

**Kamehameha Schools Bishop Estate**

**Investment Policy**

**(August 18, 1999)**

**KAMEHAMEHA SCHOOLS BISHOP ESTATE****Investment Policy****I. Introduction**

This memorandum summarizes the Investment Policy for KSBE's long-term investment assets ("the Endowment Fund"). As described below, the Endowment Fund includes all of KSBE's investment assets on a fully-consolidated basis, except for Agricultural and Conservation Lands and Reserve funds. The Policy reflects KSBE's commitment to maintaining Financial Equilibrium<sup>1</sup>. The Policy strikes a balance among three objectives:

1. The Endowment must earn a relatively high average annual real return in order to support current and potentially expanded educational programs in perpetuity. To accomplish this, the Trust must maintain a relatively high allocation to equity investments (e.g. stocks, private equity, equity real estate, etc.).
2. The Endowment must try to moderate the volatility of its market value over rolling five-year periods in order to provide a reasonably stable, growing source of support for educational programs. To accomplish this, the Trust must diversify its investments between bonds and equities and among various types of equities.
3. The Endowment must maintain an adequate level of liquidity to meet its spending requirements and to maintain its diversification by periodically rebalancing its asset allocation.

Each of these objectives is critical to the Endowment's ability to meet its short-term and long-term obligations.

There are five basic components to the Policy:

1. Assets covered by the Policy
2. Long-term and intermediate-term Investment Objectives;
3. Asset Allocation Guidelines
4. Implementation Guidelines
5. Periodic Policy Review

Each of these is summarized below.

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<sup>1</sup> Financial Equilibrium is a conceptual framework developed for evaluating the long-term financial stability of non-profit organizations. In summary, an institution is said to be in Financial Equilibrium if it at least satisfies the following conditions: 1) limits spending from its endowment assets to a level that will at least preserve the purchasing power of the endowment over the long-term; 2) spends or reserves adequate funds to preserve the useful life of its physical assets, such as physical plant and equipment including technology; 3) balances its current operating budget, consistent with at least satisfying conditions 1 and 2; and 4) establishes policies to keep the growth of revenues and expenses in balance while still at least satisfying conditions 1 and 2. Over time, a fifth condition has been added to the framework: an institution must invest adequate resources in its program to at least maintain its "Quality" relative to its peer group.

KSBE recognizes that it will require a transition period to bring the Endowment's investment strategy into conformity with this Policy. The Endowment's current portfolio is relatively illiquid and the premature sale of investments might result in substantially lower returns. However, KSBE intends to reposition the Endowment toward Policy Asset Allocation Targets as soon as possible, consistent with realizing fair value on investments. Hence, the Policy represents a target the Endowment will be moving toward over the next several years.

## **II. Assets Covered by the Investment Policy**

The Endowment includes all consolidated investment assets of KSBE, its support organizations and their direct subsidiaries and investments, wherever situated within the foregoing entities, except Agricultural and Conservation Land assets and Reserve funds as discussed below.

Agricultural and Conservation Land Assets are excluded from the Endowment. These assets are original legacies of KSBE. Based on their current use, KSBE's Agricultural and Conservation Lands cannot be expected to generate investment returns as high as commercial real estate or other types of investments and the market value of many of these assets is difficult to determine with any accuracy. For these reasons, KSBE is currently excluding these assets from the Endowment. KSBE will continue to evaluate strategies to increase the return potential of these assets and will periodically re-evaluate whether they should be included in the Endowment. Between periodic reviews, the Trustees may determine that specific Agricultural or Conservation Land assets should be recategorized as Endowment assets.

The Trustees may at their discretion use investment assets to create an Operating Reserve fund and a Technology and Capital Expense Reserve fund. The purpose of these Reserve funds is to provide the appropriate levels of readily available liquid assets to meet operating and capital expenses and to reduce the likelihood of large or unscheduled withdrawals from the Endowment's long-term investments. If Reserve funds are established, they will be established in consultation with a nationally-recognized financial or investment consultant to ensure that such Reserves are established at reasonable levels appropriate for their purposes. Such Reserves will be subject to periodic audit by KSBE's internal auditor to ensure that such funds are being utilized for their designated purpose. The Reserve funds are not considered part of the Endowment. They have shorter investment time horizons and corresponding investment objectives. Separate investment guidelines will be established for the investment of such Reserves.

## **III. Investment Return Objectives**

The long-term Investment Objective of the Endowment Fund is to earn an average annual real return of 5.0% net of investment-related expenses. For the purposes of adjusting nominal returns to real returns, a broad measure of U.S. consumer inflation such as the Consumer Price Index – All Urban Consumers ("CPI-U") will be used. Historical real capital market returns have been quite volatile even over rolling ten-year periods. Hence, the Endowment will need to exceed this objective in some periods such as the 1990's to offset inevitable periods of lower real returns such as the 1970's. However, KSBE should establish its policies to meet or exceed this Investment Objective over most rolling ten-year periods and over an extended time horizon reflecting the perpetual nature of KSBE's mission.

KSBE should also evaluate the Endowment's investment returns over rolling five-year periods versus a Policy Benchmark Portfolio, comprised of passive indexes combined in proportions reflecting the Endowment's Asset Allocation Policy Targets described below. Individual performance objectives will be established for each managed portfolio or partnership investment and their results will generally be evaluated over rolling three and five-year periods. The initial benchmarks by asset class are summarized in Exhibit 1.

#### **IV. Asset Allocation Guidelines**

The Endowment is comprised of two groups of assets: 1) "Core Assets" of Hawaiian real estate, and 2) "Non-Core" assets, which are all Endowment assets except Hawaiian real estate. For purposes of this Policy at this time, no specific asset allocation target has been established for Core Assets. However, KSBE recognizes the importance of diversifying the Endowment's investments and expects that the allocation to Core Assets will not increase materially above current levels and may well decline gradually over time as Non-Core Assets increase. In addition, the Trustees intend to review the current amount of assets invested in Core Assets in conjunction with developing a Strategic Plan for KSBE to determine whether to retain or reduce such amount. The Trustees will be revising the methodology for valuing Core Assets, so that these assets will be held at fair market values based upon periodic appraisals, rather than at tax assessed values. At present, KSBE actively manages Core Assets to maximize long-term investment returns and may decide to buy or sell assets in this process. Hence, the Endowment's allocation to Core Assets may also be determined by the ongoing development of specific investment strategies for these assets.

Specific asset allocation targets have been established for Non-Core Assets (i.e. all Endowment assets except Hawaiian real estate). The allocation targets for the Non-Core assets are as follows:

<b>Marketable Stocks</b>	<b>55%</b>
US Stocks	40%
International EAFE Stocks	13%
Emerging Market Stocks	2%
<b>Alternative Assets</b>	<b>15%</b>
Venture and Private Equity	5%
Absolute Return	5%
Energy and Other	5%
<b>Bonds and Cash Equivalents</b>	<b>30%</b>

As noted above, KSBE expects that it will require a significant transition period to bring the Endowment's asset allocation in line with its policy asset allocation targets.

#### **V. Implementation Guidelines**

KSBE will consider the following general policy guidelines as it implements its asset allocation strategy:

1. The Trustees will be responsible for establishing investment policies and guidelines and for reviewing adherence to these guidelines and investment performance relative to established objectives. KSBE staff is responsible for the implementation of the investment strategy within policy guidelines primarily by hiring and monitoring external institutional-quality investment managers.
2. KSBE will consolidate its investment assets as much as practicable with a single master custodian and will establish a system for independently calculating investment performance and evaluating the Endowment's investment asset allocation and strategy.
3. KSBE will employ institutional quality, external investment managers for the large majority of its Non-Core asset investments. KSBE will establish investment performance benchmarks for all investment portfolios and monitor performance relative to benchmarks quarterly for all marketable investments and at least annually for illiquid private investments.
4. KSBE will establish investment policies for each managed portfolio ensuring that the Endowment's marketable stock portfolios in aggregate are well diversified. Individual marketable security managers may be permitted to have more concentrated portfolios as long as the Endowment's aggregate holdings are well diversified.
5. KSBE will establish guidelines ensuring that its bonds and cash equivalent investment portfolio as a whole has a high weighted average credit quality of "A", or better.
6. KSBE will establish guidelines ensuring that its Alternative Asset investments are adequately diversified by investment, strategy and investment management firm. No more than 10% at cost of the Alternative Asset allocation will be invested with any single management firm, although exceptions may be made in the case of "fund-of-funds" products that provide underlying management diversification and for firms that offer multiple investment products each with their own management team. However, even in the case of fund-of-funds products and firms with multiple products, no more than 30% at cost of the Alternative Asset allocation will be invested by a single firm.

## **VI. Periodic Policy Review**

KSBE will conduct a formal review of its Investment Policy with the assistance of a nationally recognized investment consulting firm at least every five years. The purpose of the review will be to determine if KSBE's Investment Policy is still appropriate relative to the long- and short-term needs of its educational programs and the characteristics of the investment markets. The review will include consideration of the strategy for Core Assets and whether some or all of the agricultural and conservation land should be included in the Endowment. KSBE will continue to evaluate and adjust its Investment Policies as required between formal reviews.

## Exhibit 1

### ENDOWMENT BENCHMARKS

Asset Class	Benchmark	Time Horizon
Core Assets: Hawaiian Real Estate	CPI + 5% Net distributable income to keep pace with inflation	Rolling 10 to 20 year periods Rolling 10 to 20 year periods
U.S. Stocks	Russell 3000	Rolling 5 year periods
International EAFE Stocks	MSCI EAFE Index	Rolling 5 year periods
Emerging Markets Stocks	MSCI Emerging Markets Free Index	Rolling 5 year periods
Venture Capital	CPI + 10%	Rolling 10 year periods
Private Equity	CPI + 10% Cambridge Associates customized benchmark that reflects vintage year composition of portfolio	Rolling 10 year periods
Absolute Return	CPI + 8%	Rolling 10 year periods
Energy	CPI + 5%	Rolling 10 year periods
Externally-Managed Real Estate	NCREIF Total Property Index and NCREIF Timberland Index (as appropriate)	Rolling 10 year periods
U.S. Bonds	Lehman Brothers Aggregate	Rolling 5 year periods
Cash and Cash Equivalents	90-Day T bills	Rolling 5 year periods
Total Fund	Cambridge Associates Large Endowment Fund Median Policy Portfolio (to be developed) CPI + 5%	Rolling 5 year periods Rolling 5 year periods Rolling 10 to 20 year periods