Investment Portfolio Review of the Office of Hawaiian Affairs

A Report to the Governor and the Legislature of the State of Hawai‘i

Report No. 09-10
September 2009

THE AUDITOR
STATE OF HAWAI‘I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai‘i State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. Financial audits attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. Management audits, which are also referred to as performance audits, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called program audits, when they focus on whether programs are attaining the objectives and results expected of them, and operations audits, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. Sunset evaluations evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. Sunrise analyses are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. Health insurance analyses examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.

7. Procurement compliance audits and other procurement-related monitoring assist the Legislature in overseeing government procurement practices.

8. Fiscal accountability reports analyze expenditures by the state Department of Education in various areas.

9. Special studies respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawai‘i’s laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

THE AUDITOR
STATE OF HAWAI‘I
Kekuanao‘a Building
465 S. King Street, Room 500
Honolulu, Hawai‘i 96813

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.

Marion M. Higa
State Auditor
State of Hawai'i

Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawai'i 96813
(808) 587-0800
FAX (808) 587-0830

Investment Portfolio Review of the Office of Hawaiian Affairs

A Report to the Governor and the Legislature of the State of Hawai‘i

Conducted by

The Auditor
State of Hawai‘i
and
Navigant Consulting, Inc.

Submitted by

THE AUDITOR
STATE OF HAWAI‘I

Report No. 09-10
September 2009

Foreword

This is a report of our investment review of the Office of Hawaiian Affairs (OHA) for the period of July 1, 2003 to June 30, 2008. The review was conducted pursuant to Section 10-14.55, Hawai‘i Revised Statutes, which requires the State Auditor to conduct an audit of OHA at least once every four years. Additionally, Section 23-4, Hawai‘i Revised Statutes, requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. We engaged the services of the investment consulting firm Navigant Consulting, Inc. to perform the review. We also recently completed an audit of OHA's information technology management earlier this year, Report No. 09-08, *Management Audit of Information Technology Within the Office of Hawaiian Affairs*.

We wish to express our appreciation for the cooperation and assistance extended by the trustees, administrator, and staff of OHA during the course of the audit.

Marion M. Higa
State Auditor

Table of Contents

Chapter 1
Introduction

This is a report of our review of the Office of Hawaiian Affairs' (OHA) investment portfolio for the period of July 1, 2003 to June 30, 2008. The review was conducted by the Office of the Auditor and Navigant Consulting, Inc. We conducted this review pursuant to Section 10-14.55, Hawai'i Revised Statutes (HRS), which requires the Auditor to conduct an audit of OHA at least once every four years. The Office of the Auditor has conducted a total of six audits of OHA: in 1990, 1993, 1997, 2001, 2005, and 2009. The 1997 audit was the first to be conducted pursuant to Section 10-14.55, HRS. Our most recent audit, issued in 2009, Report No. 09-08, *Management Audit of Technology Information Within the Office of Hawaiian Affairs*, also covers the fiscal year ending June 30, 2008, but it focuses solely on OHA's information technology.

Background

The 1978 Constitutional Convention proposed the establishment of an office of Hawaiian affairs whose purpose would include the betterment of conditions of all Hawaiians. Article XII, Section 5 of the State's Constitution established OHA, and in 1979 the Legislature passed Act 196, Session Laws of Hawai'i (SLH) 1979, now codified as Chapter 10, HRS, to implement this constitutional amendment.

Section 10-3, HRS, defines OHA's purpose as including the betterment of the conditions of native Hawaiians and Hawaiians. *Native Hawaiian* includes any descendant of at least one-half part of the races inhabiting the Hawaiian Islands previous to 1778, as defined by the Hawaiian Homes Commission Act of 1920, as amended. *Hawaiian* is defined as any descendent of the aboriginal peoples inhabiting the Hawaiian Islands in 1778.

Section 10-3, HRS, also designates OHA as the principal public agency in Hawai'i responsible for the performance, development, and coordination of programs and activities relating to native Hawaiians and Hawaiians, excluding the administration of the Hawaiian Homes Commission Act. The Office of Hawaiian Affairs is also required to assess the policies and practices of other agencies that impact native Hawaiians and Hawaiians; conduct advocacy efforts for native Hawaiians and Hawaiians; apply for, receive, and disburse grants and donations from all sources for native Hawaiian and Hawaiian programs and services; and serve as a receptacle for reparations.

History of the Office of Hawaiian Affairs

Hawai‘i was granted statehood in 1959 through the Admissions Act. The act returned to the new state 1.8 million acres of lands formerly ceded to the United States, provided that the State hold these lands in public trust for two beneficiary classes: native Hawaiians and the general public. Section 5(f) of the Admissions Act limited the use of these lands and any proceeds from their sale or disposition to the following five purposes: 1) the support of public schools and other public educational institutions; 2) the betterment of the conditions of native Hawaiians; 3) the development of farm and home ownership on as widespread a basis as possible; 4) the making of public improvements; and 5) the provision of lands for public use.

To fulfill its obligation to native Hawaiians and the general public, the State's past practice was to generally direct proceeds of the ceded lands to the Department of Education. Proceeds from the ceded lands were not specifically earmarked for the betterment of native Hawaiians. During the 1978 Constitutional Convention, the Committee on Hawaiian Affairs proposed several amendments that addressed the needs of Hawaiians separately from those of the general public. Convention delegates also proposed amending the State's constitution to establish an Office of Hawaiian Affairs to act as trustee to the ceded lands, giving it legal powers to manage and administer the proceeds of land sales and other income sources for native Hawaiians and Hawaiians. Hawai‘i's voters ratified this proposal in the subsequent November elections, and the Hawai‘i State Constitution was amended to include Article XII, Section 5, which established the Office of Hawaiian Affairs. In 1979 the Legislature passed Act 196, which is codified as Chapter 10, HRS, and reflects this constitutional amendment.

Organizational structure

Hawai‘i's constitution requires that OHA be governed by a board of at least nine trustees who are chosen by the State's electorate. Trustees serve staggered four-year terms. There is no limit on the number of terms a trustee may serve. O‘ahu, Kaua‘i, Maui, Moloka‘i, and Hawai‘i each must have at least one representative on the board.

Initially, the board was to be comprised of Hawaiians who were elected by Hawaiians. However, in February 2000, the U.S. Supreme Court held that OHA's electoral qualification based on ancestry was a violation of the U.S. Constitution's Fifteenth Amendment. As a result of this decision, the entire state electorate is now eligible to vote for trustee candidates.

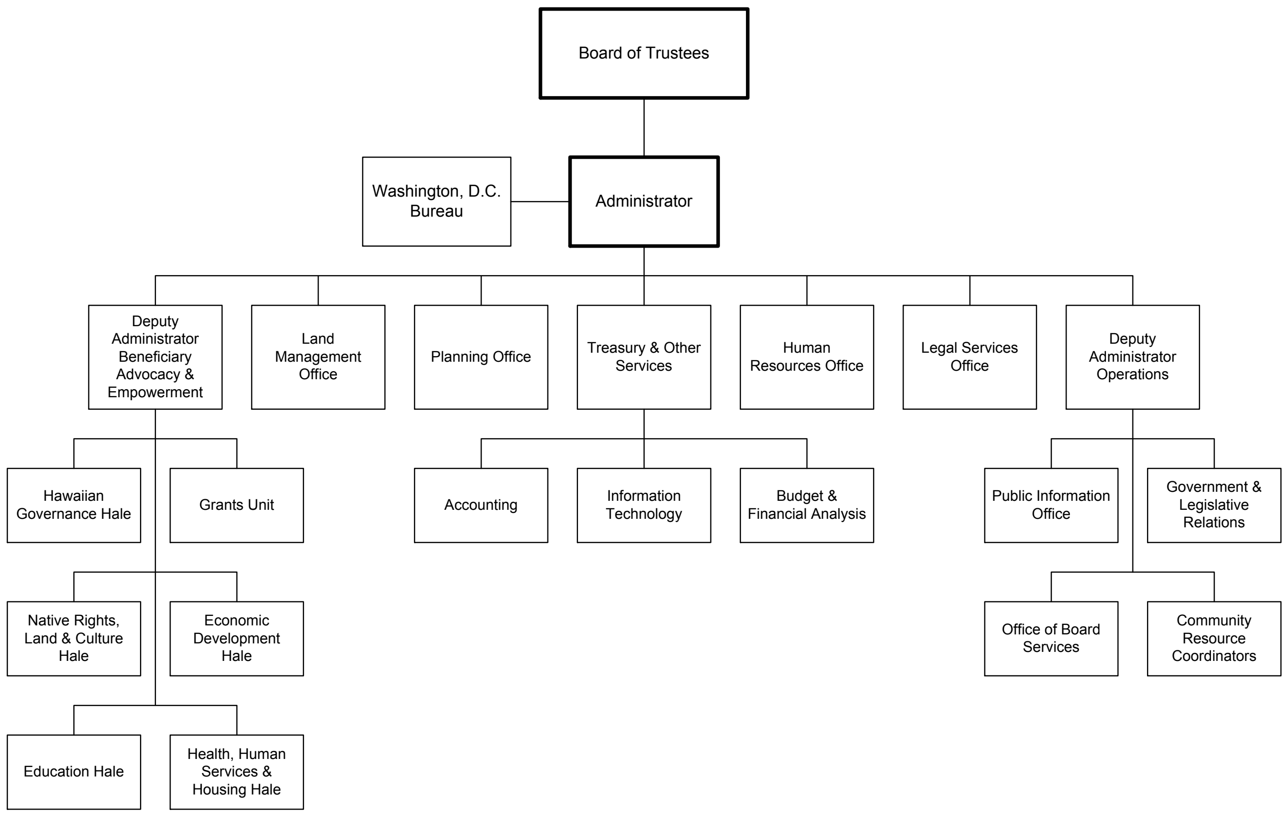
In 2002, the Court of Appeals of the Ninth Circuit also invalidated the limitation of eligibility to be a candidate for OHA trustee to Hawaiians only. Thus, at present, both Hawaiians and non-Hawaiians may qualify as candidates for the office of OHA trustee.

The Board of Trustees is responsible for setting OHA policy and managing the agency's trust. By law the trustees must appoint an administrator who serves as the agency's principal executive and is responsible for the overall management of the administrative functions of OHA. The Office of the Administrator executes board policies, implements OHA's goals and objectives, and manages agency operations. The office also works with other agencies, both government and private, that serve Hawaiians. The administrator reports to the board on fiscal matters and the status of projects and programs, including the implementation of OHA's functional and strategic plans and processes.

The Office of Hawaiian Affairs employs 152 full-time staff, 19 of whom work as board of trustee staff and 133 as administrative staff. The agency's personnel are spread throughout it's administrative office in Honolulu, community offices in Kona, Hilo, Kahului, Kaunakakai, Lānaʻi City, and Lihuʻe, as well as a bureau in Washington, D.C.

The agency is organized into two main branches under the Office of the Administrator: 1) the Operations Branch and 2) the Beneficiary Advocacy and Empowerment (BAE) Branch. Each branch is headed by a deputy administrator. The Operations Branch consists of four support services divisions tasked with managing OHA's various internal operations: Community Resource Coordinators; Government Relations and Legislative Affairs; the Office of Board Services; and the Public Information Office. The BAE Branch guides the agency's five program divisions or *hale* (the Hawaiian word for "house"), which consist of: Economic Development; Education; Hawaiian Governance; Health, Human Services and Housing; and Native Rights, Land and Culture. The BAE Branch also oversees the Grants Unit. In addition, six divisions report directly to the administrator: the Washington, D.C. Bureau; the Land Management Office; the Planning Office; the Human Resources Office; the Legal Services Office; and Treasury and Other Services. Exhibit 1.1 displays OHA's organizational structure as of March 2009.

Exhibit 1.1
Office of Hawaiian Affairs Organizational Structure



Source: Office of Hawaiian Affairs

Native Hawaiian Trust Fund

The Office of Hawaiian Affairs' Native Hawaiian Trust Fund, also known as the Public Land Trust Fund, was established in 1981 to account for OHA's portion of revenues derived from ceded lands held in public trust. In 1980, the Legislature determined that 20 percent of ceded land revenues should be expended by OHA for the betterment of native Hawaiians; however, the revenues were not allocated to OHA between 1980 and 1991. In 1993, the State of Hawai'i agreed to pay OHA approximately $135 million in back revenues on ceded lands, including interest.

The Office of Hawaiian Affairs Board of Trustees, which is responsible for managing the trust, decided to invest this acquired capital in numerous investment managers representing a variety of asset classes. From 1993 to 2003, the trust maintained up to nine investment managers who were periodically replaced based on performance. The trustees held the responsibility for hiring and terminating investment managers, performing due diligence reviews of current and potential new investment managers, and creating and maintaining a well-diversified portfolio.

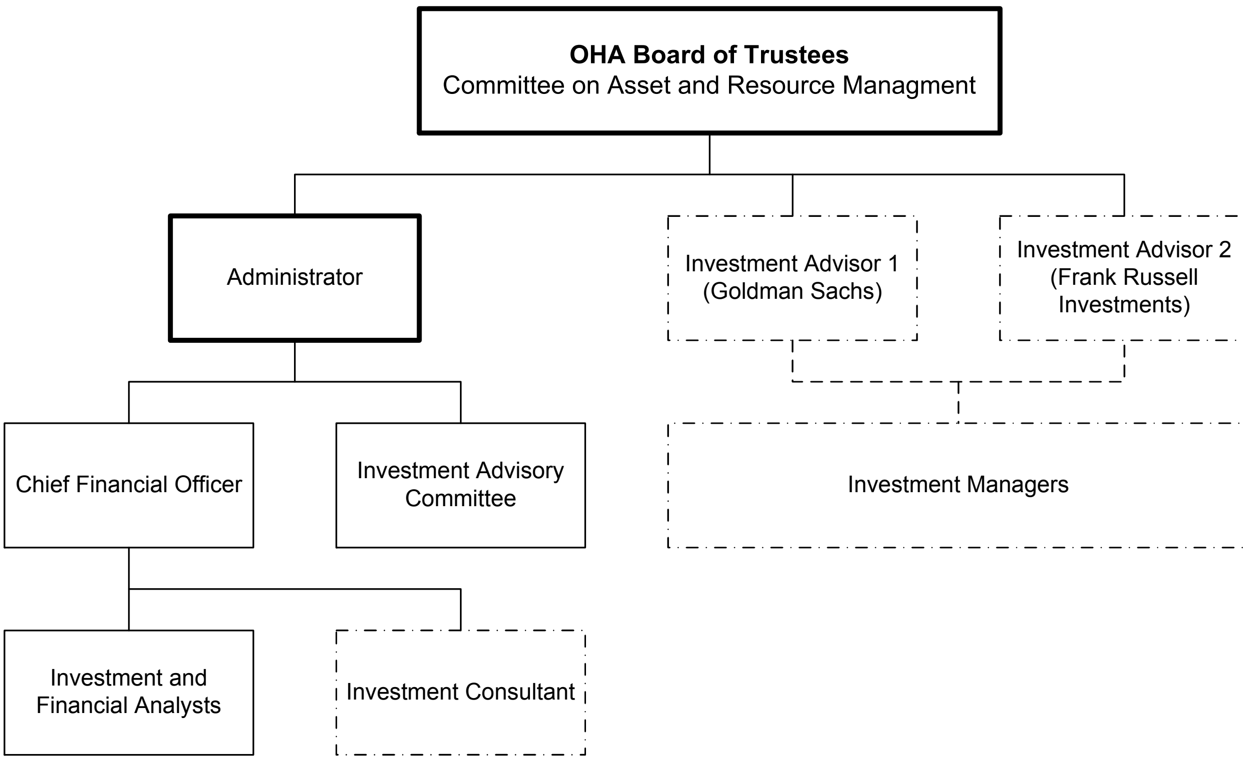
OHA investment structure

In February 2003, OHA switched to a manager-of-managers structure due to constraints placed on the trustees to oversee the numerous investment managers. The trustees selected Goldman Sachs and Frank Russell Investments as investment advisors, and allocated approximately $127 million to each.

These investment advisors have full investment discretion, including the responsibilities of hiring and terminating investment managers, performing due diligence reviews of investment managers, and allocating resources to such investment managers within OHA's stated Investment Policy Statement. The Asset and Resource Management (ARM) Committee of the board retains the oversight responsibilities of reviewing the investment advisors, including recommending policies to the board. The ARM Committee, which includes all board members, receives quarterly presentations from the investment advisors informing them of the: (i) state of the markets; (ii) performance of the trust; (iii) target goals; (iv) new investment ideas, and; (v) changes to investment managers. The board maintains the responsibility of approving appropriate investment guidelines and asset allocation constraints as recommended by the ARM Committee while ensuring that the investment advisors act prudently and follow the investment policy. An external investment consultant has also been retained to serve as a resource to the ARM Committee, and is available to answer questions and provide clarity as needed when the committee reviews the investment reports.

The Office of Hawaiian Affairs' administrative staff assist the trustees in their fiduciary capacity in regard to the investment advisors by: (i) monitoring the performance of the trust, (ii) ensuring funds are invested in accordance with stated policies, (iii) recommending and implementing policy and operational procedures, and (iv) reviewing and renewing contracts. Documentation such as internal analysis, reports, and presentations are gathered by the administrative staff and reported to the ARM Committee and the board. Exhibit 1.2 below illustrates the current OHA structure with respect to investments.

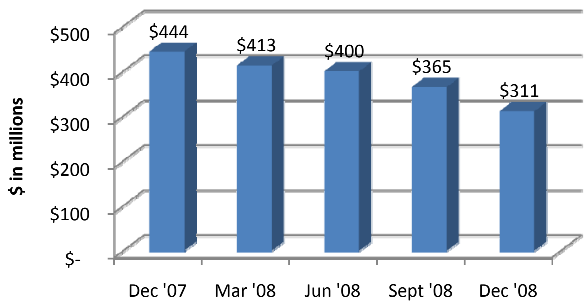
Exhibit 1.2
Native Hawaiian Trust Fund Investment Management Organization Chart

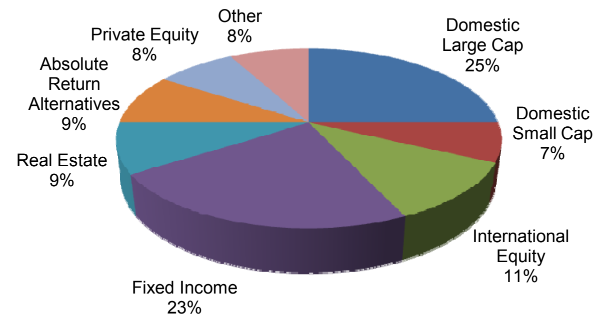


Source: Office of Hawaiian Affairs

The objective of the trust is to maximize long-term total-return and annual spending, while preserving principal and stability. To sustain the trust, OHA can withdraw no more than 5 percent of the trust's average market value for the most recent 12-quarter period ending on March 31 of the respective year. The Office of Hawaiian Affairs has the authority to spend all funds available that are held in the trust which are not spent in previous fiscal years. The trust's total expected return is exceeding inflation, as measured by the Consumer Price Index, by 4 percent for 2004 to 2008, and by 5 percent for 2009 and beyond. Exhibit 1.3 shows the trust's asset balance and allocation as of December 31, 2008.

Exhibit 1.3
Native Hawaiian Trust Fund – Asset Balance and Allocation at December 31, 2008





Source: OHA's Native Hawaiian Trust Fund 2008 Preliminary Review

Trust fund revenues

The Native Hawaiian Trust Fund's major sources of revenue are dividend and interest income and investment gains. As previously mentioned, the trust also receives OHA's portion of ceded land revenues. The State of Hawai'i, through Act 178, SLH 2006, appropriated $17.5 million to OHA to redress ceded land underpayments from FY2002 through FY2005. The State also determined that OHA's share of the proceeds from the Public Land Trust going forward will be $15.1 million annually. The trust also can receive donations and program contributions. Moneys in the trust may be spent by OHA for the betterment of the conditions of native Hawaiians. Exhibit 1.4 illustrates the trust's revenues, expenditures, and fund balances for the past five fiscal years.

Exhibit 1.4
OHA's Public Land Trust Fund – Financial Statements for FY2004 – FY2008

	FY2004	FY2005	FY2006	FY2007	FY2008
Revenues					
Public Land Trust	9,740,578	10,798,706	32,599,833	15,100,000	15,100,000
Interest	3,508,407	6,339,036	11,417,954	16,940,017	7,702,618
Investment gains (losses)	39,021,376	25,963,215	23,275,048	41,421,318	(32,289,415)
Donations	96,081	33,716	167,515	311,520	2,490,798
Program Contributions	-	-	10,105,258	-	-
Total	52,366,442	43,134,673	77,565,608	73,772,855	(6,995,999)
Expenses					
Board of Trustees	(1,669,567)	(1,467,756)	(1,694,147)	(1,667,292)	(1,782,763)
Support Services	(6,983,941)	(7,697,804)	(9,677,150)	(11,055,644)	(13,333,217)
Beneficiary Advocacy	(7,109,096)	(11,364,984)	(30,376,916)	(21,583,550)	(21,056,038)
Other	(29,298)	-	-	-	-
Total	(15,791,902)	(20,530,544)	(41,748,213)	(34,306,486)	(36,172,018)
Net Revenues (Deficiency)	36,574,540	22,604,129	35,817,395	39,466,369	(43,168,017)
Beginning Fund Balance	318,120,030	354,694,570	377,298,699	413,116,094	452,582,463
Ending Fund Balance	354,694,570	377,298,699	413,116,094	452,582,463	409,414,446

Source: Office of Hawaiian Affairs FY2004 – FY2008 audited financial statements prepared by Grant Thornton LLP

Prior Audits

Our most recent audit of the Office of Hawaiian Affairs issued in 2009, Report No. 09-08, *Management Audit of Technology Information Within the Office of Hawaiian Affairs*, found that OHA needed to recognize the critical strategic importance of electronic information and information systems, and that the agency's information systems were decentralized and lacked focused oversight and coordination.

Our previous audit of OHA conducted in 2005, Report No. 05-03*, Audit of the Office of Hawaiian Affairs,* found that OHA lacked a comprehensive master plan for bettering the conditions of Hawaiians; continued to struggle with the effects of poorly planned reorganizations; and casually administered its finances. With respect to investments, we found that OHA's investment policy and investment oversight lacked key components, and that the lack of investment advisor oversight prevented its trustees from receiving sufficient information to evaluate advisor performance. Many of the same findings were echoed in our reports from previous years as well as in audits conducted by independent auditors contracted by OHA.

Objectives of the Review

1. Review the Office of Hawaiian Affairs' organization, policies and procedures, and practices over its investment portfolio for the period of FY2004 through FY2008.

2. Assess whether OHA's Board of Trustees has fulfilled its fiduciary duties to safeguard the resources of the Native Hawaiian Trust Fund.

3. Review OHA's efforts to implement prior audit recommendations.

4. Make recommendations as appropriate.

Scope and Methodology

The scope of the engagement was to review the investment portfolio of the Office of Hawaiian Affairs for the period of July 1, 2003 through June 30, 2008. Our review considered information through December 31, 2008, as available and relevant to our overall objectives. We procured the services of the investment consulting firm Navigant Consulting, Inc. to evaluate OHA's management of its investments, including reviewing policies, procedures, and use of external advisors.

The consultant interviewed OHA trustees and personnel involved in oversight and management of investments. The firm reviewed investment policies and procedures, including those relating to organization and structure; governance and oversight; risk management and tolerance; asset allocation; third-party service agreements; and targets, performance measures, and benchmarks. In addition, the firm obtained and analyzed statements of investment holdings, transactions, and performance. The firm further reviewed agreements and relationships with external investment advisors and consultants.

We conducted our review from January 2009 through March 2009.

This page is intentionally left blank.

Chapter 2

OHA Must Strengthen Its Investment Framework To Meet Its Fiduciary Obligations

The Office of Hawaiian Affairs (OHA) is a unique entity in Hawai‘i state government—it is both a government agency and an autonomous trust. Unlike other island trusts with specific missions, such as Kamehameha Schools' focus on education and the Queen Emma Foundation's concentration on improving health, OHA has a much broader, comprehensive mandate: to provide the opportunity for a better life and future for all Hawaiians. The agency's constituents—native Hawaiians and Hawaiians—are widespread and dispersed not only throughout the islands but across the nation and the globe. According to the U.S. Census 2000 data, there are approximately 400,000 Hawaiians throughout the nation with more than 239,000 living in the State of Hawai‘i. Given OHA's vast mission and scope, as well as its numerous beneficiaries, it is critical that OHA fulfill its fiduciary responsibilities, particularly with respect to the Native Hawaiian Trust Fund.

The OHA Board of Trustees is highly involved in the activities of the agency, particularly with respect to the OHA-sponsored programs and services that benefit the Hawaiian people. Recent improvements to the board's overall governance demonstrate that the current board has a higher level of awareness of its role and better oversight of the programs and services that OHA provides. The agency has also recently enhanced its investment procedures in a number of ways. However, OHA's investment framework and process are still inadequate to satisfy OHA's responsibilities with respect to the trust and significant improvement is needed. Additionally, a majority of the recent enhancements were adopted after our review was initiated—many years after initially recommended.

While it is evident that OHA is working to strengthen its structure, policies, and procedures related to the trust's investments, the board and its agency must make further improvements to ensure that the office is prudently managing the trust and satisfying its fiduciary obligations to beneficiaries.

Summary of Findings

1. The OHA Board of Trustees must improve its investment structure and governance to carry out its duties.

2. The trust's lackluster performance warrants review of the advisory services' policies, processes, and performance.

3. Many recent improvements to the investment process have been made, but more work is needed.

The OHA Board of Trustees Must Improve Its Investment Structure and Governance To Carry Out Its Duties

The OHA Board of Trustees is highly involved in the activities of the agency, particularly with respect to the OHA-sponsored programs and services that benefit the Hawaiian people. The board's overall governance has improved since prior audits and reflects a higher level of awareness of its role in setting policy and performing oversight to carry out better the programs and services it provides. Despite these improvements, however, the board's structure and governance specific to investments are still lacking. While it is evident that the board is concerned with the trust's performance, improvements are needed to ensure the trustees are prudently and effectively monitoring the trust's investments and meeting their fiduciary obligations.

As discussed in Chapter 1, since February 2003, the board has utilized a manager-of-managers structure under which OHA's external investment advisors, Frank Russell Investments and Goldman Sachs, have full investment discretion, including the responsibilities of hiring and terminating managers, performing due diligence reviews of managers, and allocating resources to the managers within the specifications of OHA's investment policy statement.

Although the board has outsourced management of its investments to external advisors, the trustees still retain their fiduciary duty with respect to investments, as that duty cannot be delegated. In order to meet this fiduciary obligation, the board must maintain proper oversight of the investment advisors and managers, which includes not only keeping informed of details related to the trust's investment performance and asset allocation, but also maintaining a sufficient level of general investment knowledge and awareness to properly oversee them.

However, the OHA board as a whole does not possess an adequate level of financial or investment knowledge or experience to properly oversee the trust and its investments. Although proper training of trustees could remediate this deficit and optional training is offered during the year, training is not required either upon joining the board or periodically thereafter, and thus most trustees do not regularly attend. The board's Asset and Resource Management (ARM) Committee, which is responsible for investments and other fiscal matters, likewise lacks sufficient investment training and expertise to effectively provide the board with useful recommendations.

In addition, the board's governance policies that affect the trust's investments are deficient. The code of ethics policy in the board's Investment Policy Statement is inadequate to ensure potential conflicts and other violations are identified, reported, and resolved. The vague and ambiguous language of the board's policy regarding the trust's fiscal reserve has led to conflicting views among trustees and staff as to the purpose of the reserve and how it may be used, which has left the fund largely unutilized and with an excessive multi-million dollar balance.

These deficiencies diminish the ability of the board and OHA to effectively govern and oversee the investments of the trust. The board must improve upon its current investment structure and governance in order to ensure it is prudently managing the trust and satisfying its fiduciary obligations to OHA's beneficiaries.

Board members as a whole lack sufficient investment expertise and training

For the nine elected trustees, there is no minimum level of financial or investment expertise required to run for or serve on the board. The current board has three members with some type of financial experience, attaining their knowledge from board appointments, teaching positions, and degrees achieved. However, they do not have the type of investment experience or expertise that would qualify them as investment experts.

Because of the magnitude of OHA's funds and the implications of how they are used, overseeing the investment and management of OHA's funds is a primary responsibility of the board. According to the National Standards for U.S. Community Foundations published by the Council on Foundations, as a steward of charitable funds, a board must be financially literate and have a solid understanding of investments in order to prudently manage funds. In addition, the *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*, published by the Panel on the Nonprofit Sector (an independent effort by charities and foundations comprised of 24 nonprofit and philanthropic leaders in the U.S.), states:

> A board should establish an effective, systematic process for educating and communicating with board members to ensure that they are aware of their legal and ethical responsibilities, are knowledgeable about the programs and activities of the organization, and can carry out their oversight functions effectively.

Despite the varied backgrounds of the OHA trustees and their limited investment and financial experience and expertise, the board does not have any policy requiring members to attend investment training either upon initially joining the board or on a periodic (e.g., annual) basis thereafter. Trustees are not even provided a detailed training and orientation on their roles and responsibilities with respect to the trust upon first joining the board. Although OHA provides optional investment training sessions and workshops during the year, attendance is not mandatory, and therefore most trustees do not regularly attend. As a result, the trustees as a group lack sufficient investment experience and instead rely on the external investment advisors and a contracted investment consultant to provide financial guidance. However, without independent investment knowledge and awareness, the board cannot ensure that its members are up-to-date on current market events, able to properly understand the risks of investing, and able to properly analyze the reports given each month by the investment advisors.

The Asset and Resource Management Committee framework should be enhanced

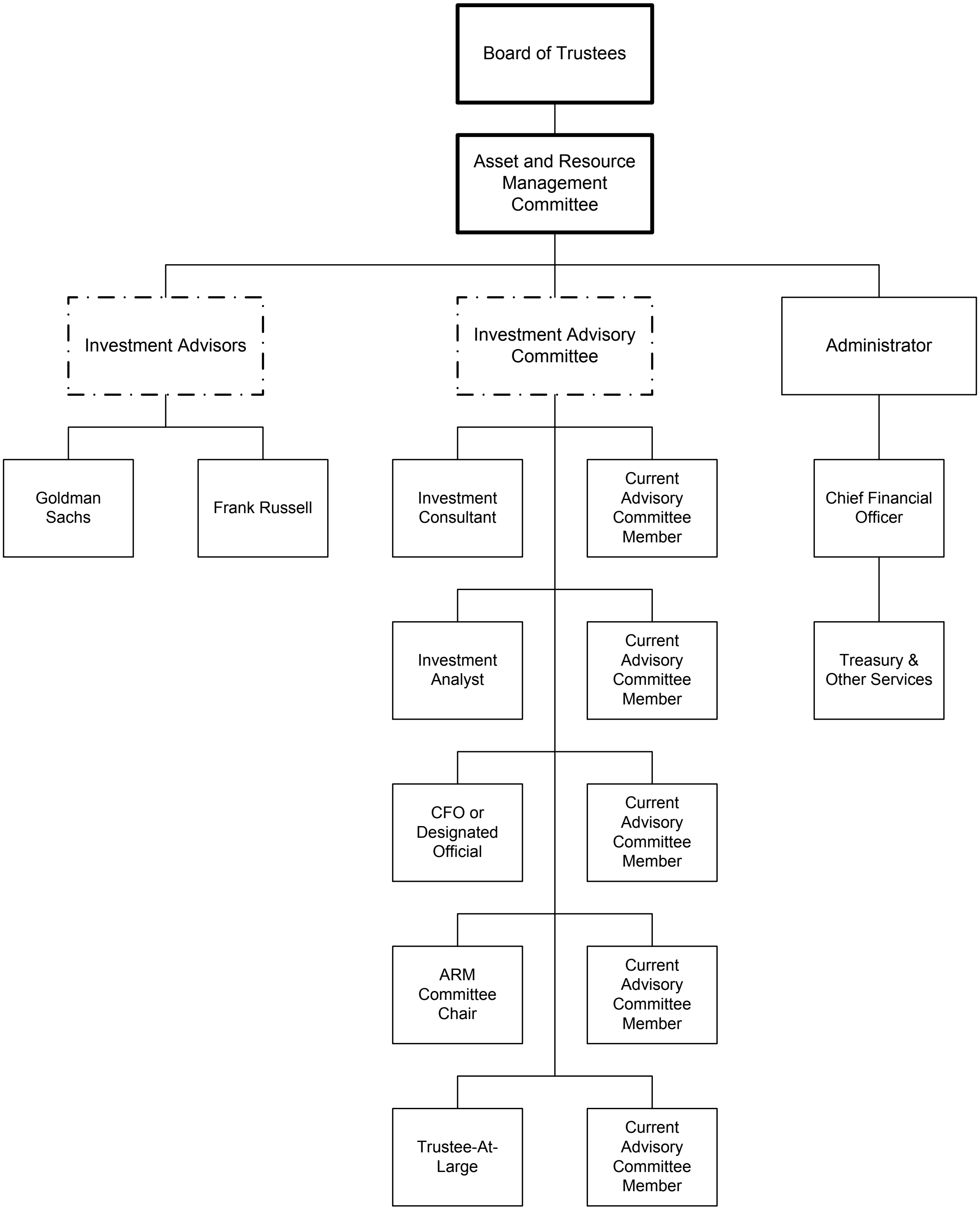
The board has two established committees whose approved actions and recommendations are forwarded to the board for consideration and final approval. The Asset and Resource Management (ARM) Committee handles all fiscal and budgetary matters, including the investment portion of the trust. The Beneficiary Advocacy Empowerment (BAE) Committee focuses on the agency's legislative and advocacy efforts, as well as OHA programs that address issues relating to health, human services, education, housing, land use, environment, and natural resources. Both the ARM and BAE Committees are committees of the whole and are comprised of all board members. According to board members and OHA staff, this two-committee structure was implemented in 2003, replacing the previous five-committee structure, which experienced information flow and quorum problems.

According to Vanguard's "View of Best Practices for Investment Committees," which provides guidance on how committees can incorporate best practices, an investment committee should have: (i) an explicit understanding of the portfolio's purpose and objective and a clear understanding of success; (ii) a charter outlining the roles and responsibilities of committee members; (iii) a clear investment strategy; (iv) a straightforward process for hiring managers; and (v) common sense and discipline. Vanguard, which holds a significant presence in institutional markets, is among the top three mutual fund money managers in the U.S. with regard to assets under management, and has had the opportunity to observe the activities of thousands of investment committees.

The ARM Committee is primarily responsible for overseeing matters related to the investments of the trust and receives reports from the investment advisors for review prior to presenting to the board. However, because the ARM Committee is comprised of all board members and, as discussed above, the board as a whole lacks sufficient investment training and expertise, the committee does not specifically consist of members with appropriate knowledge over investment-related matters. During interviews, the ARM Committee chair, vice-chair, and key OHA staff involved with investments all noted that the ARM Committee as a whole lacks expertise in dealing with capital markets and asset allocation matters.

During the review, we noted that OHA currently has an investment advisory committee made up of the OHA investment consultant and investment analyst, as well as several distinguished members of the community, such as an attorney experienced in the areas of financial services, corporate, and administrative law; two managing directors of a locally based securities brokerage firm; and the president and owner of a real estate development firm. This committee provides recommendations to OHA's administrator and staff on a periodic basis. While it does have a charter, the Investment Advisory Committee lacks mandatory trustee involvement or insight, as well as any actual authority. The current advisory committee setup should be enhanced to constitute a formalized, investment-specific committee, which provides detailed recommendations on a structured schedule directly to the ARM Committee. This enhanced committee would be comprised of more internal OHA staff, including financially literate trustee(s), to ensure the interests of OHA are at the forefront of the committee. A visual illustrating the proposed structure of the enhanced investment advisory committee is included below as Exhibit 2.1.

Exhibit 2.1
Proposed Investment Advisory Committee Structure



Source: Navigant Consulting, Inc.

The investment policy statement's code of ethics policy is inadequate

We found that the board's Investment Policy Statement does not contain a comprehensive code of ethics policy to address investment management industry best practices for preventing, identifying, and resolving conflicts of interest and other violations. The investment policy code of ethics in place during the review period included the following provisions: (i) trustees, officers and employees should refrain from personal business activities that shall impair their decisions; (ii) employees and investment personnel should disclose any material interest in financial institutions they conduct business with and any personal holdings that could relate to the trust; and (iii) employees and officers shall refrain from investment transactions with whom business is conducted on behalf of the trust. However, the policy does not identify all potential conflicts and does not establish reporting requirements, escalation procedures, or reporting lines. There is also no requirement that trustees certify that they are in compliance with the code of ethics or that they have disclosed all potential conflicts. With no formalized, documented process, the board may not be aware of potential conflicts that could affect the agency as a whole. Furthermore, conflicts and violations could go unreported.

In addition, OHA does not have a "whistleblower" policy or a toll-free phone line available to OHA staff and beneficiaries to report potential conflicts, violations, or other issues. We noted that each board meeting opens with the opportunity for the community to voice concerns and ends with the opportunity for beneficiaries to provide comments. However, OHA does not track general beneficiary concerns or complaints specifically related to the trust. Beneficiaries and staff are therefore less likely to report issues and complaints, and OHA cannot ensure complaints and issues are properly received and resolved.

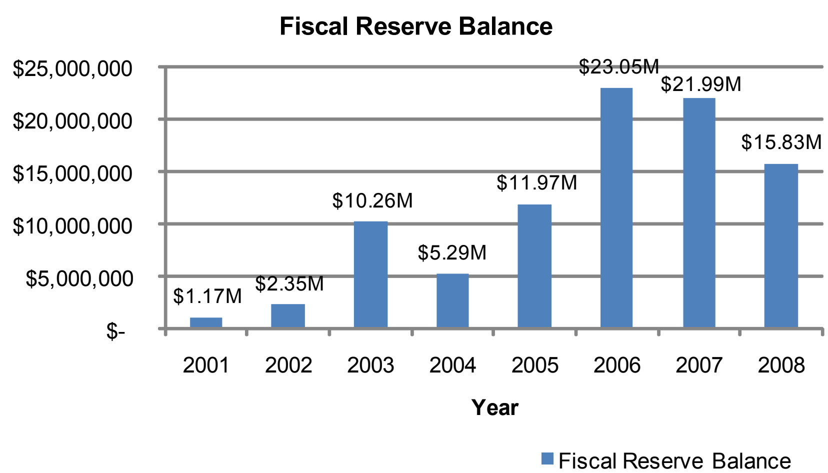
According to the National Standards for U.S. Community Foundations, a foundation's governing body should implement and approve policies to prevent perceived potential or actual conflicts of interest, including requiring the documentation of disclosures of conflicts of interest. In addition, according to the *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*, a foundation should establish and implement policies and procedures that enable individuals to come forward with information on illegal practices or violations of organizational policies. Such a whistleblower policy should specify that the organization will not retaliate against and will protect the confidentiality of individuals who make good faith reports.

OHA's vague fiscal reserve policy has resulted in a $17.7 million reserve account

We found that OHA maintains a fiscal reserve fund, which is informally known as a "rainy day fund." The fiscal reserve was established in 2001 and, although separately accounted for by the board, the related moneys remain a part of the trust fund. The fiscal reserve policy is an attachment to the Native Hawaiian Trust Fund Spending Policy and was last updated in 2003. The spending policy states that the annual spending withdrawals shall include: "Any funds available but not spent in previous fiscal years, held within the Native Hawaiian Trust Fund." Accordingly, the source of funding for the fiscal reserve is a year-end budget surplus of audited financials.

The fiscal reserve policy does not provide for any cap on the reserve, and as a result, the reserve has been allowed to balloon from $1 million in 2001 to $17.7 million as of December 31, 2008. In 2006 and 2007, the reserve balance exceeded $20 million. We do note that the entire balance of the $17.5 million legislative appropriation to OHA due to underpayments of ceded land revenues between July 1, 2001 and June 30, 2005, was credited to OHA's fiscal reserve in 2006. Exhibit 2.2 below illustrates the balance of the fiscal reserve since its inception in 2001 through 2008.

Exhibit 2.2
Fiscal Reserve Balance for 2001-2008



Source: Navigant Consulting, Inc., based on information provided by the Office of Hawaiian Affairs

A further cause for concern is the fact that the fund appears to be largely unutilized. This is likely due to the lack of a defined policy regarding how fiscal reserve funds are to be spent. The fiscal reserve policy itself does address use of the reserve funds. However, in Attachment A to the spending policy (which is not referenced in the spending policy), the Native Hawaiian Trust Fund Spending Policy's Fiscal Reserve Withdrawal Guidelines (adopted October 9, 2003), states: "OHA's fiscal reserve fund is designed to provide money in certain situations. These situations are defined as combinations of circumstances calling for immediate action."

This vague language appears to have led to confusion among board members and administrative staff as to how the fiscal reserve is to be used. The conflicting views included: (i) the trustees can utilize the reserve when they deem necessary with six votes; (ii) the reserve is only to be used for emergencies; and (iii) the administration has access to and controls the spending of the fiscal reserve. In addition, we discovered that in 2004, a few trustees raised concerns that the fiscal reserve policy was invalid due to a dispute as to whether it was considered a "policy" requiring two readings and six "yes" votes, or a "guideline" requiring one reading and five votes—the policy had received one reading and six votes. Increasing the ambiguity is the fact that the fiscal reserve policy, which was last updated in 2003, was not physically attached to or referenced in the most recent spending policy, which was amended on July 6, 2006. We noted that the OHA administrator and the chief financial officer both believe that the fiscal reserve policy is valid even though it may have received only one reading and that the 2003 version of the policy is incorporated into the current spending policy.

In addition to underutilizing the reserve, the vague fiscal reserve policy could potentially result in OHA using the reserve funds in a manner that is neither specifically mandated nor consistent with the agency's purpose. Also, with no cap on the reserve, the balance may continue to grow excessively, thereby increasing the amount of funds set aside that could be used in such a manner or not be used at all. Further, without clearly defined guidelines, it is not possible to determine the effectiveness of the grant distributions made by the board respective to the fiscal reserve pool.

The Trust's Lackluster Performance Warrants Review of the Advisory Services' Policies, Processes, and Performance

The Office of Hawaiian Affairs has a structure and process in place for overseeing the trust's investments and monitoring the performance of its contracted investment advisors and managers. Although OHA has made recent improvements to the process, for most of the review period, the policies and procedures in place were inadequate to satisfy OHA's responsibilities with respect to the trust. Even with the recent enhancements, significant progress is needed.

We found that the trust's investments were underperforming for the majority of the review period of FY2004 to FY2008, 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. In addition, despite the importance of investment performance, OHA did not properly monitor and evaluate performance by updating its investment policy statement as needed, ensuring accurate and consistent performance reporting by the investment advisors, and implementing a proper risk management program.

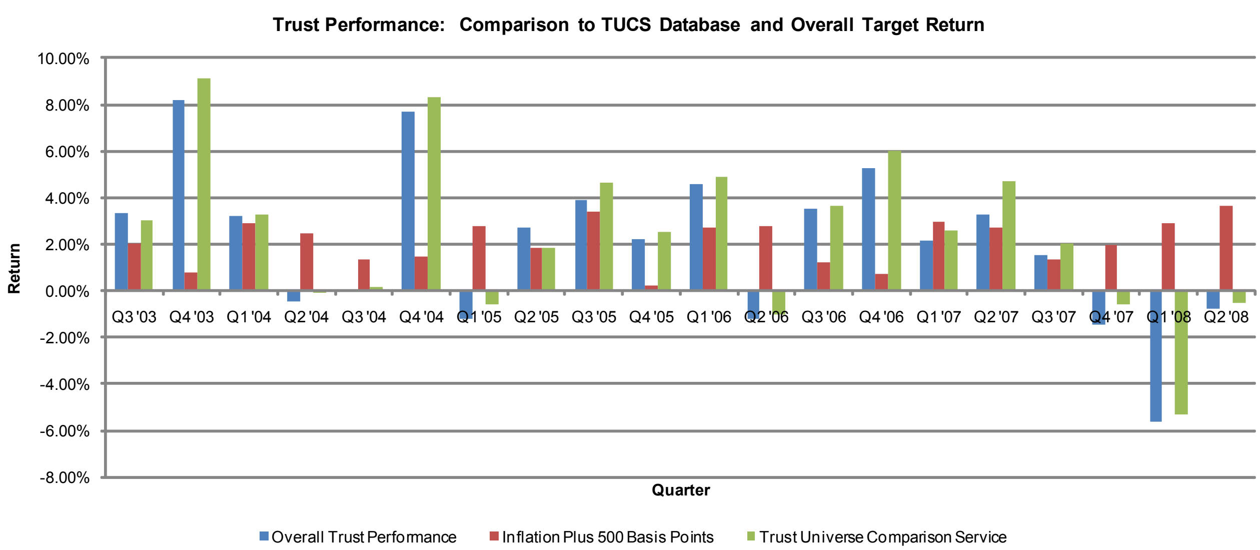
Since the initial procurement of the current investment advisors in February 2003, OHA has not evaluated whether its advisory fees—which averaged more than $3 million annually for FY2006-2007—are reasonable and competitive. Further, OHA has not established procedures to effectively monitor the activities of the advisors with respect to key areas of investment compliance, valuation, account reconciliations, and proxy voting—all critical to the proper maintenance and oversight of the trust's investments. 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 its peer group.

The recent improvements OHA has made with respect to the investment process demonstrate that the agency is working to enhance monitoring of the trust's performance and of the investment advisors and managers. If OHA continues down this path and further addresses the limitations identified below, it will strengthen its investment process and framework and help ensure that its fiduciary responsibilities with respect to the trust are satisfied.

The trust is underperforming, failing to meet target earnings' goals

The Native Hawaiian Trust Fund did not outperform OHA's overall target objective, which is the Consumer Price Index (CPI) plus 500 basis points, in eight out of 20 quarters reviewed. We further observed that the trust did not outperform the Trust Universe Comparison Service (TUCS) median return in 18 out of 20 quarters reviewed. The trust failed to be in the top half of the TUCS universe for all but two quarters during the review period of fiscal years 2004 to 2008, thus precluding it from being in the top 40 percent of tax-exempt portfolios—a stated goal in Section 13.6 of OHA's 2003 investment policy. We used the TUCS study for comparison based on readily available information; however, the CommonFund Study may likewise be a suitable peer comparison for OHA. We also noted that the OHA trust returns are calculated gross of fees by Goldman Sachs, which skews the results higher so actual returns may be lower. Exhibit 2.3 illustrates how the trust's returns have generally lagged behind its peers and its own targets over the past five fiscal years.

Exhibit 2.3
Trust Performance Compared to the TUCS Database and OHA's Overall Target



Quarter	Overall Trust Performance		Inflation Plus 500 Basis Points	Differential	Trust Universe Comparison Service	Differential
FY 2004	14.31%		8.19%	6.12%	15.35%	-1.04%
FY 2005	9.25%		7.48%	1.77%	9.78%	-0.53%
FY 2006	9.52%		9.18%	0.35%	11.08%	-1.56%
FY 2007	14.23%		7.62%	6.61%	16.97%	-2.74%
FY 2008	-6.31%		9.85%	-16.16%	-4.31%	-2.00%

*These results are presented on an aggregated basis based on the quarterly information that was reviewed.

Source: Compiled from OHA's quarterly performance reports and the TUCS Universe of Endowments

Global economic and market events can be regarded as the cause for the recent failure to beat the overall target objective. However, the fact that the trust was not in the top half of the TUCS universe for all but two of the quarters reviewed warrants a close review of the managers' advisory services and subsequent fees and performance results.

The Office of Hawaiian Affairs established a spending policy to ensure the continued viability of the trust by maintaining principal and producing stable and predictable spending. The Office of Hawaiian Affairs is allowed to spend 5 percent of the trust's average market value over the preceding 12 quarters. When compared to the spending policy, the purpose of the trust's investment target (inflation plus 500 basis points, or 5 percent) is to ensure that the assets of the trust track inflation while providing 5 percent of its value for spending purposes without decreasing the overall value of the trust.

Since the trust struggles to meet its goal of inflation plus 500 basis points, which is equal to the annual spending amount, the trust size will decrease as the annual budget is drawn in accordance with the spending policy. According to our analysis, the trust is not performing in the top half of the TUCS peer universe, and as a result, the trust's value is not increasing as much as its peers, which decreases the level of its eligible future spending.

According to the National Standards for U.S. Community Foundations, published by the Council on Foundations, a community foundation has a long-term goal of securing resources to address the changing needs of the community it serves. This standard implies that it should be the goal of OHA to secure the resources of the trust. By tracking the performance of its peers, OHA can be better positioned to achieve its target returns.

OHA has not properly monitored and evaluated investment performance

The investment performance of the trust is the most important driver of the investment advisor relationship, so OHA should ensure that it has strong monitoring capabilities in order to be fully aware of all issues and incidents. However, we found that OHA did not regularly review and update its investment policy statement, placed overreliance on the investment advisors to monitor investment performance, and had not developed a formal risk management and assessment program.

OHA does not regularly review and update its investment policy

We confirmed through interviews that OHA staff commonly understood the trust performance target to be CPI (inflation) plus 5 percent. However, Section 2.2 of the 2003 investment policy states the target to be CPI plus 4 percent. The commonly understood target return of inflation plus 500 basis points appears consistent with OHA's spending policy, which allows spending of 5 percent of the trailing 12-quarter average of trust assets on an annual basis.

While this discrepancy appears to have been addressed in OHA's updated investment policy, implemented in January 2009, which correctly states the target at CPI plus 5 percent, it illustrates the fact that OHA did not understand the importance of reviewing and ensuring the investment policy is current on at least an annual basis. This discrepancy may cause confusion when reviewing the performance of the trust compared to the stated overall target return. Also, by not regularly evaluating the tactical asset allocation through the investment policy, the trust may not benefit from adjusting the asset allocation to take advantage of asset classes that may outperform the existing allocation.

OHA relies heavily on the investment advisors' performance reports, which are not standardized

The Office of Hawaiian Affairs relies heavily on the investment advisors for performance reporting. Section 13.4 of the investment policy (2003) entitled "Performance Monitoring" states that OHA will review monthly statements, in addition to quarterly investment manager performance reports. The Office of Hawaiian Affairs informed us that it has always reviewed custodial statements monthly; however, it is not clear whether Section 13.4 pertains to detailed manager statements or custodian statements. Additionally, we noted that the custodial review has not been documented in a formalized manner during the review period, except at the time of the year-end audit.

Each quarter the investment advisors present the performance of the trust to the board. Through on-site interviews, we learned that OHA does not calculate performance independently, and during the review period, did not have a consistent process in place to aggregate the performance of the investment managers. The overreliance on investment advisors is unwarranted, especially since their reports were not consistently prepared, lacked peer comparisons, and inaccurately reflected benchmarks:

Inconsistent reporting of fees – The Frank Russell Investments quarterly performance reports calculate performance net of fees and discloses this data, whereas the Goldman Sachs quarterly performance reports calculate performance gross of fees and discloses this on each statement. This causes the reported performance to be skewed higher for Goldman, as it does not deduct management fees. Regulators have noted that performance results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid do not reflect actual investment results.

Inconsistent peer group comparisons – We also observed that OHA did not consistently receive information from Goldman Sachs comparing the results of its investments to a peer average for respective asset classes (e.g., Lipper – a global leader in supplying mutual fund information, analytical tools, and commentary), nor did the advisors consistently provide an overall trust return comparison to similar portfolio structures on a quarterly basis (e.g., TUCS, Wilshire). Since 2007, the Goldman Sachs quarterly performance reports have contained information regarding comparison to the TUCS database as well as the Lipper peer averages. The Office of Hawaiian Affairs' investment consultant reviews the TUCS database as well as CommonFund Studies on an annual basis. Frank Russell Investments provides Lipper comparisons on its quarterly performance reports to OHA and has done so throughout the entire relationship. Russell has also provided annual comparisons to the CommonFund Study since 2007.

Inaccurate benchmarks – We further observed that the quarterly performance reports presented by Goldman Sachs and Frank Russell Investments do not accurately reflect the custom benchmark as prescribed by OHA. Exhibit 2.4 below provides a detailed comparison of OHA's investment benchmarks to those of its investment advisors for fiscal years 2003 through 2008. The Frank Russell Investments benchmark is similar, although a few of the asset weightings are different from OHA's custom benchmark. These observations can be attributed to the fact that a standardized quarterly performance report was not established by OHA until early 2007, and the investment advisors have been slow in implementing these changes. The slow enhancement results from the fact that OHA had not developed and adopted vendor oversight policies and procedures to monitor the investment advisors to ensure these changes were implemented. The standardized quarterly performance report created by OHA in early 2007 created a standardized benchmark and required the investment advisors to compare returns to peer institutions and funds. As a result of these requested enhancements, OHA has been working with the investment advisors in order to standardize the quarterly reports based on these new changes.

Exhibit 2.4
Comparison of OHA's Investment Benchmarks to Its Investment Advisors for FY2003 Through FY2008

Benchmark	2003	2004	2005	2006	2007	2008
OHA						
Large Cap Equity	—	—	—	—	25% R1000	25% R1000
Small Cap Equity	—	—	—	—	10% R2000	10% R2000
Non-US Equity	—	—	—	—	10% MSCI EAFE	10% MSCI EAFE
Fixed Income	—	—	—	—	20% LB Aggregate	20% LB Aggregate
High Yield	—	—	—	—	5% Salomon HY	5% Salomon HY
Real Estate	—	—	—	—	10% of 75% NCREIF, 25% NAREIT	10% of 75% NCREIF, 25% NAREIT
Absolute Return	—	—	—	—	10% 3 mo LIBOR + 4%	10% 3 mo LIBOR + 4%
Private Equity	—	—	—	—	10% MSCI World + 5%	10% MSCI World + 5%
Goldman Sachs						
Large Cap Equity	36% R1000	36% R1000	36% R1000	36% R1000	36% R1000	36% R1000
Small Cap Equity	6% R2000	6% R2000	6% R2000	6% R2000	6% R2000	6% R2000
Non-US Equity	13% MSCI EAFE net unhedged	13% MSCI EAFE net unhedged	13% MSCI EAFE net unhedged	13% MSCI EAFE net unhedged	13% MSCI EAFE net unhedged	13% MSCI EAFE net unhedged
Fixed Income	30% LB Aggregate	30% LB Aggregate	30% LB Aggregate	30% LB Aggregate	25% LB Aggregate	25% LB Aggregate
High Yield	—	—	—	—	5% Citi US HY Cash	5% Citi US HY Cash
Real Estate	5% Wilshire RE	5% Wilshire RE	5% Wilshire RE	5% Wilshire RE	5% Wilshire RE	5% Wilshire RE
Absolute Return	10% 3 mo US Libor	10% 3 mo US Libor	10% 3 mo US Libor	10% 3 mo US Libor	10% 3 mo US Libor	10% 3 mo US Libor
Private Equity	—	—	—	—	—	—
Frank Russell Investments						
Large Cap Equity	34% R1000	34% R1000	44.5% R3000	44.5% R3000	28% R1000	28% R1000
Small Cap Equity	10% R2500	10% R2500			8% R2000	8% R2000
Non-US Equity	10% MSCI EAFE	10% MSCI EAFE	10% MSCI EAFE	10% MSCI EAFE	16% MSCI EAFE Net	16% MSCI EAFE Net
Fixed Income	35% LB Aggregate	25% LB Aggregate	25.5% LB Aggregate	25.5% LB Aggregate	23% LB Aggregate	23% LB Aggregate
High Yield	—	—	—	—	—	—
Real Estate	9% REEF Mean, 3% NAREIT	8% REEF Mean, 3% NAREIT	7% Russell Open-End RE Mean, 3% NAREIT	7% Russell Open-End RE Mean, 3% NAREIT	7% NCREIF, 3% NAREIT	7% NCREIF, 3% NAREIT
Absolute Return	—	10% 30 day LIBOR + 4%	10% 30 day LIBOR + 4%	10% 30 day LIBOR + 4%	10% 30 day LIBOR + 4%	10% 30 day LIBOR + 4%
Private Equity	—	—	—	—	5% LIBOR 30 day	5% LIBOR 30 day

Source: Compiled from OHA's quarterly investment performance reports for FY2003-FY2008

The Office of Hawaiian Affairs has become overly dependent upon the services offered by Goldman Sachs and Frank Russell Investments and did not require the managers to standardize their reports at the beginning of their respective relationships. As a result, OHA may not have accurate performance reports available with which to monitor the trust's performance; the performance reports received from Goldman Sachs were not a good representation of the portfolio's actual returns (as they are gross of fees). Also, the reports do not allow OHA to compare the returns to similar funds on an asset class basis or to peers (e.g., endowments) on an overall return basis. Consequently, the board is not aware of the trust's performance relative to its peers, and the information that was omitted by the investment advisors would provide a suitable comparison.

Subsequent to the initial review period, during November 2008, OHA entered into a new custodial contract with Frank Russell Investments, which in turn was sub-contracted to State Street. This new relationship is anticipated to provide enhanced reporting features, as State Street should aggregate investment data from both investment advisors and independently calculate trust performance.

OHA had not created a risk management program during the review period

The Office of Hawaiian Affairs had not created a risk management program during the period under review, including the development of a documented risk assessment. Section 3080, 3.8.a, of the OHA Board of Trustees Executive Policy Manual (dated November 2007), states that the board shall approve a risk management policy that will minimize potential losses, satisfy the Uniform Investment Act, improve the management of existing uncertainty, as well as improve the management of the approach and priorities to new opportunities.

The Office of Hawaiian Affairs did not have a board-approved risk management policy or a risk assessment matrix during the review period. Without a risk management or assessment policy or process, OHA is unable to identify, evaluate, and adequately monitor potential risks, including high-risk areas to the trust and OHA. The board may be unable to prevent or identify potentially damaging problems from occurring or reoccurring.

A best practice risk assessment program should include a self assessment of existing operational and compliance controls, focusing on areas within OHA where controls or supervision may place the trust at risk. Risks such as failure to meet investment return goals, failure to achieve tactical or strategic allocation goals, failure to effectively safeguard trust assets, and failure to identify potential conflicts of interest should be identified. Additionally, procedures should be written and implemented to mitigate these risks where needed. The risk assessment review process should occur at least annually to ensure OHA maintains effective implementation of mitigating risk factors.

We do note that a risk assessment program (including a risk matrix and policy), drafted and dated January 2009, is pending approval by OHA's chief financial officer. However, the drafted risk assessment does not include a risk assessment methodology.

OHA has not evaluated whether its investment advisors' fees are reasonable and competitive

The OHA board has not evaluated the cost of existing investment options against comparable investment funds to identify potential cost savings to ensure the advisory fees paid are competitive. In February 2003, the board decided to transition from the previous investment structure of nine separate money managers to the current manager-of-managers structure. The board submitted a request for proposals (RFP) to several managers and, based on the responses and internal deliberations, selected Goldman Sachs and Frank Russell Investments as its new investment advisors. Since this initial RFP request, OHA has neither reached out to the market to determine available fee structures for comparable services, nor has it completed an analysis of advisory fees being paid by peers.

According to the Uniform Prudent Investor Act in state law, Section 554C-7, Hawai‘i Revised Statutes, "In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purpose of the trust, and the skills of the trustee." Further, according to the National Standards for U.S. Community Foundations, published by the Council on Foundations, a community foundation is responsible to ensure that the foundation's financial resources are used solely in furtherance of its mission. The National Standards provide examples demonstrating that the assets of the foundation should be distributed to those employed by the foundation within a range considered to be reasonable and customary for community foundations of a similar size.

We noted that OHA's investment consultant has documented a review of advisory fees paid during his 2006 and 2007 annual reports to the board; however, this review failed to provide any analysis based on industry averages of advisory fees paid. Exhibit 2.5 illustrates the fees paid to each investment advisor during this period.

Exhibit 2.5
Investment Advisory Fees Paid By OHA During 2006 and 2007

	2006		2007	
	Advisory Fees	**% of Total**	**Advisory Fees**	**% of Total**
Goldman Sachs	$1,597,000	53.3%	$1,834,000	54.9%
Frank Russell Investments	$1,398,000	46.7%	$1,509,000	45.1%
Total Advisory Fees	$2,995,000	100.0%	$3,343,000	100.0%

Source: Derived from 2006 and 2007 investment reports prepared by OHA's investment consultant

The Office of Hawaiian Affairs is unable to ensure that its advisory fees are appropriate and reasonable for a trust similar in size without performing a fee analysis or ensuring competition by issuing another RFP for advisory services. As a result, OHA may be paying fees that are higher than necessary for comparable services, thus decreasing the value of the trust as the net performance of the trust suffers.

OHA does not maintain adequate oversight of investment advisors' activities

The Office of Hawaiian Affairs' manager-of-managers approach provides investment advisors with great responsibility, including monitoring the performance of investment managers. But the board still bears the ultimate responsibility for the performance of the trust and must understand the actions and policies of the investment advisors. However, during the review period, OHA did not have several key procedural controls in place to effectively monitor the activities of the investment advisors with respect to investment compliance, valuation, account reconciliations, and proxy voting. These areas are critical to the proper maintenance of the investment trust and require sufficient oversight by OHA and the board.

OHA did not consistently monitor investment compliance during the review period

During fiscal years 2004 to 2008, OHA did not receive sufficient information from the custodian and investment advisors, including quarterly attestations of compliance and exception reports, to monitor compliance with the investment guidelines. In addition, the investment advisors do not certify quarterly or annually that they are compliant with the trust's investment guidelines.

According to industry best practices with respect to Rule 38a-1 under the Investment Company Act of 1940, OHA should establish compliance monitoring procedures to ensure the trust is not invested in any prohibited securities and has not fallen outside the asset allocation guidelines. The Investment Company Act of 1940 is a federal law that was created to regulate the actions of investment companies (i.e., mutual funds).

The board is unable to ensure that its portfolio is comprised in accordance with its Investment Policy Statement without adequate reports and attestations provided by the investment advisors and custodian. As a result, the trust could potentially be outside the stated asset allocation parameters, or the trust may be invested in prohibited investments. We do note, however, that OHA recently entered into a new custodial agreement with Frank Russell Investments in November 2008. The new custodian is anticipated to be able provide the relevant information with respect to holdings. Additionally, OHA is currently in the process of developing a quarterly control questionnaire that requires investment advisors to certify compliance with the investment policy.

OHA does not have a valuation policy and process to ensure the trust's investment holdings are fairly and accurately valued

The Office of Hawaiian Affairs has not developed a governing valuation policy even though the trust invests in illiquid securities through its ownership of private equity funds that have illiquid holdings (such as the Pantheon Europe Fund IV, L.P. and the Goldman Sachs Private Equity Partners fund). An illiquid security is a security that cannot be readily converted into cash. Such valuations are considered high-risk processes within the investment management community, because client performance can be harmed if the investment advisor bases its advisory fee on overvalued holdings.

The board relies on the investment advisors for determining the value of illiquid securities; however, the advisors have an inherent conflict of interest to over-price these securities, thereby increasing fees and portraying better performance. If the advisors and managers' valuation procedures are not adequately reviewed or carried out in accordance with stated guidelines in the Investment Advisor's Policy, OHA may be overpaying its advisors, because it does not understand or identify whether securities are appropriately priced. This issue does appear to have been addressed in the updated investment policy, implemented in January 2009, which defines illiquid securities.

Due to the complexity of valuing illiquid securities and the inherent conflicts, a valuation policy should be created to ensure that trust assets are being properly valued in accordance with the investment advisors' policies. According to the director of the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission, in a speech to the Investment Advisor Compliance Best Practices Summit 2008, "advisory clients need to know the fair value of their holdings, and they can be harmed if the advisor overcharges its advisory fee based on overvalued holdings."

OHA did not sufficiently perform and document account reconciliations between the custodian and investment advisor statements

The Office of Hawaiian Affairs receives separate investment statements from the two investment advisors as well as a statement from the custodian. These statements should be reconciled together on a monthly basis to ensure dollar values of each portfolio are recorded accurately, identify any discrepancies, and determine the current market value of the overall trust. However, through a review of policies and procedures and documents, as well as staff interviews, we found that OHA did not consistently and sufficiently document the reconciliations between the custodian and the investment advisor statements from FY2004 through FY2008. During a majority of the review period, investment account reconciliations between the custodian and the investment advisor statements did not occur on a transparent basis, and as a result, OHA may have been unable to ensure the dollar values recorded by each party reconciled appropriately. The reconciliation process lacked working paper documentation, a review checklist or template, and evidence of supervisory review and sign-off.

The Office of Hawaiian Affairs does not have written procedures in place to document reconciliations between the custodian and the investment advisor statements respective to the assets owned by the trust to ensure important responsibilities are being performed by appropriate staff members. We also noted that the custodian maintains the official books and records of the trust. Failure to properly and timely reconcile investment accounts makes it difficult for OHA to ensure reported amounts are accurate and to timely identify and resolve discrepancies. Additionally, an inadequate reconciliation process could affect OHA's ability to ensure fees charged by the investment advisors and managers are consistent with market values as reported by the custodian. Inflated fees would potentially result in lower net performance and subsequently lower trust value.

Although outside the initial scope of our review, we do note that the account reconciliation process has become more formalized, including the documentation of monthly reconciliation work papers and supervisory review, since the hiring of an investment analyst in October 2008. Additionally, the new custodial agreement, implemented in

November 2008, requires the custodian to present aggregated investment reports that already reconcile both investment advisors' statements to that of the custodian. The Office of Hawaiian Affairs has also stated its intention to have both investment advisors produce a written attestation that the accounts have been reconciled and verified, thus providing another layer of controls for this process.

OHA has delegated proxy voting authority to the investment advisors without assessing potential conflicts

The Office of Hawaiian Affairs delegates proxy voting authority to the investment advisors/managers; however, there does not appear to be a review of advisor proxy voting policies to assess potential conflicts of interest. Proxy voting gives investors the opportunity to participate in shareholder voting when they are not able to attend the meeting; shareholder voting typically entails decisions concerning operations, corporate governance, and social issues.

Since there exists a potential for the investment advisors and managers to vote proxies in a manner that is not consistent with the interests of the trust, proper oversight is necessary. OHA should develop a proxy voting policy that describes how it shall review and monitor advisor and manager proxy voting and related actions. For example, one of the investment advisors is able to vote on its own fund proxies. We noted that OHA now has access to ClientLINK, a service provided by Frank Russell Investments that stores all proxy related information and could allow OHA to perform necessary due diligence related to proxy voting.

As stated by Rule 206(4)-6 of the federal Investment Advisor's Act of 1940, investment advisors are required to adopt and implement written policies and procedures that are reasonably designed to ensure that proxy voting is done in the best interest of the client. Under the proxy voting rule, investment advisors are required to disclose how they voted proxies with respect to the securities held in the client account. While OHA is not subject to this rule, it is considered an industry best practice to develop policies and procedures to ensure proxy voting handled by an investment advisor is done in the best interest of the client and without conflicts of interest.

Monitoring of the trust's asset allocation needs improvement

As stated in OHA's 2003 Investment Policy Statement, the "purpose of strategic asset allocation is to provide an optimal mix of investments that has the potential to produce the desired returns with the least amount of fluctuation in the overall value of the investment portfolio." However, we found that the board could do more to ensure that its asset allocation is appropriate based on its goals and risks. Currently, the board does not consistently compare its allocation ranges to peer groups to ensure its asset mix is optimal. Additionally, OHA should improve the transparency of current reports, enabling it to better monitor adherence to stated allocation ranges.

The trust's asset allocation plan appears to be inconsistent with those of its peers, making assessment difficult

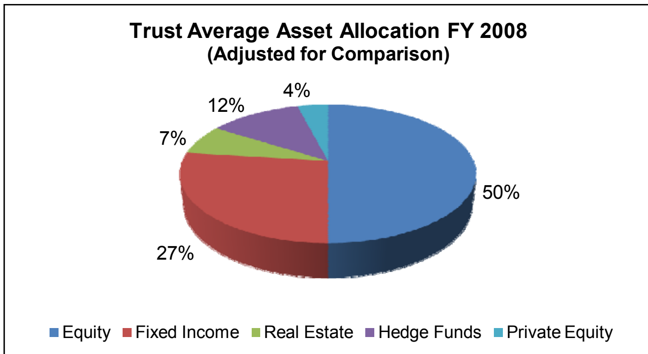
The Office of Hawaiian Affairs' Board of Trustees does not compare the investment policy to a peer asset allocation study on a consistent basis. Without this type of comparison, OHA is unable to determine whether the performance of the trust is in line with its peers. Review of, and comparison with, peer allocation plans are industry best practices and would enable the board to review current trends of the industry and make necessary adjustments.

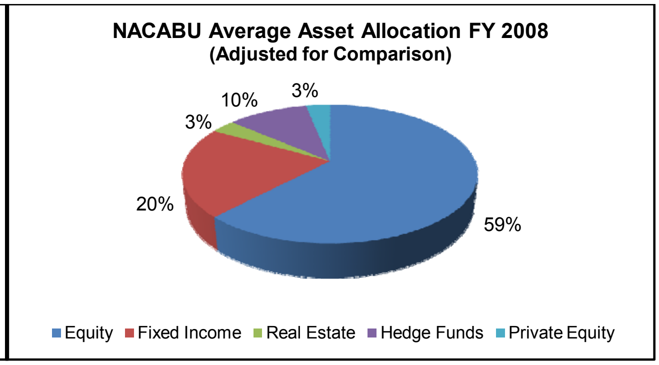
We compared the trust's asset allocation plan to the National Association of College and University Business Officers (NACUBO) peer universe average asset allocation, noting the trust was outside the peer universe during FY2004 to FY2008. The National Association of College and University Business Officers, founded in 1962, is a nonprofit professional organization representing chief administrative and financial officers at more than 2,100 colleges and universities across the country. The NACUBO peer universe contains endowments and foundations with assets between $100 million and $500 million, and is a relevant comparison due to OHA's similarities to an endowment or foundation. Exhibit 2.6 provides a detailed comparison of OHA's asset allocation to NACUBO's peer universe average asset allocation for fiscal years 2004 through 2008. Instances where the differential between the trust and NACUBO is greater than 5 percent are highlighted in red.

Exhibit 2.6
OHA Asset Allocation Comparison to NACUBO Peer Universe Average

Asset Allocation Compared to NACUBO					
	FY 2004	**FY 2005**	**FY 2006**	**FY 2007**	**FY 2008**
NACUBO Average Asset Allocation					
Equity	59.10%	57.80%	56.80%	56.60%	50.40%
Trust Average Asset Allocation					
Equity	56.65%	54.86%	55.21%	53.77%	49.64%
Differential	2.45%	2.94%	1.59%	2.83%	0.76%
NACUBO Average Asset Allocation					
Fixed Income	19.50%	18.90%	16.90%	15.10%	16.50%
Trust Average Asset Allocation					
Fixed Income	31.39%	26.94%	25.45%	26.45%	26.78%
Differential	11.89%	8.04%	8.55%	11.35%	10.28%
NACUBO Average Asset Allocation					
Real Estate	3.10%	3.00%	4.00%	3.60%	4.10%
Trust Average Asset Allocation					
Real Estate	7.14%	8.28%	8.15%	7.74%	7.49%
Differential	4.04%	5.28%	4.15%	4.14%	3.39%
NACUBO Average Asset Allocation					
Hedge Funds	10.00%	11.40%	12.30%	13.80%	16.40%
Trust Average Asset Allocation					
Hedge Funds	4.79%	9.30%	9.87%	9.62%	11.92%
Differential	5.21%	2.10%	2.49%	4.18%	4.48%
NACUBO Average Asset Allocation					
Private Equity	3.20%	3.30%	3.60%	3.90%	5.50%
Trust Average Asset Allocation					
Private Equity	0.00%	0.49%	1.24%	2.21%	4.13%
Differential	3.20%	2.85%	2.36%	1.69%	1.37%

Exhibit 2.6
OHA Asset Allocation Comparison to NACUBO Peer Universe Average (continued)





Source: OHA investment advisors' FY2004 to FY2008 quarterly investment performance reports and the National Association of College and University Business Officers

We observed that OHA receives an annual analysis based on the CommonFund Study with respect to peer asset allocation averages via the Russell quarterly performance report; however, this information is not presented to the board in the investment consultant's annual report. Without frequent comparisons to peer group asset allocations, it is difficult for OHA to ensure it is maintaining a proper diversification of asset classes, which is critical to a portfolio's investment performance and ability to weather unfavorable markets.

The strategy of tactical asset allocation transfers and redistribution requires increased reporting and monitoring

During our initial review of the trust's asset allocation, we found that during FY2004 through FY2008, the allocations appeared to be in excess of the maximum allowed under the 2003 investment policy for US Large Cap Equities (in 18 quarters out of 20 quarters), and for US Core Fixed Income (in 16 quarters out of 20 quarters) holdings. However, after further review, we discovered that Private Equity funds are initially maintained in the US Large Cap Equities asset class, and High Yield Debt is initially held in the Core Fixed Income asset class.

Based on communications from the investment advisors to OHA, it became apparent that the investment advisors initially maintain funds committed to Private Equity in US Large Cap Equities. Then, as capital calls (or draw downs) are made, the allocations are transferred back to Private Equity. This initially caused the US Large Cap Equity to exceed its allocation limit; however, when the Private Equity allocation maximum is aggregated with US Large Cap threshold, the trust falls into appropriate range. The same strategy is utilized by the investment advisors with respect to High Yield and Core Fixed Income asset class holdings. As the High Yield maximum allocation percentage is aggregated with the Core Fixed Income maximum threshold, the respective allocation percentages fall in line with the appropriate ranges as stated in the 2003 investment policy. We do note that as the trust increased its investments in Private Equity and High Yield debt, the trust moved within the stated guidelines in the investment policy (effective 2003).

This structure, although common in the industry, requires additional reporting by the investment advisors so that OHA is able to fully understand the actual asset allocation and the stage of the transition—i.e., the move from US Large Cap to Private Equity and the move from US Core Fixed Income to High Yield. This additional reporting would allow OHA to track the movement of asset allocations as well as appropriately monitor the performance attributions of the trust, such as how the overweight allocation to US Large Cap influenced the realized returns for the previous quarter.

Without the benefit of this enhanced reporting during FY2004 through FY2008, OHA experienced a lack of transparency to monitor performance attribution in the Large Cap and Core Fixed Income asset classes due to changes being implemented to the portfolio over a long period of time. Without the appropriate reporting from the investment advisors, OHA is unable to track the transition of the asset allocation weightings and is unable to appropriately monitor the performance attribution of the trust. The monitoring of the performance attribution of the trust enables OHA to determine how its returns were generated; specifically, if it was due to an overweighting in US Large Cap or US Core Fixed Income.

Although asset allocations were ultimately deemed to be within acceptable ranges, greater transparency is needed. The Office of Hawaiian Affairs' new custodian is expected to combine the portfolios of both investment advisors to present an aggregated portfolio. This aggregated portfolio should allow OHA to closely monitor the overall asset allocation of the trust.

Since the trust has underperformed when compared to peer groups, OHA must consider all relevant options to improve returns on investments—

diversification through a proper mix of asset classes is critical to performance. Without regular comparisons to peer groups and clearer investment reports, OHA will have a more difficult time ensuring that it is maintaining an optimal mix of investments.

Many Recent Improvements to the Investment Process Have Been Made, But More Work Is Needed

The Office of Hawaiian Affairs has made significant strides in correcting the findings of the previous audit; however, a majority of the improvements were made subsequent to or during the latter half of the review period, including several undertaken during and subsequent to our fieldwork in January 2009. For example, OHA's investment policy statement, which had not been reviewed since 2003, was finally updated and implemented in October 2008 and January 2009, respectively—actions we recommended in our 2005 audit report.

Despite these recent enhancements, we noted several issues during the review period that require further attention by OHA. We found that OHA had not integrated all of the recommendations from the previous audit in 2005, and recommendations that were integrated were done a considerable time later. Exhibit 2.7 displays findings and recommendations identified in our prior 2005 OHA audit report, as well as the current status and expected implementation dates, as applicable. The 2006 status was previously provided by OHA and reported in the Office of the Auditor's 2006 annual report.

Exhibit 2.7
Status of Prior Audit Findings and Recommendations as of December 31, 2008

FY2003 Office of the Auditor Recommendations	2006 Status Provided by OHA (Office of the Auditor 2006 Annual Report)	Current Status as of December 31, 2008	Implementation Prior to December 31, 2008
The Office of Hawaiian Affairs should:			
1. Revise components of its investment policy statement as follows:	The Board of Trustees will review and revise the Investment Policy in the first quarter of calendar year 2007.	OHA now maintains the following policy manuals: a Native Hawaiian Trust Fund Spending Policy (September 2004, amended July 2006), an Executive Policy Manual (November 2007), a Fiscal Procedures Manual (June 2008), an Investment Policy Statement (May 2003, update implemented January 2009), and an Operational Procedures (January 2009). We noted that OHA's trustees and administrative staff are not reviewing policies and procedures on an annual basis to ensure policies and procedures are current and accurate, leading to outdated manuals that can potentially be unresponsive to current market conditions. The Investment Policy Statement was not reviewed for 5 years. The OHA Board of Trustees and its agency may want to consider creating or enhancing the following policies and procedures with respect to the trust: a formalized fiscal reserve policy to include specific criteria for use of the fiscal reserve; a valuation policy for illiquid securities that could adopt the valuation policy and procedures of its advisors and managers; a more comprehensive code of ethics as previously noted in our report; a policy to notify	Various: September 2004 - Ongoing

Exhibit 2.7
Status of Prior Audit Findings and Recommendations as of December 31, 2008 (continued)

FY2003 Office of the Auditor Recommendations	2006 Status Provided by OHA (Office of the Auditor 2006 Annual Report)	Current Status as of December 31, 2008	Implementation Prior to December 31, 2008
		the public that it can request information with respect to the trust and OHA; and policies related to investment contracting, investment management, service provider oversight, and investment manager oversight (due diligence).	
• Delineate the legislative and procedural authority of OHA and the Board of Trustees to make and refine investment policy.	The local investment consultant has already reviewed the benchmark indices and will present a recommendation to the OHA Chief Financial Officer (CFO) by December 15, 2006.	OHA appears to clearly lay out the duties and responsibilities with respect to trust fund investments in its amended Investment Policy Statement, which was implemented on January 1, 2009. In addition, the amended Investment Policy Statement appears to delegate policy making authority to the Board of Trustees. Further, OHA maintains an Executive Policy Manual (November 2007) outlining trustee obligations and fiduciary duties.	No (implemented January 1, 2009)
• More clearly define the benchmarks to be used by the investment advisors, ensuring accuracy and consistency.	The local investment consultant will work with the OHA CFO to recommend performance objectives by December 15, 2006.	OHA has created a custom benchmark as stated in the amended Investment Policy Statement, implemented January 1, 2009.	No (implemented January 1, 2009)
• Set performance objectives and means of measurement for the trust fund as a whole, consistent with asset classes in the portfolio where it is practical and supported on a net of fee basis.	The local consultant will investigate the use of passive investments with the assistance of the two trust fund advisors and present a recommendation to the OHA CFO by December 31, 2006.	OHA has set a target return for the trust fund as a whole as stated in the amended Investment Policy Statement, implemented January 1, 2009.	No (implemented January 1, 2009)
• Evaluate the use of passive investments with those asset classes in the portfolio where it is practical and	The local investment consultant with the assistance of OHA staff and the two trust fund advisors will conduct an asset	Passive investments are addressed in the amended Investment Policy Statement, implemented January 2009.	No (implemented January 1, 2009)

Exhibit 2.7
Status of Prior Audit Findings and Recommendations as of December 31, 2008 (continued)

FY2003 Office of the Auditor Recommendations	2006 Status Provided by OHA (Office of the Auditor 2006 Annual Report)	Current Status as of December 31, 2008	Implementation Prior to December 31, 2008
supported on a net of fee basis.	allocation study and present it to the CFO and an ad hoc investment committee by January 31, 2007.		
• Formally review the impact of ceded land revenue payments from the State in terms of asset allocation and the need for additional real estate investments.	The Board of Trustees will review and revise the Investment Policy in the first quarter of calendar year 2007.	Ceded land revenue is not considered a component of the investment portfolio. Ceded land revenue led to the formation of OHA's trust.	N/A
2. Create a procedures manual, outlining the processes, controls, reporting requirements, and oversight of the investment process.	The Office of Hawaiian Affairs will produce a procedures manual which outlines processes, controls, reporting requirements, and oversight of the investment managers by June 30, 2007.	OHA now maintains the following policy manuals: an Executive Policy Manual (November 2007), an Investment Policy Statement (May 2003, amended October 2008), a Native Hawaiian Trust Fund Spending Policy (September 2004, amended July 2006), Operational Procedures (January 2009) and a Fiscal Procedures Manual (June 2008). OHA operationally has recently: (i) developed and adopted material changes to the processes to monitor investment advisors, including the creation of internal databases to allow OHA to better aggregate and monitor the performance of individual investments; and (ii) developed new lines of reporting authority within the CFO's office.	Various: September 2004 – Ongoing October 2008
3. Improve its oversight of the investment advisors to include:		OHA has selected an active management structure to achieve its investment targets, and it is therefore required to pay comparable fees for active management. Additionally, the OHA board has adopted an investment policy and asset allocation	N/A

Exhibit 2.7
Status of Prior Audit Findings and Recommendations as of December 31, 2008 (continued)

FY2003 Office of the Auditor Recommendations	2006 Status Provided by OHA (Office of the Auditor 2006 Annual Report)	Current Status as of December 31, 2008	Implementation Prior to December 31, 2008
		model which includes high/low ranges for asset allocation across all approved asset classes with trust performance focused on an absolute performance strategy. The investment advisors must invest trust assets in the manner dictated by the approved asset allocation model. The investment advisors are compensated a percentage of assets under management, which is a recognized and common practice in the investment management industry. This structure encourages the investment advisors to increase the returns of the trust, as greater returns translate to increased assets under management and ultimately, higher fees.	
• Creating an independent function, either within or in conjunction with an external consultant, to aid in reporting and oversight.	OHA recently hired an external local consultant to review the investments in the portfolio. The OHA CFO will also establish and chair a small internal ad hoc investment committee to review the reports provided by the independent consultant and quarterly reports from the two advisors. The committee will be established by the end of 2006 and meet at least quarterly. See above.	OHA operationally has recently: (i) developed and adopted material changes to the processes to monitor investment advisors, including the creation of internal databases to allow OHA to better aggregate and monitor the performance of individual investments (October 2008); and (ii) developed new reporting lines of authority within the CFO's office (late 2008). OHA has an independent consultant presenting an analysis of the advisors' actions (effective in 2006).	Various: 2006 to Ongoing

Exhibit 2.7
Status of Prior Audit Findings and Recommendations as of December 31, 2008 (continued)

FY2003 Office of the Auditor Recommendations	2006 Status Provided by OHA (Office of the Auditor 2006 Annual Report)	Current Status as of December 31, 2008	Implementation Prior to December 31, 2008
		OHA is currently requesting investment advisors to provide standardized reporting (effective 2007-2008). OHA is performing annual on-site visits of investment advisors and documenting the reviews (mid-2008).	
• Improving the formal analysis and reporting associated with the activities and performance of the advisors.		Beginning in 2006, OHA's Board of Trustees has enlisted the services of an investment consultant in order to provide the board with enhanced reporting as well as provide a resource for investment related inquiries. The board, as part of its fiduciary duty to the trust, should continue to work with the investment consultant and independently ensure the investment process is aligned with OHA's investment policies and objectives. We observed that OHA is relying on advisors for middle office responsibilities, such as portfolio accounting and reconciliations. We note that OHA is currently in the process of developing procedures with respect to shadowing these responsibilities.	2006 No (Anticipated implementation December 31, 2009)
• Creating a schedule and review process that includes visits to both investment advisors' place of business and more completely analyzes their processes and controls.	The consultant's duties include an annual due diligence of the two advisors, including site visits, and work has already begun.	OHA is currently performing on-site visits of investment advisors; however, there was not a standardized report documenting the visits. We noted that the most recent on-site due diligence review with Goldman Sachs, dated	Mid-2008 and ongoing

Exhibit 2.7
Status of Prior Audit Findings and Recommendations as of December 31, 2008 (continued)

FY2003 Office of the Auditor Recommendations	2006 Status Provided by OHA (Office of the Auditor 2006 Annual Report)	Current Status as of December 31, 2008	Implementation Prior to December 31, 2008
		November 4, 2008, was documented into an Investment Advisor Due Diligence Report. However, OHA should review the investment policy on an annual basis or more frequently as market conditions and funding requirements dictate.	
• Designing a consistent reporting package to be received from each investment advisor, containing a complete analysis of actions.	The consultant is designing portfolio parameters which each advisor will calculate the same way. The major items included in the monthly and quarterly reports will also be made consistent. The reporting format will go into effect during the first quarter of 2007.	In November 2008, OHA entered into an agreement with a new custodian. The new custodian, Frank Russell Group (sub-custodian State Street), should have the ability to provide pertinent information with respect to holdings. We noted that all information regarding performance was able to be retrieved for the applicable review period upon our request; however, the new custodian should be able to log all historical performance information going forward. Additionally, OHA is currently in the process of developing a control questionnaire that the investment advisors would be required to sign quarterly, effective March 31, 2009. The control questionnaire addresses matters related to the compliance and operations of the investment portfolio.	November 2008 No (March 31, 2009)
• Improving reports on the trust fund as a whole.	The consultant will design improved reports from both the advisors and himself by the end of the first quarter of 2007.	See above.	See above

Exhibit 2.7
Status of Prior Audit Findings and Recommendations as of December 31, 2008 (continued)

FY2003 Office of the Auditor Recommendations	2006 Status Provided by OHA (Office of the Auditor 2006 Annual Report)	Current Status as of December 31, 2008	Implementation Prior to December 31, 2008
• Developing processes to ensure that the advisors comply with investment guidelines included in the investment policy statement.	The consultant will design a compliance checklist based on the Investment Policy Statement for December 31, 2006.	OHA is currently in the process of developing a control questionnaire that the advisors would be required to sign quarterly, effective March 31, 2009. The control questionnaire addresses matters related to the compliance and operations of the investment portfolio.	No (March 31, 2009)
• Standardizing the contracting process and contracts used to retain investment-related service providers.	OHA Treasury & Other Services staff will standardize the contracting process by the end of the first quarter of 2007.	Original investment advisor contracts are still in effect (Goldman Sachs Asset Management contract is dated March 1, 2003 and the Frank Russell Trust Company contract is dated February 20, 2003). The manager-of-managers structure is still in force and carried over from the prior audit period. OHA does not perform a fiscal analysis of fees paid to advisors. The board has not undertaken evaluating the cost of existing investment options against comparable investment funds to identify potential cost savings to ensure the advisory fees paid are competitive. According to Section 554C-7, HRS, Uniform Prudent Investor Act, "In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purpose of the trust, and the skills of the trustee."	No

Source: Prepared by Navigant Consulting, Inc. FY2003 Recommendations from Office of the Auditor Report No. 05-03, *Audit of the Office of Hawaiian Affairs*, FY2006 Status from Office of the Auditor 2006 Annual Report, and Current Status based on current review work.

Conclusion

The current global financial crisis is a stark reminder to those charged with oversight of investment trusts that they cannot simply rely on outside advisors, and the market in general, to provide long-term gains and protect assets. Trust fiduciaries must fully understand their own investment strategies and holdings, as well as market risks. The Office of Hawaiian Affairs has not performed all the necessary actions, including self-education, frequent reviews of policies, and thorough and relevant reporting, to fully attain this understanding. While investment portfolios have been battered worldwide, the Native Hawaiian Trust Fund's inability to keep pace with its peers is a clear call for improved management.

The Board of Trustees of the Office of Hawaiian Affairs has many important responsibilities in addition to managing the trust's financial assets, including its primary mission of bettering the conditions of all Hawaiians. However, all of OHA's efforts are made possible by the moneys in the trust, and OHA must be proactive in preserving and growing the trust. Recent improvements in investment management demonstrate the board's understanding of this important role; however, the timing of these improvements and problems that continue to be unaddressed are cause for concern. The beneficiaries of the trust cannot afford to wait another five years before the remaining issues are addressed.

Recommendations

Board structure and governance

With respect to board structure and governance, we recommend that the Board of Trustees of the Office of Hawaiian Affairs:

1. Adopt written policies and procedures regarding investment management, service provider oversight, investment manager oversight, including the activities OHA performs in regard to due diligence of its investment advisors, and policies and procedures with respect to contracts, including review and approval. In addition, OHA should include a policy on the agency's website that clearly states the public can request documentation with respect to the trust and the organization.

2. Assess and document its decision to retain the manager-of-managers approach annually through the observations identified and following recommendations, which are described in further detail throughout the report, in order to demonstrate its overall fiduciary obligation to the Native Hawaiian Trust Fund.

3. Consider initiating enhanced training with a mandatory attendance requirement. The board will be required to sign off on trustees' attendance, which will be entered into a board training log to be maintained by OHA's administrator. At least annually, all board members should be required to receive training on their roles and responsibilities. Training for the board should include: fiduciary responsibilities, accounting, financial and investment matters, and the understanding of quarterly reports provided by the investment advisors. To achieve consistency and efficiency, training should be provided to the board, as a whole, and could potentially be done in conjunction with regularly scheduled board or committee meetings.

4. Consider enhancing the current Investment Advisory Committee and requiring additional experts as committee members. New members should include the chair of the ARM Committee, a trustee-at-large, and the CFO. The improved sub-committee would provide recommendations to the ARM Committee on a structured basis (e.g., quarterly).

5. As a best practice, consider having the board members certify, no less frequently than annually, that they have abided by the OHA Code of Ethics and document the evaluation of potential conflicts of interest related to trust fund activities. In addition, the board may want to consider logging beneficiary and community complaints via a complaint log. This log would enable the board to identify trends in complaints. The board also should consider instituting a whistleblower policy for trustees, employees, and other individuals to report illegal, unethical, or inappropriate activity anonymously and confidentially.

6. Consider clarifying and formalizing its fiscal reserve policy to include specific criteria for use of the fiscal reserve, as discrepancies have been noted during administrative staff and trustee interviews. In addition, the board may want to consider establishing a fiscal reserve cap to ensure the fiscal reserve is spent in a timely manner and according to the policies of the trust. Unspent amounts would lose their reserve status and become principal investment dollars in the trust.

Monitoring of investment performance and advisors

With respect to monitoring of investment performance and advisors, we recommend that the Board of Trustees of the Office of Hawaiian Affairs:

1. Consider reviewing the investment policy statement and asset allocations on a more frequent basis to address whether tactical changes should be made given market factors. We note that the failure to beat the overall target objective may most likely be

attributed to market events; however, the board should consider inquiring with the investment advisors as to why the trust has been outperformed by the Trust Universe Comparison Service (TUCS) database in 18 of 20 quarters reviewed. As a best practice, the board may want to consider performing a quarterly analysis of CommonFund, as well as TUCS data or the Council on Foundations to help evaluate the investment performance of the trust against a peer universe and document such analysis.

We note that OHA receives an annual analysis based on the CommonFund Study with respect to peer average investment returns via the Frank Russell Investments quarterly performance report, however, this information is not presented to the board in the investment consultant's annual report. The board may want to consider requiring the investment consultant to include a section in the annual report that compares the CommonFund Study as presented by Russell and one other peer universe to the performance of the trust. In addition, the board should consider increasing the frequency with which such an analysis is performed by the investment consultant, specifically by requiring quarterly analysis to help evaluate the average portfolio performance of peer universes against the trust's overall performance. This quarterly review would provide the board with information regarding the returns achieved by their peers and would give the board the opportunity to question on a timely basis the current investment advisors as to why they fell below the average of the peer universes. Our report used the TUCS study for comparison based on the information readily available; however, the CommonFund Study may likewise be a suitable peer comparison to be utilized by OHA.

2. Review the investment policy on an annual basis or more frequently as market conditions and OHA funding requirements dictate. We note that the investment policy, previously dated 2003, was updated in October 2008 and implemented in January 2009 and has clarified its overall target return.

3. Consider reviewing the performance of the investment managers more frequently via the online access through ClientLINK, provided after the review period of fiscal years 2004 to 2008. The board should consider clarifying the investment policy to state that the monthly review of statements refers to the custodian statements and not the investment performance of the trust. In addition, the board should consider creating a written procedure to ensure that the standardized quarterly performance reports as created by OHA are being effectively implemented by the investment managers. We note that Goldman Sachs has been providing Lipper and TUCS comparisons on a consistent basis since the start of 2007 and

that Frank Russell Investments has provided Lipper comparisons throughout the duration of the relationship. Additionally, Frank Russell Investments has consistently worked well with regard to standardizing the performance reports, while Goldman Sachs has had issues when conforming to the method prescribed by OHA.

4. Review, approve, and implement the recently developed risk assessment as soon as reasonably feasible, along with an approved risk management policy. The risk management policy should include a risk assessment methodology describing procedures and guidelines for assigning appropriate risk rankings.

5. Consider soliciting additional investment advisors in order to identify any potential cost savings for comparable services, or at the very least to negotiate with the current advisors for fee reductions.

6. Due to the complexities of valuing illiquid securities, consider developing a valuation policy for the trust, which could adopt the valuation policy and procedures of its advisors and managers. The valuation policy should describe the process whereby the administrative staff and the ARM Committee shall review periodic (i.e., quarterly or annually) valuation reports provided by the advisors to ensure compliance with stated policies and assess the description of the controls employed around valuation by the advisors. Any material valuation matters identified as a result of the periodic review of advisor valuation processes should be reported to the board.

7. Establish written polices and procedures to ensure reconciliations are accurately and properly documented between the custodian and the investment advisors. We noted that under the new custodian agreement dated November 2008, all assets are held with Frank Russell Investments, with State Street acting as sub-custodian. Under the new agreement, the custodian will perform reconciliations, and OHA will obtain monthly asset verification reviews and sign-off from State Street. In addition, the investment analyst has implemented quarterly investment manager invoice verification worksheets.

8. Require both Russell and Goldman Sachs to submit a proxy voting report to the investment consultant/analyst on a periodic basis (e.g., quarterly) in addition to creating a trust Proxy Voting Policy to be adopted by the board. Additionally, OHA should review proxy reporting information on a periodic basis to ensure investment advisors are voting proxies timely and without conflicts of interest. Any material matters or concerns identified should be reported to the board.

9. Consider requiring the investment consultant to include a section in the annual report that compares the CommonFund Study as presented by Russell to the applicable trust investment policy. Additionally, consider requiring a quarterly analysis of the CommonFund data to help evaluate the average asset allocation of a peer universe against the trust's strategic asset allocation. This quarterly review would provide the board with information regarding current trends among their peers and would enhance the members' decision making abilities with respect to the trust's asset allocation plan. As noted previously, a common practice in the industry is to review more than one peer study when performing comparison analysis with respect to asset allocation strategies. In addition to CommonFund, OHA may want to consider the review of the NACUBO study, TUCS information, or the Council on Foundations reports. Each of these would be an appropriate peer universe given that the structure of the OHA trust most resembles an endowment. We noted that the NACUBO data was used for comparison based on the information readily available to us and that the CommonFund Study may likewise be a suitable peer comparison to be utilized by OHA.

10. Consider requiring the investment advisors to provide enhanced reporting regarding the transition into Private Equity from the US Large Cap target allocation. The advisors should include documented updates on the capital call structure of the Private Equity investments and estimated schedule of capital commitments until all of the committed capital is fully realized, along with the current quarterly report. Doing so will also allow OHA and its board to be better informed with regard to the attainability (or not) of their target asset allocation model, as well as provide data to assist in measuring performance attribution from being over weighted in Large Cap and Core Fixed Income. We note that OHA has contracted with Russell (sub-contracted with State Street) for its trust custody in November 2008. This new relationship should provide aggregated reports that potentially will provide more valuable information for OHA, including aggregated asset allocation reports.

Responses of the Affected Agencies

Comments on Agency Responses

On August 31, 2009, we transmitted a draft of this report to the Board of Trustees and the Office of Hawaiian Affairs (OHA). A copy of the transmittal letter to the board is included as Attachment 1; a similar letter was sent to the agency. The board provided the only response, which included several exhibits such as OHA's investment policy statements and select board meeting minutes. The board's response is included as Attachment 2 and relevant excerpts from the enclosed exhibits are included as Attachments 3 through 9.

In its response, the board provided extensive comments on our report and made general statements that the report contained numerous errors and inaccuracies. However, although a cursory reading of the board's response may appear to contradict our findings, in most instances the board challenged secondary points but ultimately acknowledged the major points of our findings. Moreover, many of those arguments misconstrued the facts presented in our report.

The board began its response by highlighting what it claimed to be five "major factual errors" in our report. It asserted upfront and throughout its response that our report mistakenly used a target return of consumer price index (CPI) plus 5 percent in assessing OHA's investment performance, citing the stated target of CPI plus 4 percent in the 2003 Investment Policy Statement. As discussed in our report, however, OHA trustees and personnel informed us that it was commonly understood that OHA's target return has been CPI plus 5 percent since 2003 and that the 4 percent in the written policy was an error. The 5 percent target was also consistent with OHA's 5 percent spending policy and its intent to maintain the trust principal; prudence dictates that the target return should match or exceed allowable spending so as not to deplete the trust principal. Further, in the October 2008 update of the investment policy statement, the stated target return was revised to reflect the 5 percent target that had been used since 2003.

The board secondly claims our statement that the *fiscal reserve policy* received only one reading is erroneous, arguing that the second reading of the *fiscal reserve policy* and the vote to approve the *spending policy* are "clearly documented" in the minutes of the September 15, 2004 Board of Trustees meeting. This assertion highlights OHA's lack of understanding of its own policies and procedures. On August 19, 2004, the board met to discuss a proposed amendment to the *spending policy*. During this discussion the board appeared confused as to the status of the attached *fiscal reserve policy*, debating whether it was a policy or a guideline and whether it was impacted by the proposed amendment to the *spending policy*. The vice-chair of the board even acknowledged "…I don't believe these [fiscal reserve] guidelines, being that they only had one reading, wherever implemented they are not authorized." The subsequent September meeting referred to in OHA's response merely approved the proposed amendment to the *spending policy* and neither addressed the *fiscal reserve policy* nor followed up on the related unanswered questions posed in the prior meeting. More importantly, OHA focuses its response on minor points of our report while ignoring the larger issue that there was an obvious lack of understanding and guidance as to how the *fiscal reserve* can be spent.

As to the board's assertion that the investment policy statement was updated and effective as of October 24, 2008, we acknowledge that the updated policy was adopted and stated to take effect as of that date. However, key OHA personnel advised us that the updated policy was not in fact implemented until January 1, 2009. For clarification, we have revised our final report to reflect that January 1, 2009 was the implementation date of the updated policy rather than the effective date. In either case, the policy update took place after the initiation of our review and was long overdue.

Our draft report noted that OHA's Investment Advisory Committee and Asset and Resource Management (ARM) Committee both lacked formal charters; however, the board has provided us a copy of the advisory committee's charter and noted that the ARM committee's role is defined in its bylaws. These secondary points are corrected in our final report; however, our overall conclusion that the ARM Committee framework should be enhanced remains unchanged—OHA should reconstitute the Investment Advisory Committee, providing it with some degree of authority related to investment matters. This recommendation is driven by the lack of investment expertise among the board's trustees combined with the committee's current reporting responsibility being only to OHA staff.

The board commented at length on several of our specific findings, but ultimately acknowledged the validity of most findings. For example, in response to our finding that OHA did not consistently monitor investment compliance, the board declared disagreement and mentioned various actions it had taken, but then conceded that "OHA staff did not verify compliance" and indicated remediation was expected to be complete by June 30, 2010. In another instance, the board disagreed with our finding that it does not have a valuation policy and process to ensure investments are properly valued, but later concedes, "we do agree, however, that OHA should put a valuation procedure to review and adopt all valuation policies that govern the valuation of assets." In disagreeing with our comment, the board raises further concerns, indicating that OHA relies solely on external parties for valuations and has “no ability to control” valuation policy and procedure.

Other comments in the board’s response indicate a failure to comprehend the extent of the board’s role and responsibilities with respect to the trust and its investments. For example, the board’s response to our finding regarding the inadequacy of the Investment Policy Statement’s code of ethics policy highlights its lack of understanding of the policies and controls necessary to satisfy its fiduciary obligations. According to the board, because OHA does not manage any investments in-house, “no fraudulent or unethical investment activities can occur within OHA given the lack of access, authority, and opportunity.” This belief by the board is alarming, as it is well-recognized that there is always a risk fraud may occur. As plainly stated in *Managing the Business Risk of Fraud: A Practical Guide*, a report sponsored by the Institute of Internal Auditors, the American Institute of Certified Public Accountants, and the Association of Certified Fraud Examiners, “[e]very organization is susceptible to fraud” and “[n]o system of internal control can provide absolute assurance against fraud.”

The board goes on to assert that its use of a manager-of-managers structure addresses the concerns of potential conflicts and ethical issues because “full discretion” to invest and manage the trust’s assets resides with the advisors and not with OHA trustees or personnel. The board further implies that it is sufficient for the advisors to have proper controls and risk management processes in place. This flawed perspective reiterates the underlying message of our report—that the board cannot rely on external advisors to fulfill its fiduciary responsibilities over investments, and specifically, cannot rely on the advisors’ controls as sufficient to remediate the risks in OHA’s investment process.

The board criticized our finding that OHA’s vague fiscal reserve policy resulted in an idle $17.7 million reserve account. In noting our finding lacked clarity and consistency, the board implied we do not understand that these moneys do not sit idle and are fully invested. However, our report specifically states that “although separately accounted for, the [fiscal reserve] moneys remain a part of the trust fund.” We also found that the “account” is underutilized owing to the vague usage guidelines and internal confusion as to purpose, points treated as an afterthought within the board’s response.

In evaluating OHA’s investment performance, we compared trust returns on a quarterly basis to its practical goal of CPI plus 5 percent, as well as a benchmark return. The board alleges two key mistakes in our analysis—not using CPI plus 4 percent as the target (as stated in OHA’s 2003 investment policy) and analyzing results on a quarterly versus annual basis. We reiterate that CPI plus 5 percent was the target used in practice by OHA and was consistent with its spending policy. Moreover, if OHA did hold to its written goal of CPI plus 4 percent, it would effectively reduce its own goal of capital preservation from the outset as compared to a target return, prior to market performance having any effect on returns, due to its annual deduction of 5 percent of the trust's average market value as part of OHA's operating budget. Further, it is standard investment industry practice to report, compare, and analyze returns on a quarterly basis in order to ascertain reasons for poor performance real-time, not just cumulatively on an annual basis.

To supplement our finding that OHA needs to improve monitoring of the trust's asset allocation, we compared the trust's allocation to a peer universe of college and university endowments. The board responded that such a comparison is not appropriate based on many factors, including that OHA's asset allocation strategy may be different than the peer universe institutions with the objective of sustaining their endowments in perpetuity. The board's response seems to convey a misunderstanding of its own goals as Section 1.2 of the Investment Policy Statement states, "The overall goal of the Trust Fund is to provide superior investment returns to sustain the beneficiaries of the Trust in perpetuity…" Section 2.2 of the Investment Policy Statement further states, "The investment portfolio shall be designed with the objective of protecting principal while earning a rate of return…in order to preserve the fund assets…"

The board further discredited a comparison to the peer universe, noting it is an annual study and that following a trend that is a year old would be imprudent. However, we hold that an asset allocation peer study review is needed to ensure that OHA's allocation strategy is appropriate. Since asset allocation strategies do not deviate significantly year-to-year, comparison to an annual study is not unreasonable and would identify if OHA was trending in a different direction from its closest peers. The main thrust of the comment is that while OHA's asset allocation need not be identical to a chosen peer group, a periodic review is necessary to identify significant variations so they can be researched. Despite providing a detailed argument against our finding, the board does conclude that "we do, however, recognize the importance of reviewing benchmark studies and understanding industry trends and movements."

The board also claimed that our report did not fully recognize many of the improvements OHA has made to its investment process. However, the improvements cited in the board's response were either acknowledged in our report or were implemented after our fieldwork was completed and well after the period covered by our review, which we extended to December 31, 2008 to take into account OHA's more recent changes. While we commended OHA for its recent efforts to improve its investment process, we cautioned that it must continue its progress in order to ensure fiduciary responsibilities to the trust and its beneficiaries are met.

The board concluded by asserting that we "failed to base the audit on 'fact of policy' provided to [us] at the time of the audit[.]" Although we are unfamiliar with the phrase "fact of policy," our report, as well as our comments above, demonstrates that we based our findings on all of the factual evidence obtained during our review. Where written policy conflicted with OHA's actual practice and procedures, we considered the totality of the facts in reaching our findings rather than simply relying on the policy in isolation.

Our final report contains a few editorial changes based on the board's response.

ATTACHMENT 1

STATE OF HAWAI'I
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawai'i 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

August 31, 2009

COPY

The Honorable Haunani Apoliona, Chairperson
Board of Trustees
Office of Hawaiian Affairs
711 Kapi'olani Boulevard, Suite 500
Honolulu, Hawai'i 96813

Dear Chairperson Apoliona:

Enclosed for your information are nine copies, numbered 6 to 14, of our confidential draft report, *Investment Portfolio Review of the Office of Hawaiian Affairs*. We ask that you telephone us by Wednesday, September 2, 2009, on whether or not you intend to comment on our recommendations. Please distribute the copies to the members of the board. If you wish your comments to be included in the report, please submit them no later than Thursday, September 10, 2009.

The Administrator of the Office of Hawaiian Affairs, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

PHONE (808) 594-1888

FAX (808) 594-1865

ATTACHMENT 2

STATE OF HAWAI'I
OFFICE OF HAWAIIAN AFFAIRS
711 KAPI'OLANI BOULEVARD, SUITE 500
HONOLULU, HAWAI'I 96813

September 10, 2009

RECEIVED
2009 SEP 10 PM 2:37
OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

This responds to the draft of your audit report entitled "Investment Portfolio Review of the Office of Hawaiian Affairs."

We are grateful that the Auditor acknowledges that the recent improvements to the board's overall governance demonstrates that the board has a higher level of awareness of its role and better oversight over the programs and services that OHA provides and the agency has recently enhanced its investment procedures in a number of ways. However, we feel that there were many improvements not fully recognized in this report.

We apologize for the lengthy response, but we feel the contracted audit firm findings were not accurately based on the material provided before, during, and after the field work was conducted. Our response letter details many of these inaccuracies; however I would like to highlight a number of major factual errors as follows:

- The contracted audit firm reported a return target of CPI+5% for the audit period, which they reported that it was not achieved. The Investment Policy Statement ("IPS") in effect during the audit period was CPI+4% as specified in the IPS dated March 29, 2003, which was achieved. Exhibit 1 – 2003 Investment Policy Statement.

- The contracted auditor erroneously stated that the fiscal reserve policy received only one reading. The second reading of the fiscal reserve policy and the vote to approve the spending policy is clearly documented in the minutes of the September 15, 2004 Board of Trustee meeting as provided to the contract auditor and the Office of the Auditor. Exhibit 2 – September 15, 2004 BOT agenda and minutes.

- OHA's IPS was updated and effective as of October 24, 2008, not January 1, 2009 as noted by the contracted auditor. Exhibit 3 – Investment Policy Statement approved on October 24, 2008 and signed by the Chairperson on October 27, 2008.

- The contracted audit firm incorrectly stated that the Investment Advisory Committee lacks a formalized charter and inaccurately observed the attendance and composition of the Investment Advisory Committee as documented in the Investment Advisory Committee meeting notes. Exhibit 4 - Investment Advisory Committee charter.

- The contracted audit firm incorrectly stated the ARM committee does not have a charter defining its mission and delineating its roles, responsibilities, and authority. However, the Board of Trustees Bylaws clearly defines its mission, roles, responsibilities, and authority. Exhibit 5 – OHA Bylaws.

The details of our response are outlined below.

Finding 1. The OHA Board of Trustees must improve its investment structure and governance to carry out its duties.

a. Board members as a whole lack sufficient investment expertise and training

Response: Under the Office of Hawaiian Affairs' Trust Fund governance structure, the Trustees have the responsibility for the overall management of the Trust Fund and provide direction and guidance at a policy level. OHA's Administrator, staff, and investment Consultant ("Consultant") provide additional support to the Trustees by carrying out the day-to-day operations, management, and oversight of Trust Fund activities and performance. We believe that proper knowledge and understanding of the Trust Fund activities and performance is essential for the Trustees to adequately make policy level decisions. During the review period of July 1, 2003 through June 30, 2008, OHA has made efforts to help elevate the Trustee's knowledge in the area of investments by providing investment education during the Asset and Resource Management ("ARM") Committee meetings, such as the investment terminology training on January 19, 2005, asset allocation course on August 15, 2006, and an investment diversification workshop on February 19, 2008. OHA's Trust Fund advisors, Goldman Sachs, Co. ("Goldman") and Russell Investments Company ("Russell"), present their financial and economic insights on a quarterly basis, as well as provide in-depth reviews of specific asset categories, such as private equity investments, to further the Trustees' understanding on various investment types, strategies, and opportunities. Furthermore, there have been many selective educational opportunities that many Trustees have participated in, including advisor-sponsored seminars and conferences, topical webcast and conference call series, advisor due diligence meetings, and Chartered Financial Analyst ("CFA") Society of Hawai'i conferences.

Understanding that not all Trustees have the same level of investment expertise and that the composition of the Board of Trustees may change from year-to-year due to the election process, OHA has taken steps to implement bi-annual mandatory in-house trainings for all Trustees, quarterly investment workshops at the ARM Committee meetings, as well as provide optional education opportunities through events and seminars provided by the advisors and other institutions, such as the Commonfund Institute and the CFA Society of Hawai'i.

Remediation: Mandatory training beginning in 2010.

b. The Asset and Resource Management Committee framework should be enhanced

Response: We disagree with the auditor's finding that the ARM Committee does not have a charter defining its mission and delineating its roles, responsibilities, authority, duties and meeting requirements, in accordance with the established best practices. OHA's Board of Trustees Bylaws clearly defines its mission, roles, responsibilities, authority, and meeting requirements (Exhibit 5 – OHA Bylaws). Recognizing that not all Trustees have investment expertise, the Trust Fund management framework is specifically designed to support the Trustees with the knowledge and skills needed to fulfill their responsibilities via OHA's staff, Consultant, advisors, and the Investment Advisory Committee.

Furthermore, we believe that the auditors' observations regarding OHA's Investment Advisory Committee is incomplete. Established in April 2008, OHA's Investment Advisory Committee is comprised of five community members who have successful investment, financial, legal, or business backgrounds, OHA staff, OHA investment Consultant, as well as participation by at least one Trustee. OHA's Administrator and Chief Financial Officer serve as ex-officio members, while the Consultant and OHA staff serve as the Chairperson and Secretary, respectively, as outlined in the Investment Advisory Committee Charter created in April 2008 (Exhibit 4 – Investment Advisory Committee Charter). The audit report incorrectly stated that the Investment Advisory Committee lacks a formalized charter and inaccurately observed the attendance and composition of the Investment Advisory Committee as documented in the Investment Advisory Committee meeting notes.

With respect to the critique that the Investment Advisory Committee lacks authority to make decisions, we respectfully submit it is not the function of the Advisory Committee to make decisions. We believe that investment policy and management decisions should be made by the Board of Trustees. The Investment Advisory Committee should only provide comments and insights to the Trustees to help the Trustees to make high-level policy and management decisions. Given the importance of the Trust Fund, we believe that the fiduciary responsibility and liability of Trust Fund-related decisions should reside with the Board of Trustees rather than the Investment Advisory Committee. In addition, we believe that granting the Investment Advisory Committee authority over Trust Fund activities and decisions may expose the volunteer community members to unnecessary liabilities and hinder the recruitment of qualified experts to serve on the committee. Therefore, we believe that the current structure of OHA's Investment Advisory Committee is prudent in fulfilling the purpose of the committee.

Remediation: Completed in April 2008.

c. The Investment Policy Statement's code of ethics policy is inadequate

Response: As an agency under the State of Hawai'i, OHA's Trustees, Officers, and employees are subject to the State of Hawai'i's Standard of Conduct as detailed under Chapter 84 of the Hawai'i Revised Statues and protected by the State of Hawai'i's Whistleblower's Protections

Act. In addition, the OHA Bylaws and the Board of Trustees Executive Policy Manual also contain ethics and conflict of interest guidelines and policies. OHA Trustees are also required to attend ethics training upon taking office. The code of ethics section stated in the IPS was not designed to serve as a comprehensive policy to govern over OHA's Trustees and staff. Rather, the Trustees, Officers, and employees are governed by the policies established by the State of Hawai'i as outlined in the Hawai'i Revised Statues.

With respect to the need for a "whistleblower" policy or a toll-free phone line specifically related to the Trust Fund, we believe that OHA has sufficient policies, processes, and controls in place to address the concern of potential conflicts, violations, and other ethics issues. In March 2003, the Board of Trustees adopted a manager-of-managers approach to manage the Trust Fund assets. Goldman and Russell were hired as full discretion advisors to invest and manage the Trust Fund assets, while Central Pacific Bank was hired to safeguard the assets as custodian. OHA's Trust Fund management structure allows OHA Trustees and/or staff to monitor the advisors' activities, evaluate the advisors' performance, and establish and enforce investment policies and guidelines. Under this structure, OHA employees and Trustees do not have the access or authority to make investment decisions as discretionary decisions reside with the advisors. OHA also does not manage any investments in-house; therefore, no fraudulent or unethical investment activities can occur within OHA given the lack of access, authority, and opportunity. Instead, OHA monitors the advisors' activities, policies, and controls to ensure that the advisors have appropriate controls in place to prevent ethical violations or fraudulent activities. OHA reviews the advisors' Statement on Auditing Standard Number 70 ("SAS 70") reports annually and conducts regular conference calls and annual on-site due diligence reviews to ensure that the advisors' have sufficient risk management processes in place.

As mentioned previously, OHA is governed under the Standard of Conduct and Code of Ethics under Chapter 84 of the Hawai'i Revised Statues. Any policy or ethical violations by OHA employees may be reported to the Human Resources Office on a confidential basis. Such incidents are documented by the Human Resources office and may be resolved in conjunction with OHA's legal department, if needed. We believe that the structure, processes, and policies we have in place serve as a sufficient alternative to a toll-free phone line or whistleblower policy to address potential conflicts and violations in relation to the Trust Fund.

Remediation: Not applicable.

d. OHA's vague fiscal reserve policy has resulted in an idle $17.7 million reserve account

Response: We believe that the auditor's finding on the fiscal reserve policy is contradictory and inaccurate. First of all, the auditor's report recognizes that the money designated for fiscal reserve is held within the Trust Fund. However, the report finding refers to the fiscal reserve fund as an unutilized idle account. OHA does not maintain a separate account for fiscal reserve. The fiscal reserve fund does not sit idle; rather, it is fully invested with the rest of the Trust Fund. We believe this finding lacks clarity and consistency.

Secondly, the audit report erroneously stated that the fiscal reserve policy received only one reading. The second reading occurred on September 15, 2004. As noted in the auditor's report, OHA's fiscal reserve policy is an attachment to the Native Hawaiian Trust Fund spending policy. The second reading of the fiscal reserve policy and the vote to approve the spending policy is clearly documented in the minutes of the September 15, 2004 Board of Trustee meeting as provided to the Office of the Auditor (Exhibit 2 – September 15, 2004 BOT agenda and minutes).

Regarding the language utilized in the spending policy, OHA has updated the spending policy and fiscal reserve withdrawal guidelines to provide specifications of the fund objectives and utilization. In addition, an annual maximum designation has also been implemented in the updated policy.

Remediation: Spending Policy and Fiscal Reserve Withdrawal Guidelines amended by the BOT in May 2009.

Finding 2. The Trust's lackluster performance warrants review of the Advisory Service' Policies, Processes, and Performance

a. The trust is underperforming, failing to meet target earnings' goals

Response: Per the IPS the Trust Fund's performance objectives over a market cycle were (1) to exceed the CPI + 4%, (2) to protect "principal while earning a rate of return that is targeted to meet or exceed the relative benchmark of each Trust Fund investment....", and (3) for "... combined investment results of all advisors' portfolios over a market cycle will be in the top 40% of a nationally recognized universe of other tax exempt plan sponsors." From July 1, 2003 to June 30, 2008 the Trust Fund returned 7.87% annualized while the CPI + 4% earned 7.56% annualized, thereby meeting objective #1. The fund did not meet objective #2 over the same time period, with a 7.87% return vs. 9.15% return for the benchmark index. The fund also apparently failed to meet objective #3 over the same time period with a net return of 7.87% versus 7.93% for the median public fund, although it should be noted that advisory fees are not deducted from the TUCS performance figures. Objective #3 was removed when the October 8, 2008 IPS was approved because it is very difficult to find a comparable group of peer institutions; the Trustees will periodically review fund performance versus peer institutions, however, as a guidepost in determining whether the Trust Fund's strategies, asset allocation and performance are outliers.

So, over the four year period ending June 30, 2008, the fund ended up very close to all three performance hurdles. Performance is actually average in a market that itself is average. Unfortunately, the auditor has made two key mistakes in its analysis which, we believe, lead them to describe the performance as lackluster. First, they used CPI + 500 basis points for their comparison and second, they used the number of quarters exceeding-the-objective comparison, rather than the more appropriate cumulative return comparison.

We do believe that the auditor's recommendation to review the policies, processes and performance of the two advisors is warranted and it will be undertaken during the on-site due diligence visits in 2009 and beyond. OHA staff and Consultant will present the market cycle report to the ARM Committee on September 22, 2009. The next steps will be to evaluate the advisory proposals received from the request for information ("RFI") for advisory services, select advisors, complete due diligence of selected advisors, Board approval of advisors and sign contracts with advisors.

Remediation: By year-end 2010 with the signing of new investment advisory contracts with the advisors.

b. OHA does not regularly review and update its investment policy statement (IPS)

Response: Between 2003 and 2007, the Board did not formally review the IPS as market conditions and investment strategies employed did not dictate a change. In late 2007 the OHA Consultant began working with the OHA staff and Trustees in developing a new IPS to streamline the policy, incorporate changes in the control structure, more accurately designate responsibilities to the various fiduciaries, clearly define the performance targets, and set asset allocation targets and ranges based on capital markets studies prepared by the two advisors. The new policy was approved on October 24, 2008 by the Board of Trustee and then later revised and approved on August 3, 2009. The new IPS does not specify a timeframe for reviewing and updating the IPS, but the Consultant and OHA Staff are assigned the responsibility to prepare and present a market cycle review of the advisors and portfolio as a whole to the Trustees at the end of each approximately three to five year cycle.

Remediation: Complete as of October 2008.

c. OHA relies heavily on the investment advisors' performance reports, which are not standardized

Response: This was true during the evaluation period. During November 2008 OHA transitioned the custodial duties from Central Pacific Bank to Russell/State Street. Russell/State Street is now performing the performance measurement used in the standardized quarterly presentations rather than each individual advisor providing its own calculation.

Remediation: Compete as of December 2008.

d. OHA had not created a risk management program during the review period

Response: From 2003 until the end of 2006, OHA's risk management program consisted of processes in place at the two advisors, the custodian, OHA's Treasury and Other Services department, and the Board's quarterly review of the advisors' reports, strategies employed, and market conditions with the advisors. This framework represented a significant improvement over what was in place prior to 2003.

At the end of 2006, OHA began a more intensive risk management program by hiring an independent consultant to provide expert advice and to evaluate the performance of the two advisors. The Consultant established five key components of the risk management program:

1. Monitored reports from the two advisors on a quarterly basis and reported any issues to the CFO;
2. Conducted annual on-site due diligence meetings with both advisors in 2007;
3. Conducted an annual review of the fund and each advisor and presented the first report to the Board in February 2007, covering 2006;
4. Created a common set of benchmarks (index, peer manager and peer institution) for the two advisors in January 2007; and
5. Created a standardized monthly reporting template for the second quarter of 2007.

When Goldman experienced difficulty in executing items 4 and 5 above, OHA remedied the situation in November 2008 by hiring a new custodian, which is responsible for performance measurement and creating tables for a quarterly executive summary for each advisor as well as the consolidated fund. In addition, OHA hired an experienced staff investment analyst in October 2008, who along with the Consultant, completed a risk assessment matrix, developed a comprehensive risk management program, and drafted the OHA Operational Procedures for the Trust Fund, which became effective on January 1, 2009. The key components of this program are outlined in the new IPS as well as in the attached summary schedule (Exhibit 6 - IPS Risk Management Program).

Remediation: While much progress has been made, expected completion of the remediation is June 30, 2010. OHA has completed the design of the new risk management program, and has already implemented several of the processes, but still has a significant amount of implementation work remaining. Remaining items include the creation of a compliance monitoring policy and procedure, investment guideline summaries, a database, and a valuation policy. Executing the program will require periodically updating procedures, but this is not part of the remediation. Also, the most important risk management process is about half completed, and that is to update the IPS, capital markets study and strategic asset allocation, conduct RFI's for the custodian and advisors, determine who the advisors will be, negotiate a more favorable fee structure, and sign contracts with the new advisors. The OHA CFO is leading this project.

e. OHA has not evaluated whether its investment advisors' fees are reasonable and competitive

Response: In 2004 Goldman lowered their advisory fee on traditional assets from 30 bps per year to 27 bps per year. Since the beginning of 2007, the Consultant, who has considerable experience in this area, informally concluded that while the fee structure was reasonable, the fees of both advisors were above average. The Consultant also pushed both advisors for fee reductions and was successful with Russell in lowering advisory fees by about $160,000 per year. Also, in November 2009 OHA hired a new custodian, which allowed OHA to eliminate approximately $50,000 in annual fees paid by OHA to Goldman for their custody and performance reporting services. OHA is currently in fee reduction negotiations with both Goldman and Russell.

Remediation: Expected completion of the remediation is year-end 2010. In July 2009, OHA issued an RFI for advisory services to approximately 30 investment firms. The fee information from the proposals received will be utilized to execute new advisory contracts that have fees commensurate with the industry standard for the services provided.

f. OHA did not consistently monitor investment compliance during the review period

Response: We disagree that the Board's role is to "scrutinize the actions and policies of the investment advisors". The Board is responsible for the "overall management of the Trust funds" per the IPS. Nearly all of the compliance guidelines in the IPS are related to asset allocation ranges, diversification and prohibited investments. The Board monitored asset allocation every quarter at the quarterly advisor meetings of the ARM Committee; since the end of 2006, the Consultant has monitored asset allocation compliance on a quarterly basis and since the fourth quarter of 2008, the OHA investment analyst has monitored and documented asset allocation compliance. Furthermore, the Board did implement a highly diversified portfolio of commingled multi-manager funds in 2003 with two completely independent, highly regarded advisors, each with hundreds of billions of dollars in asset under management. This manager-of-manager approach significantly reduced any diversification risk. We do agree, however, that while the objective of each commingled fund was appropriate, OHA staff did not verify compliance to the IPS guidelines and did not receive formal compliance attestations from the two advisors.

Remediation: Expected completion of the remediation is June 30, 2010. OHA is working with the Investment Advisors in developing a compliance monitoring policy and procedure.

g. OHA does not have a valuation policy and process to ensure the trust's investment holdings are fairly and accurately valued

Response: We disagree with this statement for two reasons. First, the 2003 IPS specified a valuation policy, i.e. "to account for market fluctuations and volatility, the custodian or its agent (independent pricing agent) will mark to market all securities at least monthly." Second, nearly all of the Trust's assets are held in commingled funds, which have their own governance structure and valuation policies that OHA has no ability to control. In addition, during the due diligence process in place since 2007, OHA staff and the Consultant have reviewed the valuation policies of the two advisors and found them reasonable. OHA staff and the Consultant in 2008 reviewed and approved the advisors' asset valuation classifications in accordance with FAS 157. We do agree, however, that OHA should put a valuation procedure to review and adopt all the valuation policies that govern the valuation of assets.

Remediation: Expected completion of the remediation is October 31, 2009. OHA staff and Consultant will review the valuation policies of the custodian and the commingled funds and revise the OHA Trust Fund Operational Procedures authorizing the OHA CFO to adopt those policies.

h. OHA did not sufficiently perform and document account reconciliations between the custodian and investment advisor statements

Response: During the review period of FY 2004 though FY 2008, OHA staff has routinely reviewed the custodian's statement and the advisors statement on a monthly basis. We recognize that the monthly review methodology and reconciliation process may not have been consistently documented. However, OHA has always conducted reconciliation of asset values on a quarterly basis during the review of fees with signed approval by the CFO to ensure that the fees assessed by the advisors are accurate and the asset values are consistent with those reported by the custodian. The documentations for the quarterly reconciliation of market values and fees were provided to the contracted auditors during their on-site review.

As noted in your observations, OHA has improved its account reconciliation process significantly since the review period by implementing documented monthly reconciliation of asset values, certified reconciliation checklist signed by Russell, reconciliation of performance returns between the advisors and custodian, and monthly review of total Trust Fund and benchmark performance. In addition, OHA has continued to reconcile the Advisory fees on a quarterly basis and document the approval of payments signed by the CFO and Controller, or otherwise designated officers.

Remediation: Completed as of November 2008.

i. OHA has delegated proxy voting authority to the investment advisors without assessing potential conflicts

Response: OHA has always delegated proxy voting to its advisors. During the on-site due diligence in 2007 the Consultant covered proxy voting with the advisors and detected no significant issues. Review of the advisors' proxy voting policies and procedures is included in the Consultant's due diligence procedures. OHA does not consider this finding to be a significant risk to the trust fund.

Remediation: Expected completion of the remediation is October 31, 2009. OHA will add due diligence procedures specifying the review of the advisors' proxy voting policies and procedures to the OHA Operational Guidelines.

j. The Trust's asset allocation plan appears to be inconsistent with those of its peers, making assessment difficult

Response: We respectfully disagree with the auditor's finding that OHA's Trust Fund asset allocation plan should be comparable to those of other endowment and foundations as reported in the National Association of College and University Business Officers ("NACUBO") study. First of all, we believe that OHA's asset allocation plan should be established based on OHA's mission, investment objectives, spending policy, liquidity requirements, and risk tolerance, rather than following a survey average. In addition, we also believe that the regulatory environment governing the institution should be considered in establishing the asset allocation strategies.

Unlike other educational endowments or foundations, OHA is not a charitable organization and OHA's Trust Fund is not established or funded by donations. Educational endowments and charitable foundations are subject to the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") and the Financial Accounting Standards Board Staff Position No. 117-1 ("FAS 117-1") spending guidelines. However, OHA's Trust Fund was not established and is not sustained by donations; therefore OHA is not subject to the same regulatory requirements as other endowments or foundations. UPMIFA and FAS 117-1 regulations can have significant impacts on an institution's spending policy, thus affecting the asset allocation strategy. Many universities also have bond issues that result in different liquidity requirements for their endowments in effort to sustain a specific bond rating. As such, OHA has different return and liquidity objectives than most university endowments or charitable foundations, warranting an asset allocation strategy that is uniquely appropriate for OHA.

Secondly, OHA's first and foremost obligation is to the Native Hawaiian community as OHA is established for the betterment of conditions for Native Hawaiians. OHA's mission is to mālama (protect) Hawai'i's people and environmental resources and OHA's assets, toward ensuring the perpetuation of the culture, the enhancement of lifestyle and the protection of entitlements of Native Hawaiians, while enabling the building of a strong and healthy Hawaiian people and nation, recognized nationally and internationally. As such, OHA may utilize its resources, including the Trust Fund, as necessary in effort to prudently fulfill its purpose and mission. Many of endowments and foundations reported in the NACUBO study have asset allocation plans designed to ensure intergenerational equity. While capital preservation may be an important factor to consider, OHA does not share the same capital preservation or spending objectives as other institutions. Therefore, OHA's asset allocation strategy may be different than those institutions with the objective of sustaining their endowments in perpetuity.

Lastly, we believe that following the average asset allocation of other endowment and foundations as reported in NACUBO, or other similar benchmark studies, is imprudent. While NACUBO may serve as a helpful reference in understanding trends in endowment asset allocation, to align OHA's Trust Fund asset allocation with the NACUBO average without regards to the aforementioned factors would be unwise. In addition, NACUBO is an annual study reporting prior year statistics. Following a trend that is at least a year old is also not a prudent method of asset management. We believe that the most prudent method in establishing OHA's asset allocation strategy is to conduct a periodic capital market and portfolio construction analysis with consideration for OHA's investment objectives, spending policy, liquidity requirement, and risk tolerance. As such, our advisors have conducted a model portfolio and market sensitivity analysis at OHA's request in 2008 and 2009. It was determined that the Trust Fund asset allocation plan is appropriate for OHA's needs.

We do, however, recognize the importance of reviewing benchmark studies and understanding industry trends and movements. Therefore, we have requested Russell to present peer return and asset allocation comparisons to the Board of Trustees once a year as evidence in Russell' quarterly reports. Goldman also presents peer performance data in their quarterly presentations as noted in your findings. Currently, OHA staff monitors the Trust Fund's asset allocation on a monthly basis to ensure policy compliance. Moving forward, our investment staff and Consultant will continue to compile independent peer performance and asset allocation research, and will present relevant findings to the Trustees periodically as appropriate.

Remediation: Not applicable.

k. The strategy of tactical asset allocation transfers and redistribution requires increased reporting and monitoring

Response: The auditor raises two concerns here. First, potential confusion regarding the actual asset allocation versus the strategic target allocation because the advisors could not fully invest in separate high yield or private equity vehicles during the evaluation period. Second, performance attribution becomes more difficult when funds contain more than one asset class or are partially used to hedge an underexposure in another asset class. These two issues were disclosed and explained several times by the advisors during the quarterly ARM Committee meetings. Since the Consultant was hired in late 2006, the hedges and actual exposures have been monitored and no asset allocation range violations were detected. The Consultant presented and explained the hedges in the 2006, 2007 and 2008 Trust Fund Year-End Evaluations to the ARM Committee. These annual reviews cover the major tactical decisions of the advisors and whether they improved or detracted from performance. OHA staff has completed a two-factor performance attribution analysis for the six-year market cycle review, which attributes performance versus the strategic benchmark into tactical asset allocation and manager selection for each calendar year and the entire evaluation period. The report will be presented to the ARM Committee on September 22, 2009. OHA believes the approach in place since the end of 2006 is sufficient to keep the Board properly informed. Also, the private equity hedge is currently insignificant as the asset class is currently at target.

Remediation: Completed September 2009.

Finding 3. Many recent improvements to the investment process have been made, but more work is needed

In response to the status of prior audit findings and recommendations as shown in Exhibit 2.7, we would like to identify the following errors in the report:

1. Issue: Delineate the legislative and procedural authority of OHA and the Board of Trustees to make and refine investment policy. Per audit report - implementation after December 31, 2008.

   Correction: OHA's IPS was updated and effective as of October 24, 2008, not January 1, 2009.

2. Issue: More clearly define the benchmarks to be used by the investment advisors, ensuring accuracy and consistency. Per audit report - implementation after December 31, 2008.

Correction: The strategic benchmark indices were developed by the Investment Consultant in 2006 and presented to the ARM Committee as recommendations on February 21, 2007. The benchmark indices were placed into effect in 2007. Russell implemented the strategic benchmark in 2007 using actual asset allocation. Goldman partially implemented the strategic benchmark also using the actual asset allocation. The advisors' performance was independently evaluated by the investment Consultant and presented to the ARM Committee using the strategic benchmark and target allocations in 2007. The strategic benchmark was again updated as part of the new IPS dated October 27, 2008. When Goldman encountered difficulties in implementing the IPS benchmark, Russell/State Street was hired as custodian to conduct performance reporting for both advisors and the total Trust Fund.

3. Issue: Set performance objectives and means of measurement for the trust fund as a whole, consistent with asset classes in the portfolio where it is practical and supported on a net of fee basis. Per audit report - implementation after December 31, 2008.

   Correction: Long-term return objective for the Trust Fund were specified as CPI+4% in OHA's IPS dated March 29, 2003 and October 27, 2008. Target returns relative to benchmark were placed into practice in 2007 using the strategic benchmark presented to the Trustees on February 21, 2007. Strategic benchmarks were reviewed and again updated on October 24, 2008 as part of the IPS update. Exhibit 7 – ARM Committee agenda and minutes February 21, 2007.

4. Issue: Creating a schedule and review process that includes visits to both investment advisors' place of business and more completely analyzes their process and controls

   Correction: OHA implemented on-site due diligence reviews in 2007, not mid-2008, as indicated in the auditor's report. The visits were documented by the due diligence review materials received by OHA. Given the voluminous nature of the due diligence materials, a copy of the materials can be provided at the auditor's request.

In addition, we would like to identify those prior findings that have been addressed since the review period of July 1, 2003 to June 30, 2008 as follows:

1. Issue: Revise components of its investment policy statement.

   Response: OHA began the IPS review process in late 2007. Substantial changes were made to the updated IPS approved by the Board of Trustees on October 24, 2008. The IPS was again updated to reflect a few policy revisions on August 3, 2009.

2. Issue: More clearly define the benchmarks to be used by the investment advisors, ensuring accuracy and consistency.

Response: OHA implemented new strategic benchmark indices in 2007, and again updated it in 2008 and 2009. The current strategic benchmark index also identifies the peer universe benchmark indices.

3. Issue: Evaluate the use of passive investments with those asset classes in the portfolio where it is practical and supported on a net of fee basis

   Response: OHA has conducted a market cycle review of the Trust Fund, including a review of active versus passive investment results. The market cycle review has been presented to the Investment Advisory Committee and is scheduled to be presented to the ARM Committee on September 22, 2009.

4. Issue: Create a procedures manual, outlining the processes, control, reporting requirements and oversight of the investment process.

   Response: OHA has implemented a number of procedural and oversight changes in 2008 and formally created an operational procedures manual in January 2009. OHA will continue to update the reporting and oversight process in the operational procedures manual as appropriate.

5. Issue: Improving the formal analysis and reporting associated with the activities and performance of the advisors.

   Response: OHA has always conducted market value and fee reconciliations on a quarterly basis. In addition, OHA has formalized the monthly reconciliation process and implemented a quarterly report of Trust Fund activities and performance prepared by OHA staff.

6. Issue: Standardizing the contracting process and contracts used to retain investment-related service providers.

   Response: OHA is currently undergoing a RFI review and will be reviewing and renegotiating the investment advisor contracts in 2009 and 2010.

We appreciate the Office of the Auditor's findings and recommendations. While we do not agree with all of the auditor's findings and recommendations, we recognize that there are areas of improvement that can be made to further enhance the management framework for the Trust Fund. Over the past three years, the Board of Trustees and the OHA Administrator have taken numerous steps to strengthen the OHA's risk management system for the trust fund, including hiring an independent investment consultant in late 2006, revising the IPS in October 2008 and again in August 2009 to realign responsibilities and streamline the oversight process, establishing an investment advisory committee in April 2008, adding an experienced investment analyst to the staff in October 2008, and formalizing the duties of the OHA Administrator and Chief Financial Officer in relation to the Trust Fund in the fourth quarter of 2008.

Operationally, we have created an operations manual and risk assessment matrix, established monthly call schedule with the advisors, implemented internal quarterly reports on the Trust Fund's assets, and improved the monthly reconciliation process. Our Trust Fund analyst and Consultant have also conducted a market cycle analysis evaluating the Trust Fund performance, advisor performance, active investment strategy, fee comparison, and peer group reviews. We will continue to review the Trust Fund management framework against the industry best practices to ensure that the Trust Fund management structure, policy, and procedures are appropriate and effective in meeting OHA's objectives.

Since the period covered by the audit, OHA has made significant improvements in the management of the portfolio and acknowledges that improvements were needed. However, in numerous instances, the contracted audit firm failed to base the audit on 'fact of policy' provided to them at the time of the audit, i.e. the policies and practices in place at the time of the audit. We hope that the Office of the Auditor will correct the errors highlighted in our response and reconsider its findings.

Sincerely,

S. Haunani Apoliona

Trustee S. Haunani Apoliona, MSW
Chairperson, Board of Trustees

C: OHA Board of Trustees
OHA Administrator

Exhibit 1 – 2003 Investment Policy Statement
Exhibit 2 – September 15, 2004 BOT agenda and minutes
Exhibit 3 – Investment Policy Statement approved on October 24, 2008 and signed by the Chairperson on October 27, 2009
Exhibit 4 – Investment Advisory Committee charter
Exhibit 5 – OHA Bylaws
Exhibit 6 – IPS Risk Management Program
Exhibit 7 – ARM Committee agenda and minutes February 21, 2007

management of all assets subject to their oversight and will make all key investment decisions, such as manager selection, within the context set by this Investment Policy. The Board of Trustees still maintains responsibility for setting appropriate investment policy guidelines, asset allocation constraints, and monitoring the advisors to ensure they act prudently and follow the investment policy.

1.5 Spending Policy. The annual amount withdrawn from the Trust Fund expressed as a percentage of the Trust Fund's market value shall have a spending rate of no more than five percent (5%) annually, effective July 1,2000. The amount for determining annual spending withdrawals and the mechanics of its implementation shall adopt the moving average rule, whereby: The Trust Fund will spend a fixed percentage of no more than five percent (5%) of the Trust Fund's average 12-quarter market value, plus any funds available but not spent in previous fiscal years, held within the Trust Fund.

Section 2. General Objectives

2.1 Investment Objectives and Priorities. All available funds shall be invested subject to the following objectives and priorities:

a) Capital Growth. Investments shall be undertaken in a manner that seeks to ensure the preservation of purchasing power of the overall portfolio.
b) Liquidity requirements of anticipated expenditures.
c) Achieve excess return of actual fund results over a Custom Policy Benchmark on a net-{)ffee basis over a long time horizon.
d) Comply with existing and future applicable state and federal regulations.
e) Maximization of the total rate of return on investment consistent with the foregoing objectives.
f) Diversification by asset type, security and investment manager in order to reduce the volatility of returns.

2.2 Long~ Term Objective. Capital growth is the primary objective of the Trust Fund. The investment portfolio shall be designed with the objective of protecting principal while earning a rate of return that is targeted to meet or exceed the relative benchmark of each Trust Fund investment in order to preserve the fund assets and ensure that sufficient reserves will be available to cover future cash requirements. Capital growth is achieved by investing prudently in a wide range of asset classes in order to achieve proper diversification. Since these funds will focus on long-term capital appreciation, volatility including loss of principal may be experienced. Over a full market cycle and subject to market conditions, it is expected that the total return will exceed inflation as measured by CPI by 4%.

2.3 Definition of Market Cycle. Throughout this Statement *of* Investment Objectives and Policy Guidelines and the Sub-Policies referred to herein, the term "market cycle" is used. Market cycles are defined to include both a rising and a declining market. Generally, a rising market will be defined as a period of at least two consecutive quarters of rising stock prices. A declining market shall usually be defined as a period of two consecutive quarters of declining stock prices. Therefore, a Market Cycle (and a minimum period of evaluation) shall be at least one year and more typically three to five years.

2.4 Definition of Investment Advisor and Investment Manager. Throughout this Statement of Investment Objectives and Policy Guidelines and the Sub-Policies referred to herein, the terms "investment adVisor" and "investment manager" are used. "Investment advisor" shall refer to the "manager of managers"; "investment manager" shall refer to any managers selected by the investment advisors. Where the Board of Trustees selects an investment advisor that will invest assets of the Trust Fund in a registered investment company (or mutual fund) it is understood that the advisor to the investment company is acting as the manager of managers and the investment advisor with which the Board of Trustees has contracted shall be responsible for ensuring the funds selected comply with the investment objectives and guidelines contained herein.

Alice Greenwood: *(Mrs. Greenwood provided written testimony, please find it attached as Exhibit A. Mrs. Greenwood's request was referred to OHA Administration for follow up).*

Lela Hubbard: *(Mrs. Hubbard provided written testimony, please find it attached as Exhibit B. Mrs. Hubbard was referred to OHA's Administrator for further follow up regarding her specific request relating to OHA expenses).*

Tweetie Lind &John Lind: *(Mr. and Mrs. Lind came to provided the Board their mana'o regarding Mu'olea Point. They shared family history, cultural information and offered the Board their personal feelings on the possible use of Mu'olea Point. Both Mr. and Mrs. Lind expressed support to OHA for it's action regarding Mu'olea Point).*

IV. UNFINISHED BUSINESS

A. ADMINISTRATOR'S UPDATE ON HAWAIIAN GOVERNANCE AND OHA ACTIVITIES

Administrator Namu'o: *(Administrator Namu'o discussed the agenda regarding the upcoming Trustee visit to Washington D.C. No other updates where given).*

V. NEW BUSINESS

A. COMMITTEE ON ASSET AND RESOURCE MANAGEMENT

1. ARM 08-04: OHA SPENDING POLICY REVISIONS (2ND READING)

MOTION

Trustee Stender: Madame Chair, your Committee on Asset and Resource Management having met on August 18, 2004 and after full and free discussion recommends to the Board of Trustees for a second reading having passed first reading on August 19, 2004, ***To approve a revised Office of Hawaiian Affairs Native Hawaiian Trust Fund Spending Policy as discussed and amended in Attachment "A" effective for the Fiscal Year starting July 1, 2004.***

For the record, Trustee Stender clarified the amendment made on August 19, 2004.

Move to insert the term (Fiscal Reserve) after the word "years" and before the "comma" in item number 3.

Document: **Office of Hawaiian Affairs Native Hawaiian Trust Fund Spending Policy** Currently reads as: 3. Any funds available but not spent in previous fiscal years, held within the Native Hawaiian Trust Fund. Amended as: 3. Any funds available but not spent in previous fiscal years (Fiscal Reserve), held within the Native Hawaiian Trust Fund

Trustee Carpenter: ***Second.***

Chairperson Apoliona: Discussion members?

(After full and free discussion Trustee Akana stated for the record the following: *"the problem I have with this is, just like our budget, we don't even recognize how our budgets look anymore...we have to ask for details from our CFO to tell us exactly what's under the cost centers now. Then we find all these little things that we have to bring to the table and say, where did this come from? Where did this come from? When you pass something like this new spending policy it's going to be fifty times worse. Try to figure out where all this money is going. Were spending money big time in this place, but what can we put our finger on that we are really spending it on? I mean, you know. That is my concern. I have never seen such fiscal irresponsibility since I have in the past three years. I will say that, for the record, I want that verbatim").*

Chairperson Apoliona: Mr. Namu'o I suggest that the next budget, you should have workshops with the Trustees.

(After further discussion, the Board took action on the following:

Roll Call Vote
Motion

To approve a revised Office of Hawaiian Affairs Native Hawaiian Trust Fund Spending Policy as discussed and amended in Attachment "A" effective for the Fiscal Year starting July 1, 2004.

For the record, Trustee Stender clarified the amendment made on August 19, 2004.

Move to insert the term (Fiscal Reserve) after the word "years" and before the "comma" in item number 3.

> Document: **Office of Hawaiian Affairs Native Hawaiian Trust Fund Spending Policy**
> Currently reads as:
> 4. Any funds available but not spent in previous fiscal years, held within the Native Hawaiian Trust Fund.
>
> Amended as:
> 3. Any funds available but not spent in previous fiscal years (Fiscal Reserve), held within the Native Hawaiian Trust Fund

TRUSTEE	1	2	'AE (YES)	A'OLE (NO)	KANALUA (ABSTAIN)	EXCUSED
TRUSTEE ROWENA AKANA				NO		
[redacted]			[redacted]			
TRUSTEE DONALD CATALUNA			YES			

[redacted]					KANALUA(1) ABSTAIN(2)	
TRUSTEE COLETTE MACHADO			YES			
[redacted]			[redacted]			
TRUSTEE OSWALD STENDER			YES			
[redacted]			[redacted]			
CHAIRPERSON HAUNANI APOLIONA			YES			
TOTAL VOTE COUNT			7	1	1	0

MOTION: [ ] UNANIMOUS [x] PASSED [ ] DEFERRED [ ] FAILED [ ] FILED

Chairperson Apoliona: Motion is approved.

<u>B. JOINT COMMITTEES OF ASSET RESOURCE MANAGEMENT & BENEFICIARY ADVOCACY AND EMPOWERMENT</u>

<u>1. ARM/BAE 11-04: MU'OLEA POINT TRUST FOR PUBLIC LANDS MOTION</u>

Trustee Machado: Madame Chair, your Committee on Asset & Resource Management and Beneficiary Advocacy and Empowerment, having met on July 28, 2004 and after full and free discussion, recommends approval of the following action:

<u>The Board of Trustees approved the use of $342,000 from OHA's existing fiscal reserve account to be used to reimburse the Trust for Public Land for funds advanced towards the purchase of Mu'olea Point with the recommendation to the County of Maui that it consider the transfer of management and control of the land and its waters to the sovereign native Hawaiian entity upon its recognition by the United States and the State of Hawaii.</u>

Trustee Stender: **<u>Second.</u>**

Chairperson Apoliona: Discussion members? Hearing none, roll call vote.

Roll Call Vote
Motion

<u>The Board of Trustees approved the use of $342,000 from OHA's existing fiscal reserve account to be used to reimburse the Trust for Public Land for funds advanced towards the purchase of Mu'olea Point with the recommendation to the County of Maui that it consider the transfer of management and control of the land and its waters to the sovereign native Hawaiian entity upon its recognition by the United States and the State of Hawaii.</u>

NATIVE HAWAIIAN TRUST FUND

INVESTMENT POLICY STATEMENT

The following Investment Policy Statement (IPS) has been duly adopted, utilizing the Manager-of-Managers (MoM) approach, by the Office of Hawaiian Affairs, Board of Trustees at its meeting held on October 24, 2008, and is in full force and effect.

Haunani Apoliona

Haunani Apoliona, Chairperson
Board of Trustees

10/27/08
Date

First Reading: October 2, 2008
Second Reading: October 24, 2008

OFFICE OF HAWAIIAN AFFAIRS

Investment Advisory Committee
Charter

Purpose of the Charter

The purpose of Office of Hawaiian Affairs Investment Advisory Committee is to provide guidance to OHA staff regarding investment oversight of the Native Hawaiian Public Land Trust Fund. The committee consists of volunteers from the business community.

Purpose of the Advisory Committee

The committee is advisory only and may provide oversight and guidance to OHA staff on strategic direction of investment policy. The committee shall meet to review investment performance and portfolio management and advise in general regarding prudent overall strategies with the investment advisor. The committee will assess the adequacy of this charter on an annual basis or as often as conditions warrant.

Membership of the Committee

Upon invitation by trustees or other committee members the Administrator shall appoint community members who have successful investment, financial, legal or business backgrounds and are respected among their peers and the general community to serve upon the Committee, which shall also include ex officio trustees who may from time to time join the committee within the conditions applicable by state law with regard to formal meetings and sunshine laws. The Administrator and CFO of the Office of Hawaiian Affairs shall serve ex officio and OHA's Investment Consultant shall serve as the chairperson. An OHA staff person shall serve as secretary.

Meetings

The Committee shall schedule no less than four meetings annually and other special meetings as called by the chair.

Ethics

Committee members shall carry out their responsibilities objectively, honestly and in the best interest of OHA, conducting themselves according to the highest standards of personal and professional integrity.

ARTICLE VII

Administrator

The Board shall have the power to exercise control over the Office through its executive officer, the Administrator.

A. Appointment. As required by Chapter 10, Hawai'i Revised Statutes, as amended the Board, by a majority (5) of all members to which the Board is entitled, shall appoint an Administrator who shall serve a term to be determined by the Board.

B. Duties. As required by Chapter 10, Hawai'i Revised Statutes, as amended, the Administrator may employ and retain such employees as deemed necessary to carry out the function of the Office.

C. Removal. As required by Chapter 10, Hawai'i Revised Statutes, as amended, the Board, by a two-thirds vote (6) of all members to which it is entitled, may remove the Administrator for cause at any time.

ARTICLE VIII

Committees of the Board

A. There shall be a minimum of two Standing Committees of the Board. Each Committee will be led by a Chair and a Vice-Chair. The Board may increase the number of Standing Committees, but the membership of the Standing Committees shall be all nine (9) Trustees. The minimum two Standing Committees shall consist of the Committee on Asset and Resource Management (ARM) and Committee on Beneficiary Advocacy and Empowerment (BAE).

1. Committee on Asset and Resource Management. The committee shall:

   a) handle all fiscal and budgetary matters and ensure proper management, planning, evaluation, investment and use of OHA's trust funds;

   b) review and approve any and all acquisition expenditures that have a multi-year implication, and which impact the OHA Investment or Spending policies;

Committees of the Board continued

c) establish policies which strengthen OHA's fiscal controls and financial management;

d) oversee the use and condition of OHA's real estate and execute policy for the proper use of such lands including land to which OHA shall have an interest;

e) develop policy on issues of land use, native rights, and natural and cultural resources, including the inventory, identification, analysis and treatment of land, native rights and natural and cultural resources;

f) review and approve appropriate grants to programs that support OHA's overall mission;

g) evaluate OHA programs to determine effectiveness in order to decide whether to continue, modify, or terminate funding of any of OHA's programs;

h) develop training and orientation programs for Trustees and staff including materials relating to Trustees roles, fiduciary responsibilities, and ethics;

i) in consultation with the Chair of the Committee on Beneficiary Advocacy and Empowerment carry out the recruitment and selection of the Administrator; and

j) provide oversight over Permanent Special Councils or Commissions as assigned by the Board.

2. Committee on Beneficiary Advocacy and Empowerment. The committee shall:

a) plan, coordinate, and implement programs and activities which encourage Hawaiians to participate in governance;

b) facilitate OHA's legislative agenda and advocacy efforts with Federal, State, and County officials, private and community organizations, and groups involved in Hawaiian issues;

Committees of the Board continued

c) develop programs which focus on beneficiary health, human services, native rights and education;

d) develop policies and programs relating to land use and housing, the environment and natural resources;

e) evaluate all OHA programs to ensure that the programs have a positive impact on beneficiaries;

f) review and approve program grants that support OHA's legislative and advocacy efforts;

g) draft, introduce, and support the passage of legislation which benefits Hawaiians and supports Hawaiian issues, and work to defeat legislation which is not in the best interest of OHA and its beneficiaries; and

h) provide oversight over Permanent Special Councils or Commissions as assigned by the Board.

B. Each Standing Committee shall consider all matters referred to it in accordance with Section J, Article VIII, of these Bylaws and make appropriate recommendations to the Board, in a timely manner, but no later than twelve calendar days before a Board meeting, and shall make progress reports to the Board periodically or when requested by the Chair of the Board.

C. Standing Committees may meet in joint session when subject matter falls under the purview of more than one of the Standing Committees. In the case of an "un-budgeted" funding decision, a joint committee meeting with the Asset and Resource Management Committee shall be mandatory. An "un-budgeted" funding decision is one in which the Board considers the reallocation of funds in the existing budget to meet an expenditure not appropriated in the existing budget.

D. Standing Committees may create Advisory Committees as necessary which shall serve in an advisory capacity to the Standing Committees. Advisory Committees

Committees of the Board continued

shall assist in the resolution or study of issues arising in the specific areas of concern assigned to their respective Standing Committee. To avoid duplication in the consideration of issues, the Standing Committees shall create only one Advisory Committee to study or undertake the resolution of a single subject or issue. Each Standing Committee shall have no more than three Advisory Committees at any one time. All communications and advice from an Advisory Committee shall be made to the Chair of the Standing Committee, no later than twelve calendar days before a Standing Committee Meeting. All communication and advice to an Advisory Committee shall be made by the Chair of the Standing Committee or designee.

The Advisory Committee Chair and membership shall be appointed by the Standing Committee Chair, upon advice and counsel of Standing Committee members. The term of the Advisory Committees shall expire with the completion of the assigned task or at the discretion of the Standing Committee Chair. There shall be no less than three members to each Advisory Committee, at least one of whom shall be a member of the Board of Trustees of the Office of Hawaiian Affairs, who shall be appointed by the Standing Committee Chair. All Advisory Committee members, with the exception of the members of the Board of Trustees, shall serve on a voluntary basis without compensation, other than reasonable expenses such as travel, parking, and meals.

E. From time to time there shall be such Ad hoc Committees as designated by the Chair, the members of which shall be appointed by the Chair, and subject to approval of the Board by a simple majority vote. There shall be a minimum of three members on each Ad hoc Committee, at least one of whom shall be a member of the Board and who shall be the Chair of the Ad hoc Committee.

The term of the Ad hoc Committees shall expire at the completion of the assigned task or at a specific time that is determined for each Ad hoc Committee at the time of the appointment of said Committee or at the discretion of the Chair. All communications and advice from an Ad hoc Committee shall be made to the Chair

Committees of the Board continued

of the Board no later than ten days before a Board meeting. All communications and advice to an Ad hoc Committee shall be made by the Chair of the Board. All Ad hoc Committee members, with the exception of the members of the Board of Trustees shall serve on a voluntary basis without compensation, other than reasonable expenses such as travel, parking, and meals.

In the event that three or more Board members are appointed to an Ad Hoc Committee, Chapter 92, Public Agency Meetings and Records, of the Hawai'i Revised Statues, as amended, will apply.

F. There shall be such Permanent Special Councils or Commissions as the Board shall deem appropriate to create. The Board shall designate a Standing Committee that shall exercise oversight over said Council or Commission. Council members or Commissioners shall be appointed by the Standing Committee to which oversight authority is granted pending confirmation of the full Board through a majority (5) vote of all members to which the Board is entitled. Membership of each Council or Commission shall be composed of at least one member of the Board of Trustees. The subject matter and purview of said Councils or Commissions shall be clearly defined and limited to only those areas so recommended by the Standing Committee having oversight thereof and subject to the approval of the full Board by a majority (5) vote of all members to which the Board is entitled. Oversight by the appropriate Standing Committee shall include, but not be limited to, review of budgetary concerns for the operation of said Council or Commission, and affirmation of requests for actions by such Council or Commission for the continued operations of such Council or Commission. Such Council members or Commissioners with the exception of any members of the Board of Trustees, shall serve terms as established by the Board and shall serve on a voluntary basis without compensation, other than reasonable expenses such as travel, parking, and meals.

Committees of the Board continued

G. Quorum and Voting for Committees, Councils and Commissions. For Advisory, Ad hoc, and Standing Committees, Councils and Commissions, a majority of the members of the Committee, Council or Commission shall constitute a quorum. The concurrence of a quorum shall be required for any Committee (other than a Standing Committee), Council or Commission to make any recommendation to the Board or Standing Committee where appropriate, for Board or Standing Committee approval. A majority of the Members present at a Standing Committee meeting shall be required for it to make any recommendation to the Board, provided that a quorum is present at the time of the vote.

H. Authority to act on all matters is reserved to the Board and the functions of the Advisory and Ad hoc Committees, and Councils and Commissions shall be to investigate, consider, and make recommendations to the Standing Committee and the Board, respectively.

I. Staff Assignments. The Administrator shall assign to each Standing, Advisory, and Ad hoc Committee, and to each Council and Commission staff to conduct research for and to advise the respective Committee, Council or Commission and to maintain records of the proceedings of same.

J. Committee recommendations. The Chair is required to place a Committee recommendation on a full Board of Trustees agenda no later than thirty (30) calendar days after the receipt of the recommendation.

All Standing Committees are required to do the same with respect to action items referred to the committee by a Trustee.

ARTICLE IX

Meetings

A. As required in Chapter 10, Hawai‘i Revised Statutes, as amended, Board meetings shall be convened at the call of the Chair or by a quorum, as often as may be necessary for transaction of the Board's business and shall meet at least once annually on each of the islands of Hawai‘i, Maui, Moloka‘i, Lāna‘i, Kaua‘i, and

Office of Hawaiian Affairs Native Hawaiian Trust Fund
Investment Policy Statement (IPS) Risk Management Program
January 2009

Role (Purpose)	Responsible Party	Activity (Process)	Frequency	Client	Products	Information Sources Utilized
• Primary Overseer of Trust Fund • Mitigate Risk of Not Achieving Goals	Board of Trustees (BOT) via ARM Committee	• Establish Policies & Goals • Hire/Terminate Advisors • Oversee Investment & Risk Management Processes • Review Advisors' Performance Reports • Review Consultant Annual Report • Review Audit Reports • Attend Advisor On Site Due Diligence • Participate in Investment Education Programs	• Continuously as Needed • As Needed • Continuously as Needed • Quarterly • Annually • Annually • Annually • Annually	• Beneficiaries	• IPS • ARM Minutes • Advisor Contracts	• ClientLink (Online NHTF Data Updated Daily) • Quarterly Advisor Performance Reviews • Special Advisor Topical Presentations • Advisor Sponsored Workshops, Seminars & Webcasts • Annual Advisor On Site Due Diligence Sessions • Consultant's Quarterly Comments & Annual Review • Investment Advisory Committee Meetings
• Invest Assets • Provide Expert Advice & Recommendations • Provide Investment Education and Research to OHA Staff/CFO/Administrator, Consultant & BOT	Advisors	• Exercise Investment Discretion (Tactical Asset Allocation, Manager & Product Selection) • Make Recommendations (e.g. Capital Markets Studies, Asset Allocation Targets & Ranges, Investment Guideline Summaries) • Provide Risk Management • Provide Analytical Expertise • Educate & Inform • Report to OHA Staff & Consultant • Report to BOT • Provide Online access to Portfolio Holdings, Reports & Statements • Reconcile with Custodian	• Continuously • As Requested • Continuously • As Requested • As Requested • Periodically, at least monthly • Quarterly • Daily via Russell ClientLink • Monthly	• BOT • Consultant • OHA Staff • OHA CFO & Administrator	• Quarterly Performance Reviews • Monthly Calls & Compliance Reports • Monthly Reconciliation with Custodian • Quarterly Compliance Reports • Annual Due Diligence Materials • Special Studies & Reports • Webcasts • Educational Literature • Market & Portfolio Updates	• ClientLink • Extensive In-House Staff Investment & Risk Management Expertise • IPS • Programmatic & Topical Interaction with BOT, Consultant, OHA Staff, CFO and Administrator
• Primary Monitor of Advisors & Trust Fund	Consultant/OHA Staff	• Write Policies & Procedures	• As Needed	• BOT • CFO	• Quarterly Comments & Annual Review (BOT)	• ClientLink • Monthly Custody Reports

Role (Purpose)	Responsible Party	Activity (Process)	Frequency	Client	Products	Information Sources Utilized
		• Monitor Advisors (e.g. Daily Online Review, Monthly Update Calls, Quarterly Performance Reviews, Annual Onsite Due Diligence) • Prepare Annual Reviews • Conduct Annual Advisor Due Diligence • Review Advisor Recommendations • Recommend Alternatives to Administrator & BOT • Chair & Support IAC • Respond to Audit Reports • Prepare Special Studies	• Continuously • Annually • Annually • As Needed • As Needed • Quarterly • As Needed • As Requested	• Administrator	• Weekly Reports (CFO) • Monthly Reports (CFO/ Administrator) • Monthly Call Summaries • Annual Due Diligence Report • Special Reports • Investment Guideline Summaries & Exception Reports • Investment Recommendation Reviews • Checklists & Logs	• Quarterly Custodian Performance Reports • Quarterly Advisor Compliance Reports • Quarterly Advisor Performance Reports • Advisor Due Diligence Materials • Advisor Special Studies • Advisor Webcasts • Advisor White Papers & Articles • Advisor Conferences, Workshops & Seminars • Monthly Advisor Calls
• Advise	Investment Advisory Committee	• Review NHTF Performance • Provide Feedback on Strategies, Investments & Markets	• Quarterly • Quarterly	• BOT • Consultant • OHA Staff • OHA CFO • Administrator	• Meeting Notes • Agendas • Meeting Distribution Materials	• Quarterly Advisor Performance Reports • OHA Staff/Consultant Monthly & Annual Reports • Special Reports & Studies
• ☐Approve Non-Traditional Investments • Oversee OHA CFO & Staff • Hire Consultant	Administrator	• Sign Subscription Agreements •☐ Hire Consultant •☐ Approve Responses to Audit Reports	• As Needed • As Needed • As Needed	• BOT	• Subscription Agreements • Signing Authority Document	• ClientLink •☐Quarterly Advisor Performance Reports •☐Monthly OHA Staff/Consultant Report •☐Advisor Special Studies •☐OHA Staff & Consultant Recommendations •☐Advisor Conferences, Workshops & Seminars •☐Annual Advisor Due Diligence Materials

Role (Purpose)	Responsible Party	Activity (Process)	Frequency	Client	Products	Information Sources Utilized
• Oversee Staff & Consultant • Authorize Cash Transactions	Chief Financial Officer	• Review all reports	• As Needed	• BOT • Administrator	• Subscription Agreements	• ClientLink • Weekly OHA Staff Report • Quarterly Advisor Performance Reports • Monthly OHA Staff/Consultant Report Advisor Special Studies • OHA Staff & Consultant Recommendations • Advisor Special Studies • Advisor Conferences, Workshops & Seminars • Annual Advisor Due Diligence Materials
• Safeguard Assets • Execute Transactions • Produce Statements	Custodian	• Execute Transactions • Produce Statements • Reconcile with Advisors	• As Needed • Monthly • Monthly	• BOT • Consultant • OHA Staff • OHA CFO	• Authorized Signer List • Online system • Monthly Asset & Performance	• OHA Signing Authority • Instructions from Advisors & OHA (Cash & Trading)
• Audit NHTF	External Auditor	• Audit NHTF	• Annually	• Audit Report	• Audit Report	• All Documents
• Audit NHTF	State Auditor	• Audit NHTF	• Quadrennially	• Audit Report	• Audit Report	• All Documents

Clyde Namu'o stated that given the increased level of activities in this organization (OHA), having another clean audit is a testament to the staff and their dedication to making this work. They have done an outstanding job. Grant Thornton has done a great job as well.

C. Review of Investment Managers' Performance – Howard Hodel

Howard Hodel, retired Senior Vice President – Bank of Hawaii, reported to the Board of Trustees on the performance of OHA's investment managers.

Barrie Stewart, CFO, informed the Trustees that there has been an alteration in fees with Frank Russell Group; OHA will realize a savings of approximately $159,000 per year due to this change.

Howard Hodel reported that overall, 2006 (calendar year) was a good year as OHA went from $371 million to $420 million which was an increase in assets of 13% largely due to very favorable investment markets during the year. OHA's performance net of fees for the combined portfolio earned 12.15% -- Goldman Sachs at 11.45% and Frank Russell at 12. 85%. These percentages were reflected after advisory fees and expenses.

In combined asset allocations, Goldman Sachs had 49.5% and Frank Russell had 50.5% due to performance. Fifty-seven percent of the portfolio is in equity (combination of private and public, but almost all of it in the public market); 26% in fixed income; 8% in real estate; and 9% in hedge funds.

During the year, both advisors rebalanced their asset classes every month into their target allocations. The strategic asset targets have a range around them so the managers have discretion to move around inside an asset class and make tilts. Neither advisor materially changed their tactical asset tilts during the year; although, Frank Russell – toward the end of the year – recommended a 5% overweight to international equity eliminating their current domestic large cap equity overweight.

During the year, Goldman Sachs terminated four of their equity managers that were hired to manager our portfolios and then hired three managers. Frank Russell terminated two managers and hired two managers (all in equity).

At the end of 2005, the net return on investments added $123 million for a total of $371 million since inception. At the beginning of 2006, the performance between Goldman Sachs and Frank Russell was very close; at the end of 2006, there was an investment return of $20 million for Goldman Sachs and $23 million for Frank Russell resulting in $420 million in returns. Since inception, investment returns have added $166 million that is very good in terms of performance for three years and ten months (March 1, 2003 to December 2006).

About 10% of the total portfolio is earmarked for private equity that has to be phased in. Both advisors took the 10% they couldn't get invested (in private equity you have to commit and it takes a number of years for that commitment to be drawn) and put it back into equity. We need to look at their asset allocation; we need to take the hedge out and look at their public equity asset allocation. Both advisors are 5% of total assets overweight to large cap U.S. equity. Frank Russell took 5% out of fixed income small cap in international equity.

Trustee Heen inquired about what it meant to be overweight to large cap U.S. equity; **Mr. Hodel** explained that it means there is a strategic target of large cap equity that is 25% of total assets.

Trustee Cataluna noticed that one of the managers-of-managers suggested searching more international and asked what the currency exchange rates were. **Mr. Hodel** stated that the dollar is weakening and the last couple of years saw the dollar weakening significantly against the Euro. They anticipate that because of the trade deficits the U.S. is running and with the imports that we are currently bringing in from China, the prediction is that the dollar will continue to be under pressure. It is very normal/standard to have an overweight international equity to pick up the devaluation of the dollar. When the managers are investing in international currency, they are not hedging the currency exposure; they are letting it float with the dollar so they're investing in stronger currency so there is appreciation. It is a good move.

Mr. Hodel continued by reporting that Goldman Sachs was 6% underweight to small cap equity during the year; 3% overweight to both fixed income and international equity; and 4% to real estate. These numbers are not big, risky numbers.

Mr. Hodel stated that setting the strategic target, which is in the purview of this committee, is very important and should definitely be looked at because determining where to allocate assets is the most important decision that needs to be made.

Mr. Hodel reviewed OHA's allocations.

Clyde Namu'o inquired about how our managers knew when to switch from one asset allocation to another if the return is higher elsewhere; **Mr. Hodel** stated that they tend to look forward based on what the market did in the past year. Managers don't take big risks, they estimate outcomes; but it doesn't always turn out positively. **Mr. Hodel** also expressed that being in the international market is a good move.

Mr. Hodel reviewed overall performance of the total portfolio. Domestic equity was 12.05% for the year (accurate and combined); the benchmark index is 16.9% (underperformance of 4.24% which is quite large); international equity was -1.31%. **Mr. Hodel** continued reporting that fixed income was 2.7% which was excellent.
Total equity averaged a -3.63%.

Trustee Mossman asked what the benchmark index was; **Mr. Hodel** explained that it is a market-weighted index. He went on to explain that when managers are hired, our advisors (Goldman Sachs and Frank Russell) should recover their fees by their using their skills in picking investment managers and asset allocations. Active managers struggled in 2006; OHA needs to revisit active management in this particular sector or asset class (domestic equity).

Mr. Hodel clarified that his report covered only 2006 and not the years since inception. He explained that it was difficult for him to come up with a benchmark for real estate; he finally chose a combination of 75% private and 25% public because that reflected the available investments that were available. The portfolio outperformed very favorably by 7%. The total additional assets came in at -1.31% that was fairly significant (approximately 90% of the portfolio) because not all of the money has been invested yet. Hedge funds were -.53%. The total portfolio was -1.29% which means that if you took the entire portfolio, that equated to almost $5 million of lost assets. **Mr. Hodel** also shared with the Trustees that they really need to pay attention to basis points.

In domestic equity, Goldman Sachs struggled with a 9.59% return in domestic equity and was 670 basis points after fees underperforming in that asset class (about 620 basis points). Almost all of it was due to manager selection. Although Frank Russell underperformed, they did much better; their underperformance was also due to manager selection (-170 basis points in performance and about -30 basis points for their tilt towards large cap equity.

In international equity, the performances were better although still on the negative side (-1.83 and -1.53). For total equity, the totals were -5% for the year for Goldman Sachs and minus just over 2% for Frank Russell.

In response to **Trustee Akana**'s question about what these figures equated to in dollars, **Mr. Hodel** stated that for Goldman Sachs, it amounted to approximately $5 million (total equity) and for Frank Russell, it amounted to approximately $2 million.

Mr. Hodel reported that Goldman Sachs had great performance in real estate (just over $1 million). Total traditional assets totaled -1.49% and -.57; hedge funds (Goldman Sachs). Frank Russell did better on "core" allocations and Goldman Sachs does better with "exotic" allocations.

Trustee Akana requested a comparative analysis between Frank Russell and Goldman Sachs with respect to the fees they charge and the asset classes. She suggested we give allocations in areas where each advisor shows better strength. **Mr. Hodel** reminded the Trustees that this report was for only one year; he needs to look at more than this one year. **Trustee Akana** expressed her concern about Goldman Sachs whose fees are higher and whose returns are lower.

Trustee Stender requested an analysis from the time of inception to give the Trustees a better picture.

Trustee Akana stated that the l.ast time the issue of fees came up for discussion, Goldman Sachs agreed to match Frank Russells fee schedule; however, their fees have gone up again and their performance hasn't been that great. She would like to get Goldman Sachs to lower their fees. **Mr. Hodel** stated that it was a great idea to talk with OHA's investment advisors about comparative capabilities because Goldman Sachs is very sophisticated and very good with asset classes that are more exotic. He went on to say that both were excellent advisors, but the Committee might look into separate mandates for each advisor.

Trustee Mossman expressed concern about tampering with the current asset allocation. **Trustee Apoliona** pointed out that there is a recommendation for further analysis and the Trustees shouldn't make quick judgements.

Mr. Hodel hopes to have a more complete analysis by the second quarter. **Trustee Stender** reported that they are working with others outside the organization in order to produce a more complete and unbiased report. **Mr. Hodel** stated he is hopeful he will have recommendations made; a new investment policy written; and, if need be, assets reallocated by the end of the third quarter (summer).

Mr. Hodel discussed fees (basis points as well as dollar.

Mr. Hodel suggested risk management highlights that include:

- new report format
- review asset allocation
- review fees
- monthly/quarterly/annual performance reviews
- establish internal investment committee (with outside members)
- new reporting/audit formats (on-site visits with advisors)
- realign portfolio if needed
- re-write investment policy statement
- complete audit for mediation

Trustee Stender suggested on-site visits with both advisors be done prior to Marion Higa's next audit in 2008. **Mr. Hodel** reported that on-site visits are scheduled for the end of March (Frank Russell) and the end of April (Goldman Sachs).

Mr. Hodel discussed reviewing the managers and distributing a report quarterly. Benchmarks were discussed; no fees are charged. Comparisons will be made between managers. **Emma Berman** reported that in the 2005 report Goldman Sachs followed the trend of common fund managers which is generally reckoning of returns. Frank Russell slightly underperformed in 2003, performed about the same as most of the managers in 2004 and outperformed those in our portfolio range in 2005. **Mr. Hodel** felt OHA did pretty good overall.

Mr. Hodel reported that for 2006, Frank Russell was on target in terms of performance; Goldman Sachs was below the target. The total portfolio as a result of that was below the target for 2006. For fees, both advisors are on the high end; a little higher than average for what they are doing on traditional assets. In terms of client service, Frank Russell is extremely attentive in getting information needed very quickly and Goldman Sachs is average.

Mr. Hodel recommended OHA refine monitoring advisors, complete auditor mediation, negotiate advisory fees, and take a look at asset allocation and determine if changes need to be made. Overall, the year was a pretty good year; there should be some caution with regard to Goldman Sachs.

Trustee Mossman commends the staff for an excellent presentation and a job well done.

VI. ANNOUNCEMENTS

None

VII. ADJOURNMENT

Trustee Apoliona MOVED, SECOND by Trustee Akana to adjourn the meeting of the Committee on Asset and Resource Management.

Chairman Oswald Stender adjourned the meeting at 3:25 p.m.

Respectfully submitted:

Lei-Ann Durant

Lei-Ann Durant, Aide/Secretary
Committee on Asset and
Resource Management

OK Stender

Oswald K. Stender, Chair
Committee on Asset and
Resource Management

Approved: April 4, 2007