OVERVIEW

Investment Portfolio Review of the Office of Hawaiian Affairs

Report No. 09-10, September 2009

Summary

The Office of the Auditor and the investment consulting firm of Navigant Consulting, Inc. conducted an investment portfolio review of the Office of Hawaiian Affairs (OHA) for the period of July 1, 2003 to June 30, 2008. Our review examined OHA's management and oversight of investments in the Native Hawaiian Trust Fund and included inquiry, analysis of investment holdings and performance, and evaluation of relevant processes, policies, and procedures. The firm also assessed OHA's use of, and relationships with, external investment advisors and consultants. Our review considered information through December 31, 2008 where available and relevant to our objectives.

Overall, we found that OHA's investment framework and process must be improved to ensure its fiduciary obligations to beneficiaries are being met. As a government agency and an autonomous trust, OHA has been conferred a broad mandate—to provide all Hawaiians the opportunity for a better life and future. Efforts to realize this mandate are funded by the trust fund whose assets totaled $400 million as of June 30, 2008. While the current Board of Trustees has demonstrated an increased awareness of this role, the board must take further action to ensure it is prudently monitoring the trust's investments.

Since February 2003, OHA has used a manager-of-managers structure in which two external investment advisors are each allocated and granted full investment discretion over approximately half of the trust's assets. To satisfy its fiduciary duties related to the trust, the board must therefore have established the necessary policies and procedures to maintain proper oversight of the advisors. We discovered, however, that the board as a whole does not possess an adequate level of general investment or financial knowledge to properly oversee the trust's investments. While limited investment expertise is expected given the varied backgrounds of trustees, the board should have a policy requiring trustees to attend investment training upon joining the board and on a periodic basis thereafter. We found that trustees are not even adequately oriented to their roles and responsibilities with respect to the trust.

Review of the trust's investment performance brought to light further inadequacies in OHA's investment process and monitoring procedures and their impact on the trust. We found that the trust's investments were underperforming for the majority of the review period, not only failing to meet its own target earnings goals in nearly half of the quarters, but also falling below average nationwide peer performance in 18 of the 20 quarters reviewed. During the review period, OHA did not properly monitor investment performance, as it failed to update its Investment Policy Statement as needed, ensure accurate and consistent reporting by advisors, and implement a proper risk management program.

Since the initial procurement of the investment advisors in February 2003, OHA has not evaluated whether its advisory fees—which averaged more than $3 million annually for FY2006-2007—are reasonable and competitive. OHA also has not implemented procedures crucial to effective oversight of the advisors' activities, such as procedures to monitor their investment compliance, valuation, account reconciliations, and proxy voting. Finally, OHA must do more to ensure its asset allocation is appropriate based on its own established goals, risks, and asset ranges, as well as optimally diversified in comparison to peers.

Many of the current findings were echoed in our 2005 OHA audit report, as well as in other audit reports. While we credit the recent improvements OHA has made to strengthen its investment process and framework, most of them were implemented after our review was initiated—many years after initially recommended. For example, OHA did not implement a new investment policy until January 2009, despite our recommendation in 2005 to do so. We urge the board and OHA to continue their progress in order to ensure fiduciary responsibilities to the trust and its beneficiaries are met.

Recommendations and Response

We made several recommendations regarding the board's structure and governance over investments. Among them, we recommended that the board adopt written policies and procedures regarding investment management and service provider oversight and formally evaluate its decision to retain the manager-of-managers approach. We recommended that the board implement regular mandatory training for trustees on topics such as fiduciary responsibilities and financial and investment matters. We made specific recommendations for the board to enhance and formalize its investment structure and governance policies. We also made a number of recommendations on improving the agency's monitoring of investment performance and of its investment advisors' activities.

In response to our draft report, the OHA Board of Trustees claimed that our report contained major factual errors and numerous inaccuracies. However, the board's arguments generally misconstrued the facts presented in our report. Further, although the board provided extensive comments that appeared to erode our findings, in most instances the board ultimately acknowledged the validity of the findings. Other comments by the board indicated its failure to comprehend the major points of our audit and the extent of the board's responsibilities with respect to the trust. Our final report contains a few editorial changes based on the board's response.

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