 | 182,527 | 30,130 | 35,111 | 16.5% |
| Investment Adviser | 25,857 | - | 55,022 | 424,202 | 358,245 | 468,614 | 291,393 | 338,819 | 16.3% |
| *% of Net Assets* | *0.09%* | *0.22%* | *0.27%* | *0.78%* | *0.58%* | *0.58%* | *0.26%* | *0.23%* | -0.03% |
| | | | | | | | | | |
| **Administrative Expenses** | **$15,483** | **$1,077** | **$9,814** | **$72,231** | **$127,736** | **$120,381** | **$124,700** | **$129,443** | 3.8% |
| Executive Administrator | - | - | - | 57,200 | 67,850 | 80,450 | 86,982 | 93,856 | 7.9% |
| Audit Fees | - | - | 8,062 | 9,100 | 52,300 | 28,500 | 27,300 | 27,300 | 0.0% |
| Accounting Fees | - | - | - | 2,906 | 4,199 | 4,867 | 4,272 | 2,381 | -44.3% |
| Legal Fees | 15,483 | 1,077 | 1,752 | 1,837 | 1,035 | 2,070 | 1,962 | 1,198 | -38.9% |
| Miscellaneous Fees | - | - | - | 1,188 | 2,352 | 4,494 | 4,184 | 4,708 | 12.5% |
| *% of Net Assets* | *0.03%* | *0.00%* | *0.01%* | *0.09%* | *0.14%* | *0.11%* | *0.10%* | *0.08%* | -0.02% |
| | | | | | | | | | |
| **Total Expenses** | **$54,199** | **$140,150** | **$234,297** | **$672,194** | **$651,806** | **$771,522** | **$446,223** | **$503,373** | **12.8%** |
| *Total % of Net Assets* | *0.12%* | *0.22%* | *0.28%* | *0.88%* | *0.72%* | *0.68%* | *0.36%* | *0.30%* | -0.05% |

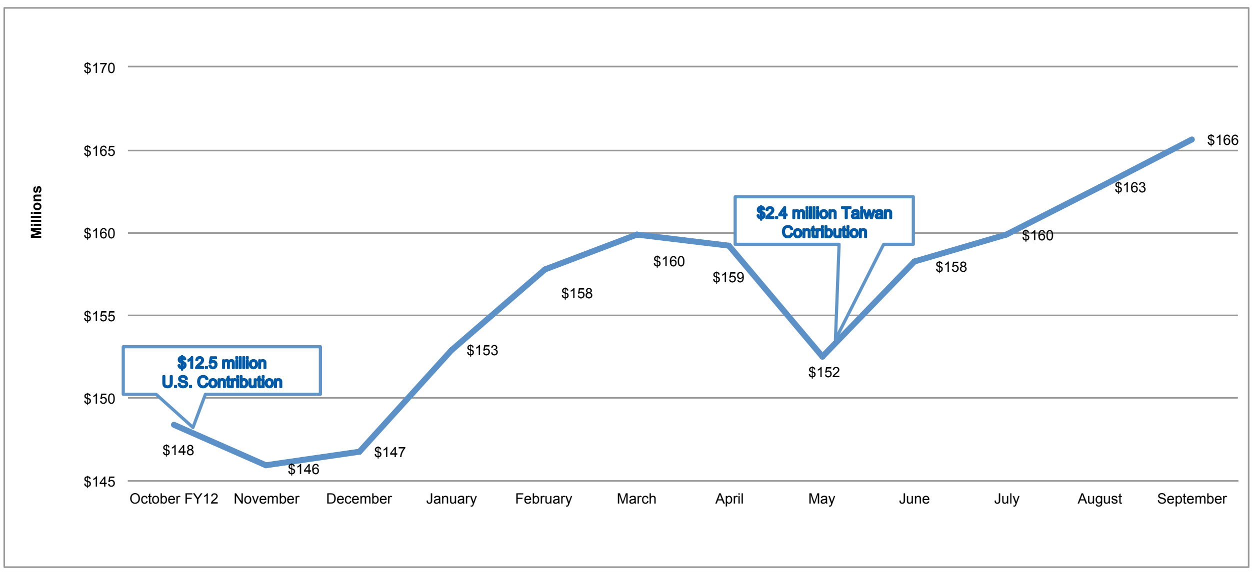
Per Figure 10, the Fund rode the movements in the overall U.S. and international public equity and capital markets. Given the structure of the Fund and its passive investment nature, as the markets moved so did the Fund, as was experienced in previous fiscal years as well.

Poor performance in 1st quarter of FY12 followed on the weak performance of FY11's 4th quarter. However, the market picked-up in the 2nd quarter and the early injection of the FY12 U.S. contribution (October 2012) helped to leverage this growth. Fluctuating performance in the 3rd quarter was helped by the Taiwan contribution in May 2012 with a notable uptick in performance since that time for the remainder of the fiscal year. With the movement to active management at the end of the fiscal year, there should be more flexibility to outperform the market in the short and medium term.

Given the changing overall market performance, the Investment Adviser did adjust portfolio weights to try to achieve better performance. As mentioned previously, and as shown in Figure 3, during times of U.S. domestic public equity market growth in the second and third quarters of the fiscal year, there was a heavier weight in those equities. Towards the end of the fiscal year, funds began to be set-aside to adjust the portfolio given the new strategic target allocations. Funds were placed in the lower risk fixed income investments to eventually be contributed to the hedge fund in early 2013. Such moves helped to either generate gains or protect asset values. Despite the gains, continuing economic uncertainties and low or negative growth in the United States and Europe weighed down the Fund, along with U.S. and international public equity markets. The strength of the real estate market was evidenced by the gains of the real estate investment asset held by the Fund.

**Figure 10: FY12 Monthly Net Asset Values**

Source: Net Asset Values from Mercer Monthly Flash Reports, $s millions; contributions from State Street records




In terms of performance measurement, overall, the Fund had a 19.3% gross gain and a 19.0% gain net of fees. The gains are slightly less than the Total Trust Benchmark (19.4%) and greater than the Foundations Median (14.5% gain). The strong growth pulled the annual rate of growth since inception up to 4.7% per year- just below the Total Trust Benchmark (4.8%) and Foundations Median (5.1%).

Of the individual asset classes U.S. equity investments (small, medium and large cap) had a significant 30.2% gain compared to the same gain for the benchmark. The U.S. equity asset category, which holds the largest amount of assets, helped to pull the entire portfolio into positive territory and fueled significant gains especially compared to that category's poor performance in FY 11.

Non-U.S. equity performance also performed well though not as strong as the U.S. equity category. The non-U.S. equity category had a 13.8% gain compared to a benchmark of the same rate. This category was weighed down by weak European economic, public equity and capital market performance. With the asset reallocation initiated toward the end of the fiscal year, that category had an emerging market fund added, as previously stated. The addition will help to diversity this category so there is more balanced growth in the future.

Fixed income, to which some funds were moved during the end of the year, performed positively with a 5.1% gain, near its benchmark of 5.2%.

The real estate investment category had a significant gain though it had less of an impact on Fund growth since it is only 5.5% of the entire portfolio. This asset category had a 31.5% gain, performing near its benchmark that had a 32.1% gain. This asset category continues to climb back after significant losses experienced in FY08 and FY09. In September 2012, the real estate investment was changed to an actively managed fund.

Overall, the Fund's asset class performances were near benchmarks, either at these benchmarks or slightly under or over performing.

A summary of end-of-year market value, percent of portfolio and performance measures is provided in Figure 11.

**Figure 11: FY12 Market Value and Percent Allocation by Asset Category and Annual Performance Compared to Benchmarks Since Inception**
Source: Mercer Quarterly Report *The Trust Fund for the People of the Republic of the Marshall Islands, Investment Performance Period Ending September 30, 2012*

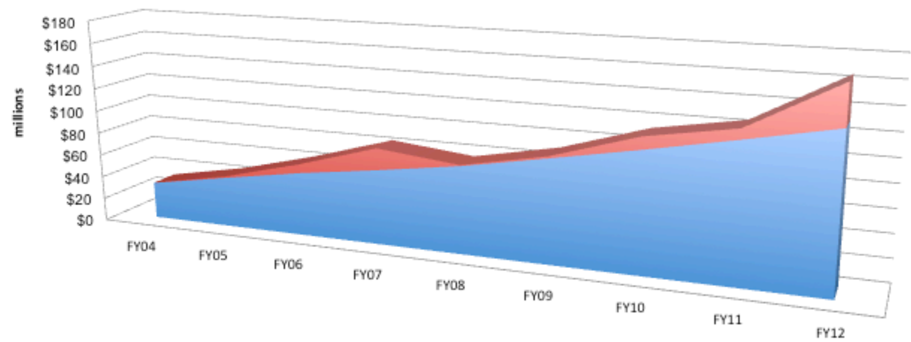
| | Market Value 9/30/12 | Percent Allocation | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | Since Inception |
|---|---|---|---|---|---|---|---|---|---|
| **Total Fund- Gross** | $165,668,411 | 100% | 15.8% | -18.5% | 0.9% | 9.6% | -1.0% | 19.3% | 4.7% |
| Total Fund -Net Fees | | | 15.8% | -18.7% | 0.7% | 9.4% | -1.1% | 19.0% | 4.5% |
| Total Trust Benchmark | | | 15.0% | -17.4% | 0.3% | 9.6% | -0.5% | 19.4% | 4.8% |
| Foundations Median | | | 16.3% | -14.6% | -1.1% | 10.0% | 1.2% | 14.5% | 5.1% |
| | | | | | | | | | |
| **U.S. Public Equity** | $57,539,791 | 34.7% | 15.1% | -21.4% | -5.7% | 10.9% | 0.1% | 30.2% | 4.7% |
| Russell 3000 Index | | | 16.5% | -21.5% | -6.4% | 11.0% | 0.5% | 30.2% | 4.5% |
| Mercer Inst'l U.S. Equity Combined Median | | | | -20.7% | -4.7% | 12.2% | -0.3% | 29.1% | 5.3% |
| | | | | | | | | | |
| **Non-US Equity** | $55,550,835 | 33.5% | 28.7% | -29.7% | 6.1% | 4.5% | -9.6% | 13.8% | 2.3% |
| MSCI EAFE Index | | | 24.9% | -30.5% | 3.2% | 3.3% | -9.4% | 13.8% | 1.3% |
| Mercer Inst'l World ex U.S. EAFE Equity Median | | | | -29.3% | 3.9% | 6.8% | -8.9% | 17.3% | 3.0% |
| | | | | | | | | | |
| **Fixed Income** | $43,389,525 | 26.2% | 4.8% | 3.3% | 11.3% | 9.8% | 4.5% | 5.1% | 6.2% |
| Barclays Capital Aggregate | | | 5.1% | 3.7% | 10.6% | 8.2% | 5.3% | 5.2% | 6.0% |
| Mercer Inst'l U.S. Fixed Core Median | | | | 1.3% | 13.1% | 10.0% | 5.2% | 7.6% | 6.8% |
| | | | | | | | | | |
| **Real Estate** | $9,187,265 | 5.5% | | -25.6% | -20.5% | 22.1% | 2.1% | 31.5% | 0.4% |
| Dow Jones Wilshire U.S. Select REIT | | | 3.8% | -12.5% | -29.4% | 30.1% | 1.9% | 32.1% | 2.3% |
| Mercer Inst'l U.S. Real Estate REITS Median | | | | -11.5% | -26.0% | 31.1% | 2.1% | 33.2% | |
| | | | | | | | | | |
| **Cash** | $994 | 0.0% | | | | | | | |

From a historical perspective, the Fund's average annual growth since inception amounted to 4.7%, as previously stated (4.5% net of fees). The strong fiscal year performance pulled the average annual growth rate up from the 2.3% (net of fees) reported in FY11.

Since inception, all asset categories have outperformed their benchmarks except the real estate asset class. However, the real estate asset class has recovered most of its losses in FY10, FY11 and FY12. Given the structure of the portfolio, the asset allocation targets, and a mix of active and passive investment approach, future performance will continue to rely mostly on U.S. and international public equity performance with some diversification into alternative investments, such as real estate, a hedge fund and a private equity fund. The latter two funds will be added in FY13. The adjustments will reduce the reliance on general market movements and provide more flexibility for asset management.

**Figure 12: Total Cumulative Contribution (Cost Basis) and Net Asset Value Annual Gain, FY04-FY12**

Source: Audited Financial Statements FY04-FY12




| | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 |
|---|---|---|---|---|---|---|---|---|---|
| Net Gain | $157,847 | $1,313,907 | $7,791,218 | $18,804,928 | $855,400 | $1,794,882 | $10,605,447 | $8,670,676 | $34,187,941 |
| Cumulative Contribution | $32,000,000 | $43,838,500 | $55,309,300 | $65,008,892 | $75,472,592 | $88,656,883 | $102,189,097 | $116,506,444 | $131,380,444 |

Per Figure 12, as of FY12 a total of $131,380,444 was contributed to the Fund. The U.S. government contributed 66.7%, the RMI government 22.9%, and Taiwan 10.4%. Figure 12 shows the growth of the Fund with a steady incline of contributions and the periodic gains and losses of the investment income. Overall, given the amount of contributions, as of the end of FY12, the Fund has gained a total of $34,187,941from those contributions. Thus, no contributor's capital investment has been diminished.

## C. The C Account

Article 16 of the Trust Fund Agreement requires that any annual income of the Fund over 6% shall be transferred to the C account. The C account funds can be used after FY23 to supplement annual distributions from the Fund if so desired by the Committee.

The C account is maintained as a sub account for accounting purposes. It is not invested separately but as part of the overall corpus. The previously described planned accounting, performed by State Street and reported in the financial statements, indicates the levels of the A and C accounts and the portion of the funds based on U.S. government, RMI government and Taiwan contributions.

Given the strong performance and significant investment gains in FY12, the 6% threshold was surpassed with a 16.92% dollar weighted rate of return on investment and the amount of $16,470,495 was transferred to the C account. Figure 13 shows the C account growth as well as the allocation of funds between the contributors. The amount in the C account was increased to $27,935,998.

The Fund's proportions amongst the contributors have changed minimally for FY12. The U.S.'s and Taiwan's shares have increased slightly given their continued contributions while the RMI's slightly decreased as a percentage since the RMI has made minimal contributions since FY06.

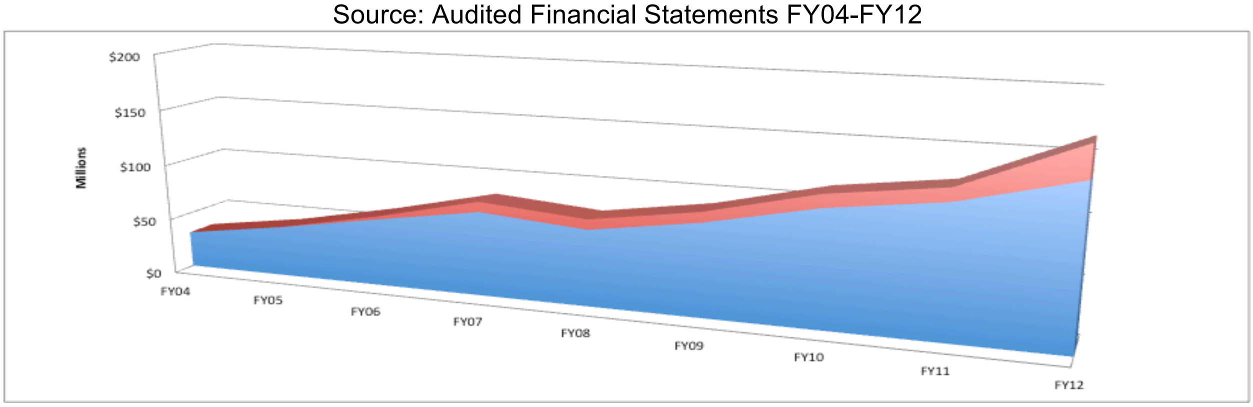
In FY11, given the adjustment in the A and C account calculation as provided in Resolution RMI 2011-7 Trust Fund A and C Account Income, Expenses and End-of-year Calculations, the proportions amongst contributors were significantly changed. The proportions had not changed since FY07 thus giving an overweight to the RMI's proportion and an underweight to the U.S.'s and Taiwan's proportions. As seen in Figure 13, the RMI's A account share only slightly increased in FY11 and the C account was decreased. For FY12, the same calculations were applied. For FY12, given the significant overall growth of the Fund and allocation to the C account, all contributor proportion values increased.

**Figure 13: A and C Account Net Asset Balances, FY06-FY12**
Source: Audited Financial Statements FY04-FY12

| | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 |
|---|---|---|---|---|---|---|---|
| **Total Assets** | **$63,100,518** | **$83,813,819** | **$76,327,991** | **$90,451,764** | **$112,794,542** | **$125,177,120** | **$165,568,385** |
| | | | | | | | |
| *A Account* | *$60,370,678* | *$74,733,354* | *$67,247,526* | *$81,371,299* | *$101,329,039* | *$113,711,617* | *$137,632,387* |
| United States | 23,461,313 | 32,739,970 | 36,308,976 | 49,567,055 | 64,521,177 | 74,918,437 | 93,453,373 |
| Marshall Islands | 33,896,388 | 38,169,102 | 27,572,585 | 26,372,415 | 28,064,946 | 28,114,632 | 30,386,641 |
| Taiwan | 3,012,977 | 3,824,282 | 3,365,965 | 5,431,829 | 8,742,916 | 10,678,548 | 13,792,372 |
| | | | | | | | |
| *C Account* | *$2,729,840* | *$9,080,465* | *$9,080,465* | *$9,080,465* | *$11,465,503* | *$11,465,503* | *$27,935,998* |
| United States | 1,060,873 | 3,836,372 | 3,836,372 | 3,836,372 | 4,839,376 | 7,554,000 | 18,968,742 |
| Marshall Islands | 1,532,726 | 4,783,560 | 4,783,560 | 4,783,560 | 6,044,626 | 2,834,789 | 6,167,743 |
| Taiwan | 136,241 | 460,533 | 460,533 | 460,533 | 581,501 | 1,076,714 | 2,799,513 |

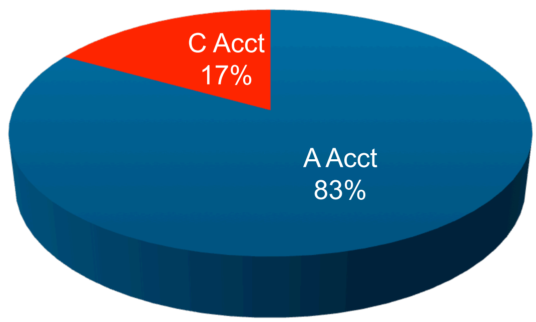
Historically, the C account has gained income in positive growth years including FY06, FY07, FY10 and FY12. Per the Trust Fund Agreement, the C account is allowed to contain up to three times the amount of FY23 grant assistance plus an inflation adjustment. The current amount in the C account is just over the amount of estimated Amended Compact sector grant assistance forecast for FY23. And, while the total Fund will continue to increase based on contributions and at least expected moderate income growth, the C account's growth is not assured since only annual income of the Fund in excess of 6% shall be transferred to the C account.

**Figure 14: A and C Account Trends, FY04-FY12**
Source: Audited Financial Statements FY04-FY12



As of FY11, the C account is 17% of the total Fund. This amount is almost double the FY11 proportion of 9%.

**Figure 15: FY12 A and C Account Breakdown**
Source: FY12 Audited Financial Statements



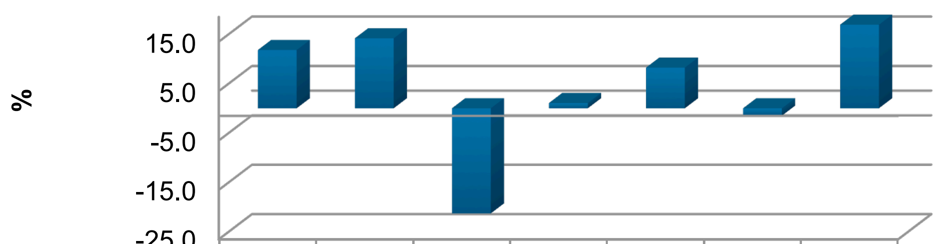
# V. Trust Fund Effectiveness and Recommendations Moving Forward

## A. Effectiveness to Achieve Purpose

As stated previously, in the Trust Fund Agreement between the U.S. and RMI governments, the purpose of the 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 Trust Fund Agreement further states that the Committee should prepare an annual report that includes the "effectiveness of the Fund to accomplish that purpose" as well as provide "recommendations regarding improving the effectiveness of the Fund to accomplish that purpose." The following section is an effort to indicate effectiveness as well as provide recommendations, some summarized from previous sections, to improve effectiveness.

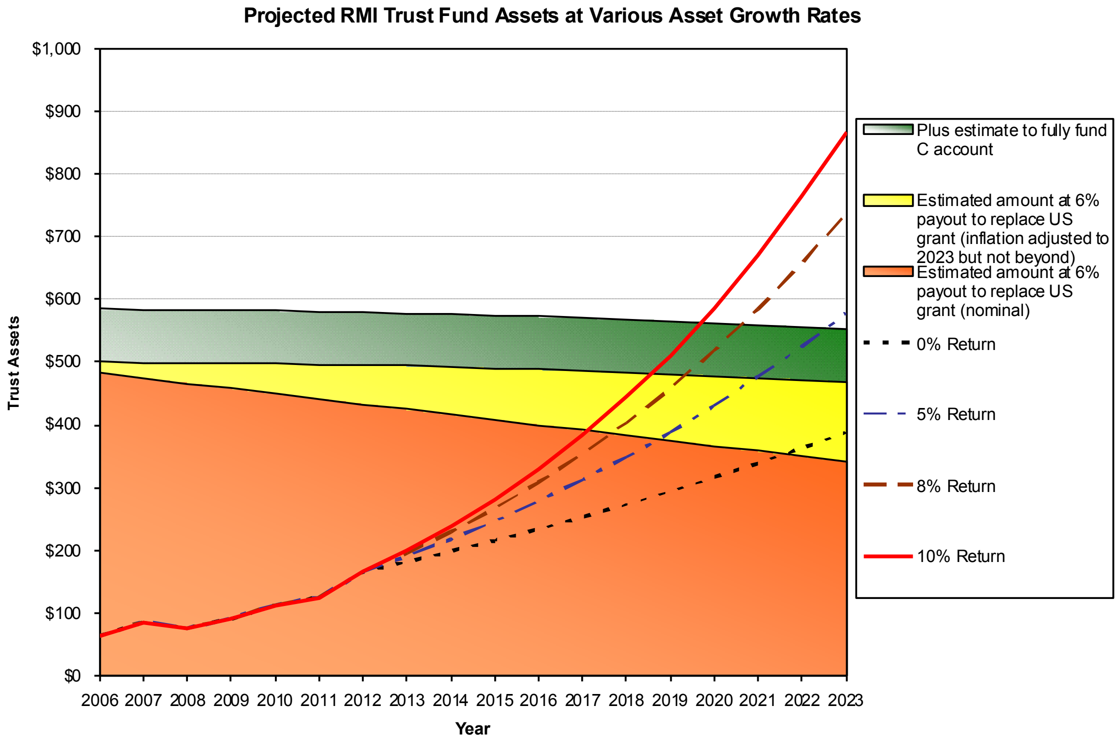
**Figure 16: Dollar Weighted Return on Investment**
Source: Audited Financial Statements




| | FY 06 | FY 07 | FY 08 | FY 09 | FY 10 | FY 11 | FY 12 |
|---|---|---|---|---|---|---|---|
| Dollar Weighted Investment Return | 11.8 | 14.17 | -21.29 | 1.07 | 8.23 | -1.5 | 16.92 |

The Fund has had varied performance annually since funds were fully invested as of FY06 with FY12 having the best return and FY08 the worst return. As stated above, since inception, the Fund has grown a total of 4.5% per annum net of fees. The low overall growth rate can largely be attributed to the fact that the funds were not fully invested until FY06 and investment performance has been weak given negative or low U.S. and global equity market performance mainly in FY08 but also in FY09 and FY11.

**Figure 17: Projected Growth Trends, FY04-FY23**
Source: Mercer Investment Consulting




An analysis by the Investment Advisor estimates that if the Fund manages an average 5% return annually from FY12 to FY23, and assuming a 6% payout from the Fund, the distribution from the estimated assets for FY24 would probably provide revenue equivalent to the FY23 Compact of Free Association, as Amended, Section 211 sector grant level, inflation adjusted, to FY23 but not inflation adjusted beyond

If the Fund were to achieve an average 8% return annually, the Fund would probably provide FY24 revenue equivalent to inflation adjusted FY23 grant assistance, allowing for 2% future inflation adjustments beyond FY23. 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 Fund has achieved 8% or more return in 4 out of its 9 years of existence- for fiscal years 2006, 2007, 2010 and 2012.

If the Fund were to achieve an average 10% return annually, the Fund would probably provide FY24 revenue equivalent to inflation adjusted FY23 grant assistance (allowing for 2% future inflation adjustments beyond FY23) and fund the C account fully. However, achieving such growth annually for the remainder of the build-up (to FY23) is not expected.

Achieving an 8% annual growth rate is possible but not certain given the potential for market volatility to FY23. In addition to potential earnings on investment, analysis shows that additional contributions beyond those currently scheduled would improve the possibility to achieve such a rate.

## B. Recommendations Moving Forward

The Fund has made significant progress in terms of recovering from the poor performance in FY11 as well as recovering some value lost in FY08 and weak performance in FY09. The growth is despite economic, capital and financial market uncertainties and instabilities that were prevalent throughout the fiscal year and will continue into FY13. Also, progress was made in moving the portfolio to a more active management approach that will allow money manager flexibility to adopt to market changes. At the same time, the Committee decided to further diversity the Fund into alternative investments, to include a hedge fund and private equity fund in 2013, so as to not be so reliant on U.S. and international public equity performance. These moves, together, will also lower the risk level and allow for a stronger base from which to achieve future growth.

Per Resolution RMI 2011-9 Additional Subsequent Contributors, the Committee has taken steps to identify other subsequent contributors to the Fund. The steps taken to date include research to identify potential contributors, applying to foundations and other sources of funding, and some inquiries with other potential bilateral donors. The U.S. and RMI governments may wish to consider, in cooperation or separately, initiating discussions or negotiations connected with efforts to seek contributions to the Fund from other sources.

Also, the Committee continues to take note, as it did in FY11, of the U.S. government's findings regarding the tax and trade compensation issue identified in the Amended Compact. If the U.S. Congress were to provide funds as a result of this request, it would result in the Fund receiving $20 million.[8]

The Fund's positive performance, as previously mentioned, was mainly based on U.S. and international public equity performance. The Investment Adviser remained within the investment allocation classes and percent ranges as indicated by the Investment Policy Statement. As the transition to a more actively managed and diversified portfolio occurs in FY13, the Committee should continue to monitor the portfolio's performance to determine, based on the Investment Adviser's advice, if any such changes to the Statement should take place.

Last, the Committee has reduced investment and administrative expenses in FY12 as a proportion of the overall Fund. The Committee should remain prudent in ensuring expenses are appropriate relative to the services provided. To maintain the expenditure ratio at the current level while assets will increase will become more challenging in FY13 and future years especially given Investment Advisor and Custodian fee increases at the end of FY12. The Committee should review if such added costs are assisting Fund performance and returns.

[8] On 8/29/11, the Committee passed a Statement of the Trust Fund Committee that takes note of the results of the U.S. government's interagency review of the Amended Compact Act's provision, carried over from the original Compact of Free Association Act (PL 99-239), which indicates that the RMI government may request from the U.S. Congress compensatory adjustments for the loss of certain tax and trade provisions of the original Compact of Free Association. The interagency committee concluded that the RMI "reasonably demonstrated net adverse impacts based on the loss of Title II benefits in making their request for $20 million in further compensation." Were the U.S. Congress to provide funds as a result of this request, it would be contributed to the Fund as an RMI contribution as stipulated in the Amended Compact.