



**ENDOWMENT & FINANCIALS**  
CONSOLIDATED FINANCIAL STATEMENTS & SUPPLEMENTAL SCHEDULES

## ENDOWMENT OVERVIEW

*Kamehameha Schools Endowment Group focuses on the long-term stabilized financial performance of assets. This goal seeks to optimize value, make efficient and prudent use of resources and undertake responsible land stewardship.*

During the fiscal year ended June 2001, the Endowment Group again implemented many positive changes that continued to efficiently and prudently utilize its resources in support of KS' mission to educate children and youth of Hawaiian ancestry.

As part of this strategy, the Endowment Group has substantially reorganized from along geographic or regional lines into functional responsibility groups. This change streamlines the Endowment Group to allow each functional area to specialize and develop its asset management skills. This strategic restructuring is designed to assist in meeting and maintaining the strategic goal that calls for optimal use of current resources and the development of new resources (financial and non-financial).

Further, as part of a continuing strategy to achieve and maintain stabilized financial performance of assets, the Endowment Group implemented an investment structure for marketable securities premised on "best practices" utilizing a Core/Satellite approach. In determining best practices, the Endowment Group worked with two nationally renowned industry consultants and conducted due diligence on various investment models.

Once the Core/Satellite model was selected, the Endowment Group conducted intensive due diligence on various investment managers. After contracting the Core managers last fiscal year, this fiscal year KS engaged Satellite investment managers with different investment expertise and styles. The Satellite managers provided the final element in implementing the Core/Satellite model. The Satellite managers will potentially add more value (albeit at slightly higher risk) to KS' marketable securities portfolio in support of KS' mission.

## ASSET ALLOCATION

Kamehameha Schools Investment Policy, adopted in August 1999, breaks down Endowment assets into two component parts: Core Assets, which include Hawai'i real estate, and Non-Core assets, which include all other investments, primarily marketable securities.

The objectives of the Core assets are to: (1) produce a sustainable net income stream of at least 4 percent that increases at least at the rate of inflation over time and (2) earn an average annual real total return of at least 5 percent per year. The objectives of the Non-Core assets are to: (1) earn a 5 percent or higher net average annual real rate of return, (2) provide adequate liquidity to meet the Schools' spending requirements, and (3) provide diversification for the endowment.

The asset allocation decision continues to be one of the main drivers of successful investment performance. The fundamental asset allocation decision – the asset classes to include in the portfolio and their normal weights – is one of the most important decisions in the entire investment process. While active shifting of the asset weights, the selection of specific securities and choice of the investment manager matter, the relative performance of various portfolios is generally governed by their asset allocation structures.

Since implementing its new strategic asset allocation targets for Non-Core assets in August 1999, KS has made significant progress in moving toward its policy targets. The progress is shown in the chart below:

### Kamehameha Schools Non-Core Portfolio<sup>9</sup>

ASSET CLASS	ALLOCATION 6/30/00	ALLOCATION 6/30/01	TARGETED PERCENTAGE
U.S. EQUITY	53.3%	33.6%	40.0%
NON-U.S. EQUITY	3.3%	11.5%	15.0%
FIXED INCOME	23.1%	31.7%	30.0%
ALTERNATIVE INVESTMENTS:			
VENTURE AND PRIVATE EQUITY	7.5%	7.0%	5.0%
ABSOLUTE RETURN	0.9%	0.9%	5.0%
ENERGY & OTHER	1.4%	2.3%	2.5%
REAL ESTATE (MAINLAND)	10.3%	13.0% <sup>10</sup>	2.5%

<sup>9</sup> Amounts may not equal 100% due to rounding.

<sup>10</sup> Resulted from updated valuation.

The expiration of the restrictive covenant on part of the Goldman Sachs stock allowed KS (on a consolidated basis) to significantly reduce its US Equity allocation to 33.6 percent from 53.3 percent. KS was then able to diversify and build-up its allocation in Non-U.S. Equity and Fixed Income to 11.5 percent and 31.7 percent, respectively.

KS' asset allocation continues to reflect a bias toward equities, broadly diversified among U.S. and international markets, large and small capitalization companies, with inflation (Energy and Other) and deflation (Fixed Income) hedges in place to hold value in economic environments, which at times may be hostile toward good equity performance. In addition, investments in Alternative Assets, such as Private Equity, Venture Capital and Absolute Return, are included to boost the diversification of the portfolio. The new Asset Allocation marks a dramatic change from previous strategies and Kamehameha stands committed to migrating toward its policy targets in a prudent and orderly fashion.

#### INVESTMENT PERFORMANCE

For the year ended June 30, 2001, the Endowment achieved a 4.8 percent return, significantly outperforming two of its three benchmarks. It outperformed the Policy Portfolio benchmark (a policy weighted average of all benchmarks for each individual asset class) by 5.6 percent and the Cambridge Associates Large Endowment Fund Median by 7.2 percent. However, it trailed the Investment Policy's long-term (i.e., rolling 10 to 20 year periods) benchmark of the Consumer Price Index (CPI) plus 5 percent by 3.6 percent. This CPI plus 5 percent benchmark represents a long-term absolute positive inflation-adjusted return standard, thus, comparison to this return threshold should be over a long time horizon (i.e., rolling 10 to 20 year periods).

In fiscal year 2001, the overall return was driven primarily by the outstanding performance of the Non-Core Asset portfolio, which achieved a 7.7 percent return, significantly outperforming its Policy Portfolio benchmark by 12.4 percent. Offsetting this return was KS' Core Asset (Hawai'i Real Estate) portfolio, which achieved a negative return of 1.8 percent for the year.

Since the August 1999 inception of Kamehameha Schools' Investment Policy, the Endowment Group has outperformed all three of its benchmarks. The annualized total return for two years ended June 30, 2001, was 9.6 percent compared to the benchmark performance of 4.1 percent (Policy Portfolio), 3.5 percent (Cambridge Associates Large Endowment Fund Median) and 8.6 percent (CPI plus 5 percent).

Overall, the Endowment's performance continues to sustain itself in a tough capital market environment. Kamehameha Schools will continue to pursue its investment objectives in order to achieve better than benchmark performance over the long term in order to support the greater reach of its educational programs and services to Hawaiians.

## DISCUSSION OF FINANCIAL RESULTS

During the 2000 -2001 fiscal year, Kamehameha Schools continued its efforts in establishing and executing certain critical financial policies and processes in support of the implementation of its Strategic Plan. These initiatives have strengthened Kamehameha Schools' financial position and ability to further extend the reach of Ke Ali'i Bernice Pauahi Bishop's legacy.

The major financial highlights for the year included:

### INCREASED FUNDING OF EDUCATIONAL PROGRAMS

In accordance with Kamehameha Schools' Spending Policy, annual trust distributions from the endowment to support educational programs are targeted at 4 percent of the five-year average market value of the endowment. Since the adoption of this policy in August 1999, Kamehameha Schools has sought to prudently increase its funding of educational programs to achieve the target set forth in this policy. To demonstrate this, in fiscal year 2000 -2001, trust spending totaled approximately \$206 million – a \$73 million increase over the prior year – representing 4.1 percent of the five-year average market value of the endowment. In comparison, trust spending for the previous year ended June 30, 2000 totaled \$133 million or 2.8 percent of the five-year average market value of the endowment.

Trust distributions during the year ended June 30, 2001 were primarily allocated to the campus-based programs on O'ahu, Maui and Hawai'i, and totaled \$78.2 million. Another \$42.1 million was spent on financial aid and post-high school scholarships and extension and early childhood education programs. Capital and major repair projects for new programs and expansion of existing programs accounted for \$53.9 million of the resources spent on education during the year. Also, an operating reserve fund of \$35.4 million, which was approved by the Probate Court in May 2001, was established and funded during the year to ensure assets are always readily available for educational programs. The remaining resources were allocated to a variety of programs and functions that support the overall educational system of Kamehameha Schools.

*See "Education Overview" beginning on page 10 for further details on the education programs and extent of Kamehameha Schools reach for the fiscal year.*

### INCREASED DIVERSIFICATION OF ENDOWMENT

Kamehameha Schools' Investment Policy, which was also adopted in August 1999, established investment objectives, asset allocation targets and performance measurement guidelines for the endowment. The overall long-term investment objective under this policy is to earn an average annual return of 5 percent plus inflation, which after average trust distributions of 4 percent as targeted under the Spending Policy, would provide at least a one-percent real growth in the endowment. In fiscal year 2000 -2001, significant progress was made toward migrating to the policy's asset allocation targets resulting in a more diversified endowment portfolio.

Accordingly, despite a tough overall capital markets environment, Kamehameha Schools' endowment significantly outperformed two of its three benchmarks with a total return of approximately 4.8 percent. In fiscal year 1999-2000, assisted by a more favorable investment environment, the Schools' total return approximated 14.7 percent. The two-year annualized return approximated 9.6 percent, which exceeds the policy's long-term objective of 5 percent plus inflation.

*See "Endowment Overview" section beginning on page 35 for further discussion of investment performance for the fiscal year.*

### **IMPROVED LIQUIDITY AND DEBT STRUCTURE**

Kamehameha Schools' ability to generate cash, both internally from its investments and operations and externally from debt issues, is adequate to maintain sufficient liquidity to fund its operating and capital projects and to cover debt and other cash requirements in the foreseeable future. The Schools' liquidity requirements specific to educational programs were enhanced during the year with the establishment of an Operating Reserve Fund Policy, which requires three months of the ensuing fiscal year's operating budget for educational programs be placed in a reserve fund. The operating reserve fund, which ensures sufficient liquidity for educational programs, amounted to \$35.4 million as of June 30, 2001.

In addition, significant strides were made during the 2000-2001 fiscal year to eliminate or substantially reduce non-conforming debt arrangements to the requirements of Kamehameha Schools newly adopted Debt Policy. The policy limits the amount of debt allowed to 10-20 percent of the fair market value of the endowment and defines the requirements and parameters for the utilization of debt and other appropriate considerations. As a result, debt and debt related guarantees represented only 2.5 percent of the fair market value of the endowment as of June 30, 2001, down from the 6.1 percent as of June 30, 2000.

### **ALIGNMENT OF FINANCIAL RESOURCES WITH STRATEGIC PLAN**

Great progress was made during the year in evaluating the current allocation of financial resources against the goals established in the Strategic Plan. This information, coupled with demographic data on Hawaiians, were utilized in the strategic plan implementation process to help align the future allocation of financial resources and the educational needs of Hawaiians within the context of the priorities and desired outcomes of the Strategic Plan.

In addition, cost structure evaluations continued throughout the organization to ensure we maximize the reach of our financial resources. Cost savings generated from this effort will be reallocated to educational programs and activities as set forth in the Five-year Strategic Implementation Plan (SIP II).

These are exciting times for Kamehameha Schools as the institution looks to expand educational opportunities for Hawaiians in a prudent manner with defined performance outcomes and objectives.

## FINANCIAL RESULTS

Kamehameha Schools experienced favorable results for the year ended June 30, 2001. The following is a review of the financial position, statement of activities and cash flows for the 2000-2001 fiscal year:

- ***Financial Position***

During the year, net assets increased by approximately 21 percent to over \$4 billion. The majority of this increase was attributable to gains from the sale of approximately 16.5 million shares of Kamehameha Schools' investment in Goldman Sachs. Gains and investment income from this investment amounted to approximately \$719 million.

Notes payable amounted to \$141 million at June 30, 2001 with the decrease from June 30, 2000 primarily coming from the paydown of \$95 million under Kamehameha Schools' commercial paper program.

- ***Statement Of Activities***

The Statement of Activities, which details the revenues and expenses during the year, reported an increase in net assets of approximately \$690 million. As previously mentioned, the majority of the increase was due to realized gains from the sale of Goldman Sachs shares. In addition, Kamehameha Schools real estate land sales, leasing activities and oil and gas operations from a taxable subsidiary contributed to the increase in net assets during the year.

This statement also reported total direct Educational Programs Expenses of approximately \$109 million. Direct expenses, capital expenditures, operating reserve funding, support function costs and other education-related costs constitute Kamehameha Schools total spending of approximately \$206 million for educational purposes, as reported on the Schedule of Trust Distributions and Spending (Schedule 1). This represents a trust spending rate of approximately 4.1 percent of the five-year average market value of the endowment.

- ***Cash Flows***

For the year ended June 30, 2001, approximately \$103 million of cash and cash equivalents were provided by operations. Primarily due to purchases of investments with external managers, investment activities resulted in a net cash outflow of approximately \$292 million. Financing activities also resulted in a net cash outflow of \$113 million principally due to the reduction of Kamehameha Schools outstanding debt obligations during the year.

## CONCLUSION

By any measure, Kamehameha Schools financial position has been greatly enhanced. This strong financial position will allow Kamehameha Schools to continue its desire to expand the reach of Ke Ali'i Bernice Pauahi Bishop's legacy as stated in its Strategic Plan. As always, Kamehameha Schools will continue to build on its financial foundation to meet current needs and, at the same time, protect and increase its resources in order to enhance its service to future generations of people of Hawaiian ancestry through education.