



EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

**INVESTMENT POLICY,
GUIDELINES, AND PROCEDURES**

APPROVED: OCTOBER 2014

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INTRODUCTION

SECTION: A

A. Introduction

The purpose of this Investment Policy, Guidelines, and Procedures manual (“Manual”) is to provide the Employees’ Retirement System of the State of Hawaii (“ERS” or “Plan”) with a comprehensive set of guidelines for proper management of its investment decisions. The Board of Trustees of the ERS, in its role as a fiduciary, is obligated to follow a procedurally prudent process when investing the Plan’s assets. Fiduciary prudence is based on the conduct of the members of the Board of Trustees (“Trustees”) in managing the Plan’s assets, and is evaluated by the *process* through which risk is managed, assets are allocated, managers are chosen, and results are supervised and monitored.

Evolving legal standards have made clear the legal responsibility of fiduciaries to manage a plan’s assets in a prudent manner, and the guidelines contained in this Manual are based on the relevant legislation and regulations confronted by public pension funds. However, the guidelines go beyond simply outlining legally prudent management of investment decisions—they are intended to assist the Trustees in achieving long-term success in investing the Plan’s assets.

Success in this context is defined as achieving a long-term return that is needed in conjunction with actuarial defined contributions to fund the plan over time and is reasonable through a fully diversified approach to the capital markets without being too aggressive or conservative as to run the risk of under-achieving a reasonable return.

Today’s prudence emphasizes fiduciary responsibility regarding the portfolio and its purpose, rather than on the performance of the plan. Trustees as fiduciaries have the responsibility for the general management of the Plan’s assets. They are responsible for setting and overseeing the implementation of the Plan’s investment policy, but need not be investment managers or investment specialists and are not responsible for the results of any single investment. Although it is not possible to guarantee investment success, following the process outlined in this Manual will significantly improve the odds of structuring an investment portfolio which will stand up to public scrutiny and benefit the Plan’s beneficiaries by providing an acceptable long-run return.

This Manual, although comprehensive in its coverage, does not provide an in-depth analysis of all-important issues, which Trustees must deal with when investing the Plan’s assets. It therefore should not be viewed as the only “tool” required by the Trustees for prudent investment management, but rather as one component of the Trustees’ “educational tool kit”, to be used in conjunction with continuing education and the advice and services of investment consultants and investment managers.



PLAN OVERVIEW

SECTION: B

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B. 1. ERS Plan Summary

The Employees' Retirement System of the State of Hawaii ("ERS" or "Plan") was established by the Hawai'i legislature in 1925. The ERS provides retirement, disability and survivor benefits for employees of the State of Hawai'i ("State") and its counties, including teachers, professors, police officers, firefighters, judiciary employees, judges and elected officials.

Administration of the ERS falls under the policy and executive direction of a Board of Trustees, with certain areas of administrative control vested in the State Department of Budget and Finance. The Board of Trustees consists of eight members ("Trustees"): the State Director of Finance, ex officio; four members of the ERS elected by the membership (two general employees, one teacher and a retiree); and three citizens of the State who are not State or county employees and are appointed by the Governor, two of whom must have at least three years of experience providing financial services, including investments, to public, corporate, or private institutional clients.

The ERS is a tax-qualified governmental pension plan that meets the requirements of section 401(a) of the Internal Revenue Code. As such, the ERS is exempt from federal income taxation on its investment earnings. Since January 1, 1988, member contributions have been tax deferred under Section 414(h) of the Internal Revenue Code.

The ERS has both contributory and noncontributory benefit structures, or "plans." ERS members in the contributory plans are required to make contributions to the ERS and may also be covered by Social Security. The ERS's original benefit structure was a contributory plan. Members of certain occupational groups are required to be members of the original contributory plan. The original contributory plan also includes employees hired before July 1, 1984, who did not elect to join the noncontributory plan, which was established effective July 1, 1984. A new contributory plan (know as the "hybrid plan") was established effective July 1, 2006. Most employees hired after June 30, 2006, as well as employees hired before July 1, 2006, who elected to join the hybrid plan, are members of the hybrid plan.

Members of the noncontributory plan do not make contributions to the ERS and must be covered by Social Security. The noncontributory plan includes most employees hired between July 1, 1984 and July 1, 2006, as well as employees hired before July 1, 1984, who elected to join the noncontributory plan and did not transfer to the hybrid plan.

B. 2. Mission Statement

The mission of the ERS is to provide superior services to members in a cost-effective manner through qualified personnel while maintaining the highest ethical standards. The mission will be accomplished by ERS in cooperation with the Board of Trustees and the ERS staff through the following objectives:

<i>Exemplary Service</i>	To provide accurate, courteous, and prompt service to ERS members.
<i>Benefit Standards</i>	To provide retirement, disability, and survivor benefits for State and county employees.
<i>Funding Standards</i>	To provide for the long-term funding of ERS on an actuarial basis so that sufficient assets will be accumulated to pay for the statutory benefits of current and future retirees.
<i>Staffing</i>	To attract and retain professional, highly trained staff in an atmosphere conducive to innovation, challenges, and a high level of performance.

Research To continuously perform studies on pension issues and to compare the ERS with other public and private pension systems.

Management To manage by leading, planning, organizing, and controlling ERS operations in a cost effective manner for the benefit of ERS members and State and county taxpayers, utilizing personnel, technology and capital efficiently, while providing the highest level of service.

Ethical Standards To maintain the highest ethical standards.

Investment Return To obtain a reasonable return on investments consistent with the preservation of principal, while maintaining sufficient liquidity to react to the changing environment and to pay benefits when due.

B. 3. Statutes

The primary statute pertaining to ERS investments is Section 88-119, Hawai'i Revised Statutes ("HRS"). Section 88-119, HRS, and other statutes pertaining to ERS investments are included in this Manual in Appendix A.

B. 4. Administration

Provisions pertaining to the administration of the ERS are contained in Chapter 88, HRS, and Title 6 (Department of Budget and Finance), Chapters 20-29 (Employees' Retirement System), Hawai'i Administrative Rules. An organization chart of the ERS is shown below.



B. 5. Responsibilities of the Various Parties

The principal parties include:

- Board of Trustees
- Investment Staff
- Actuary
- Legal Counsel
- Bank Custodians
- General Investment Consultant
- Real Estate Consultant
- Private Equity Consultant
- Investment Managers

GENERAL RESPONSIBILITIES

Board of Trustees

Main Responsibilities

- Pursuant to Chapter 88, HRS, the general administration of the ERS is vested in the Board of Trustees of the ERS (the “Board of Trustees” or “Board”).
- Responsible for setting investment policies and determining the strategic allocation of investments through the formulation of investment guidelines.
- Maintains overall responsibility for financial management of the Plan.
- Appoints the Executive Director of the ERS (“Executive Director”) and the Chief Investment Officer of the ERS (“CIO”).
- Selects the ERS’s actuaries (“Actuary” or “actuary”), bank custodians (“Custodian” or “custodian”), investment managers (“Investment Managers” or “investment managers”) and investment consultants (“Investment Consultants” or “investment consultants”) and determines specific duties, authority, responsibilities, fiduciary status, and forms and amounts of compensation of each.
- Monitors and evaluates the Actuary, Custodian, Investment Managers and Investment Consultants, as well as the results of the Plan’s investments.
- Reviews and approves strategic and tactical plans developed by ERS investment staff (“Investment Staff”), Investment Consultants, and/or Investment Managers.
- Monitors the portfolio’s development and performance through quarterly performance reports presented by the Investment Consultants.
- The Board of Trustees has formed an Investment Committee to review new investment proposals.
- Each Trustee is responsible for obtaining and maintaining the necessary training and education required to carry out his/her duties at the ERS. **It will be necessary for the Trustees to travel to industry conferences and participate in educational forums as opportunities arise.**

Investment Staff *(managed by the Chief Investment Officer)*

The Investment Staff carries out the investment administration of the Plan on behalf of the Board of Trustees and is directly responsible to the Board of Trustees.

Main Responsibilities

- The Investment Staff should receive the necessary training and education required to carry out their duties at the ERS. **It will be necessary for Investment Staff to travel to industry conferences and participate in educational forums as opportunities arise.**
- Responsible for the oversight of ERS's investment portfolio. Monitors and oversees the ERS's external investment managers and the internal investment portfolio.
- Responsible to evaluate, and to consult with the applicable investment consultant, as necessary, regarding, requests for action related to the investment portfolio and to make a recommendation to the Executive Director with concurrence from the applicable investment consultant regarding the appropriate response to the request, including, whether the requested action requires express consent from the Board. If the Executive Director determines that the Board's consent is not required for the response, the CIO is responsible for reporting the Investment Staff level response to the Board of Trustees.
- Meets with Investment Managers to review performance and to monitor compliance with investment policies and procedures, and contractual guidelines.
- Together with the applicable Investment Consultant: (i) develops search criteria for investment mandates under consideration by the Board and (ii) evaluates and selects a short-list of investment manager finalist(s) for each mandate under consideration; negotiates fees and contracts; and recommends the termination of investment managers if necessary.
- Develops search criteria for Investment Consultants; participates in the evaluation and selection of investment consultants; and recommends termination of investment consultants if necessary.
- Oversees security lending and commission recapture programs.
- Formulates, evaluates, recommends and implements investment policies and procedures for all strategic classes. Conducts ongoing review and maintains the Manual.
- Monitors performance benchmarks, risk characteristics and performance attribution analysis for the broad investment portfolio, strategic classes and individual investment managers.
- Implements long and short-term strategic allocation strategic plans. Develops programs to efficiently implement strategic allocation decisions, including securities trading and cash management.
- Develops search criteria, evaluates and participates in the selection of asset transition management firms.
- Advises the Board on a quarterly basis of cash flow requirements and the availability of funds for investment.
- Assists the Board with coordinating responsibilities/projects amongst the applicable investment consultants and investment managers.
- Develops and implements investment education and training programs for the Board and Investment Staff.
- Reviews proposed legislation on matters dealing with the ERS's investment programs. Drafts legislative proposals, testimonies and administrative rules.

Actuary

The Actuary is hired by, and responsible to, the Board of Trustees. However, the Board of Trustees does not have direct control over the work of the Actuary, because the studies do not involve any discretion but rather are based on the “facts” of the Plan and standard actuarial procedures.

Main Responsibilities

- Measures and evaluates the actuarial soundness of the Plan on an annual basis.
- Provides actuarial values for the asset/liability study.
- Performs actuarial studies as requested by the Board of Trustees.
- Reviews proposed legislation and provides estimates of the cost impact of the proposed legislation.
- Performs actuarial evaluations to determine the annual State and county contributions to fund the ERS.

Legal Counsel

The Attorney General of the State of Hawai‘i (“State Attorney General”) serves as the legal adviser to the Board of Trustees.

Bank Custodian

The Custodian is hired by, and responsible to, the Board of Trustees.

Main Responsibilities

- Provides a monthly reconciliation of ERS assets between the bank’s records and each investment manager’s statement.
- Provides safekeeping and custody of all securities purchased by managers on behalf of the Plan.
- Provides for timely settlement of securities transactions.
- Maintains short-term investment vehicles for investment of cash not invested by managers.
- Checks all investment manager accounts daily to make sure that all available cash is invested.
- Collects interest, dividend and principal payments on a timely basis.
- Processes corporate actions.
- Files and monitors class action settlements on behalf of ERS.
- Prices all securities at least on a monthly basis, preferably on a daily basis contingent on strategic class and types of securities.
- Manages a securities lending program.
- Generally provides data and reports directly to the ERS and service providers on a regular basis.
- Provides monthly, quarterly and annual reports.
- Values and monitors derivatives and the trades from which they emanate.
- Provides continuing education programs for the Board of Trustees and Investment Staff.

General Investment Consultant

The role of the general investment consultant (“General Investment Consultant”) is to provide objective, independent third-party advice to the Board of Trustees. A General Investment Consultant does not have discretionary decision-making authority on behalf of the Board of Trustees. The General Investment Consultant functions in a research, evaluation, education, and due diligence capacity for the Board of Trustees and maintains a fiduciary responsibility for the quality of the service delivered. General Investment Consultants are identified and hired by, and provide advice and services to, the Board of Trustees.

Main Responsibilities

- Recommends strategic procedures and processes.
- Upon the request of the Board of Trustees, prepares a strategic allocation study.
- Assists with investment manager structure, selection, monitoring and evaluation.
- Measures and evaluates the overall performance of the portfolio.
- Carries out special projects at the request of the Board of Trustees and Investment Staff.
- Provides continuing education to the Board of Trustees and Investment Staff.
- As deemed appropriate by Investment Staff and the general investment consultant, sources and conducts due diligence on prospective investments.

Real Estate Consultant

The role of the real estate consultant (“Real Estate Consultant”) is to provide objective, independent third-party advice to the Board of Trustees. A Real Estate Consultant does not have discretionary decision-making authority on behalf of the Board of Trustees. The Real Estate Consultant functions in a research, evaluation, education, and due diligence capacity for the Board of Trustees and maintains a fiduciary responsibility for the quality of the service delivered. Real Estate Consultants are identified and hired by, and provide advice and services to, the Board of Trustees.

Main Responsibilities

- Recommends strategic procedures and process.
- Oversees the implementation of the tactical plan process.
- Assists with investment manager structure, selection, monitoring and evaluation.
- Assists with the selection of external appraisers and has a fee that is structured to not be affected by the results of asset valuations provided by appraisers (i.e., no incentive fees based on asset valuations).
- Measures and evaluates the overall performance of the real estate program.
- As requested, represents the ERS as a member of advisory boards for commingled funds.
- Available to administer required portfolio level control and monitoring systems.
- Carries out special projects at the request of the Board of Trustees and Investment Staff.
- Provides continuing education to the Board of Trustees and Investment Staff.

Private Equity Consultant

The role of the private equity consultant (“Private Equity Consultant”) is to lead the implementation of the private equity program. The Private Equity Consultant maintains a certain level of discretionary decision-making authority on behalf of the Board of Trustees. The Private Equity Consultant operates in a

variety of capacities for the Board of Trustees including: education, evaluation, sourcing, selection, fiduciary, and implementation. Private Equity Consultants are identified and hired by, and provide advice and services to, the Board of Trustees.

Main Responsibilities

- Leads implementation of the private equity program.
- Develops the annual strategic plan with input from Investment Staff and the general investment consultant.
- Recommends use of specialty investment managers, if applicable.
- Sources and conducts due diligence on prospective investments.
- Maintains dialogue with Investment Staff regarding the investment pipeline and due diligence.
- Completes an investment disclosure form and submit to Investment Staff for review prior to closing into a prospective investment.
- Acts as a fiduciary regarding investment discretion and advice.
- Measures and evaluates the overall performance of the private equity portfolio.

Investment Managers

The role of Investment Managers is to manage assets, within a specified mandate, on behalf of the ERS. The specific relationship (including, for example, fees, investment restriction, etc.) between each Investment Manager and the Board of Trustees is outlined in the investment management or manager agreement between the specific Investment Manager and the Board of Trustees.

Main Responsibilities

- Acts as a “prudent expert” on behalf of the Board of Trustees.
- Develops a portfolio strategy within the specific mandate and asset size determined by the Board of Trustees.
- Manages, purchases, and sells assets for the portfolio in accordance with their assigned portfolio mandate.
- Acts as fiduciary for assets under their management.

Fiduciary Responsibilities

Board of Trustees

The duties and responsibilities of the Board of Trustees are governed and limited by Hawai'i statutes and laws. In the past, the Board of Trustees has also looked to general trust law, such as outlined by the Third Restatement, Trusts, for guidance as to its duties and responsibilities regarding the investment of ERS assets. In connection with the foregoing, the Board of Trustees has adhered to the following:

1. Except as otherwise provided by law, administer ERS investments solely in the interest of Plan participants.
2. Prepare written investment policies and documents the process. In doing so the Trustees must:
 - * Determining the Plan's missions and objectives.
 - * Choosing an appropriate strategic allocation strategy.
 - * Establishing specific investment policies consistent with the Plan's objectives.
 - * Selecting investment managers to implement the strategic allocation.

3. Diversify assets with regard to specific risk/return objectives for the participants/beneficiaries.
4. Use "prudent experts" to make investment decisions.
5. Control investment expenses.
6. Monitor the activities of all Investment Staff, investment managers, and investment consultants.
7. Avoid conflicts of interest.

The Board of Trustees and Investment Staff should regularly undertake continuing education relevant for their duties. Specifically, all Trustees and key Investment Staff should participate in an educational programs, which provide basic instruction on the four primary components of the investment management process:

1. Fiduciary responsibility and procedural process.
2. Developing investment policy guidelines and designing investment manager structures.
3. Implementing investment policies.
4. Evaluating and controlling an investment program.

Statutory Protection for Trustees

Section 26-35.5, HRS, is applicable to members of boards and commissions, including the Trustees. As it pertains to the Trustees, Section 26-35.5 generally protects Trustees from being personally liable in civil actions for damages or loss resulting from acts or omissions in their capacity as a Trustee unless the individual acts with a malicious or improper purpose.

More specifically, Section 26-35.5(b), HRS, states that:

Notwithstanding any law to the contrary, no member shall be liable in any civil action founded upon a statute or the case law of this State, for damage, injury, or loss caused by or resulting from the member's performing or failing to perform any duty which is required or authorized to be performed by a person holding the position to which the member was appointed, unless the member acted with a malicious or improper purpose, except when the plaintiff in a civil action is the State.

Section 26-35.5(c), HRS, describes the situations in which Trustees will be indemnified by the State in civil actions arising under federal law, the laws of another state, or the law of a foreign jurisdiction.

Section 26-35.5, HRS, also contains subsections describing when indemnification is not available and when the State Attorney General will provide representation.

Consultants (Actuary, Investment Consultants, and other Service Providers)

The ERS's consultants, including the Actuary, Investment Consultants and other service providers, have a fiduciary responsibility for the services they are contracted to provide to the ERS. Investment Consultants are not Plan fiduciaries if they have no discretion over the assets or any decision-making authority. They do, however, have fiduciary responsibility for the quality and accuracy of any service, report information, or recommendations made to the Trustees or Investment Staff. Investment Consultants are Plan fiduciaries if they have discretion over the assets or any decision-making authority. Additionally, Investment Consultants with discretion have fiduciary responsibility for the quality and accuracy of any service, report information, or recommendations made to the Trustees or Investment Staff.

Bank Custodian

The Custodian's fiduciary responsibility shall involve the proper safekeeping, valuation, pricing, accounting and reporting of Plan assets across multiple investment manager portfolios and strategic classes. As co-fiduciary to the Plan, the Custodian shall apply investment prudence to short term cash management and securities lending functions.

Investment Managers

Investment Managers have a fiduciary responsibility for the assets placed under their discretion.

B. 6. Code of Ethics

Trustees and Staff

The State Code of Ethics is contained in Chapter 84, HRS. The State Code of Ethics applies to Trustees and to all ERS employees, including Investment Staff. The State Code of Ethics includes the following requirements and prohibitions:

1. Trustees and ERS employees may not solicit or accept gifts that will influence the performance of their duties.
2. Trustees, ERS employees, former Trustees and former ERS employees may not disclose confidential ERS information or use confidential ERS information for their personal gain or the benefit of anyone else.
3. Trustees and ERS employees may not use their ERS position to secure unwarranted privileges for themselves or others.
4. Trustees and ERS employees must disqualify themselves from making any decision or recommendation on a matter in which they have a substantial financial interest.
5. Trustees and ERS employees may not, within twelve months after leaving an ERS position, represent a person or organization for compensation on ERS matters.

Trustees and Staff are responsible for familiarizing themselves with the requirements of the State Code of Ethics and for adhering to the provisions of the Code.

B. 7. Delegation of Authority

Under general trust law, trustees may, and for many purposes do, delegate authority to properly selected and supervised agents. The Board has statutory authority to hire investment advisors. Consistent with generally accepted fiduciary standards referenced in this Manual, while the Board of Trustees is able to delegate authority concerning the buying and selling of securities and other investments, they may not totally abdicate their fiduciary responsibilities. The duty of prudence requires that the Board of Trustees establish parameters and guidelines for investment, set controls to be maintained, and monitor the performance of the investment advisors.

B. 8. Conflicts of Interest

Trustees and Staff

Section 84-14, HRS, entitled “Conflicts of Interests,” is part of the State Code of Ethics. Section 84-14 applies Trustees and Investment Staff. In part, Section 84-14 prohibits Trustees and Investment Staff from taking any official action directly affecting a business or other undertaking in which the Trustee or Investment Staff member has a substantial financial interest, or directly affecting a private undertaking in which the Trustee or Investment Staff member is engaged as legal counsel, adviser, consultant, representative or agent capacity. The State Ethics Commission has issued an “Ethics Guide for Elected Officials, Employees, Members of Boards and Commissions.” The main points from this Guide are:

1. Trustees must act in good faith and not allow their personal interests to prevail over the interest of the ERS.
2. Trustees shall conduct themselves so as to avoid even the appearance of any illegal or unethical conduct, and shall at all times do their utmost to carry out their duties with courtesy and in a professional manner.
3. Trustees should exclude themselves from discussions and/or votes the results of which would or could affect that person’s immediate family, or any other entity in which that person has an ownership or other financial interest.
4. If a Trustee is not sure whether his/her interest constitutes a conflict, such Trustee shall fully disclose his/her interest and the Board should refer the matter to the State Attorney General or State Ethics Commission for advice. Until an advisory is issued, the Trustee should exclude himself/herself from discussions and/or voting on the matter in question.
5. Trustees shall disclose before the discussion of the issue any conflict or possible conflicts of interest. The Trustee shall reclude himself/herself from participating in any discussion, votes, or other decision making on the matter. The recording secretary shall note for the minutes the Trustee’s disclosure.

All Consultants and Investment Managers

The Board of Trustees requires that Investment Consultants and Investment Managers adopt policies to avoid actual or even perceived conflicts of interest by disclosing any potential conflicts. Failure of Investment Managers to disclose a conflict of interest in managing assets is grounds for watch list status and eventual termination. Similarly, the Trustees require that Investment Consultants disclose all business activities and relationships that could be perceived as potential conflicts of interest on an annual basis. Specifically, the Investment Consultants shall disclose annually any business relationships with current ERS Investment Managers, the services provided in these relationships, and the compensation earned from the Investment Manager for these services. Additionally, at the time of an investment manager search, any business relationships with the investment managers being considered must be disclosed. ERS also expects that its Investment Managers and Investment Consultants adhere to a firm-wide ethical code that explicitly seeks to avoid any conflicts of interest in order to ensure the highest possible honesty and integrity in the services that these firms provide to the Plan.

Private Markets Consultants and Private Markets Managers

Proprietary Products – In private markets, there may be situations wherein the Investment Consultant or Investment Manager may recommend its proprietary investment product(s) for investment. If considering placing the ERS in a proprietary product, an analysis of why competing non-proprietary products are not suitable must be presented to the Board and Staff. Any investment must be approved in advance by the Board of Trustees.

Allocation of Investments among Accounts – There may be instances where the Investment Manager will need to allocate an investment opportunity among a number of clients or a competing product (e.g., fund-of-funds or commingled funds). Suitable protective covenants or processes for resolving conflicts in allocation among accounts will be incorporated in the investment management agreement. The Investment Manager, as a prudent expert and fiduciary, will seek to ensure that appropriate and equitable allocation and pricing occurs with respect to the ERS's portion of any manager-apportioned investment.

Personal Investments – Investment Consultants' employees and Investment Managers' employees are permitted to invest personally or otherwise have beneficial interest in investments held on behalf of clients such as the ERS, only upon the ERS first securing a full and appropriate allocation. Each Investment Consultant and Investment Manager will provide the ERS with its policies for personal investments by employees as an attachment to its investment consultant or investment management agreement, and notify the Investment Staff and general investment consultant of any changes in those policies.

Other Conflicts of Interest – When and if other conflicts of interest become apparent, suitable protective covenants or processes for resolving conflicts will be incorporated into the investment consultant and investment management agreements.

B. 9. Operating Procedures

Meetings

1. All regular meetings shall be held on the second Monday of each month unless otherwise agreed upon by the Trustees. The schedule for the regular meetings shall be reviewed by the Trustees each January.
2. All special meetings shall be on days agreed upon by the Trustees.

Agenda

1. Deadline for requesting matters to be placed on the agenda for regular meetings by a Trustee, Deputy Attorney General, and/or Executive Director shall be by 12:00 noon, seven (7) calendar days prior to the meeting date. Should the seventh day fall on a holiday, the last working day preceding the holiday shall be the deadline.
2. Deadline for requesting matters to be placed on the agenda for special meetings by a Trustee, Deputy Attorney General, and/or Executive Director shall be 12:00 noon, seven (7) calendar days prior to the meeting date. Should the seventh day fall on a holiday, the last working day preceding the holiday shall be the deadline.
3. The final composition of the agenda shall have the approval of the Chair of the Board of Trustees.

4. A Trustee, Deputy Attorney General, and/or Executive Director wishing to place matters on the agenda after the deadline has passed, must have copies of the subject material available to the Trustees when the meeting convenes with a note indicating that he or she will be requesting that this matter be placed on the agenda. (A minimum of six (6) Trustees must be present to put matters on the agenda - Sections 92-7(d) and 88-24, HRS.)

Material

1. All regular meeting material shall be in the hands of the Trustees no later than Wednesday prior to the meeting date.
2. All special meeting material shall be in the hands of the Trustees no later than four (4) calendar days prior to the meeting date.
3. All Trustees who will not be on the island to receive their material will inform the Executive Director as soon as possible so other arrangements can be made.

B. 10 Trustee Education Policy

Preface

The Board of Trustees recognizes its role in the general administration and proper operation of the retirement system. In order to discharge their duties in a prudent and reasonable manner, the Trustees should possess basic knowledge and understanding of the component functions of the retirement system, including without limitation, statutory and regulatory requirements, financial management, investments, retirement benefits, audit, legislative, and fiduciary oversight. The Trustee Education Policy provides a framework and process for ensuring that the Trustees - both individually and collectively - are provided the knowledge and education required to fulfill their responsibilities to the retirement system.

Administration

The Executive Director (or designee) is responsible for fulfillment of the Trustee Education Policy by implementing the following:

1. Identify Trustee educational needs, including without limitation, statutory and regulatory requirements, ERS policies and practices, investments, pension plan management, and fiduciary responsibility.
2. Develop a Trustee Education Plan (TEP) for each individual Trustee to include at least one educational opportunity per year.
3. Present the appropriate educational information or opportunities to the Trustees as they are available including those offered by industry organizations, conference organizations, academic or industry institutes, and colleges and universities.
4. Upon approval of the Board of Trustees, assist the Trustees with registration and travel approvals, as required.
5. Coordinate the presentation of Trustee post-education summary reports to the Board of Trustees within three months of completion of the educational opportunity.
6. Monitor and update the TEP on a continual basis.
7. Report the status of the TEP to the Board of Trustees on an annual basis.



GENERAL INVESTMENT OVERVIEW

SECTION: C

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C. 1. ERS Investment Plan Summary

Type of Plan	Defined Benefit
March 31, 2014	\$13.7 Billion
Investment Planning Time Horizon	5 years
Expected Annualized Return and Risk	Based on 2014 projections for 10 years, the target allocation is expected to achieve an average annualized return of 7.15% (4.15% real return with expected inflation of 3.0%). The annual compound return over this ten-year period is expected to fall within a range of 2.9% and 11.4% two-thirds of the time.

Primary Goal

The preservation of capital is of primary concern of the Employees' Retirement System of the State of Hawaii ("ERS" or "Plan"). The Board of Trustees of the ERS ("Board of Trustees" or "Board") seeks preservation of capital with a consistent, positive return for the Plan. Although pure speculation is to be avoided, the Board appreciates the fact that an above average return is associated with a certain degree of risk. Risk to be assumed must be considered appropriate for the return anticipated and consistent with the total diversification of the Plan.

Structure

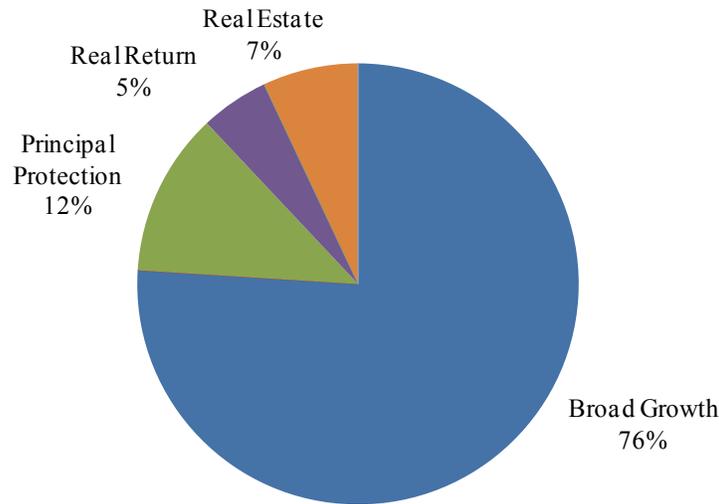
During 2014, the ERS adopted a risk-based, functional framework for allocating capital within the total portfolio. This framework makes use of strategic/functional classes that in-turn utilize underlying asset classes and strategies. Each of these classes is designed to achieve a certain goal (e.g., Real Return class) and/or be exposed to a specific set of macroeconomic risks that are common amongst the different strategy types and/or assets within the class (e.g., Broad Growth class). As a result of this structure, each strategic class is expected to be exposed to a set of major and minor macroeconomic risks. Each program's policy section contains a list of the relevant macroeconomic risks. Definitions for each of these macroeconomic risks can be found in Appendix B of this Manual.

Long-range Strategic Allocation Target

The ERS will be invested according to the following strategic class targets and ranges:

	<u>Lower Limit</u>	<u>Current Strategic Allocation</u>	<u>Upper Limit</u>
Broad Growth	66%	76%	86%
Principal Protection	8%	12%	16%
Real Return	0%	5%	10%
Real Estate	5%	7%	9%

The Chief Investment Officer of the ERS (“CIO”) may set the actual class levels anywhere within the upper and lower limits above. For deviations in excess of +/- 3%, the CIO shall provide regular ongoing justifications for the deviations. Adjustments in the above targets may be reviewed in conjunction with the annual strategic allocation review. The general investment consultant should conduct a formal strategic allocation study at least every three years for the Board of Trustees to verify or amend the strategic targets and ranges.



Portfolio Evaluation Benchmark

To monitor the total investment portfolio result, a special target benchmark is constructed to measure the target mix.

Total Investment Portfolio:

- 76% Broad Growth Blended Benchmark*
- 12% Barclays Global Intermediate Aggregate ex. Credit (hedged)
- 5% CPI + 3%
- 7% NCREIF Property Index (quarter lagged) Net

Individual ERS investment managers (“Investment Managers” or “investment managers”) will not be measured against this total investment portfolio objective. However, it is expected that the sum of their efforts will exceed the objective over time.

*Refer to program section for detailed description of benchmark, and possible evolving benchmark timeline

C. 2. Investment Management Policy

A. Guidelines for Manager Selection

The Board will select appropriate investment managers to manage the ERS's assets. This selection process shall include the establishment of specific search criteria, and documentation of analysis and due diligence on potential candidates. All manager candidates must meet the following minimum criteria:

- (1) Be a bank, insurance company, investment management company, or investment adviser as defined by the Registered Investment Advisers Act of 1940.
- (2) Provide historical quarterly performance numbers calculated on a time-weighted basis, based on a composite of all fully discretionary accounts of similar investment style, and reported net and gross of fees.
- (3) Within the manager selection process, performance evaluation reports prepared by an objective third party that illustrate the risk/return profile of the manager relative to other managers of like investment style shall be reviewed.
- (4) Provide detailed information on the history of the firm, key personnel, key clients, fee schedule, and support personnel and demonstrate financial and professional staff stability.
- (5) Clearly articulate the investment strategy that will be followed and document that the strategy has been successfully adhered to over time.
- (6) Have a reasonable and competitive fee structure.
- (7) Selected firms shall have no outstanding legal judgments or past judgments that reflect negatively upon the firm to the extent that in the Trustees judgment they would impair the ability of the firm to provide expert investment management to the ERS.
- (8) With respect to real estate advisors, the ERS shall enter into contractual arrangements only with organizations whose principal officers are engaged in the business of advising and evaluating commercial, industrial or residential real estate investments, mortgage banking, or property management, and which are duly licensed to perform real estate advisor services in the jurisdiction where the real property is located.

All investment manager candidates are expected to comply with all laws, regulations, and standards of ethical conduct.

B. Manager Discretion

The investment managers shall be given full discretion to manage the assets under their supervision subject to this Investment Policy, Guidelines, and Procedures manual ("Manual"), their assigned mandate, the laws of the State of Hawai'i ("State"), and their investment management agreements with the ERS. All transactions effected for the ERS's investments will be subject to best price and execution. If an investment manager utilizes brokerage from the Plan assets to effect commission recapture transaction, detailed records will be kept and communicated to ERS investment staff ("Investment Staff").

The investment program will be managed by designated professionals/firms in regard to both public and private securities, and investment managers will execute their mandates consistent with the strategic allocation and mandate-specific objectives set forth by the Board. Investment managers have no responsibility for the ERS's aggregate strategic investment allocation.

C. Manager Evaluation

Individual investment managers will be measured against an appropriate index and peer group. Market indices and peer group benchmarks are assigned to each manager and are intended as a guide for the investment manager to understand the risk/reward posture of their portfolio. Investment managers have full discretion to manage the risk posture of their portfolios relative to their designated market index and may, with conviction and appropriate expertise, execute security strategies not reflected by their market index as long as they conform to the investment guidelines and the laws of the State of Hawai'i.

There shall be a continual review of the investments under management. The Board shall confer with the investment managers to review the ERS's investments and the current environment. Each investment manager shall report pertinent data relating to the ERS portfolio as stipulated in the Reporting Requirements section of their guidelines.

D. Policy on Local Managers

The Board of Trustees wishes to utilize qualified local firms in the management of a portion of the ERS's assets. Due to the size of the ERS's portfolio and the fiduciary responsibility of the board members to select qualified firms in accordance with overall Board investment strategy, the following guidelines have been established for the identification, selection and evaluation of Hawai'i-based investment management firms.

- (1) It shall be the policy of the Board to allocate assets to local investment managers in accordance with the Board's strategic allocation and long term investment policies.
- (2) The asset mix of the combined local investment managers' portfolios shall not exceed more than 10% of the asset mix of total ERS assets for the broad strategic classes in which local managers invest.
- (3) Investment Staff will maintain files and data on Hawai'i-based firms that they are made aware of through known contacts, conferences, consultants, etc.

- (4) Whenever the Board initiates a search for an investment manager, the Investment Staff and applicable ERS investment consultant ("Investment Consultant" or "investment consultant") will determine if any local firm meets the specific search criteria designated by the Board.
- (5) As a guide for inclusion of a local investment manager in a Board-initiated search, staff/consultant may use some of the following qualifications in the screening of local firms:
 - a) One year of operation as an SEC registered investment management firm.
 - b) The portfolio manager handling the account must have a minimum of seven years of experience in investment management.
 - c) The firm must have a minimum of \$50 million in total assets under management and at least \$25 million in the style/product designated for the search.
 - d) The firm must have at least three tax-exempt client(s).
 - e) The senior principal must have at least two years experience in running an investment management operation, either at the present or a predecessor firm.
 - f) An acceptable and verifiable historical track record of at least three years (a prior firm's record is acceptable), which could have been reasonably achieved by the manager's current staff and resources. Local managers are not required to be in conformance with CFA Institute Standards.
 - g) Ownership or an equivalent stake in the firm by the active investment management professionals.
 - h) A sound and convincing investment management process.
 - i) An adequate staff to support the investment, administrative and regulatory functions.

(6) Evaluation of Local Firms

- a) All local firms retained by the Board of Trustees shall be evaluated in a similar fashion as all other investment managers within the same strategic class.

E. New Investment Proposals

All new investment proposals presented to the ERS are initially reviewed and analyzed by the Investment Staff (as directed by the CIO). Investment Staff will determine if the proposal(s) should be considered further.

If the investment proposal warrants further consideration, Investment Staff shall conduct a due diligence process utilizing the applicable investment consultant(s). After completion of the due diligence process, the CIO will take his findings to the Investment Committee.

Upon review, the Investment Committee will direct the CIO to do one of three things: (1) decline the investment proposal; (2) investigate the investment proposal further; or (3) present the investment proposal to the Board of Trustees for approval.

Upon review, the Board of Trustees will decide one of the following: (1) decline the investment proposal; (2) direct the CIO to investigate the investment proposal further; or (3) approve the investment proposal.

The Board of Trustees makes the final decision on all new investment proposals.

C. 3. General Investment Objectives and Guidelines

Investments will be prudent and consistent with the best investment practices, in accordance with the assigned investment mandate, and in compliance with Chapter 88, HRS.

Currently, the ERS separates its investments into a series of four strategic programs; Broad Growth, Principal Protection, Real Return, and Real Estate. Each strategic program has a corresponding section within this Manual. The strategic program sections are designed as complete, and nearly autonomous, sections for the operation of each program within the total portfolio. These sections contain goals, objectives, and guidelines for each program as a whole, as well as for the underlying managers within each strategic program.

The Board recognizes that commingled funds' guidelines are established by their trust documents/prospectuses and that ERS guidelines have no bearing on the policies of commingled funds. However, the Board expects that any manager of a commingled fund and/or index funds will inform the Board if the investment policy of any such fund conflicts with any provisions of this Manual.

C. 4. Guidelines for Manager "Watch List" or Termination

The performance of all investment managers will be monitored on an ongoing basis. The Trustees may place a manager on a "Watch List" or terminate a manager at any time.

Investment managers may be terminated or placed on a "Watch List" for a variety of reasons: personnel changes, violation of policy and investment guidelines, style deviations, underperformance, strategic allocation changes and non-disclosure of material information. The ERS has two clearly stated investment portfolio performance objectives; the preservation of capital and consistent positive returns. These "Watch List"/termination guidelines were formulated with these objectives as a foundation. There are various factors that should be taken into account when considering placing a manager on a "Watch List" or the termination of a manager. These can be separated into two broad categories - qualitative and quantitative factors. The former focuses on personnel, organizational and legal issues while the latter addresses performance.

When possible, the Board will issue a warning letter to underperforming investment managers prior to placement on the "Watch List". However, the Board may place a manager on the "Watch List" at any time whether or not a warning letter has been issued. Placing a manager on the "Watch List" is an intermediate step towards either resolving the problem or terminating the manager. Managers may only be removed from the "Watch List" under these two conditions.

A. Performance Criteria (liquid mandates)

A manager having performance that fails to meet certain performance criteria would become eligible to be placed on the "Watch List". First, any manager, regardless of tenure, would be subject to Watch status if that manager's investment performance falls

through the Short-term Relative to Benchmark criteria. Second, for managers with greater than three years of performance history, a manager would be subject to Watch status if it fails to achieve at least one Relative to Benchmark criteria (Medium-term or Long-term). Specific criteria are located in the Appendix of each strategic program section.

B. Performance Criteria (illiquid mandates)

Illiquid mandates are subject to different/customized criteria, which are discussed in the applicable sections of this Manual.

C. Procedures

Once formally placed on the “Watch List” by the Board, the manager would be allowed a reasonable amount of time to correct its performance (typically 9 to 15 months, if not sooner). During this time, the Trustees may: i) instruct the manager to present in writing and/or before the Board reasons for the underperformance, and/or ii) have the investment consultant provide the Board with documentation that discusses the factors contributing to the manager’s underperformance.

If a manager is placed on the “Watch List”, four actions are then generally available to the Board:

- 1) To release a manager from the “Watch List”.
- 2) To extend “Watch List” status in order to determine whether any changes are improving performance.
- 3) To reduce the managers assets by up to 100%.
- 4) To terminate the manager if performance continues to be below expectations.

Any of these actions would be supported by additional documentation (produced by the applicable investment consultant and/or Investment Staff) that highlight the original reasons for placing the manager on probation and discuss how these issues have or have not been addressed. Underperformance would be evaluated in light of the manager's stated style and discipline.

If the Trustees determine (with advice from the consultant) the manager is unlikely to meet the above performance criteria and/or one of the qualitative indicators is violated without signs of improvement, the manager may be terminated. A minimum of three years of performance is preferred, but not required prior to termination.

D. Watch List Guidelines - Qualitative Factors

Below are some of the *qualitative* factors that may be considered in determining whether an investment manager should be placed on the “Watch List” or terminated.

FACTOR	EVALUATION TECHNIQUE	ACTION STEPS
Violation of investment guidelines and/or the laws of the State of Hawai‘i	Review portfolio holdings vis-à-vis the investment guidelines <ul style="list-style-type: none"> - Individual securities - their percentage weight in the portfolio 	Correct violation. Review violations with manager to reestablish compliance with appropriate guidelines. Manager to compensate ERS for any losses that occurred from violation. Terminate or place on watch list - terminate on additional violation.
Deviation from stated investment style and philosophy	Style mapping- total fund analysis. Style attribution - manager specific style analysis.	Place on watch list. Monitor for on-going fit with strategic allocation policy. Terminate if no longer consistent with strategic allocation structure.
Changes in ownership	Require immediate notification of any pending changes in ownership	Place on watch list. Qualitatively determine if change may detrimentally affect asset performance. If so, terminate.
Turnover of key personnel	Require manager to establish a list of key personnel, and rank in level of importance, at the inception of the account. Manager updates on an as needed basis.	Place on watch list. Consider termination if there is key personnel turnover on the account (as specified in the manager provided list) or staffing is deemed insufficient to appropriately manage the ERS account.
Litigation	Require manager to notify ERS Staff immediately if entity which manages the funds is involved in any litigation	Evaluate nature, seriousness and likely impact of charges on the investment process and take appropriate action.
Failure to disclose significant information which could impact manager evaluation	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time.	Review non-disclosure to determine if material to manager’s ability to manage assets. If so, terminate.
Failure to disclose potential conflict of interest in managing assets	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time	Review non-disclosure to determine if conflict was material and should have been known by manager. If so, terminate.

E. Watch List Guidelines - Quantitative Factors

Each strategic program section contains detailed information for individual investment managers and their quantitative thresholds to be placed on the “Watch List”. These criteria are customized for each manager/mandate based on their respective tracking error expectations. The criteria are located in the Appendix of each strategic program section.

C.5. Investment Meeting Policy**A. Investment Managers**

- (1) Board Meetings: Investment managers shall present a formal investment portfolio review to the Investment Committee and/or Board of Trustees once every three years. At this presentation, investment managers should be represented by one or more senior ranking members of the portfolio management team (e.g., portfolio manager, chief investment officer).
- (2) Staff Meeting: Investment managers shall present a routine investment portfolio review to Investment Staff annually. The presentation should be held at the ERS offices; however, the CIO may authorize an alternative communication means for conducting the presentation, such as teleconferencing.

At either presentation, the investment manager will be expected to present appropriate information about the firm and the portfolio, including, but not limited to, performance and holdings, investment philosophy and process, organizational and personnel changes, new and lost clients, and compliance issues related to this Manual and/or its investment management agreement with the ERS.

Investment managers may be required to make a presentation to the Investment Committee and/or Board of Trustees on a more frequent basis as stated in their contract or upon request.

B. Consultants and Custodian

Investment Consultants and ERS bank custodians (“Custodian” or “custodian”) shall make presentations to the Investment Committee and/or Board of Trustees at their regularly scheduled meetings according to the contract or upon request.

At the discretion of the Investment Committee and/or Board of Trustees, such meetings with Investment Consultants and Custodians may be conducted via an alternative communication means such as teleconferencing.

C. Due Diligence Meetings

- (1) Routine Due Diligence: Investment Staff shall conduct routine on-site, due diligence meetings once every two years with each investment manager, consultant, and custodian.
- (2) Watch List Status Due Diligence: Investment Staff shall conduct an on-site, due diligence meeting of any investment manager or investment-related vendor that is placed on the Watch List or other Board-approved probationary status. The on-site visit will occur within a reasonable period but not later than one year from

the date when the investment-related vendor was placed on the Watch List or probation. Investment Staff, in consultation with the general investment consultant, may determine that an on-site due diligence meeting is unwarranted or that such due diligence meeting be conducted at another point in time beyond the first year of Watch List status.

- (3) Vendor Search Due Diligence: Prior to executing a contract, Investment Staff shall conduct an on-site, due diligence meeting when conducting an investment manager or investment-related vendor search for all managers or vendors who appear on the finalist list; or as appropriate, the on-site, due diligence meeting may be conducted with the selected manager or vendor only. The results and findings of the on-site, due diligence meeting should be conducted prior to any hiring decision unless Investment Staff, in consultation with the general investment consultant, determines that an on-site due diligence meeting is unwarranted.

The CIO may delegate the due diligence meeting responsibility to the general investment consultant, or conduct the onsite due diligence jointly.

D. Industry Conferences or Educational Forums

Investment Staff and Trustees shall attend industry conferences and educational forums that are essential and critical to discharging the responsibilities associated with institutional investing. Section B.5 of this Manual addresses this policy provision: “It will be necessary for the Trustees (and Staff) to travel to industry conferences and participate in educational forums as opportunities arise.”

E. Staff Responsibilities

The Investment Office will maintain an Investment Meeting Calendar in order to plan Trustee and Investment Staff investment meetings as outlined in this Manual.

C.6. Reporting Requirements for Investment Managers

Investment Managers of Liquid Mandates

Monthly Reporting Requirements

A. Reporting Requirements

- (1) Statement of asset positions as of the end of the month on a trade date basis. Include the following information:
 - a. Number of shares or par value.
 - b. Book cost (both U.S. dollar and local currency if applicable) based on average cost basis.
 - c. Market value (both U.S. dollar and local currency if applicable) with disclosure of pricing source.
 - d. Unrealized gains/losses (both U.S. dollar and local currency, if applicable).
 - e. Classification of assets should include cash, cash equivalents, stocks (common, preferred), bonds (corporate, government, convertible), derivatives, etc.
 - f. Asset allocation percentages.
 - g. The percentage of individual securities position to the manager's portfolio.
 - h. In the case of derivatives, the percentage of the manager's portfolio represented by the notional amount of the derivatives position to the total fund.
 - i. Any combined derivatives position with a net exposure representing greater than 25% of the market value of the total fund.
- (2) Statement of liabilities (both U.S. dollar and local currency if applicable) as of the end of the month-end period with summary amount for open trades, contract options, etc.
- (3) Listing of all transactions for the period including unit price paid or received, quantity disposed or received, total value, gain/loss, bond rating on purchases. The transactions reported must be on an accrual basis and reported in both U.S. dollar and local currency, if applicable.
- (4) Detailed schedules for the following items must be made available upon request by Investment Staff, but are not required on a regular basis.
 - a. Income receivable.
 - b. Realized and unrealized spot and forward foreign currency hedges.
 - c. Cash reconciliation.
 - d. Open or pending trades.
 - e. Interest collected or paid and/or dividend income.
- (5) One copy of the report is to be forwarded to the Custodian; one copy is to be forwarded to the ERS.
- (6) Reports are to be stapled or bound and should have the investment manager's firm name on the front.

B. Within five business days of the occurrence of any of the following, submit a written explanation of the circumstances that resulted in:

- (1) Transactions that result in the Custodian charging the ERS overdraft charges.
- (2) Transactions that are extraordinary and warrant disclosure to the ERS (also include items not reflected in the financial statements, e.g. significant changes in forward contracts, etc.).

C. Reconciliation of Manager's Monthly Report with Custodian's Monthly Report

- (1) To assist the Custodian with the reconciliation of asset position for both the number of shares/par value and book value, income realized and gain/loss, and pricing, (in U.S. dollar and local currency for foreign managers), managers must provide the required information in a reasonable format (e.g. diskette, direct transmission, etc.). Contact the Custodian for file format and layout.
- (2) Each investment manager must reconcile its records to the Custodian's reports. A copy of the manager's reconciliation report must be received within 30 days of the close of the reporting month.

D. Fees

- (1) Investment Manager's fees are based on the Custodian's reports. Fees are paid quarterly and after-the-fact. Invoices are sent to the ERS and processed for payment from the investment manager's portfolio.
- (2) Failure to submit written explanations of charges (e.g. bank overdraft) listed in B.1. and B.2. above, may result in fees being adjusted at the discretion of the ERS.
- (3) Fees may be adjusted if the market value of the portfolio presented in Custodian's reports is subsequently revised for pricing errors or other adjustments.
- (4) On an annual basis, the applicable investment consultant shall write to the investment managers inquiring whether the ERS is receiving the lowest fee structure (favored nation clause). The investment consultant will inform the ERS of any instance where the ERS is not receiving the lowest fee and recommend a course of action.

Quarterly Performance Reporting Requirements

A. Reporting Requirements

All of the information listed below shall be included in quarterly performance reporting. Performance results shall be placed at the beginning of the report.

- (1) A valuation report that includes a Statement of Assets.
- (2) Performance results for the quarter, calendar year to date, fiscal year to date, and preceding 1-year, 3-year and 5-year periods.

- (3) An analysis of the positive and negative aspects of the investment strategy during the quarter and how it affected the investment results.
- (4) A transaction report for the period, including the purchase or sale of securities, together with gains and/or losses from each sale.
- (5) An economic outlook and investment strategy for the next quarter and/or year.
- (6) Any other pertinent information that should be brought to the attention of the Board of Trustees.
- (7) One report is to be mailed to the CIO and one report is to be sent to the CIO in electronic format.

B. Organizational Changes

Important changes in an investment manager's organization, staff and investment strategy should be reported within 5 business days of their occurrence. Investment managers must also promptly report any involvement in litigation, claims, assessments, regulatory investigations, etc.

C. Registration Statement

Investment managers must also send the ERS annually a copy of part II of their registration statement (Form ADV) on file with the Securities and Exchange Commission.

D. Presentations to the Board of Trustees

Except as stated in Section C.5.A. of this Manual, the Board of Trustees does not require investment managers to meet with the Board on a regular basis. However, the Board, at its discretion, may invite managers to discuss appropriate matters pertaining to the ERS account. Attendance by manager representatives at the Board's Annual Manager's Conference is required.

Investment Managers of Illiquid Mandates

Investment managers of illiquid mandates must abide by the reporting requirements stated within the corresponding strategic/sub-component sections of this Manual.

C.7. Employees' Retirement System Distribution of Brokerage Commission

- A. Each investment manager is charged with the responsibility of seeking the best execution and best price in the best interest of the ERS.
- B. No trades of any investment manager shall be done through their own parent, subsidiary, or otherwise related firm. Also, no trades should be done which benefits a manager unless prior approval has been given by the ERS for such actions.
- C. The Board has determined that all ERS domestic and international equity investment managers must participate in the ERS's Commission Recapture Program ("the Program"). Investment managers should still comply with their responsibility of seeking best execution and best price.

Active Domestic Equity Managers*: At least thirty-five percent of all brokerage transactions for domestic equity managers are required to be directed to brokers participating in the Program.

Active International Equity Managers: Are expected to make a best effort to direct at least thirty-five percent of all brokerage transactions to brokers participating in the Program.

Passive Equity Managers**: Are expected to make a best effort to direct at least ten percent of all brokerage transactions to brokers participating in the Program.

Investment managers are also required to provide the CIO with quarterly reports detailing compliance with this requirement.

**Small Cap managers are exempt from this requirement but are expected to make a best effort attempt to direct as much as is prudently possible.*

***Including covered calls managers' ETF and equity trades.*

Investment managers will be forwarded brokers' transaction reports from the Custodian Bank and are expected to reconcile the broker's transaction reports to their in-house reports to confirm that all trades directed to the Program are properly recognized and reported.

- D. Annual reports prepared by the Investment Staff summarizing the directed brokerage transactions will be submitted to the Board of Trustees.

Exemptions:

Sands Capital, one of the ERS's active large cap growth managers, was granted an exemption from participating in the ERS Commission Recapture Program at the November 13, 2012 Board meeting, given their very low turnover and concentrated structure.

C.8. Securities Lending Guidelines

The policies and guidelines governing the securities lending program shall pertain to the Custodian, unless such services are contracted otherwise. A *separate contract*, distinct from the custody relationship, detailing the type of securities lending relationship and program is both mandatory and essential in the treatment of securities lending as, foremost, an investment function with the associated risks and return implications, and fiduciary responsibility.

On an annual basis, the Custodian shall provide a detailed report of the ERS's securities lending activities. This summary shall be the basis for verification that the Custodian is complying with these securities lending guidelines. After reviewing the report provided by the Custodian, the General Investment Consultant shall prepare a report summarizing the ERS's securities lending activity and compliance with the ERS's policies.

A. Objective

The Custodian, as the ERS's securities lending provider, receives cash or government securities (defined below) as Collateral for loans of their securities to approved Borrowers. On an ongoing basis, the securities lending provider identifies eligible Collateral and, in the case of cash Collateral, the opportunity for a market rate of return consistent with allowed investment latitude and thereby seek to generate positive program spreads.

The securities lending provider must exercise investment discretion consistent with the overall objective of: preserving principal; providing a liquidity level consistent with market conditions and the lending and trading activities of the ERS; and maintaining full compliance with stated guidelines and statutory provisions. The securities lending provider shall exercise prudence and expertise in managing the cash collateral reinvestment function.

B. Program Guidelines

Maintenance of the integrity and operational functionality of the securities lending program shall be pursued with utmost diligence. The securities lending provider shall have documented policies and procedures in place detailing the following if not stipulated in the securities lending contract for both domestic and international securities.

- Borrower Limits/Creditworthiness
- Acceptable Collateral
- Marking to Market
- Corporate Actions/Distributions
- Proxy Voting Limitations
- Recall of Loaned Securities
- Revenue Splits
- Valuation and Reporting of Loaned Securities and Cash Collateral Reinvestments
- Borrower Risk (Default)
- Cash Collateral Reinvestment Risk
- Operational Negligence
- Counterparty Indemnification
- Other relevant policies

The securities lending provider shall at all times exercise prudence and due care and shall comply at all times with Section 88-121.5, Hawai'i Revised Statutes and all other applicable laws, rules and regulations of federal, state, and local entities or agencies having jurisdiction, including but not limited to banking and securities regulatory bodies, taxation authorities and the US Department of Labor.

C. Collateral Management

The securities lending provider shall exercise prudence and reasonable care in discharging its discretion in the investment management of cash and non-cash collateral, including asset/liability (gap) management that is appropriate relative to the market environment or conditions that the securities lending provider is operating in. Provided that the management of collateral, specifically cash, imposes the greater risk, the securities lending provider shall adhere to the overall investment objective of ERS. Policies regarding issuer, credit, exposure and rating limits utilized in the securities lending program per investment vehicle shall be under the full discretion of the provider, and appropriate and consistent with the stated general guideline. Issues such as exposure guidelines, prohibited securities for cash investment, duration strategies, and matched and mismatched book are both strategic and tactical investment functions and shall be consistent with the above objective.

Initial Collateral levels will not be less than 102% of the Market Value of the Borrowed Securities, or not less than 105% if the borrowed securities and the Collateral are denominated in different currencies. Marking-to-market is performed every business day subject to de minimis rules of change in value, and the Borrower is required to deliver additional Collateral when necessary so that the total Collateral held by the securities lending provider for all loans to the Borrower of all participating lenders will at least equal the market value of all the borrowed securities of all participating lenders loaned to the Borrower.

Listed below are the cash and non-cash Collateral guidelines specifying eligible investments, credit quality standards, and diversification, maturity and liquidity requirements. Except for Prior Purchased Assets¹, all requirements listed in these guidelines are effective at the time of purchase of any security or instrument as a cash Collateral investment and at the time of receipt of any non-cash Collateral. Agent will make use of market standard settlement methods for cash investments and non-cash collateral including the use of a tri-party custodian as approved by Agent's appropriate risk committee. Settlement through a tri-party custodian may result in cash collateral being held on deposit at the tri-party custodian.

Cash Collateral Guidelines

Investment Objectives

Cash Collateral of the Collateral Account is invested to seek the following objectives:

- (i) preservation of capital

¹ There may be certain assets held as Collateral that complied with the requirements of a prior version of these guidelines then in effect at the time of purchase of such assets, but that may not meet these latest guidelines (such assets termed "Prior Purchased Assets"). Such Prior Purchased Assets may continue to impact the overall securities lending portfolio accordingly. The securities lending provider may, at its sole discretion, hold such Prior Purchased Assets until maturity, or as otherwise determined by it.

- (ii) maintenance of liquidity, and
- (iii) maximization of current income to the extent consistent with (i), and (ii), above

by investing cash Collateral in accordance with the guidelines stated below. Within quality, maturity, and market sector diversification guidelines, investments are made in those securities Agent judges to offer the most attractive relative yields.

Investment Guidelines

A separate cash Collateral account shall be maintained for each currency, subject to the eligibility rules below. Cash Collateral shall be denominated in either U.S. Dollars or Euro currency, and shall be invested in securities or instruments managed under the following guidelines:

Eligible Investments:

1. Securities and Exchange Commission (SEC) Rule 2a-7 money market mutual funds.
2. Securities issued or guaranteed as to principal and interest by the Government of the United States or issued or guaranteed by agencies or instrumentalities thereof.
3. High-grade commercial paper and commercial paper master notes, whether or not registered under the Securities Act of 1933, as amended, and promissory notes. Obligor shall have a short-term rating not lower than "A-1, P-1 or F-1", at time of purchase.
4. Corporate obligations, including the banking industry, which are marketable and rated high-grade. At the time of purchase, either the long-term rating shall not be lower than "AA-, Aa3", or the equivalent thereof, or the short-term rating shall not be lower than "A-1, P-1, or F-1" if less than one year remaining until maturity. Obligations may include fixed, floating and variable rate notes and bonds.
5. Asset backed securities, at the time of purchase, shall have either a long-term rating of "AAA, Aaa" or the equivalent thereof, or a short-term rating not lower than "A-1, P-1, or F-1" if less than one year remaining until maturity. Mortgage backed securities are not considered asset backed securities for purposes of this restriction. Asset backed securities must be collateralized by credit cards, auto receivables, equipment trusts or student loans.
6. Certificates of deposit and other bank deposit obligations of U.S. banks or U.S. branches or subsidiaries of foreign banks. At the time of purchase, the issuing bank must have either a short-term issuer debt rating not lower than "A-1, P-1, or F-1" or a long-term issuer debt rating not lower than "AA-, Aa3", or the equivalent thereof.
7. Bankers' acceptances issued by U.S. banks or issued in the U.S. by branches or subsidiaries of foreign banks. At the time of purchase, the issuing bank must have either a short-term issuer debt rating not lower than "A-1, P-1, or F-1" or a long-term issuer debt rating not lower than "AA-, Aa3", or the equivalent thereof.
8. Repurchase agreements with respect to the following types of collateral and repo counterparties:

- a. U.S. government securities, agencies, sovereigns, supranationals, commercial paper, municipal bonds, asset-backed securities, mortgage-backed securities (only pass-throughs), corporate bonds (investment grade and high yield), and equities
 - b. The credit worthiness of the repurchase agreement counterparties shall be monitored by Agent's internal risk committee.
9. Sovereign debt obligations (other than U.S. Government obligations). At the time of purchase, either the long-term rating shall not be lower than "AA-, Aa3" or the equivalent thereof, or the short-term rating shall not be lower than "A-1, P-1, or F-1" if less than one year remaining until maturity.
 10. Interests or units in any short-term investment fund (including, without limitation, such funds of The Northern Trust Company and any of its affiliates) that invests in any or of the types of investments approved above.
 11. Capped floaters, provided that Agent shall notify Lender of the usage of such securities and shall employ appropriate risk assessment and manage expertise as specified by the Office of the Comptroller of the Currency.
 12. Constant Maturity Treasury ("CMT") floaters, provided that Agent shall notify Lender of the usage of such securities and shall employ appropriate risk assessment and manage expertise as specified by the Office of the Comptroller of the Currency.

Maturity/Liquidity

The "maturity" of a security or instrument (or "maturities" for more than one security or instrument) shall be defined as follows:

1. The shorter of the date on which the principal amount is ultimately required to be paid or the put date under a demand feature, or
2. Variable rate eligible U.S. Government and U.S. Agency obligations shall have a maturity equal to the date of the next readjustment of the interest rate, or
3. The maturity of a pooled investment fund shall be the number of days required to liquidate an investment in the fund under normal market conditions, or
4. Asset-backed securities shall have a maturity equal to such security's weighted average life (i.e. the average time to receipt of expected cash flows on the security).

A minimum of 60% of the cash portion of the Collateral Account shall be invested in securities which have a maturity (as herein defined) of 97 days or less.

A minimum of 20% of the cash portion of the Collateral Account shall be available each business day. This may be satisfied by maturities (as herein defined), or demand features.

The rate sensitivity or weighted average maturity, as measured to the shorter of the remaining time until the interest rate reset (if applicable) or maturity, of the cash portion of the Collateral Account will be limited to 60 days.

The weighted average maturity, as measured to maturity (as herein defined), of the cash portion of the Collateral Account shall not exceed 120 days.

The maturity of fixed rate investments may not exceed 13 months from the date of purchase. The maturity of floating rate Eligible Investments, including the maturity of variable rate eligible U.S. Government and U.S. Agency securities (as measured to final maturity date, not the next readjustment of interest rate), may not exceed 2 years.

Diversification

Subject to the following exceptions, a maximum of 5% of the cash portion of the Collateral Account may be invested in securities or instruments of any one issuer or obligor. Exceptions are as follows:

1. 100% of the cash portion of the Collateral Account may be invested in obligations issued or guaranteed by the U.S. Government or its agencies/instrumentalities
2. 25% of the cash portion of the Collateral Account may be invested with any one counterparty in repurchase agreements collateralized by U.S. Government or U.S. Government agency securities
3. 10% of the cash portion of the Collateral Account may be invested with any one counterparty in repurchase agreements collateralized by eligible securities other than U.S. Government or U.S. Government agency securities.
4. Residual cash balances, which cannot be invested into the marketplace, shall not be subject to diversification limits.

General Ratings Provisions:

The ratings above must be designated by at least two Nationally Recognized Statistical Rating Organizations ("NRSROs"), or if only rated by one NRSRO, then rated at the time of purchase in the minimum rating category specified by that NRSRO, as above. For the avoidance of doubt, if all three NRSROs rate the obligation, then the obligation is eligible as long as two NRSRO ratings meet the minimum criteria. In the event that the obligation is not rated, the issuer rating shall be considered with respect to the class of comparable short-term obligation or long-term obligation.

Prohibited Transactions and Securities

The following transactions and securities are not permitted as direct investments of Cash Collateral:

1. Additional leverage, which shall mean that Lender may not further lend Eligible Investments in the Collateral Account.

2. Highly leveraged, structured notes
3. Range floaters, COFI floaters, Dual Index floaters inverse floaters and leveraged floaters

Non-Cash Collateral Guidelines

Listed below are the non-cash Collateral investment guidelines for eligible Collateral.

Investment Guidelines

Non-cash eligible instruments may consist of the following:

Eligible Investments

1. Obligations issued or guaranteed by the U.S. Government or its agencies or instrumentalities thereof
2. Obligations issued or guaranteed by OECD (Organization for Economic Cooperation and Development) member states or their local governments, agencies or authorities
3. Canadian Provincial Debt
4. Equity securities, which are part of U.S. and non-U.S. indices (including, but not limited to U.S., U.K., EMU, Japan, Canadian and Australian markets), as approved by Agent's internal risk committee from time to time; and
5. Such other Collateral as the parties may agree to in writing from time to time.

Credit Quality

Eligible Instruments as named above may be accepted without limit.

Diversification

Eligible Instruments as named above may be accepted without limit.

Operation of the Collateral Account

Income

Income earned from the investment of cash Collateral, net of (i) expenses, including but not limited to, transaction accounting and reporting expenses, auditing fees, brokerage fees and other commissions, and any miscellaneous expenses, (ii) any applicable withholding of tax, (iii) loan rebate fees paid or accrued to the borrowers, and (iv) any adjustments to provide for regular returns, together with loan fees for loans Collateralized by non-cash Collateral, are distributed to Lender of the Collateral Account on a monthly basis.

On a monthly basis, a portion of the income earned by Lender on a loan on any business day may be withheld by Agent and transferred to income earned on a different loan for that Lender on any other business day if on that day one or more rebates due or accrued to borrowers with respect to one or more loans should exceed the income earned from the cash Collateral supporting those loans. If, despite such transfers, during any month total rebates payable exceed total revenues with respect to any loan or loans of Lender, the net shortfall shall be charged against positive undistributed earnings from other

loans of Lender to the extent thereof, and any remaining shortfall shall be allocated between the Lender and the Agent in the same proportions as positive securities lending revenues. Any amounts thereby payable by the Lender shall be the personal obligation of Lender and shall be due and payable upon the Lender's receipt of Agent's invoice for such amounts. Agent may withhold (and Lender is deemed to grant to Agent a lien upon) future loan revenues, and any other property of the Lender then or thereafter in the possession of Agent, to secure the payment of such obligation. Notwithstanding the foregoing, however, all other Collateral losses shall not be shared between the Lender and the Agent to any extent but shall be allocated as provided in the Agreement or these guidelines.

Incidental expenses, (e.g., negative float due to payment advances) incurred in the administration of the Collateral Account are recovered against incidental receipts, (e.g., positive float from pending balances) similarly arising and any remaining balance is added to the lending revenues for the benefit of Lender. Net realized short-term capital gains or losses (if any) may be distributed (or charged) from time to time.

Net Asset Value

Lender hereby directs Agent to maintain the cash portion of the Collateral Account as a fund comprised of units having a constant net asset value of \$1.00 per unit and to value the fund using the amortized cost method (acquisition cost as adjusted for amortization of premium or accretion of discount) for that purpose. Agent will not determine or monitor the fair market value of the investments as a means of comparing the unit value with the market value of its investments. Lender hereby represents and confirms on a continuing basis throughout the term of this Agreement that such a method of valuation and account maintenance is consistent with all laws, rules, regulations and accounting procedures applicable to Lender.

The cash portion of the Collateral Account intends to maintain a constant net asset value within minimum tolerances established by Agent's senior management. There is no guarantee, however, that the cash portion of the Collateral Account will be able to attain that objective. The Collateral Account is not registered under the Investment Company Act of 1940 as a money market fund, is not subject to regulation by the Securities and Exchange Commission and does not comply with federal regulations governing registered money market mutual funds.

In no event shall Agent be personally liable to restore any loss within the Collateral Account, unless the loss was directly caused by the negligence or intentional misconduct of Agent.

Trading Policy

Although the Collateral Account will generally not engage in short-term trading, the Agent may dispose of any portfolio security prior to its maturity if, on the basis of a revised credit evaluation of the issuer or other considerations, Agent believes such disposition is advisable. Subsequent to its purchase, a portfolio security or issuer thereof may be assigned a lower rating or cease to be rated. Such an event would not necessarily require the

disposition of the security, if the continued holding of the security is determined to be in the best interest of the Lender. In any event, Agent will notify Lender as soon as reasonably practicable if any security is downgraded after initial purchase below the minimum requirements set forth in these investment guidelines.

C. 9. Strategic Allocation Rebalancing Guidelines

A. Rebalancing Assets within the Strategic Allocation

One essential component of a strategic allocation policy is the development and use of rebalancing ranges for the target allocation. According to several studies, systematic rebalancing should reduce portfolio volatility and increase a portfolio's risk-adjusted return. Using the ERS's long-term strategic target allocation, the greatest enhancement to investment performance (i.e., enhancing the annualized return while lowering the risk) is achieved by the rebalancing range shown below.

B. Target Mix With Rebalancing Ranges

Broad Growth	76%	+/- 10%
Principal Protection	12%	+/- 4%
Real Return	5%	+/- 5%
Real Estate	7%	+/- 2%
Total	100%	---

The Investment Staff will maintain the classes within their target ranges primarily by using cash flows, although the actual allocations will be rebalanced whenever a class is outside of its strategic target range. The Board of Trustees should review the targets and ranges annually for reasonableness relative to significant economic and market changes, and relative to changes in the ERS's long-term goals and objectives.

If the Plan has positive cash flow (i.e., contributions exceeding disbursements), Investment Staff has the discretion to rebalance by directing new moneys to the under allocated strategic classes on a pro-rata basis. If the Plan has negative cash flow, Investment Staff has the discretion to withdraw moneys to be disbursed from over allocated strategic classes. In each case, the CIO shall keep the Board of Trustees apprised of current asset movements. Managing strategic allocations in this manner should not incur any additional transaction cost beyond what would have been normally incurred to liquidate or invest assets.

Because of the unique valuation characteristics of Real Return and Real Estate, these strategic classes have more subjective rebalancing ranges relative to their target allocation. Concerns of liquidity and the long-term horizon for these investments suggest a more infrequent rebalancing schedule. Accordingly, other more qualitative considerations (e.g., transaction costs, liquidity needs, investment time horizons, etc.) regarding the timing of rebalancing Real Return and Real Estate will be important to consider with the guidelines shown above.

C. Rebalancing Investment Style/Mandate Allocations Within Strategic Classes

With concurrence from the applicable investment consultant, Investment Staff is responsible for maintaining appropriate style and mandate weightings, consistent with the respective strategic classes' risk profile(s). Investment Staff and/or the applicable investment consultant shall regularly report style and mandate weightings, and their deviations from policy, to the Board. Any adjustments that causes a material change to a strategic class' risk profile requires Board approval.

D. Single Manager Portfolio and Firm Allocation Limits for Active Mandates

In order to minimize any potential risk associated with large concentrations of the ERS's portfolio assets being managed in a single manager portfolio or by a single firm, the following limits have been put in place:

- (1) No single equity manager portfolio shall represent more than 5% of the total ERS portfolio and
- (2) No single manager/firm, when all active mandates associated with that manager/firm are aggregated, shall represent more than 10% of the total ERS portfolio.

If any single manager portfolio or manager/firm's active assets exceed these limitations, Investment Staff and the applicable investment consultant shall provide the Board its solution to reallocate funds from that portfolio or manager/firm within the portfolio to reduce the concentration within a reasonable time period.

C. 10. Portfolio Transition Guidelines

From time to time the ERS will have a need to restructure its portfolios as a result of manager performance or strategic allocation changes. The Board of Trustees, acting on recommendations and suggestions of the Investment Staff and investment consultants, will decide to undertake actions to allocate assets to maintain optimal strategic class weightings and/or to individual managers. The decision process will proceed as follows.

A. Asset Transition Decision Process

- (1) A determination will be made about the importance of maintaining the ERS's strategic allocation throughout the restructuring. If maintaining the strategic allocation is desired, this can be accomplished through the simultaneous purchase and sale of assets, through the use of futures, or other means.
- (2) The Executive Director and CIO, with advice from the appropriate investment consultants will determine the optimal course of action for effecting the desired transition of assets. Rebalancing processes may include the use of a transition manager or the direct transfer of in-kind securities to the target manager, for example. When determining the optimal process, Investment Staff will seek to maintain exposure to the market at all times (i.e., minimize time in cash assets) and furthermore to minimize transaction costs, including, without limitation, commissions, market impact, and opportunity cost. Whatever method chosen, Investment Staff will maintain records that show firms selected for the transition of assets have the depth of experience and commitment of resources to the portfolio restructuring business. Additionally, Investment Staff's evaluation will include pre-trade cost analysis for the transition project.
- (3) Manager(s) that may be selected by the ERS to manage and implement the portfolio restructuring, should provide the ERS a pre- and post-trading cost analysis so the results of the restructuring can be evaluated and the ERS's fiduciary obligation to monitor best execution is satisfied.

B. Asset Transition Steps

Each transition of assets project will be conducted according to the following steps.

- (1) Trustees decide to restructure the portfolio through strategic allocation rebalancing, strategic class changes, fund manager rotation, or other reasons.
- (2) The Executive Director and CIO, with input from the appropriate investment consultants, determine the optimal method to achieve the desired portfolio target.
- (3) Investment Staff may solicit bid proposals and/or pre-trade analysis from the ERS's transition manager (TM) pool and/or other relevant entities.
- (4) Investment Staff evaluates bid proposals and pre-trade analyses and the CIO recommends to the Executive Director for selection.
- (5) Administration/Accounting staff inform the following parties.
 - a. TM(s) or other Manager(s): selected Manager(s) is/are notified in appointment letter; other managers are also informed of not being selected.

- b. Legacy Manager(s): informed of transition, including where applicable transition amount (dollars), date to cease trading, date of termination, and selected manager(s) (may be in the form of a termination letter).
 - c. Target Manager(s): informed of transition, including where applicable transition amount (dollars), date of transition, date when fiduciary responsibilities begin.
 - d. Custodian: through letter of direction, is informed of transition, including where applicable the name of the manager(s) and contact, the name of the legacy manager and contact, the name of the target manager and contact; account numbers also indicated.
- (6) Investment Staff maintains coordination and communication throughout the transition process with other ERS staff and outside parties.
- (7) Investment Staff evaluates performance of manager(s) during the trade and post-trade by means of various reports.
- (8) CIO reports transition highlights to the Executive Director and the Trustees when appropriate.

C. 11. Securities Litigation Guidelines

Securities litigation has become increasingly prevalent among public pension plans. The ERS is cognizant that securities litigation can be a distraction to the Trustees and ERS staff and a tax on the ERS's limited resources. In addition, because of the diversity of the ERS's investment portfolio, and the ERS's investment policy guidelines, it is likely that other institutional investors will have a larger financial interest in the relief sought in securities class action lawsuits and would therefore be more appropriate lead or co-lead plaintiffs than the ERS. As such, the ERS generally does not seek or accept lead or co-lead plaintiff status in securities class action lawsuits, but works diligently with the Plan's custodian to ensure that the ERS collects all that it is entitled to as the result of any settlements or judgments in such lawsuits.

The ERS utilizes the services of its custodian to monitor securities class action lawsuits with respect to investments held by the ERS and to manage the timely filing of proofs of claim in such lawsuits. In this regard, ERS has adopted the following process:

1. The custodian will have a team that is dedicated to monitoring class action lawsuits.
2. The team creates and manages a database of all class action lawsuits which is accessed by service teams.
3. The ERS service team downloads class action notices and uses a tracking system based on CUSIP. The custodian access to this information because it handles custody for all the assets of ERS.
4. If it is determined that the ERS held a security during the defined class period – according to the class action notice – the custodian will file a claim on behalf of the ERS as a member of the class. (Standing Instructions)
5. The custodian will not file for ERS to become lead plaintiff unless specifically instructed to do so.
6. The custodian will obtain a claim number and track the class action right up through settlement.
7. In the event that a claim is rejected by the claims administrator, the custodian shall promptly notify the appropriate investment manager(s), and together they will identify the best course of action to remedy the reasons for rejection if possible.
8. The custodian will prepare and provide ERS with an Excel spreadsheet report listing class action filings and settlements that ERS is involved in.

The ERS does recognize that there are situations when it could benefit from active participation in a securities class action lawsuit. The State Attorney General is therefore authorized to retain up to two law firms to identify, monitor and review securities litigation in which the ERS may be a class member and to make recommendations as to whether active participation in such litigation should be considered by the ERS. The law firm or firms retained for this purpose ("monitoring counsel") shall perform their services free of charge. ERS shall participate in the selection of monitoring counsel.

ERS will provide monitoring counsel with direct access to the ERS's custodian electronic transaction database. Recommendations by monitoring counsel shall be evaluated by the State Attorney General, who shall be the primary contact with monitoring counsel.

Monitoring counsel shall report to the State Attorney General all claims or potential claims and shall provide their recommendation as to the appropriate action by the ERS with respect to any claims or potential claims of \$2,000,000 or more. When evaluating a recommendation from monitoring counsel that the ERS become actively involved in securities litigation, the Attorney General may consider the following factors:

1. The size of the claim and the likely degree of recovery versus the time and costs involved in pursuing the matter actively.
2. Staffing constraints that might make it difficult to effectively pursue the case actively (i.e., as a lead plaintiff or through an independent lawsuit).
3. Legal analysis of the merits of the case and the availability of assets from which to collect a significant recovery.
4. Any unique issues or defenses to which the ERS might be subject in the particular case.
5. The effectiveness and availability of potential witnesses.
6. Any information regarding the claim from the applicable Investment Managers including their ability to respond to requested discovery.
7. The effectiveness of potential alternatives for recovering the value of the claim, such as corporate governance actions or less costly methods of monitoring the litigation.
8. Whether the active involvement of ERS could add value to the potential resolution or management of the case.
9. Whether any other institutional investors are in the class, and whether they are likely to become actively involved.

If the State Attorney General concurs with monitoring counsel's recommendation that the ERS become actively involved in litigation to pursue recovery of a claim or potential claim, the Attorney General will present the Attorney General's recommendation of a proposed course of action to the Board of Trustees for approval.

The ERS shall participate in the selection of counsel to represent the ERS in any litigation instituted to pursue recovery of a claim or potential claim.

C. 12. Socially Responsible Investing

The practice of Socially Responsible Investing (SRI) requires that investment decisions be formulated upon considerations of societal values and concerns as well as financial returns, allowing for a balance between the investor's financial aims and needs and the investment's impact on society by the actions of the corporation or entity in which the investment is made.

Falling within the realms of the SRI is the consideration of environmental, social, and corporate governance (ESG²) factors, where ESG describes the three main areas of concern that have developed as the central factors in measuring the sustainability and ethical impact of an investment in a company or business. Within these three areas are a broad set of concerns that are increasingly being included in the nonfinancial factors that figure in the valuation of equity, real-estate, corporations, infrastructure, and fixed-income investments. ESG factors can include a spectrum of indicators pertaining to a company's impact on various stakeholders. Examples include: but are not limited to; a company's carbon footprint, human rights policies as they pertain to business relationships with dictatorial regimes, union relationships, employee gender and ethnic diversity, product safety record, child labor policies, and products that mitigate or prevent environmental damage.

Features involved in an SRI strategy include:

- (1) Avoiding companies whose records conflict with ERS investment values;
- (2) Seeking out companies whose record is consistent with ERS values;
- (3) Targeting investments directly into communities;
- (4) Taking an active role as a shareholder in influencing corporate policies; and
- (5) Evaluate environmental, social, and governance (ESG) issues.

Socially conscious investors will often include in their investment portfolios corporations with positive records on product quality, consumer relations, environmental performance, corporate citizenship, and employee relations, while screening out corporations involved in industries such as alcohol, tobacco, gambling, military weapons, and nuclear power within their investment reports. Additionally, these investors also consider ESG issues in their analysis because these factors can have an impact on investment performance.

Upon the encouragement by the House of Representatives of the Twenty-sixth Legislature of the State of Hawai'i, Regular Session of 2012, the ERS will continue to apply the principles of SRI in investment practices and decisions, and encourage other investment counselors and money managers to apply SRI to their investment portfolios.

The following sections review the ERS's policies that pertain to SRI:

- A. Proxy Voting Guidelines
- B. The Global Sullivan Principle
- C. Anti-Terrorism Policies
- D. Sudan Policies
- E. HiTIP Policies and Procedures (Created by the ERS to fulfill the mandate of Act 260, "A Bill For An Act Relating To The Innovation Economy.")

² Please note, the acronym ESG is an increasingly popular term used as a "catch-all" for responsible investing as it reflects the growing importance of environmental concerns to many investors.

A. Proxy Voting Guidelines

ERS has a fiduciary responsibility to act solely in the best interest of its members and beneficiaries. Therefore, investment managers voting proxies on behalf of the Board will do so with the primary objective of maintaining and advancing the economic value and interests of ERS members. ERS also requests investment managers, as part of their investment discretion and fiduciary responsibility, to take into consideration the importance of the Corporate Governance Policies promulgated by the Council of Institutional Investors, adherence to CFA Institute Proxy Voting Guidelines and the Global Sullivan Principles. For accounts not managed by ERS's external investment managers, or managed internally, the Executive Director or a designated authority of Investment Staff shall have the responsibility for voting proxies and/or executing other corporate actions in accordance with these guidelines.

Additionally, ERS requires investment managers to adhere to CFA Institute proxy voting standards. Investment Staff, with the assistance of the applicable investment consultants, shall poll managers annually as to their proxy voting policies and whether they comply with the CFA Institute standards, specifically the basic element of a proxy voting policy listed below. The spirit and substance of these standards amended for the ERS's use are reprinted in their entirety from the CFA Institute Standards of Practice Handbook Below. A letter affirming compliance with the proxy voting guidelines will be requested from each manager on an annual basis. ERS will engage the services of a third party provider to review the votes cast on behalf of ERS and provide a comprehensive report.

**Corporate Governance Policies
Council of Institutional Investors
(reprinted from www.cii.org)**

The Council expects that corporations will comply with all applicable federal and state laws and regulations and stock exchange listing standards.

The Council believes every company should also have written disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement. The Council posts its corporate governance policies on its web site (www.cii.org); it hopes corporate boards will meet or exceed these standards and adopt similarly appropriate additional policies to best protect shareholders' interests.

In general, the Council believes that corporate governance structures and practices should protect and enhance accountability to, and ensure equal financial treatment of, shareholders. An action should not be taken if its purpose is to reduce accountability to shareholders.

The Council also believes shareholders should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation.

The Council believes companies should adhere to responsible business practices and practice good corporate citizenship. Promotion, adoption and effective implementation of guidelines for the responsible conduct of business and business relationships are consistent with the fiduciary responsibility of protecting long-term investment interests.

The Council believes good governance practices should be followed by publicly traded companies, private companies and companies in the process of going public. As such, the Council believes that, consistent with their fiduciary obligations to their limited partners, the general members of venture capital, buyout and other private equity funds should use appropriate efforts to encourage companies in which they invest to adopt long-term corporate governance provisions that are consistent with the Council's policies.

The Council believes that U.S. companies should not reincorporate offshore because corporate governance structures there are weaker and therefore reduce management accountability to shareholders.

Council policies neither bind members nor corporations. They are designed to provide guidelines that the Council has found to be appropriate in most situations.

CFA Institute Proxy Voting Standards

To meet their fiduciary duty with regard to corporate governance, investment managers must follow adequate procedures concerning the voting of proxies. Since ERS managers are given the responsibility to vote proxies, they must adopt procedures to ensure that issues are noted, analyzed, and considered before voting. Investment managers must be thoroughly familiar with the issues that arise in proxies. Proxies have economic value and must be voted in the interest of the ultimate shareholder or plan beneficiary. Investment managers cannot simply vote without adequate examination of the underlying issues. These guidelines list the issues that arise in proxy voting and recommend ways of approaching and analyzing a number of these issues. Although each manager must establish policies and procedures appropriate to its own circumstances, the methods and approaches outlined should be followed in establishing a formal, written proxy policy. The skills and experience of the professional investment community, particularly the research and analytic skills, can be used effectively in corporate governance issues, which will ultimately benefit corporations and shareholders alike and enhance the competitiveness of business in global markets. Good corporate governance and good investment decisions go hand in hand.

I. Basic Elements of a Proxy Voting Policy

(1) Creation of a Proxy Policy

- a. Designate a policy-making body (the board, managing directors, or a committee) or an individual to recommend proxy policy and to monitor implementation. The same body or individual should:
 1. Develop initial, specific guidelines and institute a regular review process, including review of new or controversial proxy issues.
 2. Verify that any decision about how to vote is in accord with the investment interests, stated objectives, and particular preferences, if stated or known, of the ERS, its participants and beneficiaries.
 3. Discuss the issues involved with those who do the voting and decide whether additional action is necessary (i.e., to initiate and/or cosign shareholder proposals).

4. Provide a review mechanism for any unusual proposals, such as an opposition slate of directors, corporate restructuring related to hostile takeovers, or any proposals that appear not to be in the best interests of shareholders.
 5. Consider applying to proxy decisions internal financial ratios or other criteria for evaluating corporate performance. Such applications, for instance, might show such outstanding economic performance over a business cycle that investor confidence in a board and management would outweigh a proposal to classify the board.
 6. Provide a process for deciding whether a vote against management should be preceded or followed by a letter, telephone call, in-person discussion with corporate personnel, and/or action to be taken with other concerned firms and organizations.
 7. Decide under what conditions those who hold a concentration of stock in their own names or have other vested interest in the corporations in which stock is held should be excluded from participating in the voting.
 8. Decide how and when to report to the ERS on the positions taken during the proxy season, notify ERS Staff accordingly and provide a comprehensive report.
- (2) Identify major proxy issues for the ERS. Note should be taken of preferences stated by the Board and Investment Staff. A manager of a pooled account that maintains ERISA assets may be subject to conflicting proxy voting guidelines from the plans contained in the account. In that instance, the manager must reconcile, to the extent possible, the proxy voting policies of the various plans. To the extent that reconciliation is not possible, the manager should consider voting the securities in proportion to the plan's respective interests in the pooled account. The major proxy-related issues generally fall within five categories: corporate governance, takeover defenses, compensation plans, capital structure, and social responsibility. These categories may include the following:
- a. Corporate governance.
 - Confidentiality of voting.
 - Annual election of directors.
 - Composition of board.
 - Equal access to proxy statements.
 - Indemnification of management or directors or both against negligent, imprudent, or unreasonable action.
 - Removal of directors from office only for cause or by a supermajority vote.
 - Cumulative voting.
 - "Sweeteners" to attract support for proposals.
 - Unequal voting rights proposals (superstock).
 - Supermajority proposals.
 - Limitation of shareholder rights to remove directors, amend bylaws, fill board vacancies, call special meetings, nominate directors, and

act by written consent—or other actions to limit or abolish shareholder rights to act independently.

- Proposals to permit management discretion to issue “blank check” stock without prior shareholder approval.
- Proposals to vote unmarked proxies in favor of management
- Pre-emptive rights.

b. Takeover defense and related actions.

- Proposals involving tender offers and mergers.
- Fair price provisions.
- Some increases in authorized shares and/or creation of new classes of common or preferred stock.
- Proposals to introduce or eliminate greenmail provisions.
- Proposals to reevaluate in-place “shark repellents.”
- Shareholder rights plans (poison pills).

c. Compensation plans.

- Stock option plans and/or stock-appreciation plans.
- Profit incentive plans and employee stock purchase plans.
- Extension of stock option grants to outside directors.
- Stock option plans and other stock bonus plans, including plans permitting issuance of loans to management or selected employees with authority to sell stock purchased by the loan without immediate repayment, or plans that are overly generous (below market price or with appreciation rights paying the difference between option price and the stock, or allowing the directors to lower the purchase price of outstanding options).
- Incentive plans that become effective in the event of hostile takeovers or mergers (golden and tin parachutes).
- Proposals that create an unusually favorable compensation structure in advance of sale of the company.
- Proposals that fail to link executive compensation to management performance (including golden handcuffs).

d. Capital structure, classes of stock, and recapitalizations.

- Dual class recapitalizations.
- Proposals to reincorporate or reorganize into a holding company.
- Proposals designed to discourage mergers and acquisitions in advance.
- Proposals to change state of incorporation to a state less favorable to shareholder interests.

e. Social responsibility.

- Human rights.
- Environment, such as endorsing the CERES principles.
- Nuclear weapons and energy-generating facilities.
- McBride Principles (Northern Ireland).
- Equal employment and diversity.

- Community-related economic growth.
 - Anti-addiction (such as alcohol or gambling).
- (3) A useful proxy policy format is to (1) state the pros and cons of issues and (2) evaluate specific proxy proposals against the history and productivity of current management as well as the conceptual reasons for or against the proposal.

II. Administration

- (1) Responsibility for proxy voting.
- a. For accounts under the authority of ERS's external investment managers: Investment managers have the sole responsibility for voting proxies in accordance with these guidelines.
 - b. For accounts not managed by ERS's external investment managers, or managed internally: Executive Director or a designated authority of Investment Staff shall have the responsibility for voting proxies and/or executing other corporate actions in accordance with these guidelines.
- (2) Develop a system to monitor any delegation of proxy voting responsibility to others.
- (3) Provide for recordkeeping.
- a. Maintain a record of stock held.
 - b. Reconcile proxies received with the stock held on the record date.
 - c. Develop a system to trace missing proxies expeditiously.
 - d. Keep a record of how proxies are voted and why:
 - Note any deviations from any stated policy relating to specific issues.
 - Note any contacts from plan sponsors or issuers with staff related to the proxy voting function and the actions taken.
 - Note any apparent conflicts of interest and how they are handled.
- (4) Provide for a process to monitor performance of a custodian, or its agent, to ensure timely receipt of proxies; the process should include delegation of responsibility to an individual staff member.
- (5) Avoid or minimize conflicts of interest. Parties vulnerable to conflicts of interest include corporate directors and managers who may also serve on the boards of public and private funds, plan sponsors, analysts and investment management staff who may invest in stock also held in management accounts, and others with direct interest in the outcome of voting (investment banking, credit or loan obligations, corporate finance). When possible, consider implementing "Fire Wall" techniques similar to those used to prevent the flow of material nonpublic information to portfolio managers and analysts.
- (6) Educate and train Investment Staff.
- a. Provide opportunities for Investment staff members to understand the firm's proxy voting policy. Each person related to voting proxies should

have a copy of the policy and/or guidelines and an opportunity to discuss them with supervisory staff.

- b. Designate specific Investment Staff members to receive all proxies, reconcile receipt with holdings list, distribute proxies to those who do the actual voting, and trace missing proxies in a timely fashion. Make certain all staff members know who does what.
- c. Train Investment Staff to separate non-routine proxies—that is, those involving shareholder rights and the economics of a corporation—from those that are routine, as the firm guidelines define the categories.
- d. Train Investment Staff to vote non-controversial proxies under supervision of a compliance officer, committee, or other designated persons.
- e. Provide periodic review sessions at least annually to
 - acquaint Investment Staff handling or voting proxies with the overall policy,
 - reevaluate any previous decisions that deviate from guidelines,
 - discuss current proxy issues, and
 - recommend action on any current “hot issues” or unusual proposals.

B. The Global Sullivan Principles

(1) Preamble

The objectives of the Global Sullivan Principles are to support economic, social and political justice by companies where they do business; to support human rights and to encourage equal opportunity at all levels of employment, including racial and gender diversity on decision making committees and boards; to train and advance disadvantaged workers for technical, supervisory and management opportunities; and to assist with greater tolerance and understanding among peoples; thereby, helping to improve the quality of life for communities, workers and children with dignity and equality. I urge companies large and small in every part of the world to support and follow the Global Sullivan Principles of corporate social responsibility wherever they have operations.

Feb. 1, 1999
The Rev. Leon H. Sullivan

(2) Principles

As a company which endorses the Global Sullivan Principles we will respect the law, and as a responsible member of society we will apply these Principles with integrity consistent with the legitimate role of business. We will develop and implement company policies, procedures, training and internal reporting structures to ensure commitment to these principles throughout our organization. We believe the application of these Principles will achieve greater tolerance and better understanding among peoples, and advance the culture of peace.

Accordingly, we will:

- (1) Express our support for universal human rights and, particularly, those of our employees, the communities within which we operate, and parties with whom we do business.
- (2) Promote equal opportunity for our employees at all levels of the company with respect to issues such as color, race, gender, age, ethnicity or religious beliefs, and operate without unacceptable worker treatment such as the exploitation of children, physical punishment, female abuse, involuntary servitude, or other forms of abuse.
- (3) Respect our employees' voluntary freedom of association.
- (4) Compensate our employees to enable them to meet at least their basic needs and provide the opportunity to improve their skill and capability in order to raise their social and economic opportunities.
- (5) Provide a safe and healthy workplace; protect human health and the environment; and promote sustainable development.
- (6) Promote fair competition including respect for intellectual and other property rights, and not offer, pay or accept bribes.
- (7) Work with governments and communities in which we do business to improve the quality of life in those communities – their educational, cultural, economic and social well-being – and seek to provide training and opportunities for workers from disadvantaged backgrounds.
- (8) Promote the application of these principles by those with whom we do business.

We will be transparent in our implementation of these principles and provide information which demonstrates publicly our commitment to them.

5/26/99

Source of Global Sullivan Principles: [mallenbaker.net](http://www.mallenbaker.net),
<http://www.mallenbaker.net/csr/CSRfiles/gsprinciples.html>, 11/05/03

ERS has a fiduciary responsibility to act solely in the interest of its members and beneficiaries. Therefore investment managers voting proxies for the board will do so with the primary goal of maintaining or increasing the economic interests of ERS.

C. Anti Terrorism Policy

(1) Introduction

Since 9/11, attention has been focused on the potential security threats certain countries and specific companies pose to the United States of America. The ERS Board of Trustees recognize the heightened awareness of security risks and the fact that public pension funds have come under increased pressure from the general public to divest from companies that do business in countries that support terrorism. On the surface this issue may appear simple and straightforward, but in reality it is very complex and requires information that is not currently available to public pension funds. A policy as simple as requiring divestiture

from all companies that do business in certain countries may actually work to the detriment of US foreign policy objectives and needlessly damage US companies and jobs. The Board maintains its fiduciary obligations to the members of the System as its top priority. This requires the Board to act prudently and in the exclusive interest of participants in the management of System assets. In an effort to balance their fiduciary obligations with their moral and ethical responsibility as citizens of the United States of America, the Board of Trustees is hereby establishing this Anti-Terrorism Investment Policy.

(2) Background on US Foreign Policy Related to Countries Supporting Terrorism

In the area of foreign policy, regulations and sanctions are complex and continually changing to address the needs of US national security. The US State Department maintains an official list of countries that the US deems to be supporting international terrorism. The countries included on this list and the regulations and sanctions that apply in these countries change frequently. Unfortunately, a list of companies that are deemed to be supporting terrorism is not publicly available at this time. The fact that a company may have a business link to a listed country does not mean that the US government believes the company is supporting terrorism. In many cases, the US government allows business relationships because they believe they further US policy goals via the contracts and leverage that trade and other business connections create. Placing investment restrictions that would discourage business relationships in these countries could actually run counter to US anti-terrorism initiatives in some instances. As a result of the complexities and lack of public information in this area, ERS must rely upon federal agencies such as the Securities and Exchange Commission and the State, Commerce, Justice and Treasury Departments to provide factual information regarding companies that are supporting terrorism. To date, this information has not been available to ERS or any other public pension fund. Quite simply, factual information that ERS would need to prudently divest from these companies is not available.

(3) ERS's Actions Related to an Anti-Terrorism Policy

Given the importance of this issue, on an annual basis, the Chief Investment Officer will contact the Department of Homeland Security, the State Department, the Commerce Department, the Justice Department, the Treasury Department, the Securities and Exchange Commission, and any other federal agency deemed to have useful information in accurately identifying companies that are supporting terrorism. Specifically, the CIO will request guidance from these agencies on countries and more specifically companies that are believed to be supporting terrorism. Once the information is received, Investment Staff will compare the list of companies with current holdings. In the event that ERS is a holder of one of these companies, the CIO will immediately contact the manager of the specific investment account to bring the situation to their attention and discuss appropriate actions for divesting from the company. In addition, the CIO will forward all information received from any of these federal government agencies to our investment managers so they can avoid making initial investments or divest of existing investments in companies that are identified as supporting terrorist activities. Finally, the CIO will provide a report to the Board on an annual basis that identifies any investment actions taken due to links to terrorist activities.

This policy is intended to avoid 1) discriminating against companies whose activities abroad are supported by the US government; 2) discriminating against companies whose activities abroad do not further terrorism; 3) unnecessarily harming US companies and jobs; and 4) compromising the Board's fiduciary duties to the beneficiaries of the System. Recognizing the dynamic nature of the issue, annually Investment Staff will evaluate this policy to determine if changes need to be made to reflect recent developments in this area. In the event that Investment Staff believes changes to this policy are warranted, they will bring the issue to the attention of the Board of Trustees for consideration.

D. Sudan Investment Policy

Act 192, Session Laws of Hawai'i 2007, expresses the State's desire to not participate in ownership of companies that provide "significant practical support" for genocide activities as currently being conducted by the Sudanese government in the Darfur region. The ERS Board of Trustees wishes to recognize its agreement with the intent of Act 192 and to abide by its requirements. The Board, however, also applies a decision framework of acting for the exclusive benefit of ERS Plan participants. In this respect, the Board recognizes that divestment activities could potentially increase the portfolio's idiosyncratic investment risk. Therefore, divestment guidelines and procedures should seek to minimize the impact of a specific divestment policy (such as Sudan divestment) upon the investment results of the portfolio.

The Board has determined to use the following procedures to comply with Act 192 by requiring the CIO, or another designated member of Investment Staff, to:

- (1) Assemble a list of all direct holdings in "scrutinized companies"³;
- (2) Review publicly available information regarding companies with business operations in the Sudan provided by nonprofit organizations (e.g., the Sudan Divestment Taskforce) and other appropriate parties;
- (3) Send written notice informing companies of their scrutinized company status and the possibility that they may become subject to divestment;
- (4) Monitor other institutional investors that have divested from or engaged with companies that have business operations in Sudan;
- (5) Consider divestment or other corrective actions to the extent reasonable with due consideration for among other things, return on investment, diversification, and the System's other legal obligations;
- (6) Inform the ERS's equity investment managers of Board decisions as related to the above processes; and
- (7) Review and update progress of scrutinized companies on a quarterly basis.

This policy is intended to avoid: 1) discriminating against companies whose Sudan-related business activities are supported by the U.S. government; 2) discriminating against companies whose Sudan-related business activities do not support genocide

³ Reference Act 192, Section 2. Definitions of "Scrutinized Company."

activities; 3) unnecessarily harming U.S. companies and jobs; and 4) compromising the Board's duties to the beneficiaries of the ERS.

E. Hawaiian Targeted Investment Program (Hi-TIP)

HiTIP was initiated to fulfill the mandate of Act 260, "A Bill For An Act Relating To The Innovation Economy" passed by the Legislature and signed by the Governor in July 2007. The stated purpose of Act 260 is "to encourage the employees' retirement system to invest in Hawai'i venture capital..."

The SRI legislation pertains to HiTIP in that HiTIP targets investments that are directly a part of the Hawaiian community.

A full account of the Hawaiian Targeted Investment Program can be found in Section H Hawai'i Targeted Investment Program Policies and Procedures.

C.13. Policy for the Use of Placement Agents

The ERS shall require the specific and timely disclosure of payments and compensation to Placement Agents⁴ in connection with the ERS's investments. This Placement Agent Policy is intended to apply broadly to all investment contracts made by the ERS. The goal of this Placement Agent Policy is to help ensure that the ERS investment decisions are made by the Board solely on the merits of the investment opportunity in accordance with the Board of Trustees' fiduciary responsibility and to avoid the appearance of undue influence on the Board or illegal pay-to-play practices in the award of investment related contracts.

A. Investment Manager Placement Agent Disclosures

Each investment manager shall provide to the ERS the required information listed below within 45 days of the initiation of investment discussions between the investment manager and the ERS but in any event prior to the completion of due diligence. The investment manager must notify the Investment Staff of any changes to any of the information required within 14 calendar days of the investment manager knowing of the change(s).

(1) Required Disclosure of Payments Made to Placement Agents

- a. A written statement of whether the investment manager or any of its principals, employees, agents or affiliates has compensated or agreed to compensate any person or entity to act as a Placement Agent in connection with the ERS's investments.
- b. The name of the Placement Agent, and resumes of every officer, partner and principal of the Placement Agent. The resumes shall include educational history, professional designations, regulatory licenses and investment and work experience.
- c. Description of any and all compensation paid or agreed to be paid to the Placement Agent, including payment to employees of the investment manager who are retained in order to solicit, or who are paid based in whole or in part upon, an investment from the ERS.
- d. Description of the services rendered or the services expected to be performed by the Placement Agent and a list of the prospective clients for which such Placement Agent is utilized.
- e. Copies of all agreements between the investment manager and the Placement Agent.
- f. Name of the regulatory agencies the Placement Agent or any of its affiliates are registered with, such as The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Association (FINRA), or any similar regulatory agency; proof and details of such registration shall be included, or an explanation as to why no registration

⁴ "Placement Agent" includes any person or entity hired, engaged, retained by, acting on behalf of or serving for the benefit of an investment manager or on behalf of another Placement Agent as a third-party marketer, finder, solicitor, marketer, consultant, broker, or other intermediary to market, solicit, obtain access to the ERS, and/or raise money or investments either directly or indirectly from the ERS. Notwithstanding the foregoing, an individual who is an employee, officer, director, equity holder, partner, member or trustee of an investment manager and who spends one-third or more of his or her time, during a calendar year, managing the securities or assets owned, controlled, invested or held by the investment manager is not a Placement Agent.

is required.

(2) Required Disclosure of Relationships to the Board and; Campaign Contributions

- a. Full disclosure of any connection between the Placement Agent or the investment manager and the ERS, including whether anyone receiving compensation or who will receive compensation with respect to an investment from the ERS from the Placement Agent or the fund manager is: a current or former ERS Board Member, ERS employee, or ERS consultant; a member of the immediate family of anyone connected to or formerly connected to the ERS; a current or former elected or appointed official of the State and/or cities and counties of the State, a current or former employee of the State and/or cities and counties of the State; or anyone seeking to be elected to public office of the State and/or cities and counties of the State or a member of his/her campaign organization or a political action committee.
- b. Full disclosure of the donations made by the Placement Agent or the investment manager during the prior 24-month period to any organization (including contributions to political campaign funds and donations to non-profits) in which any person listed in Paragraph 2.a is an officer, employee, or member of the Board or Advisory Board (or similar body). Additionally, any subsequent donations made by the Placement Agent or the investment manager to any such organization during the time the Placement Agent or the investment manager is receiving compensation in connection with a the ERS investment shall also be disclosed.
- c. Full disclosure of the names of any current or former members of the Board, ERS employees or investment consultants who suggested the retention of the Placement Agent to the investment manager.

B. Responsibilities of Staff and Consultants

At the time that investment discussions between an investment manager and the ERS for a prospective investment commence, Investment Staff is responsible for providing investment managers and Placement Agents with a copy of this Placement Agent Policy.

Investment Staff and investment consultants must confirm that the applicable Placement Agent disclosures have been received prior to the completion of due diligence and completion of any recommendation to proceed with the decision to invest with the investment manager. For new contracts and amendments to existing contracts, the ERS will:

- Stop investment negotiations with an investment manager who refuses to disclose the required information;
- Decline the opportunity to retain or invest with an investment manager who has used or intends to use a Placement Agent who is not registered with the SEC, FINRA, or any similar regulatory agency and cannot provide an explanation as to why no registration is required; and

Investment Staff and investment consultants will assist legal counsel as necessary to secure in the final contract terms and side letter agreements between the ERS and the investment manager, including but not limited to, the following:

- The investment manager's agreement that it has complied with and will continue to comply with this Placement Agent Policy.
- The investment manager's representation and warranty that it will notify the Investment Staff of any changes to any of the information required above within 14 calendar days of when the investment manager knows or should have known of the change(s).

At any meeting where an investment decision with an investment manager will be considered, Investment Staff and the applicable investment consultants must notify the Board of the name(s) of any Placement Agent(s) used by the investment manager in connection with the proposed investment, and any campaign contributions or gifts reported by each Placement Agent.

Staff must maintain records of all information disclosed to the ERS in accordance with this policy, and provide the Board with notice of any violation of this policy as soon as practicable.

C. Responsibilities of Counsel

Legal counsel to the ERS must secure in the final contract terms and side letter agreements between the ERS and the investment manager all requisite agreements and representations and warranties by the investment manager for compliance in accordance with this Placement Agent Policy.

D. Responsibilities of the Board

The Board must review all violations of this Placement Agent Policy reported by Investment Staff, consider whether each violation is material, and consider whether to prohibit that investment manager and/or Placement Agent from soliciting new investments from the ERS for a certain period (the length of such period to be at the Board's sole discretion) from the date of the determination.



BROAD GROWTH PROGRAM

SECTION: D

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D.1. Overview

A. General Description

The Broad Growth class consists of investment strategies and assets that are largely exposed and/or susceptible to changes in global economic growth and corporate profitability. Such investments typically contain relatively high degrees of risk and exhibit more volatility than other strategic classes. The Broad Growth class consists of three major components: Growth-oriented, Stabilized Growth, and Private Growth. The Growth-oriented component consists largely of global public equity and other similar-risk investments. The Stabilized Growth component consists of a spectrum of growth-exposed investment strategies that exhibit expected returns close to Growth-oriented investments, but exhibit materially lower levels of volatility. The Private Growth component consists of growth-oriented higher-risk investments that rely on the private markets rather than the public markets to raise investment capital.

B. Purpose

The Broad Growth class provides the bulk of the total portfolio's investment return due its exposure to the equity risk premium. The equity risk premium, while volatile, is the reward associated with bearing economic and corporate risk – it is the highest risk premium available to investors. In addition, over long investment horizons (i.e., greater than 10 years), the equity risk premium is generally significantly positive after accounting for inflation. Due to this feature, the Broad Growth class is expected to increase the purchasing power of the total portfolio's assets over time.

By diversifying into the three major Broad Growth components (Growth-oriented, Stabilized Growth, and Private Growth), the Broad Growth class seeks to moderate its risk profile versus investing solely in any one component. This approach seeks to capture the entirety of the equity risk premium as well as capture premiums associated with other risk factors that are closely related to the equity risk premium.

C. Risk Factor Exposures

Major

- *Growth Risk*

Minor

- *Interest Rate Risk*
- *Liquidity Risk*

D.2. Class Structure

A. Components

The Broad Growth class consists of three major components: Growth-oriented, Stabilized Growth, and Private Growth.

Growth-oriented

Component currently includes the entire publicly-traded (i.e., liquid) global equity market opportunity set.

Other similar-risk public-market investment strategies considered for Growth-oriented include:

- Equity-biased long/short
- Liquid opportunistic credit

Stabilized Growth

Component includes a spectrum of liquid investment strategies that are primarily exposed to economic risk (similar to investments within the Growth-oriented component) with risk profiles that exhibit 25%-50% less volatility than strategies within the Growth-oriented component. Strategies currently included in this component are:

- Covered call writing
- Public market credit strategies (investment-grade debt, high yield debt)

Other similar-risk public-market investment strategies considered for Stabilized Growth include:

- Long/short
- Defensive/low-volatility/low-beta public equity
- Collateralized put-writing
- Dynamic options-based strategies
- Private market credit strategies

Private Growth

Component includes a spectrum of private equity investment strategies that are primarily exposed to economic growth risk and can exhibit high levels of measured investment risk. Private equity strategies currently included in this component are:

- Buyout equity
- Growth capital
- Venture capital
- Distressed debt
- Mezzanine debt
- Special situations

Other similar-risk public-market investment strategies considered for Private Growth include:

- Opportunistic/Return-driven Real Estate
- Value-added/highly-levered Real Estate

More detailed information regarding the Private Growth component can be found in the Appendix of this section.

B. Modifications to Component Structure

Modifications to the Broad Growth class's component structure can take four forms:

- i. Adding or deleting a specific investment strategy within a specific component;
- ii. Adding or deleting a specific component;
- iii. Establishing allocation levels and ranges among the components;
- iv. Establishing strategy allocation levels and ranges within the components.

Modifications to the Broad Growth's component structure will occur only with approval of the Board of Trustees.

C. Components' Allocations and Allocation Ranges

The Broad Growth class's allocation targets and allocation ranges among its three major components is as follows (as a percent of total Broad Growth class assets):

Long-term Broad Growth Class Component Allocation Policy

<u>Component</u>	<u>Lower Limit</u>	<u>Allocation Target</u>	<u>Upper Limit</u>
Growth-oriented	50%	73%	85%
Stabilized Growth	5%	17%	40%
Private Growth		10%*	

* Due to the illiquid nature of the *Private Growth* component, its allocation will be based on pre-established policy allocation ranges, and likely not fluctuate dramatically

Interim Broad Growth Class Component Allocation Policies

	<u>Target Structure</u> <u>1/1/2015</u>	<u>Target Structure</u> <u>1/1/2016</u>	<u>Target Structure</u> <u>1/1/2017</u>	<u>Target Structure</u> <u>1/1/2018</u>
Growth-oriented	78%	77%	75%	73%
Stabilized Growth	17%	17%	17%	17%
Private Growth	5%	6%	8%	10%
Total	100%	100%	100%	100%

D. Management of Components

To manage the assets assigned to the Broad Growth class components, the Board of Trustees (“Board of Trustees” or “Board”) of the Employees’ Retirement System of the State of Hawaii (“ERS”) utilizes a combination of active and passive external managers. Per policy, the Board delegates the manager selection process to the ERS’s general investment consultant (“General Investment Consultant”) and the ERS’s investment staff (“Investment Staff”), but retains final decision authority for selecting managers for a specific investment mandate. Investment Staff is also expected to manage the components’ allocations to align with their respective allocation targets over time. From time-to-time, based on market dynamics and trends, Investment Staff has the discretion to vary each respective component’s allocation away from the allocation target, but always within the upper and lower limits as shown in the table under Section C. above. Investment Staff is responsible for reporting to the Board component allocation levels that vary materially from their allocation targets.

Within each component, assets are allocated across a series of mandates and/or investment styles. In combination, these mandates and styles capture a broad, representative sampling of the available investment opportunity set within the specified component. The mandate/style allocations within each component are as follows:

Growth-oriented Component Allocation Policy

Public Equity – 100%			
Domestic – 54%		International – 46%	
Within Domestic Equity		Within International Equity	
Large Company	85%	Developed Markets**	70%
Core	30%	Passive	23%
Passive*	24%	Active	47%
Active	6%	Emerging Markets**	30%
Value	28%	Passive	7%
Passive*	7%	Active	23%
Active	21%		
Growth	27%		
Passive*	13%		
Active	14%		
Small Company	15%*		
Passive	0%		
Active	15%		
Total Passive	45%	Total Passive	30%
Total Active	55%	Total Active	70%

*Per structural reviews | small cap set to account for current actual weight

**Based on 12/31/13 market index weights

Stabilized Growth Component Allocation Policy

Covered Calls – 40%		Extended Global Credit – 60%	
Within Covered Calls		Within Extended Global Credit	
Passive (replication)	50%	Passive	0%
Active	50%	Active	100%

*Private Growth Component Allocation Policy**

Private Markets – 100%	
Private Equity – 100%	
Within Private Equity	
Passive	0%
Active	100%

*See the Appendix of this section for further detail on the structure of the Private Growth component

E. Components' Managers and Managers' Allocations

To manage the assets allocated to each strategic class and its underlying components, the Board delegates investment authority to external investment managers (“investment managers”). The General Investment Consultant and Investment Staff have joint authority for identifying and selecting investment manager candidates for specific investment mandates. The Board has final authority over the selection of specific managers for each mandate. Investment Staff has the authority to manage the allocation to each investment manager. Under this authority, Staff may reduce funding to one or more specific manager(s) and/or increase funding to one or more specific manager(s) as long as the risk profile of the component or sub-component is maintained. The investment manager allocations within each component mandate are as follows:

Growth-oriented Component Manager Allocation Policy

Public Equity – 100%			
Domestic – 54%		International – 46%	
Within Large Company Core (30%)*	100%	Within Developed Markets (70%)*	100%
Passive – Mellon	80%	Passive – Mellon	33%
Active – CM Bidwell	10%	Active – Franklin	25%
Active – Bk. Of Hawaii	10%	Active – JP Morgan	25%
Within Large Company Value (28%)	100%	Active – Mercator	17%
Passive – Mellon	25%	Within Emerging Markets (30%)	100%
Active – CS McKee	38%	Passive – Mellon	24%
Active – Barrow Hanley	37%	Active – QMA	38%
Within Large Company Growth (27%)	100%	Active – Research Affiliates	38%
Passive – Mellon	50%		
Active – JP Morgan	25%		
Active – Sands	25%		
Within Small Company (15%)	100%		
Active – Jennison	50%		
Active – T Rowe Price	50%		
Total Passive	45%	Total Passive	30%
Total Active	55%	Total Active	70%

*%’s in brackets are % of Domestic Equity and International Equity, respectively

Stabilized Growth Component Manager Allocation Policy

Covered Calls – 40%		Extended Global Credit – 60%	
Passive (replication) - Gateway	50%	Active – Wamco	50%
Active - Gateway	50%	Active – Bradford & Marzec	30%
		Active – PIMCO	20%

Private Growth Component Manager Allocation Policy

Investment manager allocations are determined separately by the ERS's Private Equity Consultant. See the Appendix of this section for more detailed information.

D.3. Return Objectives & Risk Profile

A. Class Return Benchmarks

The ERS utilizes the custom target benchmark below to monitor the performance results of the Broad Growth Class:

Growth-oriented	78% MSCI ACWI IMI +
Stabilized Growth	6.8% CBOE BXM + 5.1% BC Global Credit (Hedged) + 3.4% BC Global High Yield (Hedged) + 1.7% S&P LSTA Leveraged Loan +
Private Growth	5% MSCI ACWI IMI+2%/year

The Broad Growth Class portfolio is expected to outperform the above blended benchmark, net of fees, over a full investment cycle. An appropriate measure of an investment cycle would be rolling 5-year periods. The Broad Growth Class portfolio should outperform its benchmark, net of fees, over the majority of rolling 5-year periods.

The Growth-oriented component portfolio is expected to outperform the MSCI ACWI IMI, net of fees, over the majority of rolling 5-year periods.

The Stabilized Growth component benchmark is a combination of four underlying benchmarks, three of which provide broad representation of the global credit markets. Normalizing these benchmark weights to 100%, the Stabilized Growth benchmark is:

40% CBOE BXM +
30% BC Global Credit (Hedged) +
20% BC Global High Yield (Hedged) +
10% S&P LSTA Leveraged Loan

The Stabilized Growth component portfolio is expected to outperform the above blended benchmark, net of fees, over the majority of rolling 5-year periods.

The Private Growth component portfolio is expected to outperform the MSCI ACWI IMI+2%/year benchmark, net of fees, over the majority of rolling 10-year periods. A longer measure of an investment cycle is used for the Private Growth component due the long-term funding nature of investments within the component.

B. Class Risk Profile

In aggregate, the Broad Growth Class is the ERS's most volatile investment class and is the class that is most sensitive to economic growth trends. Based on current capital market assumptions and the Broad Growth Class's long-term structure, there is a 10% probability this class will lose an estimated 19% of its capital within the next five years. Conversely, there is also a 10% statistical probability that the portfolio could double in five years. This degree of potential volatility is unique to the Broad Growth Class.

Each of the components exhibit varying degrees of volatility:

- The volatility of the Stabilized Growth component is expected to be approximately two-thirds the volatility of the Growth-oriented component.
- The volatility of the Private Growth component is expected to be approximately fifty percent greater than the volatility of the Growth-oriented component.

Based on this policy, Investment Staff can rebalance the components of the Broad Growth Class (specifically, the Growth-oriented and Stabilized Growth components) to manage the overall class's expected volatility. Increasing the allocation to Stabilized Growth to its 40% maximum cuts the expected 10% probability loss to an estimated 14% from 19% while only minimally reducing upside potential.

C. Component Risk Profiles

The ERS is expected to manage the Growth-oriented and Stabilized Growth component portfolios by taking active risk (tracking error) around the respective benchmarks discussed under Section D.3.A. above. Active risk within a specific component portfolio is the aggregation of several risks taken/accepted by Investment Staff and/or ERS's external investment managers as they implement the component portfolios. Types of active risk include: security selection risk, sector/style bias risk, manager weighting risk, and benchmark misfit risk. The allowable active risk ranges for the Growth-oriented and Stabilized Growth components are:

Tracking Error Ranges – Key Broad Growth Class Components

Component	Allowable Tracking Error
Growth-oriented	2.5% - 3.5%/year
Stabilized Growth	3.0%-4.0%/year

Private Growth does not have an active risk threshold/budget due to the difficulty of benchmarking private markets investments on a continuous basis. The two segments above consist almost entirely of investments traded in the public markets.

D.4. Manager Investment Guidelines

All investments and investment managers are subject to Section 88-119 (Investments), Hawai'i Revised Statutes ("HRS"), the Derivatives Policy and Watch Criteria in the Appendix of this section, and the following guidelines:

A. Growth-oriented Manager Guidelines

Domestic Equity – Active Large Cap Core

Manager(s):	CM Bidwell
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	Russell 1000 Index
Max. Tracking Error Objective:	6.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Manager(s):	Bank of Hawaii: CM Bidwell
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	S&P 500 Index
Max. Tracking Error Objective:	6.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Domestic Equity – Active Large Cap Value

Manager(s):	CS McKee
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	Russell 1000 Value Index
Max. Tracking Error Objective:	4.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 40%; systematic factors: maximum: 60%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Manager(s):	Barrow Hanley
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	Russell 1000 Value Index
Max. Tracking Error Objective:	4.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Domestic Equity – Active Large Cap Growth

Manager(s):	J.P. Morgan
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	Russell 1000 Growth Index
Max. Tracking Error Objective:	5.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 15% of the portfolio value - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Manager(s):	Sands Capital
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Manager was granted an exemption from participating in the ERS Commission Recapture Program	
Component:	Growth-oriented
Benchmark:	Russell 1000 Growth Index
Max. Tracking Error Objective:	8.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 15% of the portfolio value - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Domestic Equity – Active Small Cap

Manager(s):	Jennison
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	Russell 2000 Index
Max. Tracking Error Objective:	6.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 40%; systematic factors: maximum: 60%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Manager(s):	T. Rowe Price
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	Russell 2000 Index
Max. Tracking Error Objective:	4.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

International Equity – Active Developed Markets

Manager(s):	Franklin Templeton
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	MSCI World ex USA ND Index
Max. Tracking Error Objective:	7.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Manager(s):	J.P. Morgan
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	MSCI World ex USA ND Index
Max. Tracking Error Objective:	4.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 40%; systematic factors: maximum: 60%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

International Equity – Active Developed Markets

Manager(s):	Mercator
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	MSCI World ex USA ND Index
Max. Tracking Error Objective:	6.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 40%; systematic factors: maximum: 60%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

International Equity – Active Emerging Markets

Manager(s):	Quantitative Management Associates (QMA)
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	MSCI Emerging Markets Index
Max. Tracking Error Objective:	3.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 50%; systematic factors: maximum: 50%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Manager(s):	Research Affiliates
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmark:	MSCI Emerging Markets Index
Max. Tracking Error Objective:	3.0 % annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 15%; systematic factors: maximum: 85%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Passive Equity

Manager(s):	Mellon Capital
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Growth-oriented
Benchmarks:	Russell 1000 Value Index Russell 1000 Growth Index MSCI ACWI Index
Max. Tracking Error Objective:	0.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark - ETFs or Preferred Stock may not exceed 15% of the portfolio value - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

B. Stabilized Growth Manager Guidelines

Covered Calls - Replication

Manager(s):	Gateway Investment Advisers
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Stabilized Growth
Benchmark:	CBOE S&P 500 BuyWrite Index (BXM)
Max. Tracking Error Objective:	2.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 0%; systematic factors: maximum: 100%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark, excluding options - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark, excluding options - ETFs or Preferred Stock may not exceed 15% of the portfolio value, unless ETF's are used to provide broad market exposure - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Covered Calls - Active

Manager(s):	Gateway Investment Advisers
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Stabilized Growth
Benchmark:	CBOE S&P 500 BuyWrite Index (BXM)
Max. Tracking Error Objective:	5.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 0%; systematic factors: maximum: 100%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 5% - Individual securities shall not exceed 5% of the portfolio value where the security constitutes less than 3% of the benchmark, excluding options - Individual securities shall not exceed benchmark weight + 2% where the security constitutes more than 3% of the benchmark, excluding options - ETFs or Preferred Stock may not exceed 15% of the portfolio value, unless ETF's are used to provide broad market exposure - Rule 144a securities are allowable up to 10% as long as the securities purchased are issued by a company that has conventional shares already held in the portfolio

Extended Global Credit

Manager(s):	Western Asset Management Company (WAMCO) Pacific Investment Management Company (PIMCO) Bradford & Marzec
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Stabilized Growth
Benchmark:	50% BC Global Credit (Hedged) + 33.34% BC Global High Yield (Hedged) + 16.66% S&P LSTA Leveraged Loan
Max. Tracking Error Objective:	5.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 35%; systematic factors: maximum: 65%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Rating agencies: Moody's, Standard & Poor's, and Fitch - Securities rated by all three agencies are assigned the middle rating <ul style="list-style-type: none"> o For example, for a security to be rated A it must be rated at least A by two of the three agencies - Securities rated by only two agencies are assigned the most conservative rating - Securities rated by only one agency are assigned that rating - Stock (converted common and preferred) shall not exceed 10% of the portfolio value - Converted common stock shall not be held for longer than 180 days - Individual issuer shall not exceed 5% of the portfolio value at time of purchase <ul style="list-style-type: none"> o Excludes Government Supported securities. Specific mortgage pools and trusts are considered separate issuers, and each tranche within a CMO is considered a separate issue. <ul style="list-style-type: none"> ▪ Government Supported = Supranationals, U.S. Treasuries, sovereign debt of OECD governments, U.S. agencies and government sponsored enterprises, and equivalently-rated agencies of OECD governments. - Minimum issuance size is \$100 million - Quality: <ul style="list-style-type: none"> o Non-Investment Grade / Unrated = 0-75% - Non-Benchmark Markets (ex cash): <ul style="list-style-type: none"> o Non-Benchmark (excluding Government Supported) = 0-40% o Non-Benchmark Government Supported = 0-40% Benchmark markets are based on currency denomination and security type. - Foreign Currency: <ul style="list-style-type: none"> o Max. Net* = 40% o Max. Gross* = 80% - Note: Managers are required to segregate and summarize explicit currency exposures in the reporting process - <i>Acceptable Securities:</i> Repurchase agreements with Government Supported securities as collateral, money market instruments & funds, supranationals, convertibles, bank loans, emerging markets debt, non-leveraged structured notes, credit-linked notes, PIKs and PIK-toggles - <i>Prohibited Securities:</i> Mortgage Derivatives (IOs / Pos / Inverse Floaters), Re-REMICs

Net foreign currency exposure is the amount of offsetting currency exposure versus a portfolio's or benchmark's cash market security positions. For example, a local-market sector amounting to a 5% portfolio weighting offset by a (5%) short position in the commensurate local currency would result in a zero net foreign currency exposure. Net foreign currency exposure will be measured as the absolute value of all country-level net currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies. Gross foreign currency exposure will be measured as the absolute value of all country-level currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies.

BROAD GROWTH: APPENDIX

Derivatives Policy

Derivatives may be used in the ERS portfolio as a substitute for a cash market security, risk control, income (e.g. Covered Calls), cost reduction, or liquidity management. Derivatives are not permitted for purposes of speculation. **Any derivative investment not explicitly authorized below is prohibited.**

- Where derivatives are used as substitutes for a specific cash security or set of cash securities, the return volatility of the combination of the derivative and associated cash position shall be equivalent to the unleveraged cash security or securities underlying the derivative instrument.
- When options are used for income and risk control (e.g. Covered Calls), the notional value of the options may not exceed the total value of the underlying securities.
- Managers shall mark-to-market their derivative positions daily.
- Permitted Instruments:
 - *Futures* – stock index futures, stock and bond futures, money market futures, and currency futures where the manager has the authority to invest in the underlying or deliverable cash market security.
 - *Options* – options on stocks, indices, ETFs, and bonds (including interest rate caps and floors). Options on futures, swaps, and currencies are allowed for those managers who have permission to invest in the comparable cash instruments.
 - *Currency forwards* – only those managers who have the authority to invest in the underlying cash market instrument.
 - *Swaps (Extended Global Credit managers)* – where the manager has the authority to invest in the underlying cash market instrument. Minimum counterparty rating: A-
- Futures contracts must be CTFC (Commodity Futures Trading Commission) approved and exchange traded.
- Options may be either exchange traded or over-the-counter (OTC) subject to counterparty guidelines as noted.
- Managers may purchase back options in order to close out positions.
- Counterparties to OTC traded instruments (options and forwards) must be rated investment grade or better as determined by at least one major rating agency.
- Cross-hedging is not permitted by international equity managers; however, as it is a standard practice for non-U.S. bond managers, it is allowed for Extended Global Credit managers. These credit managers may also use certain developed-market currencies as proxies for otherwise illiquid emerging-market currencies. In such cases, use of such proxies will be disclosed through the ongoing reporting process. The counterparties for foreign currency derivatives must be rated A- or equivalent.
- On an annual basis, all investment managers shall provide a summary of the derivatives used and the reasons for their use. This summary shall be the basis for verification that the investment managers are generally complying with the objectives and constraints of the investment policy. The investment consultant shall elicit responses on each manager's policy in the form of a letter.
- On a daily basis the custodian bank shall examine all manager derivatives purchases for prohibited derivatives. Should any prohibited derivatives be found, the custodian bank should promptly notify Staff and instruct the manager to sell the prohibited derivatives. The custodian bank will also value and monitor all derivatives and the trades from which they emanate.

Watch Criteria and Implied Excess Returns (annualized)

		Tracking Error									
		0.50%	1.00%	1.50%	2.00%	2.50%	3.00%	3.50%	4.00%	4.50%	5.00%
Short-Term (1-year)	Watch Threshold	-0.41%	-0.82%	-1.23%	-1.63%	-2.04%	-2.45%	-2.86%	-3.27%	-3.68%	-4.08%
	Implied Excess Return	0.17%	0.33%	0.50%	0.67%	0.83%	1.00%	1.17%	1.33%	1.50%	1.67%
Medium-Term (3-year)	Watch Threshold	-0.17%	-0.33%	-0.50%	-0.67%	-0.85%	-1.02%	-1.20%	-1.38%	-1.55%	-1.73%
	Implied Excess Return	0.17%	0.33%	0.49%	0.65%	0.81%	0.97%	1.13%	1.28%	1.43%	1.58%
Long-Term (5-year)	Watch Threshold	0.995	0.991	0.986	0.981	0.976	0.971	0.966	0.961	0.956	0.951
	Implied Excess Return	0.17%	0.33%	0.49%	0.65%	0.81%	0.96%	1.12%	1.27%	1.42%	1.57%

		Tracking Error									
		5.50%	6.00%	6.50%	7.00%	7.50%	8.00%	8.50%	9.00%	9.50%	10.00%
Short-Term (1-year)	Watch Threshold	-4.49%	-4.90%	-5.31%	-5.72%	-6.13%	-6.53%	-6.94%	-7.35%	-7.76%	-8.17%
	Implied Excess Return	1.83%	2.00%	2.17%	2.33%	2.50%	2.67%	2.83%	3.00%	3.17%	3.33%
Medium-Term (3-year)	Watch Threshold	-1.92%	-2.10%	-2.29%	-2.47%	-2.66%	-2.85%	-3.04%	-3.24%	-3.43%	-3.63%
	Implied Excess Return	1.73%	1.88%	2.03%	2.17%	2.32%	2.46%	2.60%	2.74%	2.88%	3.01%
Long-Term (5-year)	Watch Threshold	0.946	0.940	0.935	0.929	0.924	0.918	0.912	0.907	0.901	0.895
	Implied Excess Return	1.71%	1.86%	2.00%	2.14%	2.28%	2.42%	2.55%	2.69%	2.82%	2.95%

Short-Term Criteria (ex Private Growth mandates):

Performance below the threshold for 3 consecutive months.

Medium-Term Criteria (ex Private Growth mandates):

Performance below the threshold for 6 consecutive months.

Long-Term Criteria (ex Private Growth mandates):

VRR (Value Relative Ratio) below the threshold for 6 consecutive months.

VRR = manager cumulative return / benchmark cumulative return

The Watch Thresholds and Implied Excess Returns assume an **Information Ratio of 0.33**.

Rationale:

The establishment of an assumed information ratio (excess return / tracking error) is important in order to develop consistent active risk taking evaluation criteria across the portfolio. Investors should expect a positive return to active risk taking, or they should not do it.

Absolute returns to volatility (Sharpe ratio) for a traditional 60/40 portfolio over the long-term has been between 0.3 and 0.4, and was approximately 0.33 over the 1973 to 2010 time period. Intuitively then, if an uncorrelated active strategy could be isolated, it should be expected to contribute at this level of return to volatility in order to be additive to portfolio return to risk.

There is no certainty about future active returns, correlation of those returns to market risks, distributions of those active returns, or even the future return to market risks. Given all of this uncertainty, establishing an expected information ratio requirement for active managers to evaluate their performance is useful. A 0.33 information ratio across public market strategies provides a reasonable and objective level based on the considerations outlined above.

Performance-related criteria for the Private Growth component is specified within the corresponding component section.

PRIVATE GROWTH COMPONENT

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Appendices

Investment Disclosure Form – Appendix D.1

1. Program Management

Responsibilities

The Private Growth program shall be implemented and monitored through the coordinated efforts of the Board of Trustees (“Board of Trustees” or “Board”) of the Employees’ Retirement System of the State of Hawaii (“ERS”), the ERS investment staff (“Investment Staff”), the ERS general investment consultant (“General Investment Consultant”), the ERS private equity consultant (“Private Equity Consultant”), and the ERS specialty managers (“Specialty Managers”). Specific responsibilities that fall outside the general responsibilities highlighted in Section B.5. are listed below:

Specific Responsibilities: Board of Trustees

Investment Selection

- a. Evaluate all proposed activities or investments that may fall outside the parameters and direction of the annual Strategic Plan
- b. Mediate any disputes regarding investment selection that may take place between Investment Staff, the Private Equity Consultant(s) and/or Specialty Managers

2. Investment Objectives

A. Portfolio Construction

The ERS has determined that, over the long term, inclusion of private equity and debt investments would enhance the ERS's expected portfolio investment characteristics. Specifically, as a result of the possibility of enhanced rates of return over publicly traded securities and returns that have a low correlation with those associated with other major strategic classes, the use of private equity investments tends to increase the portfolio's overall long-term expected real return, and reduce year to year portfolio volatility.

Private equity investments of the ERS shall be made in a manner consistent with the fiduciary standards of the prudent expert rule: (1) for the sole interest of the ERS's participants and their beneficiaries; and, (2) to safeguard and diversify the private equity portfolio. The selection and management of private equity assets will be guided to preserve investment capital and to maintain prudent diversification of assets and management responsibility. The diversification objective is required to manage overall market risk and the specific risks inherent in any single investment or management selection.

B. Target Allocation

The allocation of ERS assets to private equity investments shall remain within the limits authorized by the Board of Trustees. As of July 2014, the long-term target allocation of 10% of the Broad Growth class was adopted by the Board of Trustees (based on net asset value of allocated capital). Allocated capital will be defined as invested capital (based on market value). The Board of Trustees recognizes that it will be necessary to make capital commitments in excess of the target allocation in order to achieve and maintain a 7.0% net asset value.

The goal of the ERS is to spread out the timing of new commitments so as to avoid an undue concentration of commitments in any one year. Over the long-term, it is expected that barring any unforeseen events approximately equal amounts of new funding will be committed each fiscal year to garner the benefits of vintage year diversification.

C. Benchmarking / Return Targets

The ERS shall use the following rate of return tests to evaluate the performance of the private equity portfolio:

Total Return (Realized and Unrealized Gain/Loss plus Income)

1. Over rolling 10-year periods, the total private equity portfolio is expected to generate a minimum total dollar-weighted rate of return (internal rate of return or IRR) that exceeds an equivalent public equity return (the Russell 3000) by 350 basis points ("bps") per year, net of all investment management fees and expenses
2. Any individual fund investment is expected to produce a commensurate return that contributes to the overall private equity portfolio return objectives
3. The ERS will also measure the portfolio employing a time-weighted rate of return calculation
4. The primary investment strategies included in the allocation will provide the opportunity for long term capital gains. The allocation will include investment

strategies that provide an element of predictable cash flow to the ERS that is not dependent on non-recurring events such as the permanent disposition of assets

5. The portfolio and individual investments shall also be benchmarked against generally accepted and utilized private equity benchmarks (such as Preqin, Inc. and/or Venture Economics Inc.).

D. Risk Management

The selection and management of assets in the private equity portfolio will be guided to generate a high level of risk adjusted return, to provide a moderate amount of current income, and to maintain prudent diversification of assets and specific investments.

With private equity investments, there is an inherent risk that the actual return of capital, gains and income will vary from the amounts expected. The ERS shall manage the investment risk associated with private equity investments in several ways:

1. **Manager Selection / Institutional Quality**
 - a. All assets must be of institutional investment quality. Institutional quality will be defined as being of a quality whereby the investment would be considered acceptable by other prudent institutional investors (e.g. insurance company general accounts and separate accounts, commercial banks and savings institutions, public employee retirement systems, corporate employee benefit plans - domestic and foreign, and other tax-exempt institutions).
 - b. It shall be expected that “foundation managers” to the ERS private equity portfolio (that is, are expected to comprise a significant subset of total ERS private equity assets – subject to Diversification Requirements in Section (g) below) periodically report to the Board of Trustees and/or Investment Staff on the progress of ERS investments under their management.

E. Investment Structures

The following are considered allowable investment structures for the private equity program. It shall be noted that the Private Equity Consultant or Specialty Manager are expected to act as fiduciaries on behalf of the ERS and the investment structures mentioned below must be within accordance of the investment policies set forth in this Manual and the annual Strategic Plan. Such investment activity is subject to active review by the Board of Trustees and Investment Staff on a regular basis.

1. Co/Direct Investments: Co-investments may be sourced by the Private Equity Consultant, Specialty Manager, or Investment Staff, and must be approved by the Board of Trustees
2. Primary Investments in Private Equity Funds: Capital commitments to limited partnerships and/or limited liability companies established for the purpose of private equity investment are managed through the Private Equity Consultant or the Specialty Manager
3. Secondary Investments: Purchasing an existing interest in a private equity fund (generally at a discount) is managed through the Private Equity Consultant or the Specialty Manager
4. Separate Accounts: investment vehicles typically set up for a single limited partner where the investment manager constructs a diversified portfolio of private market investments that are tailored specifically to the needs and objectives of the investor.

Separate accounts should offer the ERS access to economics that are below generally prevailing rates and/or target strategies that are traditionally difficult for the ERS to access directly (e.g., Venture Capital)

F. Investment Strategies

The following private equity strategies and investment types will be considered eligible for the ERS's portfolio:

1. Corporate Finance/Buyout: Partnerships/LLCs which provide funding to acquire majority or controlling interests in a business or product lines from either a public or private company. Buyout sub-strategies are classified by total capital commitments and include Small, Mid, Large and Mega buyouts
2. Fund-of-Funds: Blind pool partnerships/LLCs that evaluate, select and monitor investments in other limited partnership/LLC investments
3. Mezzanine Debt: Partnerships/LLCs which invest in unsecured or junior obligations in financings. These generally take the form of subordinated debentures or preferred stock. They typically earn a current coupon or dividend and have warrants on common stock or conversion features
4. Distressed Debt: Partnerships/LLCs which invest in non-investment grade privately placed debt securities. Common sub-strategies include Distressed For Control, Non-Control and Trading
5. Project Finance: Partnerships/LLCs which invest in industrial leveraged or unleveraged lease or project financings. These can include participation in equity, mezzanine, or senior debt investments. Investments should be made after the development phase, as part of the project's permanent financing, when projects are going operational
6. Special Situations: Partnerships/LLCs with investment strategies which have gained an institutional following, but where sporadic opportunities do not justify a separate long-term strategic allocation. Categories includes partnerships/LLCs which make strategic block investments, have very broad mandates, focus on restructuring/recovery or focus on specific industries or which seek to exploit opportunities created by changing industry trends or governmental regulations
7. Venture Capital: Investments in start-up companies generally exhibiting promising potential and/or high-growth characteristics. Such investments generally exhibit minimal leverage and can consist of the following stages: Seed/Early, Middle, Late-Stage and Growth Equity
8. Other: Partnerships/LLCs which invest in publicly-traded securities or which employ strategies different from those cited above such as, hedge fund strategies, commodity trading, post-venture equities, investments in commercial leases, and other non-traditional strategies. The purchase of secondary partnership/LLC interests is also allowed

G. Diversification Requirements

The private equity portfolio shall be diversified as to investment strategy, timing of investment, size and life cycle of investment, industry sector, investment sponsor organization (e.g., general partner group), capital structure and geographical location. Diversification reduces the impact on the portfolio of any one investment or any single investment style to the extent that an adversity affecting any one particular area will not impact a disproportionate share of the total portfolio.

These limits are subject to waiver on a case-by-case basis by the Board of Trustees. It is also recognized that during the portfolio development and wind-down stages the full investment parameters may not, of necessity, be met.

The scope and size of the ERS program is such that significant investments in fewer, more concentrated "foundation" managers are preferred to smaller, more numerous managers. While ERS has not set a minimum dollar amount per partnership/LLC, the Private Equity Consultant and/or Specialty Manager will be charged with deploying the capital efficiently, such that funding targets are achieved with a minimal number of partnership/LLC holdings. Long-term diversification targets among eligible investment strategies will be set forth in the annual Strategic Plan document, and reviewed and updated as necessary.

1. Geographic

Over the long-term, the ERS portfolio should seek portfolio diversification with regard to major regional areas both domestically (e.g., Northeast, Mid-Atlantic, Southeast, Midwest/Plains, Southwest/Rockies, West Coast, Pacific Northwest), and internationally (e.g., Europe, Asia Pacific, South and Latin America, Middle East and Africa).

The portfolio shall primarily target investments domiciled within North America. In line with the ERS's total international allocation, the portfolio shall seek to limit international investments (outside of North America) by targeting no more than 35% of the private equity investment allocation to such investments. The currency exposure to the ERS from the non-dollar aspect of the allocation is expected to be negligible.

2. Industry

The ERS portfolio will seek to diversify by industry sector (as outlined through the Global Industry Classification Standard) and shall target that no one industry classification represent more than 35% of the private equity portfolio.

3. Life Cycle

Commitments to partnership/LLC investments generally will be staged over time. It is the long-term goal of ERS to spread out investment timing such that new commitments will be made each fiscal year. This policy will have the effect of dollar cost averaging the ERS's portfolio over business cycles to help insulate the portfolio from event risk.

4. Strategic

The private equity portfolio shall target that no single private equity investment sub-strategy (as highlighted in Section II(f) above) comprise more than 50% of the total allocation.

5. General Partner

The ERS portfolio will seek to diversify by issuer of limited partnership/LLC securities, and other specific investments sponsors. No more than 20% of the ERS's

private equity portfolio net asset value will be invested with any one investment sponsor organization.

It is the intention of ERS to keep the total holdings of the portfolio to a reasonable number. Given the significant total dollar size of the ERS's private equity net asset value target, large concentrated investments in fewer partnerships/LLCs, are preferred to smaller investments across numerous partnership/LLC securities.

6. Single Investment

No single private equity commitment shall comprise more than 50bps of total ERS assets under management or greater than 20% of targeted annual commitment pace per the annual Strategic Plan. An exception to this limitation may be offered for separate accounts, subject to approval by the Board of Trustees.

7. Limited Partner

The ERS is permitted to own up to 20% of any particular partnership/LLC subject to the General Partner limitation (item v) above.

3. Implementation

A. Annual Strategic Plan

1. Annually, the Private Equity Consultant and Specialty Managers (if applicable), in conjunction with Investment Staff, will prepare a Strategic Plan which reviews the current status of the portfolio, recent historical and prospective market conditions, and proposes the actions to be taken over the next approximately twelve month period. This document will recommend general capital allocations to each investment strategy and the rationale and expectations for inclusion
2. The annual Strategic Plan will then be presented to the Board of Trustees for approval

B. Investment Approval Process

The following steps shall be followed in order for the ERS to commit to any prospective private equity investment opportunity:

1. Private Equity Consultant sources and performs comprehensive due diligence on attractive investment opportunities consistent with criteria set forth in the annual Strategic Plan
2. If, as a fiduciary of the ERS, the Private Equity Consultant determines that the investment merits a commitment from the ERS, the Private Equity Consultant will take the following steps:
 - Discuss with Investment Staff the key findings during due diligence, including investment merits, risks and key conclusions
 - Follow-up with Investment Staff on additional requests for information based on this discussion and complete an Investment Disclosure Form
 - In conjunction with the ERS's legal review process, facilitate legal negotiation and closing into the investment opportunity
3. The Board of Trustees shall be notified in the event of a disagreement between Investment Staff and the Private Equity Consultant on an investment recommendation
4. The Specialty Manager (if applicable) will be expected to operate on a discretionary basis
 - The Specialty Manager is to operate under the oversight of and provide regular updates to the Board of Trustees, Staff and the Private Equity Consultant

C. Monitoring and Reporting

1. Reporting System

There shall be a comprehensive reporting and monitoring system for the entire portfolio, Private Equity Consultant, Specialty Manager and individual investments. Situations of underperforming investments, portfolio diversification deficiencies from the Policies & Procedures, and conflicts of interest can then be identified, facilitating active portfolio management.

2. Performance Measurement

The Private Equity Consultant and Specialty Manager will provide cash flow, valuation, and any other requested information to Investment Staff and the Private

Equity Consultant quarterly, and the ERS's custodian bank ("custodian") on a monthly basis, and will notify Investment Staff of any instances of materially different carrying values from those reported by general partners.

Performance will be calculated on both a time-weighted and dollar-weighted (internal rate of return or IRR) basis, with primary emphasis being placed on the internal rate of return. The rate of return calculations will be net of all partnership/LLC fees and expenses, but gross of Private Equity Consultant and/or Specialty Manager fees and expenses. So that the performance numbers reported by the manager and the custodian are the same, the manager will be responsible for reviewing the custodian's figures as to timing, amount, value of in-kind securities at distribution and reported net asset value, and reconciling and explaining any discrepancies.

Investment Staff and/or the appropriate designated retained Private Equity Consultant will provide performance measurement information, if requested by the Board, on all other private markets investments outside of the authority of the Private Equity Consultant or Specialty Manager(s).

In-kind Distributions: Partnerships/LLCs will be valued on the distribution price of the in-kind security or other valuation method stipulated in the partnership/LLC membership agreement. Any change from distribution price to realized price of the in-kind distributions will then be monitored as a separate component of the total portfolio return.

Benchmarks: For IRR calculations, the Vintage Year methodology developed by Preqin, inc. and/or Venture Economics, Inc. will be used for purposes of performance comparisons to the industry. For time-weighted returns, comparable publicly traded market indicators (such as small cap indices) will be employed.

APPENDIX D.1

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
Prospective Private Equity Investment Disclosure Form

Please provide the following information in hard copy to Private Equity (PE) Consultant at least 5 business days prior to legally committing to any investment on behalf of the ERS, as follows:

Paul Yett, Hamilton Lane, 200 California Street, Suite 400, San Francisco, CA 94111
 Ph: 415-365-1060, Email: pyett@hamiltonlane.com.

1. General Information:

Name of Partnership/LLC: _____
 GP/Investment Advisor: _____
 Address: _____

Contact Person: _____ Title: _____
 Phone: _____ Fax: _____

2. Investment Size:

Anticipated Total Partnership/LLC Size: \$ _____
 Anticipated Commitment by the ERS \$ _____
 % ERS Commitment of Total Partnership/LLC: _____ %
 # of other clients placed in investment _____
 Total Ownership of Advisor's Clients \$ _____ (excluding Hawai'i)

3. Proposed Category:

_____ VC Early	_____ Special Situations - Hybrid
_____ VC Multi	_____ Special Situations - Strategic Block
_____ VC Late	_____ Subordinated Debt
_____ Buyouts - Large	_____ Restructuring
_____ Buyouts - Small/Medium	_____ Project Finance/Other Cash Flow
_____ Buyouts - Industry Consolidation	

4. Provide Brief Description of Investment Objective:

6. Description of Fit with the ERS's Annual Tactical Plan:

7. Disclosure/Other Comments:

- A. Describe any prior investment history with the general partner group and of any existing holdings affiliated with the general partner group.
- B. Are there any items associated with the investment of which the ERS or the PE Consultant should be aware?
- C. Are there any other comments the Oversight Manager would like to mention?

8. Attachments:

- A. Include Offering Memorandum and any other relevant materials.



PRINCIPAL PROTECTION PROGRAM

SECTION: E

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E.1. Overview

A. General Description

The Principal Protection class consists of investment strategies and assets that are largely exposed and/or susceptible to changes in interest rates and/or inflation, while only minimally exposed to the equity risk premium. Such investments typically contain relatively low levels of risk and exhibit lower volatility than other strategic classes. Investments within the Principal Protection class are expected to produce relatively low levels of returns commensurate with their relatively lower risk profile. In addition, periodic income will likely be a material portion of the Principal Protection class's investment return.

B. Purpose

The Principal Protection class is expected to perform two functions. First, the Principal Protection class is expected to provide consistent, stable returns during all phases of an investment cycle. Second, the Principal Protection class is expected to preserve principal during periods when investments in the Broad Growth class are experiencing significant drawdowns/reductions in value. There may be instances when the correlation between Principal Protection investments and Broad Growth investments are positive (e.g., during a period of rapid rises in interest rates), but such periods should be relatively rare. Over long investment horizons (i.e., greater than 10 years), the Principal Protection class is expected to maintain its purchasing power, producing nominal returns that are near, or slightly exceed, the rate of inflation.

An objective of the Principal Protection class is to capture a spectrum of risk premiums/risk factors that are unrelated to and/or offset the behavior of the equity risk premium.

C. Risk Factor Exposures

Major

- *Interest Rate Risk*

Minor

- *Inflation Risk*
- *Liquidity Risk*

E.2. Class Structure

A. Modifications to Component Structure

Currently, the Principal Protection class is a single-component class. Modifications to the Principal Protection class's structure can take four forms:

- v. Adding or deleting a specific component;
- vi. Adding or deleting a specific investment strategy within a specific component;
- vii. Establishing strategy allocation levels and ranges;
- viii. Establishing allocation levels and ranges among the components (if needed).

Modifications to the Principal Protection class's structure will occur only with approval of the Board of Trustees.

B. Management of Class

To manage the assets assigned to the Principal Protection class, the Board of Trustees ("Board of Trustees" or "Board") of the Employees' Retirement System of the State of Hawaii ("ERS") utilizes active management. Per policy, the Board delegates the manager selection process to the ERS's general investment consultant ("General Investment Consultant") and ERS investment staff ("Investment Staff"), but retains final decision authority for selecting managers for a specific investment mandate.

Within the class, assets are allocated across a series of mandates and/or investment styles. In combination, these mandates and styles capture a broad, representative sampling of the available investment opportunity set within the class. The mandate/style allocations for the Principal Protection class are as follows:

Principal Protection Allocation Policy

Principal Protection – 100%			
U.S. Intermediate Fixed – 40%		Non-U.S. Intermediate Fixed – 60%	
Within U.S. Intermediate Fixed		Within Non-U.S. Intermediate Fixed	
Passive	0%	Passive	0%
Active	100%	Active	100%

Investment Staff is responsible for reporting to the Board strategy/style allocation levels that vary materially from their allocation targets.

C. Class Managers and Managers' Allocations

To manage the assets allocated to each strategic class, the Board delegates investment authority to external investment managers ("investment managers"). The ERS's general investment consultant and Investment Staff have joint authority for identifying and selecting investment manager candidates for specific investment mandates. The Board has final authority over the selection of specific managers for each mandate. Investment Staff has the authority to manage the allocation to each investment manager. Under this authority, Investment Staff may reduce funding to one or more specific manager(s) and/or increase funding to one or more specific manager(s) as long as the risk profile of

the Principal Protection class is maintained. The manager allocations within the Principal Protection class are as follows:

Principal Protection Class Manager Allocation Policy

Principal Protection – 100%			
U.S. Intermediate Fixed – 40%		Non-U.S. Intermediate Fixed – 60%	
Within U.S. Intermediate Fixed		Within Non-U.S. Intermediate Fixed	
Active – First Hawaiian	50%	Active – Oechsle	67%
Active – Pacific Income	50%	Active – PIMCO	33%

Staff is responsible for reporting to the Board manager allocation levels that vary materially from their allocation targets.

E.3. Return Objectives & Risk Profile

A. Class Return Benchmarks

The ERS utilizes the target benchmark below to monitor the performance results of the Principal Protection class:

Barclays Capital Global Aggregate Intermediate ex-Credit Index (Hedged)

The Principal Protection class portfolio is expected to outperform the above blended benchmark, net of fees, over a full investment cycle. An appropriate measure of an investment cycle would be rolling 5-year periods. The Principal Protection class portfolio should outperform its benchmark, net of fees, over the majority of rolling 5-year periods.

B. Class Risk Profile

In aggregate, the Principal Protection class is the ERS's most stable investment class and is the class that should be the least sensitive to varying economic growth trends. Based on current capital market assumptions and the Principal Protection class's long-term structure, there is an extremely low probability that this class will lose any of its capital within the next five years. This absence of potential volatility is meant to complement the high volatility associated with the Broad Growth class. The key tradeoff is that the long-term expected return of the Principal Protection class is significantly lower than that of the Broad Growth class.

The ERS is expected to manage the Principal Protection class portfolios by taking active risk (tracking error) around the respective benchmarks discussed under Section E.3.A. above. Active risk within the broader class is the aggregation of several risks taken/accepted by Investment Staff and/or ERS's external investment managers as they implement the class's portfolios. Types of active risk include: security selection risk, sector/style bias risk, manager weighting risk, and benchmark misfit risk. The allowable active risk range for the aggregate Principal Protection class is 1.0% - 3.0%/year.

E.4. Manager Investment Guidelines

All investments and investment managers are subject to Section 88-119 (Investments), Hawai'i Revised Statutes, the Derivatives Policy and Watch Criteria in the Appendix of this section, and the following guidelines:

A. Principal Protection Class

US Intermediate Fixed Income

Manager(s):	First Hawaiian Bank Pacific Income
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Class:	Principal Protection
Benchmark:	BC U.S. Intermediate Aggregate ex-Credit
Max. Tracking Error Objective:	2.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 35%; systematic factors: maximum: 65%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Rating agencies: Moody's, Standard & Poor's, and Fitch - Securities rated by all three agencies are assigned the middle rating <ul style="list-style-type: none"> o For example, for a security to be rated A it must be rated at least A by two of the three agencies - Securities rated by only two agencies are assigned the most conservative rating - Securities rated by only one agency are assigned that rating - Minimum issuance size is \$100 million Excludes Agency MBS - Specific security-type limits: <ul style="list-style-type: none"> o Summary concentration comments: Concentration limits should be determined exclusive of explicit currency and/or currency derivative positions. Sector, rating, and other allocations shall be compared to equivalent allocation levels of the appropriate <i>unhedged</i> benchmark. For example, if a manager holds a 5% position of debt issued in South Africa, holds a (2%) short position in the Rand, and the unhedged benchmark weighting of South Africa is 1%, then the 5% unhedged position counts against Emerging Markets limitation and the manager is 4% overweighted in South Africa. Separately, a 3% currency exposure (5% less 2%) counts against the absolute currency exposure constraint. o Individual issuers shall not exceed 5% of the portfolio value at time of purchase Excludes Government Supported securities. Specific mortgage pools and trusts are considered separate issuers, and each tranche within a CMO is considered a separate issue. <ul style="list-style-type: none"> ▪ Government Supported = Supranationals, U.S. Treasuries, sovereign debt of OECD governments, U.S. agencies and government sponsored enterprises, and equivalently-rated agencies of OECD governments. o CMOs and asset-backed securities: minimum of AAA rating o Preferred stock and converted common stock: no more than 10% of portfolio; converted stock not held more than 180 days o Non-U.S. Dollar Denominated Max. 10% o Emerging Markets (local currency and USD debt) Max. 10% <p style="margin-left: 20px;">Manager uses the World Bank's definition for emerging markets,</p>

	<p>which is based on a GNP per capita calculation.</p> <ul style="list-style-type: none"> o Private Placements Max. Excludes 144A 10% o Convertible Securities Max. 0% o Non-U.S. Agency CMO Max. 10% <p>- Quality:</p> <ul style="list-style-type: none"> o Non-Investment Grade / Unrated = 0% <p>- Non-Benchmark Markets (ex cash):</p> <ul style="list-style-type: none"> o Non-Benchmark = 0-20% <p>Benchmark markets are based on currency denomination and security type.</p> <p>- Foreign Currency:</p> <ul style="list-style-type: none"> o Max. Net* = 10% o Max. Gross* = 20% <p>- Note: Managers are required to segregate and summarize explicit currency exposures in the reporting process</p> <p>- <i>Prohibited Securities:</i> Mortgage Derivatives (IOs / Pos / Inverse Floaters), Re-REMICs</p>
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Net foreign currency exposure is the amount of offsetting currency exposure versus a portfolio's or benchmark's cash market security positions. For example, a local-market sector amounting to a 5% portfolio weighting offset by a (5%) short position in the commensurate local currency would result in a zero net foreign currency exposure. Net foreign currency exposure will be measured as the absolute value of all country-level net currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies. Gross foreign currency exposure will be measured as the absolute value of all country-level currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies.

Non-US Intermediate Fixed Income

Manager(s):	Pacific Investment Management Company (PIMCO)
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Class:	Principal Protection
Benchmark:	BC Global Intermediate Aggregate ex-Credit ex-USD (hedged)
Max. Tracking Error Objective:	1.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 30%; systematic factors: maximum: 70%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Rating agencies: Moody's, Standard & Poor's, and Fitch - Issuers rated by all three agencies are assigned the middle rating <ul style="list-style-type: none"> o For example, for a security to be rated A it must be rated at least A by two of the three agencies - Issuers rated by only two agencies are assigned the most conservative rating - Issuers rated by only one agency are assigned that rating - Minimum issuance size is \$100 million - Specific security-type limits: <ul style="list-style-type: none"> o Summary concentration comments: <p>Concentration limits should be determined exclusive of explicit currency and/or currency derivative positions. Sector, rating, and other allocations shall be compared to equivalent allocation levels of the appropriate <i>unhedged</i> benchmark. For example, if a manager holds a 5% position of debt issued in South Africa, holds a (2%) short position in the Rand, and the unhedged benchmark weighting of South Africa is 1%, then the 5% unhedged position counts against Emerging Markets</p>

	<p>limitation and the manager is 4% overweighted in South Africa. Separately, a 3% currency exposure (5% less 2%) counts against the absolute currency exposure constraint.</p> <ul style="list-style-type: none"> o Individual issuers shall not exceed 5% of the portfolio value at time of purchase Excludes Government Supported securities. Specific mortgage pools and trusts are considered separate issuers, and each tranche within a CMO is considered a separate issue. <ul style="list-style-type: none"> ▪ Government Supported = Supranationals, U.S. Treasuries, sovereign debt of OECD governments, U.S. agencies and government sponsored enterprises, and equivalently-rated agencies of OECD governments. o CMOs and asset-backed securities: minimum of AAA rating o Preferred stock and converted common stock: no more than 10% of portfolio; converted stock not held more than 180 days o Emerging Markets (local currency and USD debt) Max. 20% Manager uses the World Bank's definition for emerging markets, which is based on a GNP per capita calculation. o Private Placements Max. 15% Excludes 144a o Convertible Securities Max. 0% o Non-U.S. Agency CMO Max. 10% <ul style="list-style-type: none"> - Quality: <ul style="list-style-type: none"> o Non-Investment Grade / Unrated = 0% - Non-Benchmark Markets (ex cash): <ul style="list-style-type: none"> o Non-Benchmark = 0-40% Benchmark markets are based on currency denomination and security type. - Foreign Currency: <ul style="list-style-type: none"> o Max. Net* = 100% o Max. Gross* = 100% - Note: Managers are required to segregate and summarize explicit currency exposures in the reporting process - <i>Acceptable Securities:</i> Repurchase agreements with Government Supported securities as collateral, money market instruments & funds, supranationals, emerging markets debt, spread trades - <i>Prohibited Securities:</i> Mortgage Derivatives (IOs / Pos / Inverse Floaters), Re-REMICs
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Net foreign currency exposure is the amount of offsetting currency exposure versus a portfolio's or benchmark's cash market security positions. For example, a local-market sector amounting to a 5% portfolio weighting offset by a (5%) short position in the commensurate local currency would result in a zero net foreign currency exposure. Net foreign currency exposure will be measured as the absolute value of all country-level net currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies. Gross foreign currency exposure will be measured as the absolute value of all country-level currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies.

Manager(s):	Oechsle
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Class:	Principal Protection
Benchmark:	BC Global Intermediate Aggregate ex-Credit ex-USD (hedged)
Max. Tracking Error Objective:	4.0% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 20%; systematic factors: maximum: 80%
Security Allowances/Restrictions:	- Rating agencies: Moody's, Standard & Poor's, and Fitch

	<ul style="list-style-type: none"> - Issuers rated by all three agencies are assigned the middle rating <ul style="list-style-type: none"> o For example, for a security to be rated A it must be rated at least A by two of the three agencies - Issuers rated by only two agencies are assigned the most conservative rating - Issuers rated by only one agency are assigned that rating - Minimum issuance size is \$100 million - Specific security-type limits: <ul style="list-style-type: none"> o Summary concentration comments: <p style="margin-left: 40px;">Concentration limits should be determined exclusive of explicit currency and/or currency derivative positions. Sector, rating, and other allocations shall be compared to equivalent allocation levels of the appropriate <i>unhedged</i> benchmark. For example, if a manager holds a 5% position of debt issued in South Africa, holds a (2%) short position in the Rand, and the unhedged benchmark weighting of South Africa is 1%, then the 5% unhedged position counts against Emerging Markets limitation and the manager is 4% overweighted in South Africa. Separately, a 3% currency exposure (5% less 2%) counts against the absolute currency exposure constraint.</p> o Individual issuers shall not exceed 5% of the portfolio value at time of purchase Excludes Government Supported securities. Specific mortgage pools and trusts are considered separate issuers, and each tranche within a CMO is considered a separate issue. <ul style="list-style-type: none"> ▪ Government Supported = Supranationals, U.S. Treasuries, sovereign debt of OECD governments, U.S. agencies and government sponsored enterprises, and equivalently-rated agencies of OECD governments. o CMOs and asset-backed securities: minimum of AAA rating o Preferred stock and converted common stock: no more than 10% of portfolio; converted stock not held more than 180 days o Emerging Markets (local currency and USD debt) Max. 20% <p style="margin-left: 40px;">Manager uses the World Bank's definition for emerging markets, which is based on a GNP per capita calculation.</p> o Private Placements Max. 10% Excludes 144a o Convertible Securities Max. 0% o Non-U.S. Agency CMO Max. 10% - Quality: <ul style="list-style-type: none"> o Non-Investment Grade / Unrated = 0% - Non-Benchmark Markets (ex cash): <ul style="list-style-type: none"> o Non-Benchmark = 0-40% <p style="margin-left: 20px;">Benchmark markets are based on currency denomination and security type.</p> - Foreign Currency: <ul style="list-style-type: none"> o Max. Net* = 100% o Max. Gross* = 100% - Note: Managers are required to segregate and summarize explicit currency exposures in the reporting process - <i>Prohibited Securities:</i> Mortgage Derivatives (IOs / Pos / Inverse Floaters), Re-REMICs
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Net foreign currency exposure is the amount of offsetting currency exposure versus a portfolio's or benchmark's cash market security positions. For example, a local-market sector amounting to a 5% portfolio weighting offset by a (5%) short position in the commensurate local currency would result in a zero net foreign currency exposure. Net foreign currency exposure will be measured as the absolute value of all country-level net currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies. Gross foreign currency exposure will be measured as the absolute value of all country-level currency positions (long and short) versus the U.S. Dollar. Both long and short foreign currency positions may be held without owning securities denominated in such currencies.

PRINCIPAL PROTECTION: APPENDIX

Derivatives Policy

Derivatives may be used in the ERS portfolio as a substitute for a cash market security, risk control, income, cost reduction, or liquidity management. Derivatives are not permitted for purposes of speculation. **Any derivative investment not explicitly authorized below is prohibited.**

- Where derivatives are used as substitutes for a specific cash security or set of cash securities, the return volatility of the combination of the derivative and associated cash position shall be equivalent to the unleveraged cash security or securities underlying the derivative instrument.
- The notional value of the options may not exceed the total value of the underlying securities.
- Managers shall mark-to-market their derivative positions daily.
- Permitted Instruments:
 - *Futures* – bond futures, money market futures, and currency futures where the manager has the authority to invest in the underlying or deliverable cash market security.
 - *Options* – options on indices, ETFs, and bonds (including interest rate caps and floors). Options on futures, swaps, and currencies are allowed for those managers who have permission to invest in the underlying or deliverable cash market security.
 - *Currency forwards* – only those managers who have the authority to invest in the underlying cash market instrument.
 - *Swaps* – where the manager has the authority to invest in the underlying cash market instrument. Minimum counterparty rating: A-
- Futures contracts must be CTFC (Commodity Futures Trading Commission) approved and exchange traded.
- Options may be either exchange traded or over-the-counter (OTC) subject to counterparty guidelines as noted.
- Managers may purchase back options in order to close out positions.
- Counterparties to OTC traded instruments (options and forwards) must be rated investment grade or better as determined by at least one major rating agency.
- Cross-hedging is permitted for managers who are measured against a benchmark that contains non-USD securities. Additionally, these managers may also use certain developed-market currencies as proxies for otherwise illiquid emerging-market currencies. In such cases, use of such proxies will be disclosed through the ongoing reporting process. The counterparties for foreign currency derivatives must be rated A- or equivalent.
- On an annual basis, all investment managers shall provide a summary of the derivatives used and the reasons for their use. This summary shall be the basis for verification that the investment managers are generally complying with the objectives and constraints of the investment policy. The investment consultant shall elicit responses on each manager's policy in the form of a letter.
- On a daily basis the custodian bank shall examine all manager derivatives purchases for prohibited derivatives. Should any prohibited derivatives be found, the custodian bank should promptly notify Staff and instruct the manager to sell the prohibited derivatives. The custodian bank will also value and monitor all derivatives and the trades from which they emanate.

Watch Criteria and Implied Excess Returns (annualized)

		Tracking Error									
		0.50%	1.00%	1.50%	2.00%	2.50%	3.00%	3.50%	4.00%	4.50%	5.00%
Short-Term (1-year)	Watch Threshold	-0.41%	-0.82%	-1.23%	-1.63%	-2.04%	-2.45%	-2.86%	-3.27%	-3.68%	-4.08%
	Implied Excess Return	0.17%	0.33%	0.50%	0.67%	0.83%	1.00%	1.17%	1.33%	1.50%	1.67%
Medium-Term (3-year)	Watch Threshold	-0.17%	-0.33%	-0.50%	-0.67%	-0.85%	-1.02%	-1.20%	-1.38%	-1.55%	-1.73%
	Implied Excess Return	0.17%	0.33%	0.49%	0.65%	0.81%	0.97%	1.13%	1.28%	1.43%	1.58%
Long-Term (5-year)	Watch Threshold	0.995	0.991	0.986	0.981	0.976	0.971	0.966	0.961	0.956	0.951
	Implied Excess Return	0.17%	0.33%	0.49%	0.65%	0.81%	0.96%	1.12%	1.27%	1.42%	1.57%

Short-Term Criteria:

Performance below the threshold for 3 consecutive months.

Medium-Term Criteria:

Performance below the threshold for 6 consecutive months.

Long-Term Criteria:

VRR (Value Relative Ratio) below the threshold for 6 consecutive months.

VRR = manager cumulative return / benchmark cumulative return

The Watch Thresholds and Implied Excess Returns assume an **Information Ratio of 0.33**.

Rationale:

The establishment of an assumed information ratio (excess return / tracking error) is important in order to develop consistent active risk taking evaluation criteria across the portfolio. Investors should expect a positive return to active risk taking, or they should not do it.

Absolute returns to volatility (Sharpe ratio) for a traditional 60/40 portfolio over the long-term has been between 0.3 and 0.4, and was approximately 0.33 over the 1973 to 2010 time period. Intuitively then, if an uncorrelated active strategy could be isolated, it should be expected to contribute at this level of return to volatility in order to be additive to portfolio return to risk.

There is no certainty about future active returns, correlation of those returns to market risks, distributions of those active returns, or even the future return to market risks. Given all of this uncertainty, establishing an expected information ratio requirement for active managers to evaluate their performance is useful. A 0.33 information ratio across public market strategies provides a reasonable and objective level based on the considerations outlined above.



REAL RETURN PROGRAM

SECTION: F

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F.1. Overview

A. General Description

The Real Return class is expected to invest in investment strategies and assets that are largely exposed to changes in inflation and/or interest rates, while only minimally exposed to the equity risk premium. Such investments contain various levels of risk and typically exhibit modestly more volatility than the Principal Protection class, but less volatility than the Broad Growth class. The Real Return class consists of two major components: Public Inflation-Linked and Private Inflation-Linked. The Public Inflation-Linked component consists of investment strategies that rely on the public markets to gain exposure to inflation-oriented assets. The Private Inflation-Linked component consists of investment strategies that rely on the private markets to gain exposure to inflation-oriented assets, and as such, may exhibit higher levels of liquidity risk. While both components may utilize strategies that gain exposure to inflation through price appreciation and/or cash flows, the Public component return contributions tend to be more appreciation-oriented, whereas the Private component tends to be more evenly split between appreciation and cash flows.

B. Purpose

The total portfolio is expected to produce a long-term return in excess of inflation. While an inflation risk premium is typically priced into most assets, unexpected changes in inflation and/or higher-than-average structural inflation can often be the most damaging to a plan sponsor's purchasing power. As a result, the Real Return class seeks to provide the Plan with diversification and protection against unanticipated changes in inflation and/or higher-than-average inflation. Due to this feature, the Real Return class is expected to increase the purchasing power of the total portfolio's assets over time, while limiting drawdowns during inflation-oriented crises.

By diversifying into the two major Real Return components (Public Inflation-Linked and Private Inflation-Linked), the Real Return class seeks to moderate its risk profile versus investing solely in any one component. This approach seeks to provide the Plan with a more robust portfolio of inflation exposures.

C. Risk Factor Exposures

Major

- *Inflation Risk*

Minor

- *Interest Rate Risk*
- *Liquidity Risk*
- *Growth Risk*

F.2. Class Structure

A. Components

The Real Return class consists of two major components: Public Inflation-Linked and Private Inflation-Linked.

Public Inflation-Linked

Strategies currently included in this component are:

- Global Inflation-Linked Fixed Income (GILS)
- Collateralized Commodity Futures

Private Inflation-Linked

Component includes a spectrum of relatively illiquid investment strategies that are known to have close linkages to changes in inflation. Private Inflation-Linked strategies currently included in this component are:

- Timber
- Agriculture
- Infrastructure

Other inflation-oriented investment strategies considered for Private Inflation-Linked include:

- Unlevered / Low-Levered Core Real Estate

B. Modifications to Component Structure

Modifications to the Real Return class's component structure can take four forms:

- ix. Adding or deleting a specific investment strategy within a specific component;
- x. Adding or deleting a specific component;
- xi. Establishing allocation levels and ranges among the components;
- xii. Establishing strategy allocation levels and ranges within the components.

Modifications to the Real Return's component structure will occur only with approval of the Board of Trustees.

C. Components' Allocations and Allocation Ranges

The Real Return class's allocation targets and allocation ranges among its two major components is as follows (as a percent of total Real Return class assets):

Long-term Real Return Class Component Allocation Policy

<u>Component</u>	<u>Lower Limit</u>	<u>Allocation Target</u>	<u>Upper Limit</u>
Public Inflation-Linked	20%	50%	80%
Private Inflation-Linked	---	50%*	---

* Due to the illiquid nature of the *Private Inflation-Linked* component, its allocation will be based on pre-established policy allocation targets, and likely not fluctuate dramatically

Interim Real Return Class Component Allocation Policies

	Target Structure 1/1/2015	Target Structure 1/1/2016	Target Structure 1/1/2017	Target Structure 1/1/2018
Public Inflation-Linked	70%	63%	56%	50%
Private Inflation-Linked	30%	37%	44%	50%
Total	100%	100%	100%	100%

D. Management of Components

To manage the assets assigned to the Real Return class components, the Board of Trustees (“Board of Trustees” or “Board”) of the Employees’ Retirement System of the State of Hawaii (“ERS”) utilizes a selection of external investment managers (“investment managers”). Per policy, the Board delegates the investment manager selection process to the ERS’s investment consultants (“investment consultants”) and ERS investment staff (“Investment Staff”), but retains final decision authority for selecting managers for a specific investment mandate. Investment Staff is also expected to manage the components’ allocations to align with their respective allocation targets over time. From time-to-time, based on market dynamics and trends, Investment Staff has the discretion to vary each respective component’s allocation away from the allocation target, but always within the upper and lower limits as shown in the table under Section C. above. Investment Staff is responsible for reporting to the Board component allocation levels that vary materially from their allocation targets.

Within each component, assets are allocated across a series of mandates and/or investment styles. In combination, these mandates and styles capture a broad, representative sampling of the available investment opportunity set within the specified component. The mandate/style allocations within each component are as follows:

Public Inflation-Linked Component Allocation Policy

GILS – 50%		Commodities – 50%	
Passive	0%	Passive	0%
Active	100%	Active	100%

Private Inflation-Linked Component Allocation Policy

Timber – 25-35%		Agriculture – 15-25%*		Infrastructure – 40-60%*	
Passive	0%	Passive	0%	Passive	0%
Active	100%	Active	100%	Active	100%

*Mandate is currently unfunded as of 7/1/2014

E. Components' Managers and Managers' Allocations

To manage the assets allocated to each strategic class and its underlying components, the Board delegates investment authority to external investment managers. The ERS's investment consultants and Investment Staff have joint authority for identifying and selecting investment manager candidates for specific investment mandates. The Board has final authority over the selection of specific managers for each mandate. Investment Staff has the authority to manage the allocation to each investment manager. Under this authority, Investment Staff may reduce funding to one or more specific manager(s) and/or increase funding to one or more specific manager(s) as long as the risk profile of the component or sub-component is maintained. The investment manager allocations within each component mandate are as follows:

Public Inflation-Linked Component Manager Allocation Policy

GILS – 50%		Commodities – 50%*	
Active – BlackRock	100%	Active – TBD	TBD
Passive	0%	Passive	0%
Active	100%	Active	100%

*Mandate is currently unfunded as of 7/1/2014

Private Inflation-Linked Component Manager Allocation Policy

Timber – 25-35%		Agriculture – 15-25%*		Infrastructure – 40-60%*	
Active – Hancock	100%	Active – TBD	TBD	Active – TBD	TBD
Passive	0%	Passive	0%	Passive	0%
Active	100%	Active	100%	Active	100%

* Mandate is currently unfunded as of 7/1/2014

F.3. Return Objectives & Risk Profile

A. Class Return Benchmarks

Within the Real Return class, the standards for component performance reporting vary materially. Keeping this factor in mind, the ERS utilizes the target benchmark below to monitor the performance results of the aggregate Real Return class:

$$\text{CPI} + 3\%$$

The Real Return class portfolio is expected to outperform the above benchmark, net of fees, over a full investment cycle. An appropriate measure of an investment cycle would be rolling 5-year periods. The Real Return class portfolio should outperform its benchmark, net of fees, over the majority of rolling 5-year periods.

The Public Inflation-Linked component portfolio is expected to outperform the following custom target benchmark, net of fees, over the majority of rolling 5-year periods:

$$\begin{aligned} &50\% \text{ Barclays WGILB Index (hedged) +} \\ &50\% \text{ Barclay CTA Index} \end{aligned}$$

The Private Inflation-Linked component portfolio is expected to outperform the following custom blended benchmark, net of fees, over the majority of rolling 10-year periods:

$$\begin{aligned} &30\% \text{ NCREIF Timber +} \\ &20\% \text{ NCREIF Farmland +} \\ &50\% \text{ CPI} + 4\% \end{aligned}$$

The Private Inflation-Linked benchmark will be lagged one quarter to align with performance reporting. A longer measure of an investment cycle is used for the Private Inflation-Linked component due to the long-term funding nature of investments within the component.

B. Class Risk Profile

In aggregate, the Real Return class is designed to provide consistent and relatively stable returns above inflation during non-volatile periods, as well as serve as a hedge against unanticipated inflation during inflationary periods. Based on current capital market assumptions and the Real Return class's long-term structure, there is an extremely low probability that this class will lose any of its capital over a 10 year period. While not producing the bulk of Plan's investment returns, the Real Return class is positioned to provide nominal returns near 5.5-6%/year over the long-term. This class is meant to complement the high volatility associated with the Broad Growth class, while providing a level of return moderately above the Principal Protection class. A strategic allocation to the Real Return class should provide an improved level of diversification for the total portfolio. The class may be negatively impacted by periods of stagnant/declining economic growth and deflation.

The aggregate Real Return class does not have an active risk (tracking error) threshold/budget due to the stable nature of the class benchmark (CPI + 3%), and the difficulty of benchmarking a class containing private markets investments on a continuous basis.

C. Component Risk Profiles

The ERS is expected to manage the Public Inflation-Linked component portfolio by taking active risk (tracking error) around the respective benchmark discussed under Section F.3.A. above. Active risk within a specific component portfolio is the aggregation of several risks taken/accepted by Investment Staff and/or ERS's external investment managers as they implement the component portfolios. Types of active risk include: security selection risk, sector/style bias risk, manager weighting risk, and benchmark misfit risk. The allowable active risk ranges for the Public Inflation-Linked component is:

Tracking Error Ranges – Key Real Return Class Components

Component	Allowable Tracking Error
Public Inflation-Linked	1.5% - 3.0%/year

Private Inflation-Linked does not have an active risk threshold/budget due to the difficulty of benchmarking private markets investments on a continuous basis.

F.4. Manager Investment Guidelines

All investments and investment managers are subject to Section 88-119 (Investments), Hawai'i Revised Statutes, the Derivatives Policy and Watch Criteria in the Appendix of this section, and the following guidelines:

A. Public Inflation-Linked Manager Guidelines

Active Global Inflation-Linked Fixed Income (GILS)

Manager(s):	BlackRock
All allowable securities are described in Section 88-119 (Investments), HRS, the Derivatives Policy in the Appendix of this section, and the following guidelines:	
Component:	Public Inflation-Linked
Benchmark:	Barclays World Government Inflation-Linked Bond Index (hedged)
Max. Tracking Error Objective:	1.5% annualized Refer to appendix for Watch Criteria and Return Expectations
Active Risk Allocation Objective:	security selection: minimum: 35%; systematic factors: maximum: 65%
Security Allowances/Restrictions:	<ul style="list-style-type: none"> - Cash equivalent portion shall not exceed 10% - All holdings will be of sufficient size and held in issues that are traded actively enough to facilitate transactions at minimum cost and accurate market valuation - Rating agencies: Moody's, Standard & Poor's, and Fitch - <i>Investment Grade</i> is considered the following: <ul style="list-style-type: none"> Moody's Baa3, or Prime-2, or Standard & Poor's BBB-, or A-2, or Fitch BBB-, or F-2 - Securities rated by all three agencies are assigned the middle rating <ul style="list-style-type: none"> o For example, for a security to be rated A it must be rated at least A by two of the three agencies - Split Rated Securities: Will utilize the methodology utilized by the benchmark provider. For non-benchmark securities, it will be the lower of two ratings or the middle rating of three ratings. - Unrated Securities: Securities not covered will normally be, in the judgment of the manager, at least equal in credit quality to investment grade. - Obligations in unrated securities are limited to 10% of the portfolio - Rated Treasury/Sovereign securities may be rated by only one agency - Rated Non-Treasury/Sovereign securities must be rated by at least two agencies, otherwise they will be considered unrated - Downgraded Securities: Securities which fall below the stated minimum credit requirements subsequent to initial purchase may be held by the manager up to a maximum of 5% in aggregate market value of the total portfolio. The managers shall notify ERS of these securities. - Securities Inside 270 Days: For securities with legal final maturities of 270 days or less, the manager may use the underlying credit's short-term ratings as proxy for establishing the minimum credit requirement.

	<ul style="list-style-type: none"> - Modified real duration of portfolio should be +/- 20% of benchmark - Weighted average credit quality shall not fall below AA- or equivalent - Up to 30% of the portfolio may be invested in non-inflation-indexed securities. - Quality: <ul style="list-style-type: none"> o Non-Investment Grade = 0% o Unrated = 0-10% - Non-Benchmark Markets (ex cash): <ul style="list-style-type: none"> o Non-Benchmark = 0-30% Benchmark markets are based on currency denomination and security type. - Issuer: Holdings are subject to the following limitations: <ul style="list-style-type: none"> o Obligations issued or guaranteed by the US government, US agencies or US government-sponsored corporations and agencies are eligible without limit. o Obligations of other national governments are limited to 50% of that country's holdings. o Obligations of other issuers are subject to a 5% per issuer limit. - Currency: Both long and short currency exposures are permitted. However, the aggregate of all active long exposures (local country bond plus currency position) will not exceed 5% of the portfolio. (For example, a 5% local bond position in a country combined with a short (-5%) position in that country's currency is fully hedged and, therefore, has 0% active long currency exposure. A 5% local bond position in a country with an "additional" 5% currency position represents a 10% active long currency exposure).
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REAL RETURN: APPENDIX

Derivatives Policy

Derivatives may be used in the ERS portfolio as a substitute for a cash market security, risk control, income, cost reduction, or liquidity management. Derivatives are not permitted for purposes of speculation. **Any derivative investment not explicitly authorized below is prohibited.**

- Where derivatives are used as substitutes for a specific cash security or set of cash securities, the return volatility of the combination of the derivative and associated cash position shall be equivalent to the unleveraged cash security or securities underlying the derivative instrument.
- The notional value of the options may not exceed the total value of the underlying securities.
- Managers shall mark-to-market their derivative positions daily.
- Permitted Instruments:
 - *Futures* – bond futures, money market futures, and currency futures where the manager has the authority to invest in the underlying or deliverable cash market security.
 - *Options* – options on indices, ETFs, and bonds (including interest rate caps and floors). Options on futures, swaps, and currencies are allowed for those managers who have permission to invest in the underlying or deliverable cash market security.
 - *Currency forwards* – only those managers who have the authority to invest in the underlying cash market instrument.
 - *Swaps* – where the manager has the authority to invest in the underlying cash market instrument. Minimum counterparty rating: A-
- Futures contracts must be CTFC (Commodity Futures Trading Commission) approved and exchange traded.
- Options may be either exchange traded or over-the-counter (OTC) subject to counterparty guidelines as noted.
- Managers may purchase back options in order to close out positions.
- Counterparties to OTC traded instruments (options and forwards) must be rated investment grade or better as determined by at least one major rating agency.
- Cross-hedging is permitted for managers who are measured against a benchmark that contains non-USD securities. Additionally, these managers may also use certain developed-market currencies as proxies for otherwise illiquid emerging-market currencies. In such cases, use of such proxies will be disclosed through the ongoing reporting process. The counterparties for foreign currency derivatives must be rated A- or equivalent.
- On an annual basis, all investment managers shall provide a summary of the derivatives used and the reasons for their use. This summary shall be the basis for verification that the investment managers are generally complying with the objectives and constraints of the investment policy. The investment consultant shall elicit responses on each manager's policy in the form of a letter.
- On a daily basis the custodian bank shall examine all manager derivatives purchases for prohibited derivatives. Should any prohibited derivatives be found, the custodian bank should promptly notify Staff and instruct the manager to sell the prohibited derivatives. The custodian bank will also value and monitor all derivatives and the trades from which they emanate.

Watch Criteria and Implied Excess Returns (annualized)

		Tracking Error									
		0.50%	1.00%	1.50%	2.00%	2.50%	3.00%	3.50%	4.00%	4.50%	5.00%
Short-Term (1-year)	Watch Threshold	-0.41%	-0.82%	-1.23%	-1.63%	-2.04%	-2.45%	-2.86%	-3.27%	-3.68%	-4.08%
	Implied Excess Return	0.17%	0.33%	0.50%	0.67%	0.83%	1.00%	1.17%	1.33%	1.50%	1.67%
Medium-Term (3-year)	Watch Threshold	-0.17%	-0.33%	-0.50%	-0.67%	-0.85%	-1.02%	-1.20%	-1.38%	-1.55%	-1.73%
	Implied Excess Return	0.17%	0.33%	0.49%	0.65%	0.81%	0.97%	1.13%	1.28%	1.43%	1.58%
Long-Term (5-year)	Watch Threshold	0.995	0.991	0.986	0.981	0.976	0.971	0.966	0.961	0.956	0.951
	Implied Excess Return	0.17%	0.33%	0.49%	0.65%	0.81%	0.96%	1.12%	1.27%	1.42%	1.57%

		Tracking Error									
		5.50%	6.00%	6.50%	7.00%	7.50%	8.00%	8.50%	9.00%	9.50%	10.00%
Short-Term (1-year)	Watch Threshold	-4.49%	-4.90%	-5.31%	-5.72%	-6.13%	-6.53%	-6.94%	-7.35%	-7.76%	-8.17%
	Implied Excess Return	1.83%	2.00%	2.17%	2.33%	2.50%	2.67%	2.83%	3.00%	3.17%	3.33%
Medium-Term (3-year)	Watch Threshold	-1.92%	-2.10%	-2.29%	-2.47%	-2.66%	-2.85%	-3.04%	-3.24%	-3.43%	-3.63%
	Implied Excess Return	1.73%	1.88%	2.03%	2.17%	2.32%	2.46%	2.60%	2.74%	2.88%	3.01%
Long-Term (5-year)	Watch Threshold	0.946	0.940	0.935	0.929	0.924	0.918	0.912	0.907	0.901	0.895
	Implied Excess Return	1.71%	1.86%	2.00%	2.14%	2.28%	2.42%	2.55%	2.69%	2.82%	2.95%

Short-Term Criteria (public inflation-linked mandates):

Performance below the threshold for 3 consecutive months.

Medium-Term Criteria (public inflation-linked mandates):

Performance below the threshold for 6 consecutive months.

Long-Term Criteria (public inflation-linked mandates):

VRR (Value Relative Ratio) below the threshold for 6 consecutive months.

VRR = manager cumulative return / benchmark cumulative return

The Watch Thresholds and Implied Excess Returns assume an **Information Ratio of 0.33**.

Rationale:

The establishment of an assumed information ratio (excess return / tracking error) is important in order to develop consistent active risk taking evaluation criteria across the portfolio. Investors should expect a positive return to active risk taking, or they should not do it.

Absolute returns to volatility (Sharpe ratio) for a traditional 60/40 portfolio over the long-term has been between 0.3 and 0.4, and was approximately 0.33 over the 1973 to 2010 time period. Intuitively then, if an uncorrelated active strategy could be isolated, it should be expected to contribute at this level of return to volatility in order to be additive to portfolio return to risk.

There is no certainty about future active returns, correlation of those returns to market risks, distributions of those active returns, or even the future return to market risks. Given all of this uncertainty, establishing an expected information ratio requirement for active managers to evaluate their performance is useful. A 0.33 information ratio across public market strategies provides a reasonable and objective level based on the considerations outlined above.

Performance-related criteria for private inflation-linked mandates are specified within the corresponding sub-component sections.

TIMBER SUB-COMPONENT

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Appendices
 Timber Annual Tactical Plan Outline – Appendix F.1

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII TIMBERLAND PORTFOLIO POLICIES & PROCEDURES

I. INVESTMENT OBJECTIVES

A. INVESTMENTS IN TIMBERLAND ASSETS

The Employees' Retirement System of the State of Hawaii ("ERS") has determined that, over the long-term, inclusion of direct equity timberland investments and any other timberland-related investments ("timber investments"), as allowed for in these *Timberland Portfolio Policies & Procedures* would enhance the ERS's expected portfolio investment characteristics. Expected benefits to the ERS include: (1) the possibility of competitive rates of return with publicly traded securities, (2) returns that have a low correlation with those associated with other major strategic classes, and (3) a hedge against unexpected inflation. The use of timber investments will diversify the portfolio's source of overall long-term expected real return, and reduce year-to-year portfolio volatility.

Timber investments involve the privately negotiated purchase and, to a lesser degree, leasing of forestland tracts, upon which trees are grown for commercial sale. Investments in timber will be made directly through a separate account or indirectly through a multi-investor structure (i.e., two or more investors investing in a specific timber asset as a limited liability company ["LLC"] or other investment vehicle, as appropriate) in which ERS's separate account is an investor. Investments will be managed by a qualified timberland investment manager ("timberland manager" or "manager"). Eligible timber investments are further described in Section I.D. Other portfolio parameters are further described in Section II.A.

The investment policies of the ERS are determined by the ERS Board of Trustees ("Board of Trustees" or "Board"). In general, the goal of the ERS is to obtain the optimum return on the portfolio consistent with the assumption of prudent risk.

Timber investments of the ERS shall be made in a manner consistent with the fiduciary standards of the prudent expert rule: (1) for the sole interest of the ERS's participants and their beneficiaries; and, (2) to safeguard and diversify the timber portfolio. The selection and management of timber assets will be guided to preserve investment capital, to maintain prudent diversification of assets. The diversification objective is required to mitigate overall market risk and the specific risks inherent in any single property. Management, administrative and other responsibilities for the timberland portfolio will be clearly delineated.

B. STRATEGIC ALLOCATION

The ERS's allocation to timber investments shall remain within the limits authorized by the Board of Trustees. The target allocation is 12.5-17.5% of the Real Return strategic class (25-35% of the Private Inflation-Linked Component).

C. PORTFOLIO PERFORMANCE

The ERS shall use the following rate of return tests to evaluate the performance of the timber investment portfolio:

1. Total Return (Income Plus Realized and Unrealized Gain/Loss)

Over rolling 5-year periods, the total timber investments portfolio is expected to generate a minimum total real time-weighted rate of return of 6%, net of all investment management fees and expenses. The inflation measure employed to benchmark the real rate of return calculation will be CPI-U. The timber investments portfolio's rate of return is expected to be generated substantially from the following sources:

- A material component of return on the portfolio will be from the biological growth of the timber.
- A material component of return attributable to the portfolio will be moderate cash income from the sale of timber inventory.
- Long-term, a component of return will result from capital gains through active management, from improving property values and opportunistic purchases and sales of properties.
- The manager will also exploit other opportunities for increasing the rate of return, such as usage leases and easements, moderate use of leverage as permitted by Section II.A, below, and other active management techniques.

The portfolio and individual investments will be compared to an appropriate timber index (such as the NCREIF Timberland Index), or other relevant proxies as appropriate. In any event, the 6% minimum real rate of return hurdle will apply.

2. Risk with Regard to Individual Properties

In timber investing there exists the risk of sustaining a loss on any of the individual property investments. It is the ERS's expectation that, while specific investments may incur losses of all or part of the capital invested, a diversified portfolio of holdings will produce a positive rate of return at least equal to the expected minimum set forth in Section I.C.1., above.

D. PROGRAM MANAGEMENT

The selection and management of assets in the timber investments portfolio will be guided to generate a high level of risk-adjusted return, to provide current income, and to maintain prudent diversification of assets and specific investments.

With timber investments, there exists an inherent risk that the actual return of capital, income and gains will vary from the amounts expected. The investment risk associated with timber investments will be mitigated through both the structure of these *Timberland Portfolio Policies & Procedures* and the actions of the timberland manager. The key program management parameters are as follows:

1. Institutional Quality

All assets must be of institutional investment quality. Institutional quality will be defined as being of a quality whereby the investment would be considered acceptable by other prudent expert institutional timber market participants and corporate forest product industry investors.

2. Diversification

Diversification reduces the chance of an adverse impact suffered by any one holding or investment type from adversely affecting a disproportionate share of the total portfolio. The timber portfolio shall be diversified by:

- regional geographical location (South, Northeast, West, Other, and International)
- non-contiguous tract and parcel locations
- type and species of tree (e.g., softwood “conifer,” such as pine, fir redwood, etc., and hardwood “deciduous,” such as oak, maple, etc.)
- end-use market of forest product (building and construction, pulp and paper, furniture and decorative wood)
- potential purchasers of inventory (mills and processing plants)
- stage of tree growth (seedling through mature)
- timing of investment

Investments will be made such that no single property purchase will represent more than 25% of the fully invested target net asset value of the allocation. These limits are subject to waiver on a case-by-case basis by the Trustees. It is also recognized that during the portfolio development and wind-down stages the full investment parameters may not, of necessity, be met.

Long-term diversification target ranges among eligible investments will be set forth in Section II of this document, and reviewed annually or more often as necessary. Interim investment goals for the implementation of the Portfolio will be set forth in an *Annual Tactical Plan* (Appendix IV.4 - A), as described herein.

3. Ownership Structure

Account and Investment Structure: The ERS's ownership structure will comprise an arrangement whereby separate account relationships will be established with one or more fiduciary timberland managers. The separate account timberland manager will in turn purchase, on a discretionary basis, timber assets for the ERS's account. The separate account may be structured as an LLC or employ other holding vehicles, as appropriate (e.g., 501(c) corporation, insurance annuity contract, group trust, etc.), to shield the ERS from potential tax and general liabilities. The timber investments will be subject to the standards and parameters established in this *Timberland Portfolio Policies and Procedures* and the ERS's approval of an *Annual Tactical Plan*. The ERS will be the sole beneficial owner of all properties, and assets held for the ERS will not be commingled with any other investor or owner, subject to the following exceptions:

- (a) *Multi-Investor Structures:* Multi-investor structures consisting of two or more institutional investors pursuing a specific timber asset under an LLC or another investment vehicle may be used, provided that: (1) the ERS is shielded from potential tax and general liabilities; and (2) multi-investor structure investments may not comprise more than 25% of the portfolio based on timberland market value at the time of acquisition.

- (b) *Board Waivers*: Investments not wholly owned by the ERS (other than investments held under a multi-investor structure, as provided in (a), above, or in joint ventures, as provided in (c) below, may be purchased by the manager, subject to review by and only upon prior approval of the Board.
- (c) *Joint Ventures*: Investment managers may undertake joint venture arrangements with forest product industry companies for up to 20% of the portfolio; however, joint ventures are allowable only if the ability of the ERS to dispose of the property in an arms-length transaction at fair market value is not impeded.

4. Reporting System

There shall be a comprehensive reporting and monitoring system for the entire portfolio. Situations of underperforming investments, portfolio diversification deficiencies from the *Timberland Portfolio Policies and Procedures*, and conflicts of interest can then be identified, facilitating active portfolio management. Further definition of this reporting system is provided in Sections III.C.2.b. "Investment Management Ongoing Operations" and III.C.3. "Investment Management Portfolio Accounting and Financial Control."

5. Performance Measurement

The timberland manager will provide cash flow, valuation, and any other requested information to the ERS investment staff ("Investment Staff"), and the ERS's real estate consultant ("Real Estate Consultant") quarterly, and the ERS's custodian bank ("custodian") on a monthly or quarterly basis, as required by the ERS.

Performance will be calculated on a time-weighted basis. The rate of return calculations will be net of all fees and expenses. So that the performance numbers reported by the manager and the custodian bank shall be the same, the manager will be responsible for reviewing the custodian's figures and bringing any discrepancies to reconciliation.

Benchmarks: The ERS will employ an absolute rate of return benchmark of a 6% real rate of return over rolling 5-year periods. Other appropriate performance comparisons will also be examined, such as an appropriate timber index or other relevant proxies (e.g., the NCREIF Timberland Index).

II. INVESTMENT POLICIES

Long-term target diversification ranges will guide the timber investment program. Each year the program will be further implemented or modified in accordance with an *Annual Tactical Plan* prepared by the timberland manager, reviewed by Investment Staff and the Real Estate Consultant, and approved by the Board.

A. **ELIGIBLE INVESTMENTS**

In general, the timberland manager will have discretion to purchase forest tracts that are expected to meet or exceed the ERS's rate of return objectives for timber investment. The rate of return must be appropriate after the consideration of any risk measures employed by the manager. Multi-investor structure investments may not comprise more than 25% of the portfolio based on timberland market value at the time a multi-investor structure is made. Lease holdings may comprise no more than 30% of the portfolio, with the remainder of holdings being fee simple. The timberland manager is allowed to enter into joint ventures with forest product companies for up to 20% of the portfolio. However, the structure of the joint venture must not impede, at any time, either the sale of the

holding or the ability of the ERS to replace the timberland manager. Also, the manager will minimize the concentration of holdings in areas known to be frequented by natural disasters, for example coastal tracts known to be frequent hurricane paths, flood zones, etc.

Without compromising the geographical diversification targets, the timberland manager will use reasonable efforts to mitigate the incurrence of unrelated business taxable income in the portfolio.

Leverage may be used, on a nonrecourse basis, up to 20% of the timberland market value of the portfolio, with no more than 50% leverage on any one timber investment. The single investment debt level will be measured for compliance at the time leverage is added to the portfolio. Leverage for the total portfolio will be measured for compliance at the time the leverage is added to the portfolio or a portfolio asset is purchased or sold. Leverage may not be added to any investments held as of September 15, 2010.

B. GEOGRAPHICAL LOCATION DIVERSIFICATION

Over the long-term, the ERS portfolio should seek portfolio diversification with regard to major US-domestic timber growing regions. The timberland manager may seek to diversify internationally up to 20% of the portfolio based on timberland value of the portfolio at the time the investment is made. The currency exposure to the ERS from any non-U.S. dollar aspect of the allocation is expected to be negligible over the long-term.

The following ranges set forth the geographic diversification targets for the timberland manager to fulfill:

Region	Range	Midpoint
South	45% - 65%	55%
West	25% - 45%	35%
Northeast	0% - 20%	10%
Other/International	0% - 20%	10%

C. TREE MATURITY DIVERSIFICATION

The ERS portfolio will seek to diversify by maturity of timber ranging from immature, pre-merchantable trees through mature, merchantable timber. The timberland manager will create a sustainable timberland portfolio where tree seeding, planting, growth and purchases will replace trees harvested and properties sold.

D. TREE SPECIES DIVERSIFICATION

The portfolio will be diversified by timber type and include both hardwoods and softwoods.

E. END USE DIVERSIFICATION

The ERS portfolio will be structured to sell into several commercial industries, such as paper goods and cardboard, various building and construction materials markets, and finished carpentry and furniture. The timberland manager will also take into account the number of regional processors or purchasers of timber inventory.

F. TRACT AND PARCEL DIVERSIFICATION

The portfolio will be composed of numerous non-contiguous tracts with the goal of diversifying the risk of natural disasters **such** as fire, disease, pests, etc.

III. PROCEDURES FOR TIMBER PROGRAM MANAGEMENT

A. INVESTMENT PROCEDURE

Timber investments in compliance with these *Timberland Portfolio Policies & Procedures* (Section II: Investment Policies and Section II: Investment Objectives) shall be made and managed through the following process:

1. Timber Acquisition, Management and Disposition: Periodically, the Investment Staff and the Real Estate Consultant will review and modify, as necessary, the *Timberland Portfolio Policies and Procedures* that specify long-term diversification parameters for the timberland investment portfolio. Any modifications to the plan will be incorporated as necessary. The *Timberland Portfolio Policies and Procedures* will then be submitted to the Investment Staff for review and the Board of Trustees for final approval.
2. Annual Tactical Plan: Annually, the timberland manager will prepare an *Annual Tactical Plan* which reviews the current status of the portfolio, recent historical and prospective market conditions, and proposes the steps to be taken over the next twelve month period to further implement the long-term strategic plan. The *Annual Tactical Plan* will be reviewed by the Real Estate Consultant and Investment Staff and approved by the Board. The outline for the *Annual Tactical Plan* is provided in Appendix IV.4 - A.

B. MANAGER RESPONSIBILITIES

1. Investment Management

Timberland managers are directly accountable for the following investment management responsibilities. This section designates certain investment responsibilities that the timberland manager will perform or cause to be performed.

- a. Acquisition – The manager will be responsible for sourcing, evaluating and selecting, on a discretionary basis with fiduciary responsibility, timber investments to be made on behalf of the ERS.

The acquisition process will be made with a view to maximize the ERS's risk adjusted rate of return, within the portfolio diversification parameters set forth in the Objectives, Policies, and Program Management sections of these *Timberland Portfolio Policies & Procedures*. The process will include, but not be limited to, the following services:

- (1) Review and maintain a record of opportunities available in the market over time.
- (2) Evaluate opportunities and identify investments that will provide the most attractive risk and return characteristics, and are in accordance with the long-term and short-term objectives of the portfolio.
- (3) Conduct full and proper acquisition due diligence and fully document the process. Due diligence will be conducted to a standard of completeness attributable to a prudent expert. Prospective investments will be inventoried and evaluated on the timberland manager's financial model at an appropriate discount rate, in determining appropriate acquisition pricing.

The timberland manager will make available for review by the ERS, or its agents, the manager's policies, procedures, and standards for conducting property

evaluation and due diligence and the due diligence documentation performed on any investment made on the ERS's behalf.

- (4) Negotiate purchase agreements and other closing documents on the ERS's behalf, with a view to maximize returns, minimize expenses, safeguard the ERS's assets, and secure investor rights, and make timberland investments on the ERS's behalf.

b. Ongoing Operations – The timberland manager shall manage or cause to be managed, the portfolio and individual properties such as to enhance the ERS's value in the investment. The manager shall be responsible for conducting or supervising the following services with respect to each investment:

- (1) Management Plan – The manager will develop and execute a management plan for each holding and the overall portfolio to maximize the value of the investments for the ERS.
- (2) Property Management – The manager will monitor budgeted versus actual performance for the properties and shall take all necessary or appropriate steps consistent with applicable capital and operating budgets to assure the ERS's investment is managed to or above its anticipated performance level. This process will involve applying silvicultural⁵ and other forest management techniques to maximize inventory yield and property value, and minimize risk of loss. It will also involve techniques to maximize return and provide cash flow, such as negotiating hunting and usage leases.

The manager shall keep itself informed of the overall market conditions relative to the managed investments and the managed investments' valuations. The manager will also be responsible for ensuring compliance with all environmental and other governing laws. All such activities will be undertaken with the intention to maximize value to the ERS.

- (3) Sale of Timber Inventory – The manager will maintain an awareness of current market pricing and future pricing forecasts, and sell inventory according to the management plan, or opportunistically as determined at the manager's discretion.
- (4) Valuation and Appraisals – Properties will be appraised by an outside appraiser at least every three years, or as necessary. Appraisals will also be updated by an outside appraiser, as necessary or requested by the manager. The manager will provide updated valuations of each investment quarterly, based on inventory measures and updated outside appraisals as available.
- (5) Disbursement, Receipt and Cash Management – The manager will develop procedures for funding investment on a timely basis and coordinating the receipt of cash distributions from the sales and other income sources.

c. Disposition – Ongoing, and based on timber market circumstances, the timberland manager shall review the managed investments with respect to continued timely return of capital, income and gains, including both planned and opportunistic sales of timber

⁵ Silviculture is the theory and practice of controlling the establishment, composition and growth of forests. Examples of silvicultural practices include planned cutting, planting, thinning, fertilizing, proper drainage, controlling insects and other similar activities.

inventory and properties. The manager shall identify qualified buyers, solicit and evaluate offers, and negotiate property sales.

2. Portfolio Accounting and Financial Control

The timberland manager's accounting, reporting, financial control, and administration systems shall meet the following objectives:

- a. Financial Control – The manager will provide control systems to protect assets, detect errors and insure the reliability of information generated by the accounting system.
 - (1) Books and Records – The manager shall maintain books of account with correct entries of all receipts and expenditures incident to the management of the investment. These books, together with all records, correspondence, files and other documents, shall at all times be open to the inspection of the ERS. The manager shall maintain complete and accurate records of all transactions related to the managed investment, including receipts and all correspondence relating thereto on such forms as the ERS's auditors may reasonably require and make such records available for inspection and copying by the ERS at all reasonable times. The manager shall bear the costs associated with the retention of such records and if the ERS shall request copies of such records, the manager shall bear the cost of duplicating and sending such records to the ERS.
- b. Financial Statements – On a quarterly basis, the timberland manager will create unaudited financial statements, and annually, audited financial statements for the overall portfolio.
- c. Accounting Policies – Accounting policies for the ERS are outlined below:
 - (1) Current Value Reporting – Accounting data shall be computed using current values. The timberland manager will report performance in compliance with the CFA Institute standards, or other appropriate standards as agreed to with the ERS. The manager will be held to a standard of a prudent expert in valuing the underlying value of the investments.

3. Reporting Requirements

- a. Manager Quarterly Report – On a quarterly basis, within 45 days following the quarter-end, the timberland manager shall provide the Investment Staff and Real Estate Consultant with a report on the portfolio which will address activities occurring during the prior quarter, an updated list of holdings, cash flows, valuations, return calculation, and any and all other items of which the ERS should be apprised.
- b. Custodian Bank Monthly Statement – On a monthly basis, the timberland manager shall provide the ERS's custodian a report of the ERS's account cash flows and valuations, and any other information reasonably requested.
- c. Funding Procedures – The timberland manager shall provide the ERS, on a best efforts basis, with ten (10) business days notice of funding for purchases. The ERS shall also be provided with documented wiring instructions in advance.
- d. Annual Tactical Plan – Within 60 days of calendar year end, the timberland manager will submit an *Annual Tactical Plan* for review by the Investment Staff and the Real Estate Consultant, and for approval by the Board of Trustees. The *Annual Tactical Plan* (outlined

in Appendix IV. 4 - A) will include: (1) a review of the current status of the portfolio, (2) perceived investment environment, (3) the types and amount of property investments to be sought and underlying rationale, (4) goals for other management responsibilities such as situations being monitored and adding value, and (5) outline the steps anticipated toward portfolio development over the course of the coming fiscal year.

- e. Notice – The timberland manager shall notify the Investment Staff and Real Estate Consultant as soon as practicable in writing of any investigation, examination or other proceeding involving the timberland investments commenced by any regulatory agency or of any action, suit or proceeding commenced against or by the manager or any parties affiliated with the portfolio.
- f. Other Information – The timberland manager will also provide any other reasonable information requested by the Investment Staff, or the ERS's custodian, the Real Estate Consultant or other agent of the ERS.

APPENDIX F.1

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
TIMBER ANNUAL TACTICAL PLAN GUIDELINES**

Tactical Plan: The Tactical Plan is a report which outlines the steps to be taken in the next 12 month period to further implement the timber portfolio, and any other actions or considerations germane to the active management and success of the portfolio. It also documents the reasons for the particular courses of action to be taken, and importance of items under consideration.

The Investment Staff and Real Estate Consultant shall review the *Annual Tactical Plan*, submit comments, and recommend approval of the finalized plan to the Board of Trustees. All sections should be as brief as possible using a format as follows:

I. FUNDING LEVEL

Annual Tactical Plan Period: 1/1/xx through 12/31/xx

A. Funding Tables:

1. Current Funding Position (As of x/xx/xx)

Total Fund Market Value	\$xx billion
Market Value (Excl. Multi-Investor Structure Investments)	\$xx billion
Multi-Investor Structure Investments	\$xx billion
Target for Timber	\$xx million
Current Net Asset Value Deficit/(Surplus)	\$(xx) million

- Discuss any planned undertakings with respect to the allocation's size in the next 12 months.
- Leverage – List individual investments where leverage is used and the specific dollar and percentage amount of leverage used on the investment. Also state the total percentage and dollar amount of leverage used relative to the total portfolio timberland market value.

II. DIVERSIFICATION AND PORTFOLIO STATUS

A. Geographic Diversification

	% Range	\$ NAV	% NAV
South	45-65	0	0%
West	25-45	0	0%
Northeast	0-20	0	0%
Other*	0-20	0	0%
International*	0-20	0	0%
Totals		0	100%

Note: While Other and International are listed separately, the combined total of the two will not exceed 20%.

- Discuss all planned undertakings with respect to the allocation's geographic diversification in the next 12 months.

2. Discuss the outlook for each region regarding property purchase and sales, timber prices, and any other relevant factors.
- B. Timber Maturity – Discuss the composition and plans for the portfolio with respect to biological maturity.
 - C. Species, End-Use, Tract & Parcel Diversification – Describe and comment on the portfolio's diversification with regard to the listed considerations and any specific actions to be undertaken.
 - D. Current Status of the Portfolio – Comment on the portfolio's current status with regard to any other material considerations and specific actions to be undertaken. Include comments specific to the portfolio's:
 1. Return
 2. Risk
 3. Diversification
 4. Leverage

III. MARKET ENVIRONMENT

- A. Recent Past – Discuss the market environment in which the portfolio has been operating for the past year, and any ramifications.
- B. Coming Year – Discuss the expected market environment for the next year, and any ramifications.
- C. Are any material transactions planned or anticipated in the next year? If so, discuss the underlying rationale.

IV. PORTFOLIO MANAGEMENT

- A. Discuss objectives and plans for other portfolio or property management responsibilities, such as situations being monitored and adding value, property sales, etc.
- B. Specific situations being monitored, underperforming investments.
- C. Discuss projected changes in capital calls and distributions.
- D. Other items relevant to the ERS's portfolio and any items of which the Board should be apprised.

SUMMARY

Investment Objectives: Summary of basic goals for the portfolio for the next 12 months.



REAL ESTATE PROGRAM

SECTION: G

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Appendices

- Real Estate Investment Brief Format – Appendix G.1
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G.1. Real Estate Investment Objectives

A. Investments In Real Estate

The Employees' Retirement System of the State of Hawaii ("ERS") completed a strategic allocation study for the investment of its assets. This analysis demonstrated that, over the long term, inclusion of investments in private and public equity real estate and debt positions in real estate properties would enhance the ERS's expected portfolio investment characteristics while reducing expected total portfolio volatility.

In general, the ERS desires to obtain the optimum return on the portfolio consistent with the assumption of prudent risk. While safety of principal is given primary consideration, the ERS recognizes the need to use active asset management strategies in order to obtain the highest attainable total investment return (income plus appreciation) within the ERS's framework of prudence and managed risk.

Real estate investments of ERS shall be made in a manner consistent with the fiduciary standards of the prudent person rule: (1) to safeguard and diversify the real estate portfolio; and, (2) for the sole interest of the participants and their beneficiaries. The selection of investment managers and development of investment policy will be guided to enhance diversification within the portfolio of the ERS's real estate investment program ("Real Estate Investment Program") thereby limiting exposure to any one investment, organization, real estate property type and geographic region (Refer to Section II: Program Management).

1. **Real Estate Defined** - Real estate assets are defined as those investments that are unleveraged or leveraged, private or public equity or debt positions in real property. The ownership structure should be fee simple, or ownership in shares of a real estate corporation or limited partnerships, either wholly-owned or owned jointly with other suitable investment partners having the same or greater standards of fiduciary care and responsibility as those adopted by the ERS. The ERS will pursue both discretionary separate account investment management and discretionary commingled fund investment management for its real estate allocation.

B. Strategic Allocation

The ERS allocation to real estate shall remain within the limits authorized by the ERS Board of Trustees. The current target allocation is 7% of the total ERS investment portfolio market value.

C. Portfolio Return Objectives

1. **Total Return**- Over rolling 5-year periods, the real estate investment portfolio is expected to generate a minimum total real rate of return (net of investment management fees) of 5% using a Time-Weighted rate of return calculation. The inflation index used to calculate the actual real rate of return is the USA CPI-All Urban.

Individual investment risk categories within the real estate investment portfolio shall have different return objectives established from time to time by the Board in order to account for increased risk relative to a core strategy. The return objectives are as follows:

Risk Category	Return Objectives Over rolling 5-year periods (Unleveraged)
Core	5% Net real rate of return
Value Added	7% Net real rate of return
Opportunistic	9% Net real rate of return
Public REITS (Domestic)	NAREIT Equity Index*
Public REITS (International)	FTSE / EPRA / NAREIT*
Public REITS (Global)	EPRA / NAREIT / Global*

*NAREIT – National Association of Real Estate Investment Trusts

*FTSE – Financial Times Stock Exchange

*EPRA – European Public Real Estate Association

2. **Income Return** - Income, which is defined as cash distributed to the ERS, should comprise at least 2/3 of the total return over rolling five year periods for core investments. The ERS may use the minimum total rate of return calculation instead of the time-weighted rate of return calculation for the specialty portfolio (value added and opportunistic) with assets or investment strategies reasonably expected to derive all or substantially all investment yields from appreciation. Due to the significant increase in risk associated with the specialty investments, these types of assets shall be limited to 30% of the real estate portfolio market value and have a higher real rate of return target than the total real estate portfolio return objectives as outlined in the above chart.

3. **Minimum Yields** - On separate accounts that invests in core properties, the manager's five (5) year yield (internal rate of return) projection shall exceed the then current ten year treasury yield by no less than 150 basis points. Given a market cycle in which this yield test cannot be met, ERS investment staff ("Investment Staff") and the ERS's real estate consultant ("Real Estate Consultant") will review the real estate allocation in light of the current market and achievable risk adjusted returns.

G.2. Program Management

A. Overview

In compliance with current ERS investment philosophy, the Real Estate Investment Program will utilize discretionary separate account relationships and discretionary commingled fund investment vehicles that are sponsored by real estate investment managers ("Investment Managers"). Under this program, the Investment Managers acquire, operate and dispose of real estate assets in accordance with a work assignment that is outlined in their investment management contract with the ERS (the "Contract") and in the Annual Tactical Plan for separate accounts and the fund documents for commingled funds. The Contract describes the acceptable property types, geographic restrictions, investment structures, leverage and other specific investment parameters. The Annual Tactical Plan is the Investment Manager's "working plan" for each fiscal year and must be reviewed by Investment Staff and Real Estate Consultant (Refer to Section IV: Control and Monitoring Systems) and approved by the Board of Trustees. Commingled fund documents typically refer to the fund's offering memorandum or private placement memorandum, limited partnership or LLC membership agreement, and subscription agreement.

B. Participant Roles and Responsibilities

The ERS's Real Estate Investment Program shall be implemented and monitored through the coordinated efforts of the Board of Trustees; through the Investment Staff; the ERS's general investment consultant ("General Investment Consultant"); the ERS's real estate consultant ("Real Estate Consultant"); the Investment Manager(s); and external appraisers ("Appraiser" or "Appraisers"). Specific responsibilities that fall outside the general responsibilities highlighted in Section B.5. are listed below:

1. **Investment Manager** - Qualified real estate organizations, registered as Investment Advisors under the 1940 Act that provide institutional real estate investment management services to the ERS. ERS may invest in commingled fund vehicles that are not registered, however, it is preferred that the commingled fund be sponsored and/or managed by a Registered Investment Advisor.

Separate Account Manager Responsibilities - The separate account Investment Manager, acting as a fiduciary on behalf of ERS, acquires, manages and disposes of real estate properties in accordance with the annual Tactical Plan and Contract. The Investment Manager retains appropriate property management expertise and shall (1) recommend to Investment Staff and the Real Estate Consultant qualified appraisers annually; (2) complete internal valuation estimates of the real estate assets managed by them on behalf of the ERS quarterly; and, (3) provide any additional information regarding valuation requested by Investment Staff or the Real Estate Consultant.

Commingled Fund Manager Responsibilities - The commingled fund Investment Manager, acting as a fiduciary on behalf of ERS, acquires, manages and disposes of real estate investments in accordance with the terms of the investment vehicle documents.

2. **External Appraisers** - Independent real estate valuation experts selected to provide their opinions regarding the current values of the ERS's real estate separate account investments. While the Appraiser selection process is further described in Appendix

G.5 of this section, the Appraisers shall have at a minimum the industry or governmental certifications and designations (e.g., Member of the Appraisal Institute or an MAI) required by the Investment Staff and the Real Estate Consultant. The Appraisers shall be recommended by the Investment Managers and approved by the Investment Staff and the Real Estate Consultant. The selected Appraisers shall have reasonable experience and expertise in the property type and geographic location of the individual property or asset being valued.

C. Portfolio Composition

The real estate program will be comprised of two different but complementary components – core and specialty.

1. **Core Portfolio** - Core investments include equity or debt investments on existing, substantially leased income-producing traditional property types located principally in metropolitan areas that exhibit reasonable economic diversification. Core properties, therefore, must have the following characteristics:

- Traditional institutional quality property types including office, industrial, retail and multifamily;
- Operating and stabilized properties that demonstrate predictable income flows with a high proportion of anticipated total return arising from current income and cash flow;
- At least 70% leased upon purchase of the asset;
- Located in institutional markets and in economically diversified metropolitan areas;
- High credit quality tenants and a staggered lease maturity schedule;
- Quality construction and design features;
- Reasonable assurance of a broad pool of potential purchasers upon disposition;
- Properties requiring quality asset and portfolio management but not requiring specialized operating expertise which is not readily available in the market;
- Investments structures using all cash or low leverage. Leverage is limited to 50% on each investment;
- Total gross return expectations between 6% and 8% per year.

Core properties can be further classified as:

- Trophy
- Commodity

Trophy properties represent dominant and unique properties that cannot be easily reproduced due to such factors as legislative limitations and physical constraints. Trophy properties are typically located in only the largest metropolitan areas often with a significant global environment.

Commodity properties are core properties without trophy characteristics but with nearly similar economic, financial and operating expectations. Typically, commodity properties should have a competitive advantage in their immediate marketplace by virtue of size, location, tenant base and/or design features.

2. **Specialty Portfolio**- Specialty investments represent equity or debt investments in those properties and/or investment strategies that require specialized acquisition and management expertise or skill to mitigate the business and leasing risk that may be associated with individual investments. Specialty investments which may be referred to as Value Added or Opportunistic have greater volatility compared to core investments and as such are expected to provide yields higher than those associated with core investments.

2.1 Value Added – Value added investments include equity or debt investments in institutional quality assets that offer the opportunity to enhance value through rehabilitation, redevelopment, development, lease-up or repositioning. A significant portion of return is from appreciation and includes moderately higher leverage than core. Value added investments typically exhibit one or more of the following characteristics:

- Properties located in primary as well as secondary and tertiary markets which may not be economically diversified and may have accompanying susceptibility to imbalance of demand and supply;
- Traditional as well as non-traditional property types including hotels, motels, senior housing, student housing, manufactured and residential housing;
- Properties that are undermanaged with specific problems that require specialized management skills;
- Properties that are less than 70% leased upon purchase or where more than 30% of leases expire in the first three years of purchase
- Properties which are considered to be in a “work out” mode;
- Properties involving significant appreciation, lease-up, development and/or redevelopment risks;
- Properties using moderate leverage between 50% and 65%;
- Investments in institutional quality properties located in mature real estate markets showing high levels of market transparency outside of the United States and Canada;
- Total gross return expectations are between 11% and 13%

2.2 Opportunistic – Opportunistic investments include equity or debt investments in real estate properties, real estate operating companies and other investment vehicles that offer the opportunity to capitalize on the disequilibrium of the real estate markets caused by dramatic shifts in capital flows or other fundamental real estate characteristics. Opportunistic investments not only include distressed assets in need of lease up but also assets that provide returns from financial restructuring. Opportunistic investments typically exhibit one or more of the following characteristics:

- Strategies that seek to exploit inefficiencies in the capital and real estate markets
- Strategies that involve financing or acquisition of real estate assets, operating companies, portfolio of real estate assets
- Properties with substantial leasing, development and entitlement risk
- Distressed assets
- Distressed debt
- Major financial re-structuring required
- High leverage of between 65% and 75%

- Investments in emerging real estate markets driven by growth and continued improvements in market transparency, located outside of the United States and Canada
 - Total gross return expectations are in excess of 15%
3. **Allocation Between Core and Specialty** - As required, the ERS shall approve the Investment Plan which directs capital allocations into either core or specialty (value added and opportunistic) property types predicated on the required return to the ERS and current market yield expectations with the objective of minimizing risk while achieving targeted returns. The current investment strategy target objective is 70% (+ 10%) in core investments, 20% (+ 10%) in value added and 10% (+ 10%) in opportunistic investments as shown below:

Risk Strategy	Target Objective	Allowable Range
Core	70%	60% to 80%
Value Added	20%	10% to 30%
Opportunistic	10%	0% to 20%

4. **Core and Specialty Return Objectives**

Core – Consistent with ERS total real estate portfolio return objectives, the core portion of the portfolio is expected to provide net real annualized returns of at least 5%.

Specialty – The specialty portion of the portfolio is expected to provide returns above the core portfolio return to compensate for the additional risk associated with these types of investments and/or strategies. Value added investments are expected to provide net real returns of at least 7% and opportunistic investments are expected to provide net real returns of at least 9%.

D. Investments and Risk Management

The ERS shall manage the investment risk associated with real estate in several ways:

1. **Institutional Quality** - All assets within the Core portfolio must be of institutional investment quality as evidenced by a history of institutional investment in similar properties; expert analysis which supports the economic viability of the market; high quality construction and design features; and a current or potentially competitive position within the property's immediate market area.
2. **Diversification** - The real estate portfolio shall be diversified by geographic region and property type. Diversification reduces the impact on the portfolio of any one investment or any single Investment Manager's style to the extent that an adversity affecting any one particular area will not impact a disproportionate share of the total portfolio.

Target Portfolio

The long-term real estate strategy is for the ERS real estate portfolio to be diversified by geographic regions and property type within the following target ranges:

Geographic Regions

West	20-50%
Midwest	5-30%
South	10-35%
East	10-40%
International (Non US and Canada)	10%-20%

Property Types

Apartments	10-40%
Industrial	10-30%
Office	10-50%
Retail	10-30%
Other*	0-10%

* “Other” includes property types not classified by the NCREIF Index, such as, hotels, motels, residential housing, senior housing, and raw land.

3. **Ownership Structure** - The ownership structure for Core investments includes leveraged and unleveraged equity investments owned 100% by ERS or owned jointly with Suitable Investment Partners. “Suitable Investment Partners” include public, corporate and union pension plans, foundations and endowments, insurance company general accounts or separate accounts, and other tax-exempt institutions, having the same or greater standards of fiduciary care and responsibility as those imposed by ERS guidelines. When dealing with specialty investments that are directly owned, Operating Partners shall be added to the list of “Suitable Investment Partners.” The ownership structure of Specialty assets within commingled funds will be governed by the fund documents.
4. **Leverage** - Leverage may be utilized in a constrained manner in the Core portfolio in order to enhance yields of the various investments and/or facilitate the diversification of the portfolio. The use of debt must result in positive leverage where cash flow is in excess of debt service. The total expected return to ERS over the term of the investment must be expected to increase a minimum of 2 basis points for each 1% of leverage, as a result of leverage. For example, leverage returns on an acquisition with 50% debt should be higher than the unleveraged returns for the same property by a minimum 100 basis points. The total level of debt for any single investment will not exceed fifty percent (50%) of the value of that asset for core investments and 75% for specialty investments. Total portfolio debt will be limited to thirty percent (30%) in the core portfolio, 65% in value added investments and 75% in opportunistic investments. The single investment debt level will be measured for compliance at the point leverage is added to the portfolio. The total portfolio debt levels will be measured for compliance at the point leverage is added to the portfolio or a portfolio asset is purchased or sold.

ERS intends to invest in Specialty (Value added and opportunistic) commingled funds that utilize higher levels of leverage as a component of their investment strategy. Total debt for value added investments will be limited to 65% of the total value of the commingled fund and total debt for opportunistic investments will be limited to 75% of the total value of the commingled fund.

The maximum debt permitted on the total real estate portfolio is 45%

5. **Manager Concentration** – ERS shall limit its exposure to any single manager. No single Investment Manager shall be permitted to manage more than 35% of the total allocation to real estate at the time of investment (i.e., purchase).
6. **Investment Size** – There is no minimum investment size. The maximum net investment in a single property within the separate account shall be limited to 5% of the allocation to real estate at the time of investment. The maximum investment in any single commingled fund shall be limited to 10% of the allocation to real estate at the time of investment. The ERS's investments in a single commingled fund shall not exceed 20% of the total net market value of the commingled fund at the time of investment.

G.3. Real Estate Investment Process

A. Manager Selection

In an effort to maintain program simplicity and ensure appropriate underwriting of investment management organizations, the ERS shall utilize only ERS approved real estate investment management firms for the acquisition, asset management and disposition of property. In addition to the existing separate account Investment Managers, the ERS has approved a program of commingled fund investing. Each Investment Manager will be provided a specified capital allocation. Investment Manager capital commitments shall periodically be balanced in accordance with the overall real estate strategic allocation objectives.

B. Transaction Review And Closing - Separate Accounts

- 1. Investment Identification** - Upon identifying a specific investment that meets the program guidelines and Tactical Plan objectives, the Investment Manager must provide to the Investment Staff and Real Estate Consultant, a written summary of the property characteristics, investment structure and notification of joint venture partners and/or investment partners in the format provided in Appendix G.1.
- 2. Property Closing and Funding** - Once the Investment Manager identifies an investment that meets portfolio objectives, the Investment Manager shall provide to the Investment Staff and Real Estate Consultant a Critical Dates list which includes scheduled funding dates, wire transfer instructions and other important timing information. In addition, the Investment Manager shall prepare a Closing Report as appropriate. Upon close of the investment, the Investment Manager shall provide to ERS a summary of all uses of capital funded by the ERS.

C. Asset Management - Separate Accounts

In conjunction with its asset management responsibilities, the Investment Manager must comply with the reporting requirements as outlined in Appendix G.2. Revisions to the original ten year pro forma and capital budget that require unscheduled capital fundings must be presented to the Investment Staff for review; however, it is not necessary to present to staff unscheduled capital fundings that were already described in the annual property plans. Refinancing or partial dispositions that were not approved as a part of the Annual Tactical Plan must also be presented to the Investment Staff.

D. Disposition – Separate Accounts

Annually, the Investment Manager must review each property managed by it on behalf of ERS and complete a “hold” or “sell” analysis. Assets targeted for sale are identified and documented and a brief explanation of the sell decision and strategy is provided to the Investment Staff, the Real Estate Consultant, and the Board at the annual Tactical Planning presentation. In addition, the Investment Manager must submit to the Investment Staff and Real Estate Consultant notification of any unsolicited sales offers. Once an offer is accepted by the Investment Manager, the Investment Staff and the Real Estate Consultant must be provided with a Critical Dates list that details the disposition activities.

E. Commingled Fund Investments

The ERS does not anticipate using the commingled fund vehicle for additional Core investing. Rather, separate accounts are the preferred vehicle for Core investments. However, commingled fund vehicles may be used to access “specialty investments” to meet its 30% target as stated above. The selection process used to invest in commingled funds is similar to the process used to retain separate account Investment Managers. Selection criteria for commingled funds shall include minimally conflicted fee structures and maximum investor controls. In addition, the ERS shall use similar strict control and monitoring systems to evaluate the commingled fund Investment Managers as used for evaluating the separate account firm.

G.4. Control and Monitoring Systems

In real estate investing, separate and distinct from other strategic classes, the Investment Manager has direct control over the operations of the assets. This inherent conflict of interest contributes to the lower volatility associated with the strategic class but also creates a need for greater oversight by the ERS. The Board of Trustees shall be notified by the Investment Staff and the Real Estate Consultant of Investment Manager reporting problems, significant organizational changes such as mergers, and prolonged under-performance. Investment Managers performing below expectations in any of the before mentioned areas shall be placed on the “watch list” outlined below. All Investment Managers will be subject to an annual review in Hawai‘i and may also be called in by the Investment Staff or Board for a special review. Finally, the ERS also recognizes that it may elect to terminate separate account Investment Managers within thirty (30) days for “cause” as outlined in the Contracts. The ERS shall manage the Real Estate Investment Program in the following manner:

A. Annual Reporting Requirements

Separate Account Investment Managers

1. **Tactical Plans** - Annually, the separate account Investment Manager prepares a Tactical Business Plan, an outline of which is in Appendix G.3. In the Tactical Plan, the Investment Manager outlines its targeted investment plan including the basis upon which targets have been established. The Plan must include property type, investment structure, return expectations and exit strategies as well as any other pertinent strategy specific parameters. This Plan is to be completed or revised every year and submitted to the Investment Staff and the Real Estate Consultant. The plan shall be presented in September of each year, unless otherwise directed by the Investment Staff or Board, and, if appropriate, shall be approved by the Board.
2. **Asset Management Plans** - The separate account Investment Manager must also prepare annual asset management plans for each property managed by the firm and owned by the ERS. Asset management plans include property-specific operating budgets; estimates of cash to be distributed to the ERS, management fees, debt service, lease expirations and rollover, and all other relevant property information. A sample outline is included as Appendix G.4. Asset management plans are due thirty days prior to the ERS fiscal year end and are to be submitted to the Investment Staff and Real Estate Consultant. When submitting the annual asset management plan, the Investment Manager should review any significant line item variances (greater than 10% and \$25,000) from the prior year.
3. **Investment Manager Reviews** - At least annually, and as often as twice a year as determined by the Board, the Investment Staff and Real Estate Consultant shall coordinate an Investment Manager review presentation for the Board. Each review is required to discuss how the investments managed on behalf of the ERS have met the previous year’s plan as well as the program objectives of ERS. The Investment Manager’s organization is also reviewed. This monitoring system is designed to assist the ERS in identifying troubled investments and changes at the organizational level that may suggest additional monitoring is required.

Commingled Fund Managers

At least annually and as often as twice a year as determined by the Board, the Investment Staff and Real Estate Consultant shall coordinate an Investment Manager review

presentation for the Board. Each review is required to discuss the Fund's performance and how the investments managed on behalf of the ERS have met the objectives of the Fund and of ERS. The presentation will include a discussion of important developments regarding the investments as well as the Investment Manager's organization. This monitoring system is designed to assist the ERS in identifying troubled investments and changes at the organizational level that may suggest additional monitoring is required.

B. Quarterly Reporting

1. **Performance Measurement** - Within 35 days for separate accounts and 45 days for Specialty commingled funds of the quarter close, the Investment Manager is required to submit to the Real Estate Consultant an investment position work sheet and distribution worksheets for use in the calculation of performance figures for that period.
2. **Operations Report** - The Investment Manager shall analyze financial statements quarterly comparing budgeted operations to actual investment performance. This analysis must be available at Investment Staff's request within 60 days of the quarter close.

C. Property Valuations

1. **Appraisals** - Appraisals shall be conducted in accordance with the ERS approved Investment Manager contracts and the Separate Account Appraisal Policies and Procedures (Appendix G.5). Investment Staff, on behalf of the ERS, reserves the right to obtain and review the list of appraisers and their qualifications. Generally, ERS recommends the following appraisal policy for its commingled and separate account managers.
 - a. **Commingled Funds** - Investment Managers sponsoring commingled fund vehicles in which ERS may own or consider acquiring an interest should include in the offering documents an appraisal policy such that independent MAI valuations are conducted at least annually. This criteria may be modified in specific cases where the cost of appraisal is greater than the benefit received by the participants. However, if fees are paid based on "market value" of an investment, then in no case should annual independent MAI appraisals be waived.
 - b. **Separate Accounts** - For separate account structures, appraisals are conducted in accordance with the Separate Account Appraisal Policies and Procedures as detailed in Appendix G.5.
2. **Performance Measurement** - For performance measurement purposes, both the MAI appraiser's and the Investment Manager's interim internal estimates of value will be used to calculate returns. Every year, the independent appraisals are to be provided by the Investment Manager in its performance measurement reporting.
3. **Notification of Variance** - Should the appraised value of any asset vary by more than 10% from one year to the next, the Investment Manager must provide to the Investment Staff and the Real Estate Consultant a written explanation for the variance. This report is due Investment Staff within 30 days of the final property appraisal.

D. Subcontractors

1. **Property Management** - The selection of property management is left to the discretion of the Investment Manager. It is expected and required that the Investment Manager will retain the highest caliber market rate property management service either through a third party fee manager or the Investment Manager's affiliated property management division.
2. **Affiliates** - Property management contracts and other service relationships provided by an affiliate of the Investment Manager may be reviewed by the Investment Staff and the Real Estate Consultant to ensure appropriate compensation and capability. The Investment Staff and the legal counsel need not review contracts with independent vendors as the Investment Manager, in its capacity as a fiduciary, represents the ERS's interests. Prior to terminating a property management assignment, the Investment Manager must inform the Investment Staff and the Real Estate Consultant in writing of the release, and designate the new firm to be retained.
3. **Bonding** - All subcontractors employed by the Investment Manager must be bonded. The level of bonding and implementation is left to the discretion of the Investment Manager. The Investment Manager shall employ the highest standards of care in this matter.

E. Audit Process

1. **Unrelated Business Income Tax ("UBIT")** - As a tax-exempt entity, the ERS hereby instructs its Investment Managers to avoid transactions generating UBIT. Should ERS be at any time invested in real estate or other assets that result in UBIT, the Investment Manager is to provide immediate notification and an evaluation of the financial impact to the Investment Staff who will then provide a report to the Board.
2. **Audited Financial Statements** - On an annual basis, the Investment Manager will provide ERS with a combined audited financial statement for the total portfolio it manages, to be prepared by a nationally recognized audit firm. The auditor shall complete an income statement, balance sheet and changes in cash position analysis.

F. Accounting and Cash Management

1. **Accounting Policies** - All accounting data shall be computed in accordance with generally accepted accounting principles prepared on a current value basis, not historical cost accounting. Therefore, the carrying value of real estate assets shall be adjusted annually to reflect the most recent current value based on the most recent independent appraisal value or internal estimate of value. Accrual based accounting is also generally used to allocate revenues and expenses to the appropriate periods.
2. **Cash Management** - The Investment Manager shall provide strict control over cash transactions and balances ensuring that all excess funds are continually invested in accordance with the ERS's approved specifications as outlined in the manager's Contract. Cash balances will be swept to an account designated by ERS in compliance with a previously agreed-upon schedule and in accordance with maximum balance restrictions.

G. Hazardous Materials

1. **Environmental Evaluations** - As a standard procedure during the acquisition analysis and due diligence, the Investment Manager will evaluate each property, using a qualified environmental consultant. In carrying out the review, the Investment Manager must comply with the procedures outlined below.
2. **Investment Criteria** - The ERS will invest in properties that contain asbestos or other toxic substances only in accordance with the following criteria:
 - a. **Disclosure** - The substance and potential risks are fully disclosed to the ERS and the Real Estate Consultant and documented in reports developed by an environmental consultant as a result of a Phase II study.
 - b. **Legal Compliance** - The property is not in violation of any federal, state or local law, ordinance or regulation relating to the property's environmental condition.
 - c. **Removal/Containment Costs** - The estimated cost of removal or containment programs is reflected in the investment pro forma and purchase price assumptions.
 - d. **EPA** - The substance can be properly contained or removed in accordance with the current Environmental Protection Agency protocol.
 - e. **Leasing** - The property leasing rollover pattern accommodates a removal program.
 - f. **Operations** - The property can continue to operate, commanding the commensurate level of rents, during any removal or containment program.

H. Insurance Coverage

1. **Required Coverage** - The Investment Manager will affect insurance for the physical properties and assets under its investment management control in accordance with the terms set forth in the Contract in such amounts and, against such risks as, in the Investment Manager's professional judgment, shall be in accordance with sound institutional practices applicable to such properties or assets in the specific geographic area. It is expected that such insurance will include, but not be limited to, casualty loss, including where deemed appropriate by the Investment Manager, earthquake, flood and any other disaster-type insurance coverage; comprehensive general liability; and title insurance.
2. **Reporting to the ERS** - Prior to the annual policy renewal date, the Investment Manager will provide the Investment Staff and the Real Estate Consultant with a synopsis of the ensuing year's coverage to include the terms and level of coverage; any risk exposure to ERS resulting from coverage which is unavailable or cost prohibitive; an assessment of the quality of the coverage relative to the prior year; and the price and terms of the projected coverage. In the event the terms of the ensuing year's coverage result in less coverage than the prior year, Investment Staff must acknowledge less coverage by providing written consent to the Investment Manager. All policies shall name ERS as an insured party and shall contain express conditions that ERS shall be given written notice by registered mail at least thirty (30) days in advance of any modification or termination of any insurance coverage.

I. Guidelines for Real Estate Manager “Watch List” or Termination

The performance of the Board’s Investment Managers will be monitored on an ongoing basis. The Board may place an Investment Manager on a “Watch List” or terminate a manager at any time.

Investment Managers may be terminated or placed on a “Watch List” for a variety of reasons: personnel changes, violation of policy and investment guidelines, underperformance, strategic allocation changes and non-disclosure of material information. The ERS has two clearly stated investment portfolio performance objectives: the preservation of capital and consistent positive returns. These “Watch List”/termination guidelines were formulated with these objectives as a foundation. Various factors should be taken into account when placing a manager on a “Watch List” or recommending termination. These can be separated into two broad categories - qualitative and quantitative factors. The former focuses on personnel, organizational and legal issues while the latter addresses performance.

When possible, the Board will issue a warning letter to underperforming Investment Managers prior to placement on the “Watch List”. However, the Board may place an Investment Manager on the “Watch List” at any time whether or not a warning letter has been issued. Placing an Investment Manager on the “Watch List” is an intermediate step towards either resolving the problem or terminating the Investment Manager. Investment Managers may only be removed from the “Watch List” under these two conditions.

Real Estate Manager Watch List Guidelines - Qualitative Factors

Below are some of the *qualitative* factors that may be considered in determining whether an Investment Manager should be placed on the "Watch List" or terminated.

FACTOR	EVALUATION TECHNIQUE	ACTION STEPS
Violation of investment guidelines and/or the laws of the State of Hawai'i	Review portfolio holdings vis-à-vis the investment guidelines <ul style="list-style-type: none"> - individual properties - their percentage weight in the portfolio 	Correct violation. Review violations with manager to re-establish compliance with appropriate guidelines. Manager to compensate ERS for any losses that occurred from violation. Terminate or place on watch list - terminate on additional violation.
Changes in ownership	Require immediate notification of any pending changes in ownership.	Place on watch list. Qualitatively determine if change detrimentally affect asset performance. If so, terminate.
Turnover of key personnel	Require manager to establish a list of key personnel, and rank in level of importance, at the inception of the account. Manager updates on an as needed basis.	Place on watch list. Consider termination if there is excessive key personnel turnover on the account (as specified in the manager provided list) or staffing is deemed insufficient to appropriately manage the ERS account.
Litigation	Require manager to notify ERS Staff immediately if entity which manages the funds is involved in any litigation other than property level covered by insurance.	Evaluate nature, seriousness and likely impact of charges on the investment process and take appropriate action.
Failure to disclose significant information which could impact manager evaluation	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time.	Review non-disclosure to determine if material to manager's ability to manage assets. If so, terminate.
Failure to disclose potential conflict of interest in managing assets	Require manager to provide immediate full disclosure, in writing, within a reasonable amount of time.	Review non-disclosure to determine if conflict was material and should have been known by manager. If so, terminate.

Real Estate Manager Watch List Guidelines - Quantitative Factors

Below are the *quantitative* factors to be considered in determining the appropriateness of terminating an Investment Manager or placing the Investment Manager on the “Watch List.”

PERFORMANCE TEST	BENCHMARK	FAIL CRITERIA
Test 1: Relative to Benchmark, for trailing 3 and 5 years	Annualized performance relative to a 5% real return benchmark.	Managers fail if underperform benchmark by .45% per annum over measurement periods, net of fees.
Test 2: Relative to income objective, for trailing 3 and 5 years	Annualized performance relative to a 3.34% real rate of return	Managers fail if underperform benchmark by .30% per annum over measurement periods, net of fees.
Test 3: Peer group comparison, for trailing 3 and 5 years	Performance compared to the Courtland Core Manager Index which is lagged by one quarter.	Fail if cumulative performance is at 65% percentile or lower over relevant time frames.
Test 4: Peer group comparison of income for trailing 3 and 5 years	Performance compared to the Courtland Core Manager index which is lagged by one quarter.	Fail if cumulative performance is at 65% percentile or lower over relevant time frames.

The quantitative guidelines above refer to separate accounts and a minimum time frame of three years. Any underperformance for three years relative to any or all of the above referenced benchmarks should trigger a review with the corresponding Investment Manager. Specialty commingled fund managers will be evaluated against the stated return objective of the fund at the time of the original investment (as included in the fund documents) and the ERS’s Specialty return objectives of 7% net real return for value added and 9% net real return for opportunistic. All of the qualitative criteria should be reviewed along with an explanation of the underperformance from the manager.

The explanation of underperformance is to be accompanied by a plan to resolve the performance issues. The plan should include specific objectives that can be measured by the Board and an appropriate timeframe to accomplish the objectives. The Board can choose to allow the Investment Manager to resolve the issues or terminate.

APPENDIX G.1

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
REAL ESTATE INVESTMENT BRIEF FORMAT**

Date:

Manager:

Property Name/Property Location:

Property Type:

(Scheduled) Funding Date(s) and Amounts (Net Investment)

Third Party Debt:

Gross Investment:

Investment Structure:

Investment Partners and Ownership Share:

Expected Return (Year 1 Cash-On-Cash and Nominal IRR both gross and net of fees):

Investment Summary: Elaborate on sellers, investment structure, and major business points.

Real Estate Depreciation: Describe the competitive market area, improvements, and major tenants (if applicable); when available include maps, aerial and surface pictures of building interior and exterior.

Expected Return: In addition to the Investment Manager's base case pro-forma, include a forecast that is consistent with the investment strategy utilizing the ERS's CPI assumption and both before and after fee scenarios.

Pro Forma Assumptions: Describe key assumptions such as investment period, growth rates and residual capitalization rate.

Investment Strategy: Outline the real estate investment strategy including a review of the anticipated future hold term, financing, development, or redevelopment plans, and any other relevant issues. Also, discuss the investment's classification as core or specialty and the associated risk level (low, moderate, high).

Major Investment or Property Risks: List the major investment risks on a market, property, tenant and transaction level.

Potential Conflicts of Interest: Discuss any potential conflicts of interest and how they will be resolved.

Program Compliance: Discuss the acquisition or disposition rationale and its consistency with the program guidelines, the current Tactical Plan and other governing documents.

APPENDIX G.2

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
REAL ESTATE INVESTMENT MANAGER REPORTING REQUIREMENTS**

<u>REPORT</u>	<u>DUE DATE</u>	<u>RECEIVER</u>	<u>COMMENTS</u>
ACQUISITION			
1. Investment Brief	As Identified	Staff ⁶	Copy to Consultant
2. Critical Dates List	3 Weeks BF Close	Staff	Provide ASAP
3. Closing Report	Before Closing	Staff	As Required
4. Sources/Uses of Capital	Upon Closing	Staff	For Each Capital Call
DISPOSITION			
1. Unsolicited Sales Offer	As Occur	Staff	Report as Received
2. Critical Dates List	Offer Accepted	Staff	Provided ASAP
ANNUALLY			
1. Tactical Business Plan	Annually	Staff	Governs Ensuing Year
2. Manager Review Data	As Scheduled	Consultant	Present to Investment Committee
3. Insurance Coverage	As Renewed	Staff	Due 5 days before or after renewal
4. External Financial Audits	After Fiscal Year End	Staff	Nationally Recognized Firm
5. Independent Appraisals	Anniversary	Staff	External Every 3 Years
6. Variance Notice	As Occurs	Staff	Within 30 Days
QUARTERLY			
1. Investment Worksheets	Quarter End	Consultant	30 Days After Close
2. Portfolio Operations Report	Quarter End	Consultant	30 Days After Close
3. Ltd Partnership/LLC Inv Summ.	Quarter End	Consultant	30 Days After Close

⁶ "Staff" refers to ERS investment staff and "Consultant" refers to the ERS real estate consultant.

APPENDIX G.3

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
REAL ESTATE SEPARATE ACCOUNT
TACTICAL BUSINESS PLAN OUTLINE**

PURPOSE: The Tactical Business Plan provides the manager an opportunity to articulate its capital allocation objectives for the ensuing 12 month period relative to the Work Assignment as outlined in each contract. Once a year the Tactical Plan is revised and all interim manager work should comply with the business plan. Variances should be discussed with the Investment Staff and Investment Committee. The following is the Tactical Business Plan outline:

I. EXPECTED PERFORMANCE (Net of Fees)

1. Ratio of Current Versus Total Return;
2. Projected Initial Market Capitalization Rates;
3. Total Net Return Expectations - Both Nominal and Real; and
4. Return Trends For Sector Components (i.e. markets, property types such as community versus regional retail centers, operating life cycle).

II. INVESTMENT OBJECTIVES AND OPPORTUNITIES

1. Targeted Property Type (within work assignment);
2. Targeted Markets and Rationale;
3. Leasing Exposure - Occupancy and Rollover Pattern;
4. Tenant Mix Preferences;
5. Leverage; and
6. Special Opportunities.

III. SELL DISCIPLINE

1. Factors That Would Initiate a Sell; and
2. Properties Targeted For Sale and Rationale.

IV. CAPITAL DEPLOYMENT

1. Acquisition Objectives; and
2. Portfolio Repositioning.

V. PROGRAM ADMINISTRATION AND TIMING

1. Appraisals - Scheduled Internal or External;
2. Audits - Firm and Timing;
3. Insurance; and
4. Other Special Notices.

APPENDIX G.4

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
ANNUAL REAL ESTATE ASSET MANAGEMENT PLAN**

PURPOSE: The Annual Asset Management Plan should be prepared for each strategic class held in the ERS. The Investment Managers are typically reviewed in core and specialty investment groups in early spring and late fall. Generally, the following information will be requested.

I. PROPERTY SUMMARY

Narrative discussion of the specific property, including changes to market environment, leasing status, occupancy rate, property manager, renovation or scheduled maintenance details, and other relevant operational issues.

II. BUDGETS

The Annual Asset Management Plan should include at least the following information and more as the manager deems appropriate:

1. REVENUE

- Base Rent
- Overage Rents
- Recoveries
- Interest or Other Income

2. EXPENSES

Operational

- Real Estate Taxes
- Common Area Maintenance
- Insurance
- Utilities
- Ground or Other Rent
- Building Maintenance
- General & Administrative
- Property Management Fees

Non-Operating

- Capital Reserves
- Leasing Commissions
- Tenant Improvements
- Management Fees

3. DEBT SERVICE AND FINANCING

4. PROJECTED PERFORMANCE FOR SHORTER AND LONGER TIME PERIODS

APPENDIX G.5

**EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII
REAL ESTATE SEPARATE ACCOUNT
APPRAISAL POLICIES AND PROCEDURES**

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EXHIBITS

- A. SCHEDULE OF ESTIMATED QUARTERLY GROSS ASSET VALUE CHANGES
- B. SCHEDULE OF ESTIMATED QUARTERLY NET ASSET VALUE CHANGES
- C. DEBT OVERVIEW

1. Appraisal Process

The following outline sets forth the frequency, timing, and the type of appraisal to be obtained with respect to each ERS real estate separate account investment over the calendar year. As noted, approximately one-third of the ERS's real estate separate account investments shall be valued externally per year, unless otherwise directed by Investment Staff or the Real Estate Consultant.

A. Internal Valuations:

- (1) Prior to each quarter end, Manager shall provide Staff with an Internal Manager valuation Desktop Review, as outlined in Section V, unless otherwise directed by Investment Staff and the Real Estate Consultant, with respect to each of the real estate separate account investments of the ERS:
 - a. **"As of" date:** The Managers' Desktop Review valuation estimates shall be "as of" the last day of each quarter (i.e. 3/31, 6/30, 9/30 and 12/31) and shall be provided to Investment Staff at least 10 days prior to each quarter's end;
 - b. **Property Level Information:** On or before the 20th day of the last month of each quarter the Managers shall provide Investment Staff a schedule depicting the gross asset investment cost of each asset, the quarterly estimated gross asset value of each asset (i.e., the property or asset value including or gross of leverage and partnership and joint venture interests), the current and prior quarter cap and discount rates and the dollar and percentage changes in the gross asset value each quarter, consistent with the format shown in Exhibit A;
 - c. **ERS NAV Information:** On or before the 20th day of the last month of each quarter the Managers shall provide Investment Staff a schedule indicating the ERS's investment cost of each asset, the ERS's estimated quarterly net asset value of each asset (both gross and net of accrued incentive fees), accrued incentive fees and the dollar and percentage changes in the ERS's net asset value each quarter, consistent with the format shown in Exhibit B;
 - d. **Debt Overview:** The Managers shall include a quarterly debt overview (Exhibit C) within their quarterly financials outlining: the terms of existing debt, estimated prepayment penalty amount as of the end of the respective quarter, and other information as requested by Staff or Real Estate Consultant. The Managers shall carry debt secured by an asset at book value, unless otherwise requested by Staff and/or the Real Estate Consultant. The Managers shall footnote in their quarterly statements that, unless otherwise noted, debt is being carried at book value and not marked to market. *Once assets are "held for sale", Staff may instruct Manager to adjust the value of the debt by any applicable prepayment penalties or yield maintenance costs.*

B. External Valuations:

- (1) One-third of the ERS's separate account real estate portfolio is to be appraised externally each year, unless otherwise directed by Investment Staff or the Real Estate Consultant. The Appraisers shall be recommended by the Managers and approved by Investment Staff and the Real Estate Consultant

in the manner described in Section III. Said appraisal reports should be prepared in accordance with the scope outlined in Section V.

- (2) The remaining assets of the ERS's real estate separate accounts, which are not appraised by the Appraisers, shall be internally valued by the Managers using the Internal Desktop Review (described in Section V).
- (3) All parties involved should proceed through the appraisal/valuation process according to the timeline outlined below:

EXTERNAL & INTERNAL APPRAISAL PROCESS TIMELINE - ANNUAL DEADLINES	
The Managers provide Investment Staff and the Real Estate Consultant with a schedule of the assets to be externally appraised	January 31 (2 nd Quarter) May 31 (4 th Quarter)
The Managers send out Appraiser RFP's, copying the Real Estate Consultant on distribution	February 15 (2 nd Quarter) June 30 (4 th Quarter)
The Managers provide Investment Staff and the Real Estate Consultant Appraiser recommendations along with grading schedules	March 1 (2 nd Quarter) July 31 (4 th Quarter)
Investment Staff and the Real Estate Consultant approve Manager recommended Appraisers	Mid-March (2 nd Quarter) Mid-August (4 th Quarter)
The Managers negotiate and finalize agreements with the Appraisers on behalf of the ERS	March 31 (2 nd Quarter) Mid-September (4 th Quarter)
The Managers forward property/asset information to the Appraisers	On or before April 5 (2 nd Quarter) & October 4 (4 th Quarter)
The Appraisers provide the Managers, Investment Staff and the Real Estate Consultant draft self-contained reports with preliminary values	On or before May 15 (2 nd Quarter) On or before November 1 (4 th Quarter)
Managers provide Real Estate Consultant and Staff with draft Internal Desktop Reviews	
The Appraisers, the Managers and the Real Estate Consultant discuss any valuation issues and agree to final appraised values	On or before June 15 (2 nd Quarter) On or before November 30 (4 th Quarter)
The Managers provide estimated gross and net asset values and other schedules to Investment Staff and the Real Estate Consultant	June 20 (2 nd Quarter) End of the first week of December (4 th Quarter)
The Appraisers provide the final appraisal reports	End of July (2 nd Quarter) End of the first week
Manager shall provide final Internal Desktop Reviews	week of January (4 th Quarter)
The Real Estate Consultant provides its report to Investment Staff	End of the second week of August (2 nd Quarter) & January (4 th Quarter)
Investment Staff reports the final net asset values to the ERS custodian	Upon receipt of final quarterly financial reports from the Manager (30–45 days after quarter-end)

2. External Appraiser Selection Process

Appraiser Selection and Qualifications

The selection of the Appraisers shall be completed annually by the Managers, Investment Staff and the Real Estate Consultant. The Manager shall recommend appraiser candidates based on a number of factors, which at a minimum shall include the following:

1. Reasonable expertise and experience with respect to the property type of the assets to be appraised;
2. Reasonable expertise and experience with respect to the real estate markets of the assets to be appraised;
3. Reasonable firm financial condition - Have appraisers certify in the RFP that they have the financial wherewithal to complete the assignment;
4. Reasonable firm organizational capacity given the valuation assignment under consideration;
5. A history of quality appraisal work, as supported through references;
6. A reasonable demonstration of independence specifically with respect to the Manager whose assets the Appraiser may be reviewing (Manager must fully explain the situation and the reason for recommending the appraiser if the Manager believes there is a conflict of interest or lack of independence);
7. Reasonable fee; and
8. Reasonable level of certifications (e.g., state certified general appraiser) and industry designations (e.g., Member of the Appraisal Institute, MAI).

Appraiser Grading & Recommendation

Each candidate shall be graded by the Managers based on at least these aforementioned factors, which grading shall be evidenced in a table provided to Investment Staff and the Real Estate Consultant along with the Manager's Appraiser recommendation. The Appraiser recommendations shall be approved by Investment Staff and the Real Estate Consultant.

The Managers shall complete the Appraiser contracts using a form approved by Investment Staff and the Real Estate Consultant. Any communications regarding changing or modifying Appraisal findings and conclusions shall be shared with Investment Staff and the Real Estate Consultant at the same time they are provided to the Managers.

3. Annual Fiduciary Report

The Real Estate Consultant shall serve as a fiduciary to the ERS. The Real Estate Consultant's role as a fiduciary shall be to:

1. Assist in defining the external and internal appraisal processes;
2. Oversee the implementation of the valuation activities;
3. Monitor and review the reasonableness of the appraisal process relating to the value estimates provided by the Managers and the Appraisers;
4. Review the reasonableness of the value opinions provided by the Appraisers in the final reports and by the Managers in their Desktop Reviews; and
5. Issue to Investment Staff an annual report confirming the value estimates provided by the Appraisers and the Managers.

The Real Estate Consultant shall discuss the internal valuation estimates completed by the Managers and external appraisals completed by the Appraisers with the Managers to confirm the reasonableness of the value opinions. The Real Estate Consultant shall issue a report summarizing its valuation review. This report shall include the following:

1. A schedule setting forth the separate account property values, including the most recent values prior to the appraisal, the Appraiser value opinion, the Manager value opinion and the final reconciled value opinion;
2. A discussion of current market conditions;
3. Emails and other evidence of discussions between the Real Estate Consultant, the Managers and/or the Appraisers; and
4. Any value changes resulting from the discussions with the Managers and the Appraisers.

An important part of the Real Estate Consultant's role is to provide an independent and objective view with respect to the valuation process and the property value conclusions. The Real Estate Consultant shall maintain its independence in the appraisal process, including having no financial incentives relating to the quarterly property valuations.

4. Scope of External Appraisals and Internal Desktop Reviews

External Appraisal

The external appraisal report should be a comprehensive appraisal report, which shall contain the following sections as directed by Investment Staff and the Real Estate Consultant:

Scope of External Appraisal

1. Executive Summary describing asset valued and value conclusions by valuation approach (i.e., income, cost and sales approaches and the reconciliation value);
2. Regional Map & Analysis
3. Local Area Map & Analysis
4. Market Analysis
5. Site Description
6. Improvements Description
7. Real Property Taxes and Assessments
8. Zoning and entitlements
9. Highest and Best Use Analysis
10. Rent Roll providing summary of terms, including but not limited to: original tenant move-in date, options, rent, rent increases, operating expense reimbursement structure and assumptions for vacant space
11. Valuation Process
 - a. Land Valuation
 - b. Cost Approach
 - c. Sales Comparison Approach
 - d. Income Capitalization Approach
12. Reconciliation and Final Value Opinion
13. Insurable Value
14. Assumptions and Limiting Conditions
15. Certification of Appraisal
16. Glossary of Terms and Conditions
17. Addenda Contents

Other sections that may be desired include:

1. A description of the property ownership;
2. The existing leverage or other encumbrances relating to the property, and
3. Fair value of debt.

Internal Desktop Review

Desktop reviews are designed to provide the ERS with up-to date internal valuations of portfolio assets. The desktop review comprises internal manager valuations using the income approach. Additionally, the Manager evidences the assumptions used in the valuation in a report containing the following sections.

Scope of Internal Desktop Review

1. Notable Changes in Market Conditions
2. Valuation based on the Income Capitalization Approach or other discounted cash flow analysis, including all of the inputs used to derive the valuation
3. Reasonable evidence of the validity of the income approach assumptions used, including, but not limited to, discount and cap rates, lease-up rates, tenant improvement and leasing commission costs and other related expenditures
4. Valuation Matrix showing a sensitivity analysis utilizing a range of discount and cap rates

5. Commingled Real Estate Funds – Valuation Policy

The ERS shall use the NAV calculated by the commingled fund administrator. Investment Staff and Real Estate Consultant will review and report its findings to the Board of Trustees on the validity of the process and valuations as part of the normal pre-acquisition and ongoing due diligence processes.

EXHIBIT C Debt Overview (Page 1 of 3)

MANAGER NAME DEBT OVERVIEW QUARTER Q 2 Year 2010																	
Property Details					Basic Loan Terms												
Property Name	City	State	Property Type	Estimated 2010 Budget NOI	Lender	Original Loan Amount	Current Loan Balance (Qtr ending 6-30-10)	Term (years)	Commence Date	Date	Fixed / Floating	Index Rate	Index	Spread	All-In Rate	Basis	Est. Prepayment Penalty (\$) as of quarter end
ABC Building	Anywhere	Anystate	Office	\$5,000,000	XYZ Lending LLC	\$50,000,000	\$50,000,000	10	1/1/2009	12/31/2019	Fixed	3.00%	10-yr T	2.50%	5.50%	A/360	TBD

EXHIBIT C

Debt Overview (Page 2 of 3)

MANAGER NAME										
DEBT OVERVIEW										
QUARTER		Q 2								
Year		2010								
Property Details					Debt Service					
Property Name	City	State	Property Type	Estimated 2010 Budget NOI	Years I/O	Amortization (years)	Year Amort Begins	Constant	Monthly P&I	DSCR (based on 2010 Budget NOI)
ABC Building	Anywhere	Anystate	Office	\$5,000,000	3	30	4	TBD	TBD	TBD

EXHIBIT C Debt Overview (Page 3 of 3)

MANAGER NAME												
DEBT OVERVIEW												
QUARTER		Q 2										
Year		2010										
Property Details					Other Loan Provisions / Comments					Current Loan-to-Value		
Property Name	City	State	Property Type	Estimated 2010 Budget NOI	Extension Options	Extension Option Details	Recourse	Name of Recourse Guarantor	Coverage Tests / Occupancy Thresholds, etc.	Comments	Current Gross Asset Value as of quarter end	LTV as of quarter end
ABC Building	Anywhere	Anystate	Office	\$5,000,000	1, 1 year	60 days prior notice, DSCR>1.35x, LTV <=65%	Standard Bad-Boy	HCM or Name of JV Partner	if DSCR < 1.05x, all CF swept to hard lockbox		\$75,000,000	66.7%



HiTIP PROGRAM

SECTION: H

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H.1. Introduction

The Hawaii Targeted Investment Program (HiTIP) was created by the Employees' Retirement System of the State of Hawaii ("ERS") to fulfill the mandate of Act 260, "A Bill For An Act Relating To The Innovation Economy" ("Act 260") passed by the Legislature and signed by the Governor in July 2007. The purpose of Act 260 is "to encourage the employees' retirement system to invest in Hawai'i venture capital..."

The HiTIP should be viewed as a distinct component of the broader ERS private equity program for two distinct reasons. First, Act 260 stipulates that the ERS provide specific updates to the State of Hawai'i ("State") with respect to the HiTIP. Second, the investment directives that apply to the HiTIP are different than those that apply to the broader ERS private equity investment portfolio. Act 260 stipulates that the ERS require that the HiTIP earn returns for the ERS investment portfolio by making investments in emerging growth and growth-oriented businesses in traded sector industries in Hawai'i.

In accordance with HRS chapter 88, the Board of Trustees of the ERS (the "Board") determines the investment policies and procedures for all ERS investment activities, including the HiTIP. ERS employees will act as staff overseeing HiTIP and its fund-of-funds advisor and report HiTIP activities to the Board, in conjunction with the fund-of-funds advisor. In this capacity, ERS investment staff ("Investment Staff") and/or the fund-of-funds advisor may periodically recommend new or updated HiTIP investment policies and procedures to the Board for review and comment. HiTIP investment policies and procedures, which are attached, reflect the following principles:

1. The purpose of the HiTIP is to produce competitive risk-adjusted investment returns for the ERS by making investments in emerging growth and growth-oriented businesses in traded sector industries, with specific emphasis on Hawai'i. The HiTIP's mission is not economic development, but economic development may be one significant byproduct of the investment program.
2. HiTIP funds will be invested only through external general partners/managers or co-investments.
3. General partners/managers will be fully discretionary, i.e., after funds are allocated to the limited partnership or limited liability company ("LLC"), they are totally responsible for the investment of these funds within the partnership's or LLC's investment guidelines.

The Board and Investment Staff will delegate the selection, retention and monitoring of external partnerships or LLCs to a dedicated fund-of-funds advisor (or manager-of-manager) and will not entertain individual investment proposals from individual businesses or for particular projects, except as a result of in-kind distributions of assets to the HiTIP by external partnerships/LLCs. Except as described in the preceding sentence, individual investment decisions will be left to the general partnership or LLC managers.

H.2. Policy

A. Background

The Hawaii Targeted Investment Program (HiTIP) is a distinct component of the ERS private equity portfolio. The ERS has established the HiTIP to participate in attractive long-term alternative investment opportunities in emerging growth and growth-oriented businesses in traded sector industries, emphasizing the greater-Hawai'i geographic region. Investment of moneys in the HiTIP will generally be implemented through participation in limited partnerships or LLCs that make private equity and debt investments, including investments in emerging growth and growth-oriented businesses, although other management and investment arrangements may be considered under appropriate circumstances. For the purposes of this policy:

- "Emerging growth business" means a new or small company that has the capacity, upon obtaining appropriate capital, to generate significant high skill, high wage employment within one or more traded sector industries.
- "Growth-oriented business" means an existing company with the potential to generate significant revenue and/or profit growth within one or more traded sector industries, resulting in a commensurate increase in high skill/wage employment in the pertinent sectors.
- "Traded sector" means industries in which member firms sell their goods or services into markets for which national or international competition exists.
- "Co-investment" means an investment in a company where one or more of the HiTIP's external general partners/managers is already an investor or will become an investor at the same time as HiTIP.

Chapter 88, Hawai'i Revised Statutes ("HRS"), which governs ERS investment activities, and this ERS Investment Policies, Guidelines and Procedures manual ("Manual") will govern investment the activity of the HiTIP.

B. General Policy

Private equity investments, such as those encompassed by the HiTIP, should contribute favorably to the risk-adjusted investment returns of the total ERS investment portfolio, and are compatible with the general objectives of the ERS investment portfolio, which include:

1. Providing a means to provide benefits to the State's public employees and their beneficiaries.
2. Investing to produce a return on investment which, based on levels of liquidity and investment risk, are prudent and reasonable.
3. Attaining an adequate real return over the expected rate of inflation.
4. Complying with all applicable laws and regulations concerning the investment of trust fund assets.

Private equity investments possess a higher degree of risk with a higher return potential than traditional investments. Accordingly, total rates of return are expected to be greater than those that may be obtained from conventional public equity or debt investments. They have a lower correlation relative to other investment classes and should therefore contribute to an effective management of risk and the enhancement of returns on a total ERS portfolio basis.

Similar to other portfolio segments under its authority, ERS should endeavor to retain appropriate fiduciary expertise to manage all or a portion of the private equity portfolio, including the HiTIP.

C. Objectives**1. Portfolio Investment Performance Objective**

The performance objective for HiTIP investments is significant long-term net returns to the ERS investment portfolio, (e.g., after management fees and general partner's carried interest) above a benchmark reflecting public market alternatives or counterparts plus an appropriate premium to compensate for illiquidity, risk, and expense. The return expectation should be tempered, however, given the potential concentration of investments within Hawai'i. The performance objective for private equity investments is a net internal rate of return (i.e., dollar-weighted rate of return) of: the Russell 3000 Index plus 350 basis points, measured over the life of the partnership or LLC. Staff will periodically evaluate the performance benchmark and associated premium. In any case, results of such investments may not be meaningful for several years.

2. Diversification of HiTIP Investment Risks

Diversification helps to minimize risk in the HiTIP's investments and the following types of diversification should be considered, including, but not limited to:

- a) Stage -- Diversify investments throughout the various stages from early stage through later stage financing.
- b) Industry Sectors -- Investments will be diversified across industries, subject to the investment opportunities and the discretion, within the parameters of the partnership/LLC agreements, of the general partners/managers retained.

- c) Size of Investments -- Investments will be diversified among a range of partnerships/LLCs of varying sizes, generally with a minimum commitment size of \$1 million but with an ERS ownership percentage usually at or below one-third of the total fund.
- d) Geographical -- The HiTIP, by statute, will be biased toward Hawaiian companies and/or concentrated within the State; this risk cannot be diversified away and may be significant. While such a geographic bias is likely to exist, there is a reasonable likelihood that the business mix of the underlying companies could be global in nature, offsetting the above-referenced lack of geographic diversification.
- e) Time – The HiTIP will endeavor to invest in a consistent manner over time and shall not seek to “time the market.”

3. Total Private Equity Portfolio Diversification

Correlation of the HiTIP's investment return to other private equity segments is expected to be relatively low, and the inclusion of this component should, therefore, provide an added measure of diversification to the broader ERS private equity program.

4. HiTIP Program Size – Prudent Level of Investment

Act 260, requires ERS to “develop criteria to determine the amount of funds that may be prudently invested in Hawai‘i private placement investments.” To meet this requirement, the ERS relied upon an independent third-party analysis of Hawai‘i private equity investment trends, published in January 2008 by the Hawai‘i Institute for Public Affairs (HIPA), a nonpartisan research institute focusing on key Hawaiian economic trends. The analysis, entitled *Venture Capital in Hawai‘i – An assessment of Market Opportunities*, is the most current definitive study on private equity capital formation within the State.

One important condition for any private equity program to deliver its expected return objective is that the market(s) it serve(s) have an imbalance of supply and demand for private equity capital. Specifically, if the expected amount of capital available for investment is less than the expected amount of capital required, then a “funding gap” is said to exist. Such a funding gap can cause investor capital to be marginally more attractive, allowing investors to seek incrementally higher returns. The larger the funding gap, the broader the investment choices and the lower the competition among investors placing capital in the marketplace.

The HIPA report found that a modest private equity funding gap exists in Hawai‘i. Based on a review of the report’s figures by the ERS’s general investment consultant (Pension Consulting Alliance, Inc. – or PCA), the expected funding gap will range from \$20 million to \$130 million over the next three-to-five years. In order to increase the probability of the HiTIP’s successfully meeting its objectives, PCA recommended to ERS that the HiTIP fund only a fraction of the expected funding gap, to a maximum of 50%, to bring more flexibility and higher returns to the program, and a minimum of 25%, to attract a sufficient number of vendors to compete for the opportunity to manage a Hawai‘i-oriented private equity program with a focus on venture capital and other growth-oriented opportunities.

H.3. Procedures

A. Procedures and Standards

1. General Procedures

- a) The Board, Investment Staff, and the ERS's general investment consultant ("General Investment Consultant") will seek, identify, and screen appropriate fund-of-funds advisors that exhibit (i) expertise in structuring successful long-term targeted investment programs, (ii) sufficient resources to screen, analyze, and conduct due diligence on a wide array of private equity partnerships (and/or LLCs), and (iii) a willingness to commit significant resources to Hawai'i-focused private equity investment.
- b) The Board, with assistance from the General Investment Consultant, will select an appropriate advisor to execute the HiTIP investment program. Key aspects of the program are (i) identifying partnerships or partnership groups (or LLCs) that are focused on, emphasize, or have made material investment allocations to the greater-Hawai'i economy, (ii) developing a long-term investment strategy and/or business plan that places high priority on committing material amounts of capital to Hawai'i businesses, and (iii) establishing and fostering a growing private equity network within Hawai'i.
- c) The fund-of-funds advisor will identify promising investment vehicles and co-investment opportunities and conduct full due diligence (including legal due diligence) on prospective investments on a discretionary basis. Upon completion of its due diligence, the fund-of-funds advisor will evaluate the investment vehicle and determine whether the investment should be pursued.
- d) Upon satisfactory due diligence and legal reviews, the fund-of-funds advisor will, on behalf of the Board, authorize a commitment to the specific partnership, LLC, or co-investment.
- e) The fund-of-funds advisor will provide a written report to the Board containing a summary of the approved investment vehicle as soon as practical. For fund investments the summary may include: a description of the general partner's/manager's background, historical performance, and organization; the proposed investment strategy; the terms of the investment; the expected rate of return; the merits of the investment; issues and concerns surrounding the investment and how they were resolved; and issues and provisions that were subject to negotiation. For co-investments, the summary may include: a description of the company, including company history, management, key business lines, and key growth drivers, a description of the industry including industry attractiveness, comparative advantage within the industry, and market opportunities, summary of the sponsor fund, summary financials, merits and risks of the co-investment, and the potential exit routes and expected return.

2. Selection Criteria – External General Partners/Managers

- a) The HiTIP's fund-of-funds advisor will generally invest with partnership (or LLC) groups with prior investment management experience. Primary emphasis will be on the quality and experience of the individuals who manage the investments.

- b) Additional criteria to be considered shall include:
- i. A well-developed investment focus that meets the HiTIP's objectives, and a favorable assessment of the proposed investment's strategy and market conditions;
 - ii. Relevant investment experience of partners/managers and key staff, individually and as a team, as well as their stability;
 - iii. Organizational depth and significant time commitment to the investment vehicle;
 - iv. Well-structured decision-making and transaction execution processes, including:
 - deal flow and initial analysis of portfolio investments,
 - pricing, selection and negotiation of portfolio investments,
 - financial structuring of portfolio investments,
 - management or oversight of portfolio companies,
 - development of exit strategies;
 - v. Consideration of relevant issues, such as conflicts of interest and alignment of interests, among others;
 - vi. Experience in, and a demonstrated record of, successful prior investments;
 - vii. Appropriate proposed terms and structure for the investment.
 - viii. Meaningful capital commitments by the partners/managers.

3. Selection Criteria – Co-Investments

The HiTIP fund-of-funds advisor may consider co-investments meeting the following criteria:

- a) The maximum commitment for an individual co-investment opportunity shall be the lesser of \$1.5 million or 5% of the total size of the HiTIP partnerships/LLCs co-investing in the opportunity.
- b) Number of co-investments shall not exceed 33% of the number of HiTIP partnerships/LLCs.
- c) Co-investments, in aggregate, shall be no more, by commitments, than 20% of the HiTIP program.
- d) Where co-investments shall be made on the same or better terms and conditions as provided to the partnership/LLC *under the same funding series*, with the understanding that a investment by the partnership/LLC *under an earlier funding series* may have been made with different terms and conditions.
- e) The HiTIP fund-of-funds advisor shall seek to minimize management and/or carry fees on con-investment opportunities. Any management and/or carry fees charged to HiTIP on a co-investment shall be less than or equal to the rate HiTIP pays on its investment in the partnership/LLC. If HiTIP is charged management and/or carry fees on a co-investment, all other investors brought in by the partnership/LLC under the same funding series shall be subject to the same or greater management and/or carry fees as HiTIP.

- f) The co-investment must be an emerging growth or growth-oriented business in traded sector industries in Hawai'i.

4. Standards

- a) Types of Allowable Investments – The applicable State statute (Section 88-119, HRS) allows for a wide array of investment vehicles. ERS private equity investment policies allow investments in limited partnership LLC vehicles, and co-investment as discussed within this policy without prior Board approval.
- b) Prudent Investor Standard -- The selection of HiTIP investment vehicles will be guided by the care, skill and diligence that a prudent investor acting in a similar capacity and familiar with such investments would use in managing and investing a similar account. Investments should be expected to enhance the expected risk-adjusted investment returns of the broader ERS investment portfolio.
- c) Negotiated Terms -- Terms, such as preferred returns, lower fee structures, and profit splits should be negotiated where prudent, adhering to best practices within the institutional investment community. All agreements are subject to the satisfactory negotiation of terms by the fund-of-funds advisor.

B. Strategy

1. Allocation

The HiTIP will be selective and more focused than the current private equity program, and invest such assets prudently, and as opportunities become available. Diversification within the HiTIP is a consideration, but is extremely limited given the intent of Act 260, which is the primary impetus for HiTIP.

a) Allocation by Fund Type

An important component of the HiTIP investment strategy is to seek out and invest in Hawai'i-based opportunities. Access to such opportunities may occur through (i) partnerships/LLCs that are headquartered in Hawai'i or (ii) partnerships/LLCs that are not located in Hawai'i, but make investments in Hawai'i. The earlier referenced HIPA report organized partnerships/LLCs as follows:

- i. Partnerships/LLCs that are Hawai'i focused – Those partnerships/LLCs that invest 90% of their capital locally.
- ii. Partnerships/LLCs that have a Hawai'i presence – Those partnerships/LLCs that have invested in at least two Hawai'i-based companies in their most recent funds and visit Hawai'i on a regular basis.
- iii. Partnerships/LLCs that are occasional investors – Those partnerships/LLCs that invested in Hawai'i at least once across all their funds.

Longer-term, the HiTIP seeks to achieve reasonable and prudent weightings among the above fund types as well as those partnerships/LLCs that commit to review Hawai'i-based companies for potential investment by their existing

funds. However, significant concentration toward any of the above segments can occur over time as a result of how and when opportunities become available and because each HiTIP investment will likely not be fungible and/or exhibit low levels of liquidity. In addition, specific direct or co-investments may alter the diversification characteristics of the HiTIP portfolio.

2. Method of Participation

The HiTIP will consider well-established investment vehicles as well as new and smaller investment vehicles. To the extent possible, partnerships and/or LLCs shall be structured to create an alignment of interest between the limited partners/passive investors and the general partners/managing members.

Co-Investments: The HiTIP fund-of-funds advisor may offer direct placement services on the ERS's behalf. Suitable arrangements for co-investment authorization may be incorporated in the fund-of-funds advisor's investment management agreement. Co-investments entail providing additional funding to specific company investments being made by the general partners of the limited partnerships/LLCs to which the HiTIP program has commitments. Co-investments fall under the fiduciary oversight of the HiTIP fund-of-funds advisor. In this capacity, the fund-of-funds advisor would act as a fiduciary to ERS.

3. Investment Funding

Partners/managers retained by the HiTIP shall make capital calls during agreed upon investment periods in accordance with negotiated agreements. Such requests must be in compliance with both fund-of-funds advisor and ERS internal control procedures.

4. Investment Liquidations

Partners/managers shall return capital to the HiTIP through cash distributions, whenever possible. Partners/managers shall liquidate any marketable securities before making distributions to the HiTIP. In instances where liquidation is not in the best interest of the HiTIP, partners/managers may distribute securities with sufficient advance notice to the fund-of-funds and Staff. ERS may utilize the fund-of-funds advisor or retain a third party manager to liquidate such securities as deemed appropriate by the third party manager, generally, within a six-month period.

5. Declarations of Distribution From HiTIP

All investment returns on capital in the HiTIP, including but not limited to returns from investments in limited partnerships/LLCs and interest income, shall remain in the HiTIP account until such time as the Board, in accordance with this policy, declares them as HiTIP distributions available for transfer from the HiTIP account and back to the overall ERS investment portfolio. The Board will, from time to time, review the HiTIP's investment returns and determine whether a portion of those returns can be distributed to other accounts without impairing the HiTIP account's long-term goal of maximizing the overall rate of return consistent with the HiTIP's investment focus. In making this determination, the Board will consider (1) the current and anticipated future expenses of the HiTIP in carrying out its operations, (2) the existence and need for reserves in the HiTIP account to cover current investment commitments, (3) the potential need to make additional investments in current investment vehicles to

maximize the overall return from those investment vehicles, (4) the existence (or anticipated future development) and relative attractiveness of new investment opportunities and the availability of other moneys in the HiTIP account for such investment opportunities, and (5) such other factors as ERS and/or the fund-of-funds advisor may consider appropriate under the current circumstances.

C. Implementation

1. Staff Requirements

Appropriate Investment Staff will be assigned as the workload necessitates. It is expected that the retained fund-of-funds advisor will be responsible for much of the day-to-day operations of the HiTIP. To gain further insights into the overall due diligence process (particularly within the State), Investment Staff may conduct due diligence visits in conjunction with, or separate from, the fund-of-funds advisor on specific investment opportunities. Such visitations should not impact the advisor's recommendations and implementation activities.

2. Legal Counsel

The fund-of-funds advisor is responsible for obtaining all relevant legal advice for the HiTIP investments.

3. Contract Execution

- a) The Board will approve an overall multi-year commitment level to the fund-of-funds advisor. The Board will give discretion to the fund-of-funds advisor, acting as a fiduciary on behalf of the ERS, to conduct business, financial, and legal due diligence on, and then approve commitments to, underlying partnerships/LLCs. Appropriation of roles, responsibilities, and duties of the Board, Investment Staff, and the HiTIP fund-of-funds advisor are codified in the HiTIP Co-Investment Policy's Appendix H.1 Hawai'i Targeted Investment Program Co-investment Procedures.
- b) The fund-of-funds advisor, as general partner or manager of the limited partnership or LLC described in D.1, below, is authorized to execute contracts for specific HiTIP investments, up to the total commitment level authorized by the Board.

4. Fund-of-Funds Advisor Contract

- a) The fund-of-funds advisor contract shall be structured as a general partner/limited partner agreement with a termination date not to exceed twelve years, including extension periods.
- b) The fund-of-funds agreement shall include a "no-cause" fund-of-funds advisor/general partner replacement clause with a maximum 90 day notice period.
- c) It is the policy of the Board to continuously review all contracts.

- d) Upon the final expiration of the original contract, or whenever directed by the Board, Investment Staff and/or General Investment Consultant shall undertake and complete a search process which shall include the following:
 - iv. Identification of those potential fund-of-funds advisor candidates who may reasonably be believed to perform those services under examination;
 - v. Directing of a request for proposal which shall include, but not be limited to:
 - 1. description of services requested;
 - 2. description of the potential or preliminary standards required by the Board of the candidates; and,
 - 3. request for pricing or fee schedule information.

D. Monitoring

1. Reports

- a) Reports prepared by the HiTIP fund-of-funds advisor will be furnished to the Board and Investment Staff, quarterly, on HiTIP activity and performance, and annually in an expanded format.
- b) Underlying general partners/managers shall provide quarterly reports to the fund-of-funds advisor and Investment Staff on investment activity and performance. In addition, audited financial statements shall be provided on an annual basis.
- c) Section 88-119(11), HRS, requires that ERS report annually to the legislature on HiTIP investment activity, as well as on any other ERS investments that are located in Hawai'i. As part of the reporting process, ERS is required to report rationale for not investing in Hawai'i venture capital investments.
- d) To monitor co-investments within the HiTIP program, the Board will direct the HiTIP fund-of-funds investment advisor to provide the necessary and appropriate oversight management/reporting for any co-investments.

2. Adherence to Strategy

The actual strategy employed by underlying general partners/managers will be judged relative to stated objectives and strategies. Investment Staff and the fund-of-funds advisor will interact with the general partners/managers periodically as necessary. It is also expected that the fund-of-funds advisor and/or Investment Staff will also attend advisory meetings, board meetings, and/or annual investor meetings of the underlying partnerships or LLCs, as required (particularly with respect to Hawai'i-based investments), as part of the monitoring process. Given the illiquid nature of these investments, however, it is not anticipated that these investments can be exited once a commitment is made.

E. Review and Modification of Investment Policy Statement

The Board may review this policy statement and procedures from time to time to determine if the Board deems modifications to be necessary or desirable.

APPENDIX H.1

Hawaii Targeted Investment Program (HiTIP) Co-Investment Procedures

	Role of Board	Role of Staff	Role of HiTIP Manager
Strategy/Policy	<ul style="list-style-type: none"> • Approve HiTIP co-investment program and commitment amount. • Approve and adopt co-investment policies, procedures, guidelines, commitment allocation and/or target, ranges, and other assumptions. 	<ul style="list-style-type: none"> • With the HiTIP Manager and the Private Equity Consultant, develop and revise policies, procedures, guidelines, allocation targets, ranges, assumptions for recommendation to the Board. 	<ul style="list-style-type: none"> • With Investment Staff and Private Equity Consultant, develop policies, procedures, guidelines, allocation targets, ranges, assumptions for recommendation to the Board.
Investment Selection	<ul style="list-style-type: none"> • Review co-investment analysis reports. • Approve co-investment if co-investment is outside of the established scope of this policy. • Delegate to HiTIP Manager sourcing, vetting, screening, due diligence, legal review, monitoring, and work-out situations activities. 	<ul style="list-style-type: none"> • May refer investments to HiTIP Manager for preliminary screening. Such referrals are to be considered only for the purpose of enlarging the candidate pool, and are not to be considered to be a staff endorsement or request for differentiated consideration. • Conduct meetings with potential new investments prior to recommending to the Board, if practical. • Execute agreements. 	<ul style="list-style-type: none"> • Conduct extensive analysis and due diligence on co-investments as described in the attached <i>HiTIP Co-investment Due Diligence Check List</i>. • Approve co-investments according to the Selection Criteria stated in the HiTIP Policy, Section III.C. • Provide an investment analysis report for each new co-investment as soon as practical to the Board. • Communicate with Staff regarding potential opportunities undergoing extensive analysis and due diligence. • Coordinate meetings between Staff, Board, and general partner upon request. • Negotiate and execute legal documents on behalf of the ERS.
Investment Monitoring	<ul style="list-style-type: none"> • Review quarterly, annual, and other periodic monitoring reports. 	<ul style="list-style-type: none"> • Review quarterly, annual and other periodic monitoring reports prepared by HiTIP Manager. • Conduct meetings with GP representing the co-investment periodically. • Fund capital calls and distributions upon written recommendation of HiTIP Manager. • Review HiTIP Manager's recommendations on amendments. • Execute legal documents as necessary or required. 	<ul style="list-style-type: none"> • Maintain regular contact with co-investment portfolio companies to ascertain significant events within the portfolio. • Recommend co-investment Policy amendments to Investment Staff for approval. • Provide quarterly, annual, and other periodic monitoring reports as required by the Board or Investment Staff. • Attend annual partnership meetings when appropriate. •

APPENDIX H.2**HiTIP Co-investment Due Diligence Check List
(an attachment to the HiTIP Co-investment Procedures)**

The following checklist is a general guide to use when reviewing a co-investment opportunity. Each co-investment opportunity is unique and appropriate due diligence may require the addition of checks not included in this list or the removal of some items from this list.

1. Executive Summary

The executive summary should be concise, but include sufficient information to assess the attractiveness of an investment and provide a summary of the key issues and risks. The Executive Summary should include the following information:

- **Client:** Client(s), bite size, manager, company name, industry/activity. Important client specific issues that should be highlighted
- **Timing**
- **Transaction summary:** transaction size, total equity stake, client equity stake, entry valuation (summary comparable valuations), summary deal structure, leverage ratios (if relevant), summary sources and uses of funds, any other unique features that should be noted.
- **Business/industry:** summary of key business lines, brief industry outlook, key growth drivers.
- **Summary financials:** revenue, gross margins, EBITDA, operating margin, PAT, net debt, key ratios, covenants. Use tables.
- **Merits/risks:** Summarize to the extent possible.
- **Exit/returns:** Summary of potential exit route, expected returns (net of fees, carry). Major tax considerations.
- **Co-investment terms.**

2. Business and Market

- Summary of company history. Detailed history can be included in appendix unless considered highly relevant to investment case.
- Business description, products/services.
- Business strategy
 - Business model and growth strategy
 - Recent performance
 - Strengths & weaknesses
- Operations
 - Description
 - Areas of improvement (e.g. inventory management or systems)
- Market
 - Market/industry outlook
 - Industry attractiveness: size, growth, margins, demand/supply dynamics, underlying drivers, trends and macroeconomic factors impacting attractiveness of the industry
 - Industry structure: e.g. 5 Forces Analysis of the relevant industry segment (entry barriers, supplier & buyer power, substitutes & complements & existing competition) – impact of forces on industry profitability and business risk
 - What drives competitive advantage in the industry?
 - Market opportunities
 - Competitive landscape
 - Key players – company positioning within the industry – how players differentiate their products/services, business model, SWOT analysis / financials to the extent available

- Competitive advantage and risks
- Regulation
- Environment. ESG.

3. Management

- Background, experience
- Comments on quality of management, strengths and weaknesses
- Feedback from GP or reference checks.
- Conduct criminal background checks on key executives

4. PE Manager

- Summary of Manager background
- Relevant experience, or track record on similar deals
- Relationship with MFGPE

5. Financials

- Summary Profit & Loss, Balance Sheet and Cash flow Statements
 - Include both historic and projected financial statements (same format) (detailed statements can be included in the Appendix)
 - Show relevant breakups – revenues, COGS, operating expenses, EBITDA, depreciation, EBIT, PBT, PAT
 - Include interest expense, other income, one time items
 - Capex, ROCE, and FCF
- Management projections
- HiTIP Manager projections
- Comments on key performance drivers (revenues, earnings, cash flows, margins, return on assets/equity, etc)
 - Highlight key assumptions underlying the projections
 - Explain rationale for assumptions and compare/link this to:
 - Industry outlook
 - Company's position in the industry
 - Company's strategy
 - Competitors
 - Key events impacting future financials
 - Management's capability to execute to plan
 - Sensitivity analysis around changes to assumptions
 - Discussion of risks around assumptions changing
- Provide key financial ratios with discussion/analysis.
- Other useful analyses may include:
 - Earnings bridge (graph)

6. Deal and Investment Structure

- Deal background. Why is the seller selling? Why do they need PE funding? What is the process?
- Valuation:
 - Earnings, sales, growth. What are the relevant valuation metrics (EV/Sales, P/E, EV/EBITDA, PEG, etc)?
 - Present comparable entry valuations. Compare with recent transactions, industry comparables – domestic, global. Comment on why entry valuation differs from comparables.
- Sources and uses table
 - Is funding sufficient to complete strategy or meet operational needs?
 - Follow-on investment? Expectation and potential reserve required.

- Structure
 - Instruments (shares, preferred shares, shareholder loans, junior debt) and features of these instruments
 - Comments on appropriateness of structure
 - Shareholder rights. Comment on enforceability of rights.
 - Direct or through vehicle? Diagram. If vehicle, do we have the same rights as if we were a direct shareholder?
- Debt Package and Covenants (if applicable)
 - Summary tables (leverage ratios, covenants and headroom)
 - Comments on risk of covenant breach
 - Comments on debt pricing
 - Who are the debt providers, and what is the nature of relationship?
- Regulatory approvals and risks
- Co-investment terms
 - Management fees and/or carry payable to Manager
 - Other fees charged by the Manager (e.g. transaction fees)
 - Co-investment rights
- Tax (if any, factored into return expectations?)
- Any other significant details of tax and legal negotiations should be mentioned

7. Exit/Projected Returns

- Highlight key drivers to generating returns – EBITDA growth, sector revaluation, key events, industry cyclicality
- Expected holding period, IRR and cost multiple (before and after fees/carry)
- Expected exit route (e.g. trade sale, IPO)
 - If strategic/trade sale – who are the potential buyers and why?
 - If IPO, does the profile and size meet listing requirements? Lock-up periods if any.
- Expected exit valuation, highlight expected return range
- Sensitivity analyses/tables on expected returns from
 - Changes in earnings
 - Changes in valuation on exit
 - Changes in exit year
 - Absolute downside case

8. Client Specific Issues

- Fund/portfolio blueprints
- Portfolio fit
- Reserve for follow-on (if any)
- Other issues relating to exposures or limits

9. Strengths and Risks

- Investment rationale
- Industry rationale
- Company rationale
- Exit opportunities
- Other features of the deal that make it attractive
- Key issues/risks and how they can be mitigated

Appendices

- Detailed financial projections
- Detailed business description
- Competitor profiles

- Industry statistics
- Important operating variables
- Other relevant analysis/information
- Client blueprint



APPENDIX

SECTIONS: A-F

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NOTE:

The information contained in Appendices B, C, and D are included in this Manual solely for use as an educational guide for Trustees and Staff in their decision-making process. Appendices B, C, and D are not part of the Board's Investment Policy, Guidelines, and Procedures manual. The Board's adopted policies and procedures are the sole governing instruments.

Appendix A

Statutes

CHAPTER 88: HAWAI'I REVISED STATUTES AS AMENDED 2014

§88-119 Investments. Investments may be made in:

- (1) Real estate loans and mortgages. Obligations (as defined in section 431:6-101) of any of the following classes:
 - (A) Obligations secured by mortgages of nonprofit corporations desiring to build multirental units (ten units or more) subject to control of the government for occupancy by families displaced as a result of government action;
 - (B) Obligations secured by mortgages insured by the Federal Housing Administration;
 - (C) Obligations for the repayment of home loans made under the Servicemen's Readjustment Act of 1944 or under Title II of the National Housing Act;
 - (D) Other obligations secured by first mortgages on unencumbered improved real estate owned in fee simple; provided that the amount of the obligation at the time investment is made therein shall not exceed eighty per cent of the value of the real estate and improvements mortgaged to secure it, and except that the amount of the obligation at the time investment is made therein may exceed eighty per cent but no more than ninety per cent of the value of the real estate and improvements mortgaged to secure it; provided further that the obligation is insured or guaranteed against default or loss under a mortgage insurance policy issued by a casualty insurance company licensed to do business in the State. The coverage provided by the insurer shall be sufficient to reduce the system's exposure to not more than eighty per cent of the value of the real estate and improvements mortgaged to secure it. The insurance coverage shall remain in force until the principal amount of the obligation is reduced to eighty per cent of the market value of the real estate and improvements mortgaged to secure it, at which time the coverage shall be subject to cancellation solely at the option of the board. Real estate shall not be deemed to be encumbered within the meaning of this subparagraph by reason of the existence of any of the restrictions, charges, or claims described in section 431:6-308;
 - (E) Other obligations secured by first mortgages of leasehold interests in improved real estate; provided that:
 - (i) Each leasehold interest at the time shall have a current term extending at least two years beyond the stated maturity of the obligation it secures; and
 - (ii) The amount of the obligation at the time investment is made therein shall not exceed eighty per cent of the value of the respective leasehold interest and improvements, and except that the amount of the obligation at the time investment is made therein may exceed eighty per cent but no more than ninety per cent of the value of the leasehold interest and improvements mortgaged to secure it; provided further that the obligation is insured or

guaranteed against default or loss under a mortgage insurance policy issued by a casualty insurance company licensed to do business in the State. The coverage provided by the insurer shall be sufficient to reduce the system's exposure to not more than eighty per cent of the value of the leasehold interest and improvements mortgaged to secure it. The insurance coverage shall remain in force until the principal amount of the obligation is reduced to eighty per cent of the market value of the leasehold interest and improvements mortgaged to secure it, at which time the coverage shall be subject to cancellation solely at the option of the board;

- (F) Obligations for the repayment of home loans guaranteed by the department of Hawaiian home lands pursuant to section 214(b) of the Hawaiian Homes Commission Act, 1920; and
- G) Obligations secured by second mortgages on improved real estate for which the mortgagor procures a second mortgage on the improved real estate for the purpose of acquiring the leaseholder's fee simple interest in the improved real estate; provided that any prior mortgage shall not contain provisions that might jeopardize the security position of the retirement system or the borrower's ability to repay the mortgage loan.

The board may retain the real estate, including leasehold interests therein, as it may acquire by foreclosure of mortgages or in enforcement of security, or as may be conveyed to it in satisfaction of debts previously contracted; provided that all the real estate, other than leasehold interests, shall be sold within five years after acquiring the same, subject to extension by the governor for additional periods not exceeding five years each, and that all the leasehold interests shall be sold within one year after acquiring the same, subject to extension by the governor for additional periods not exceeding one year each;

- (2) Government obligations, etc. Obligations of any of the following classes:
 - (A) Obligations issued or guaranteed as to principal and interest by the United States or by any state thereof or by any municipal or political subdivision or school district of any of the foregoing; provided that principal of and interest on the obligations are payable in currency of the United States; or sovereign debt instruments issued by agencies of, or guaranteed by foreign governments;
 - (B) Revenue bonds, whether or not permitted by any other provision hereof, of the State or any municipal or political subdivision thereof, including the board of water supply of the city and county of Honolulu, and street or improvement district bonds of any district or project in the State; and
 - (C) Obligations issued or guaranteed by any federal home loan bank, including consolidated federal home loan bank obligations, the Home Owner's Loan Corporation, the Federal National Mortgage Association, or the Small Business Administration;
- (3) Corporate obligations. Below investment grade or nonrated debt instruments, foreign or domestic, in accordance with investment guidelines adopted by the board;
- (4) Preferred and common stocks. Shares of preferred or common stock of any corporation created or existing under the laws of the United States or of any state or district thereof or of any country;

- (5) Obligations eligible by law for purchase in the open market by federal reserve banks;
- (6) Obligations issued or guaranteed by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, or the African Development Bank;
- (7) Obligations secured by collateral consisting of any of the securities or stock listed above and worth at the time the investment is made at least fifteen per cent more than the amount of the respective obligations;
- (8) Insurance company obligations. Contracts and agreements supplemental thereto providing for participation in one or more accounts of a life insurance company authorized to do business in Hawai'i, including its separate accounts, and whether the investments allocated thereto are comprised of stocks or other securities or of real or personal property or interests therein;
- (9) Interests in real property. Interests in improved or productive real property in which, in the informed opinion of the board, it is prudent to invest funds of the system. For purposes of this paragraph, "real property" includes any property treated as real property either by local law or for federal income tax purposes. Investments in improved or productive real property may be made directly or through pooled funds, including common or collective trust funds of banks and trust companies, group or unit trusts, limited partnerships, limited liability companies, investment trusts, title-holding corporations recognized under section 501(c) of the Internal Revenue Code of 1986, as amended, similar entities that would protect the system's interest, and other pooled funds invested on behalf of the system by investment managers retained by the system;
- (10) Other securities and futures contracts. Securities and futures contracts in which in the informed opinion of the board, it is prudent to invest funds of the system, including currency, interest rate, bond, and stock index futures contracts and options on the contracts to hedge against anticipated changes in currencies, interest rates, and bond and stock prices that might otherwise have an adverse effect upon the value of the system's securities portfolios; covered put and call options on securities; and stock; whether or not the securities, stock, futures contracts, or options on futures are expressly authorized by or qualify under the foregoing paragraphs, and notwithstanding any limitation of any of the foregoing paragraphs (including paragraph (4)); and
- (11) Private placements. Investments in institutional blind pool limited partnerships, limited liability companies, or direct investments that make private debt and equity investments in privately held companies, including but not limited to investments in Hawai'i high technology businesses or venture capital investments that, in the informed opinion of the board, are appropriate to invest funds of the system. In evaluating venture capital investments, the board shall consider, among other things, the impact an investment may have on job creation in Hawai'i and on the state economy. The board shall report annually to the legislature on any Hawai'i venture capital investments it has made; provided that if the board determines it is not prudent to invest in any Hawai'i venture capital investments the board shall report the rationale for the decision. The board, by January 1, 2008, shall develop criteria to determine the amount of funds that may be prudently invested in Hawai'i private placement investments. [L 1925, c 55, pt of §7; RL 1935, pt of §7926; am L 1935, c 156, §1; am L 1939, c 5, pt of §1; am L 1941, c 50, §1 and c 61, §1; RL 1945, §710, subs 2; am L 1947, c 233, §1; am L 1949, c 297, §1; am L Sp 1949, c 27, §1; am L 1951, c 56, §1; am L 1955, c 270, §§1, 2; RL 1955, §6-75; am L 1959, c 81, §1, c 144, §1, and c 175, §1; am L

1961, c 111, §1; am L 1965, c 222, §11; am L 1967, c 166, §§1, 2; HRS §88-110; am L 1969, c 107, §1, c 110, pt of §1, and c 159, §1; am L 1970, c 89, §§1 to 3; am L 1974, c 177, §1; am L 1977, c 83, §1; am L 1978, c 11, §2; am L 1981, c 129, §1; am L 1983, c 105, §1; am L 1986, c 71, §1 and c 77, §2; am L 1987, c 114, §1; am L 1990, c 34, §8; am L 1991, c 17, §1; am L 1998, c 151, §21; am L 1999, c 168, §1; am L 2000, c 297, §12; am L 2006, c 169, §21; am L 2007, c 260, §2]

§88-119.5 Investment guidelines. Notwithstanding any other law to the contrary, real estate loans and mortgages made pursuant to section 88-119(1)(D) and (E) shall be in accordance with conditions and restrictions set forth by the board of trustees; provided that the board may establish the minimum and maximum loan amounts and interest rates for these real estate loans and mortgages by motion, at any duly noticed meeting of the board. The board of trustees, subject to chapter 91, shall adopt, amend, and repeal rules having the force of and effect of law to implement all provisions of this section other than those relating to loan amounts and interest rates for its real estate loans and mortgages. [L 1982, c 165, §3; am L 1991, c 17, §2; am L 1998, c 151, §22]

§88-120 Service charges. The board of trustees may pay out of any of the several funds held for investment, a reasonable amount to any person for servicing and handling of mortgages purchased by the board or for supplying investment advisory or consultative services; and to meet such other costs incident to the prudent investment of system funds as the board may approve.

§88-121 Power to make agreements to protect securities on reorganization or otherwise. Anything in this part to the contrary notwithstanding, the board of trustees may enter into an agreement or agreements for the purpose of protecting the interests of the system in securities held by the system, or for the purpose of reorganization of a corporation which issued securities so held, and deposit of securities there under with a committee or depositories appointed under the agreement, but the agreement and deposit must first be approved in writing by a majority of the members of the board with a statement of their reasons for such approval. The board may accept corporate stock or bonds or other securities, which may be distributed pursuant to any such agreement approved as aforesaid or to any plan or reorganization approved in writing by a majority of the members of the board with a statement of their reasons for such approval. But if securities so received consist in whole or in part of stock in any corporation or of bonds or obligations which are not secured by adequate collateral security or where less than two-thirds of the total value of the required collateral security therefore consist of collateral other than stock, then any stock and any such bond or obligation so received shall be disposed of within five years from the time of acquisition or before expiration of such further period or periods of time as may be fixed in writing for that purpose by the governor.

§88-121.5. Power to enter into security loan agreements. Anything in this part to the contrary notwithstanding, the board of trustees may enter into an agreement or agreements with a financially responsible stock or bond brokerage firm, bank, or similar financial institution (“borrower”) authorized to do business under the laws of any state or the United States, for the purpose of lending to the borrower securities held by the system, subject to the following conditions:

- (1) The securities shall be loaned to the borrower for a period not to exceed one year;
- (2) At the termination of the loan period, the borrower shall deliver to the board of trustees certificates for identical securities which are of the same class and issue as the loaned securities;
- (3) For the protection of the system, the borrower shall deliver to the board of trustees or its agent, collateral in the form of cash, letters of credit, bonds, or other interest-bearing notes and obligations of the United States or federal instrumentalities which are eligible for investment by the board of trustees, in an amount not less than one hundred two percent

of the market value of the loaned securities, as determined by the board of trustees. The system shall have a security interest in the collateral to secure borrower's obligations under the agreement. The board of trustees shall not be obligated to return the collateral or any part thereof to the borrower, except upon borrower's delivery to the board or its agent of securities identical to the loaned securities, as provided in paragraph (2). The board of trustees or its designated agent shall monitor the market value of the loaned securities daily, and if, on any business day, the amount of the collateral deposited by the borrower is less than one hundred two percent of the market value of the loaned securities on that day, the borrower shall immediately deposit with the board or its agent additional collateral in the form of cash, letters of credit, bonds, or other interest-bearing notes and obligations of the United States or federal instrumentalities which are eligible for investment by the board of trustees. Such additional collateral, together with the collateral previously on deposit, shall be in an amount not less than one hundred two percent of the market value of the loaned securities at the time of such deposit;

- (4) The board of trustees, at its election, may use or invest any collateral delivered by a borrower to the board or its agent pursuant to the agreement, and any income and profits earned on the collateral shall be retained for the benefit of the system. Any investment of the collateral shall be subject to section 88-119;
- (5) Until the termination of the loan, the borrower may securities, including the right to transfer the loaned securities to others and vote or otherwise consent as a holder of such securities; provided that the borrower shall exercise all the incidents of ownership of loaned, be obligated to the board of trustees for all dividends and distributions made with respect to the loaned securities during the period of the agreement, including, without limitation, cash, stock or property dividends or distributions, interest payments, and subscription rights;
- (6) In the event that the borrower, at the termination of the loan period, fails to deliver to the board of trustees certificates for identical securities which are of the same class and issue as the loaned securities, the borrowers shall forfeit to the system the collateral deposited. (L 1981, c 212, §1)

Appendix B

Risk Factor Definitions

Growth Risk - Risk related to uncertainties associated with the future growth path of a society's economy, and in particular, Gross Domestic Product (GDP) and corporate profitability. In general, economic growth is measured by the real (inflation-adjusted) growth rate of a society's GDP or per capita real GDP growth rate. Since many types of investments are dependent on the growth rate of an economy, other measures can be used to determine an investment market's sensitivity to economic growth uncertainties. Such measures might include: VIX (a measure of equity market uncertainty), credit spreads (high-yield bonds and/or investment-grade bonds), and/or changes in the dispersion of economists' GDP growth estimates.

(synonym(s): economic growth risk)

Inflation Risk - The uncertainty over the future real value (after inflation) of your investment. This is the risk that inflation will undermine the performance of your investment and that it will lose purchasing power over time.

Interest Rate Risk - The variability and/or uncertainty of interest rate changes over time. There are various dimensions of interest changes, including changes in the level of yields, changes in the term structure of interest rates (the yield curve), and changes to a portfolio's general sensitivity to interest rates changes (duration and convexity).

Leverage Risk - Societal leverage risk is reflected by both the amount of total debt of a society (government debt plus individual debt plus corporate debt) and the tightness or looseness of the terms and conditions associated with such debt. If debt is shrinking and terms are relatively stringent, then leverage risk is declining. If debt is increasing and terms are loosening and/or becoming more accommodating, then leverage risk is increasing.

Liquidity Risk - The potential that the trading volume of a market or a specific investment or security will freeze up, leaving investors with no opportunity (or at least extremely limited opportunity) to exit an investment at a market-determined price. In such cases, investors who must liquidate such investments quickly will likely confront only liquidation options that require a substantial sacrifice of the investment's value.

Regulatory Risk- Uncertainty in relation to the geopolitical environment, as analyzed and ranked by the Economist Intelligence Unit, a subsidiary of The Economist publishing group out of London.

Appendix C

Manager Style Groups

Domestic Equity Management Style Groups

The Equity management style groups that follow are maintained in two separate databases; one exclusively for open-end mutual funds with the indicated style and one for separate account investment manager products with the indicated style.

Aggressive Growth – Managers who invest in growth securities with significantly higher risk/return expectations than the broader market. Sometimes make concentrated “bets” by selecting a small number of securities or by investing in only a few specific sectors. Selects from companies with market capitalization significantly below the broader market. Invests in companies with P/E ratios, Price-to-Book values, and Growth-in-Earnings values above the broader market. The companies typically have zero dividends or dividend yields below the broader market. Invests in securities which exhibit greater volatility than the broad market as measured by the securities’ Beta and Standard Deviation values.

Contrarian – Managers who invest in stocks that are out of favor or which have little current market interest, on the premise that gain will be realized when they return to favor. Sometimes makes concentrated “bets” by selecting a small number of securities or by investing in only a few specific sectors. Invests in companies with Return-on-Assets values, Return-on-Equity values, Growth-in-Earnings values, and Growth-in-Dividend values below the broad market. Chooses securities that, due to their contrary status, do not move with the broader market, as measured by a low Beta and significant non-market risk.

Core – Managers whose portfolio holdings and characteristics are similar to that of the broader market as represented by the Standard & Poor’s 500 Index, with the objective of adding value over and above the index, typically from sector or issue selection. The core portfolio exhibits similar risk characteristics to the broad market as measured by low residual risk with Beta and R-Squared values close to 1.00.

Large Cap Growth – Managers who invest mainly in large companies that are expected to have above average prospects for long-term growth in earnings and profitability. Future growth prospects take precedence over valuation levels in the stock selection process. Invests in companies with P/E ratios, Price-to-Book values, Return-on-Assets values, and Growth-in-Earnings values above the broader market. The companies typically have zero dividends or dividend yields below the broader market. Invests in securities which exhibit greater volatility than the broader market as measured by the securities’ Beta and Standard Deviation. The Growth Style Group is composed of two Growth Style sub-groups; the Growth (Sector Rotator) Style Group and the Growth (Stock Selection) Style Group.

Large Cap Value – Managers who invest in predominantly large capitalization companies believed to be currently undervalued in the general market. The companies are expected to have a near-term earnings rebound and eventual realization of expected value. Valuation issues take precedence over near term earnings prospects in the stock selection process. Invests in companies with P/E ratios, and Price-to-Book values below the broader market. Usually exhibits lower risk than the broader market as measured by the Beta and Standard Deviation. The Value Style Group consists of the Value (Bottom Up) Style Group and the Value (Top Down) Style Group.

Middle Capitalization – Managers who invest primarily in mid-range companies with market capitalizations between core equity companies and small capitalization companies. The average market capitalization is approximately \$3 billion. Invests in securities with greater volatility than the broader market as measured by the risk statistics Beta and Standard Deviation. The Middle Capitalization Style

Group consists of the Middle Capitalization Growth Equity and the Middle Capitalization Value Equity Style Groups.

Middle Capitalization (Growth) – Managers who invest primarily in mid-range companies that are expected to have above average prospects for long-term growth in earnings and profitability. Future growth prospects take precedence over valuation levels in the stock selection process. The average market capitalization is approximately \$3 billion with market capitalizations between core equity companies and small capitalization companies. Invests in companies with P/E ratios, Price-to Book values, and Growth-in Earnings values above the broader market as well as the middle capitalization market segment. Invests in securities with greater volatility than the broader market and the middle capitalization segment as measured by the risk statistics Beta and Standard Deviation.

Middle Capitalization (Value) – Managers who invest primarily in mid-range companies believed to be currently undervalued in the general market. Valuation issues take precedence over near term earnings prospects in the stock selection process. The average market capitalization is approximately \$3 billion with market capitalizations between core equity companies and small capitalization companies. Invests in companies with P/E ratios, Return-on-Equity values, and Price-to-Book values below the broader market and the middle capitalization segment. Invests in securities with risk/reward profiles in the lower risk range of the medium capitalization market.

Sector Rotation – Managers who identify sectors of the economy that show the best potential for investment, and then target markets and firms for investment within the selected sectors according to fundamental investment criteria. Sector weighting takes precedence over individual security selection in the investment process.

Small Capitalization – Managers who invest in companies with relatively small capitalization. The average market capitalization is approximately \$400 million. The companies typically have zero dividends or dividend yields below the broader market. The securities exhibit greater volatility than the broader market as measured by the risk statistics Beta and Standard Deviation. The Small Capitalization Style Group consists of the Small Capitalization (Growth) Style Group and the Small Capitalization(Value) Style Group.

Small Capitalization (Growth) – Managers who invest mainly in small companies that are expected to have above average prospects for long-term growth in earnings and profitability. Future growth prospects take precedence over valuation levels in the stock selection process. Invests in companies with P/E ratios, Price-to Book values, and Growth-in Earnings values above the broader market as well as the small capitalization market segment. The companies typically have zero dividends or dividend yields below the broader market. The securities exhibit greater volatility than the broader market as well as the small capitalization market segment as measured by the risk statistics values Beta and Standard Deviation.

Small Capitalization (Value) – Managers who invest in small capitalization companies that are believed to be currently undervalued in the general market. Valuation issues take precedence over near term earnings prospects in the stock selection process. The companies are expected to have a near-term earnings rebound and eventual realization of expected value. Invests in companies with P/E ratios, Return-on-Equity values, and Price-to-Book values below the broader market as well as the small capitalization market segment. Invests in securities with dividend yields in the high range for the small capitalization market. Invests in securities with risk/reward profiles in the lower risk range of the small capitalization market.

Yield – Managers whose primary objective is a high current dividend yield. Invests in companies with Price-to-Book values and Growth-in-Earnings values below the broader market. Invests in securities with dividend yields above the broader market. Invests in securities with significantly lower volatility than the broader market as measured by risk statistics values for Beta and Standard Deviation.

Fixed-Income Management Style Groups

The fixed-income management style groups that follow are maintained in two separate databases; one exclusively for open-end mutual funds with the indicated style and one for separate account investment manager products with the indicated style.

Mortgage – Managers who invest primarily in mortgage-backed securities including agency (FHLMC, GNMA, FNMA) and private issue pass-throughs, asset-backed securities, and mortgage derivatives (REMICs/CMOs, IOs, POs). Funds may also contain a small percentage of U.S. Treasuries.

Active Cash – Managers whose objective is to achieve a maximum return on short-term financial instruments through active management. The average portfolio duration is typically less than one year.

Active Duration – Managers who aggressively employ interest rate anticipation in setting portfolio duration. Portfolios are actively managed so that large changes in duration are made in anticipation of interest rate in hopes of profiting from downward rate movements and minimizing losses from upward rate movements.

Convertible Bond – Managers who invest in convertible bonds. Convertible bonds offer the downside floor price of a “straight” bond while potentially allowing the holder to share in price appreciation of the underlying common stock. This conversion feature makes it possible for the bondholder to convert the bond to shares of the issuer’s common stock.

Core Bond – Managers who construct portfolios to approximate the investment results of the Barclays Capital Government/Corporate Bond Index or the Barclays Capital Aggregate Bond Index with a modest amount of variability in duration around the index. The objective is to achieve value added from sector and/or issue selection.

Core Plus – Active managers, benchmarked against the broad market (i.e. Barclays Capital Aggregate Index), whose objective is to add value by tactically allocating significant portions of their portfolios among non-benchmark sectors (e.g. high yield corporates, non-US\$ bonds, etc.) while maintaining majority exposure similar to the broad market. The median tendency of allocation between the two determinant sectors, high yield and non-US\$ bonds, is 10% and 5% respectively. In addition, municipals, CMBS, convertibles and others are marginally utilized by core plus managers to add value.

Defensive – Managers whose objective is to minimize interest rate risk by investing predominantly in short to intermediate term securities. The average portfolio duration and risk/return profile is similar to that of the Merrill Lynch 1-3 Year Bond Index.

Extended Maturity – Managers whose average portfolio duration is significantly greater than that of the Barclays Capital Government/Corporate Bond Index. These portfolios exhibit risk/return characteristics similar to the long-bond portion of the Barclays Capital Government/Corporate Index, called the Barclays Capital Government/Corporate Long Bond Index. Variations in bond portfolio characteristics are made to enhance performance results. This results in an aggressive risk/return profile that embraces interest rate risk in search of both high yields as well as capital gains.

High Yield – Managers whose investment objective is to obtain high current income by investing primarily in non-investment grade fixed-income securities. Due to the increased level of default risk, security selection focuses on credit-risk analysis.

Intermediate – Managers whose objective is to lower interest rate risk while maintaining reasonable yield levels by investing primarily in intermediate term securities. The average portfolio duration and

risk/return profile is similar to that of the Barclays Capital Intermediate Government/Corporate Bond Index.

Money Market – Open-end mutual funds that invest in low-risk, highly liquid, short-term financial instruments and whose net asset value is kept stable at 1\$ per share. The average portfolio maturity is 30 to 60 days.

International Equity Management Style Groups

The International Equity Management Style Groups that follow are maintained in two separate databases; one exclusively for open-end mutual funds with the indicated style and one for separate account investment manager products with the indicated style. All International Equity Style Groups exclude pure index funds and regional funds (outside of regional style groups) in favor of actively managed, well-diversified products.

Developed Markets – Managers who invest predominantly in well developed markets (i.e. G-20 nations) in the regions of Europe, Australia, the Far East, and Canada. The objective of adding value over and above the index is achieved through stock selection and/or changes in the weighting of individual countries versus the index. These portfolios will exhibit risk/return profiles similar to the MSCI World ex US ND Index.

Emerging Markets –Managers whose well-diversified portfolio holdings are mostly large holdings in emerging countries, as characterized by the countries within the MSCI Emerging Markets Free Index. The objective of adding value over and above the MSCI Emerging Markets Free Index is achieved through stock selection and/or changes in the weighting of individual countries versus the index. These portfolios are characterized by aggressive risk/return profiles that generate high volatility in search of high returns.

Bottom Up/Stock Selection – Managers who primarily emphasize stock selection in their portfolio construction. The country weighting process is mainly a by-product of the stock selection decision, or can be passively set according to the index country weights.

Core – Managers whose well-diversified portfolio holdings are mostly large issues in developed countries with liquid markets, resulting in characteristics similar to that of an index such as the Morgan Stanley Capital International(MSCI) EAFE Index. The objective of adding value over and above the index, is achieved through stock selection and/or changes in the weighting of individual countries versus the index.

Europe – Managers who invest predominantly in the well developed stock markets of Europe. These products will exhibit risk/return profiles similar to the MSCI Europe Index.

Japan – Managers who invest predominantly in the equity of companies in Japan.

Pacific Basin – Managers who invest predominantly in Pacific Basin equities. Countries include Japan, Hong Kong, Singapore, Malaysia, Australia, and New Zealand. These products will exhibit risk/return profiles similar to the MSCI Pacific Index.

Pacific Rim – Managers who invest predominantly in Pacific Basin equities excluding Japan. Countries include Hong Kong, Singapore, Malaysia, Australia, and New Zealand. These products will exhibit risk/return profiles similar to the MSCI Pacific ex-Japan Index.

Small Capitalization – Managers who invest in international companies with relatively small capitalization. The companies typically have zero dividends or dividend yields below the broader market.

The securities exhibit greater volatility than the broader market as measured by the risk statistics Beta and Standard Deviation.

Top Down/Country Allocator – Managers who attempt to add value over an index such as the Morgan Stanley Capital International (MSCI) EAFE Index by emphasizing macroeconomic analysis in selecting allocations in countries with above average gain prospects. Stock selection plays a secondary role in the investment decision process, or can be passively matched to the index stock holdings within each country.

Global Equity Management Style Groups

Active Global Equity – Managers who invest in both foreign and domestic equity securities in varying proportions. These products will exhibit risk/return profiles similar to the MSCI World Index.

Passive Global Equity – Managers who seek to replicate the performance and characteristics of the MSCI All Country World Index.

International Fixed-Income Management Style Groups

Global Fixed-Income – Managers who invest in both foreign and domestic fixed-income securities. These funds seek to take advantage of international currency and interest rate movements, differing bond yields, and/or international diversification.

Non-U.S. Fixed-Income – Managers who generally invest their assets only in non-U.S. fixed-income securities. These funds seek to take advantage of international currency and interest rate movements, bond yields, and/or international diversification.

Other Management Style Groups

CAI Total Real Estate Funds – This is not officially a style group. Rather it consists of 150 open and closed-end commingled funds managed by real estate firms.

Appendix D

Glossary Of Investment Terms

144(a) Securities -- 144a securities are in concept "semi-private placement securities," that are normally traded by sophisticated institutional investors with limited financial information on the issuing company. SEC rule 144a exempts issuers from SEC registration requirements. While not legally required to file with the SEC, issuers normally do provide some sort of documentation describing the issue and financial information about the issuing company.

Accrual Basis Accounting – As opposed to cash basis accounting, this values assets based upon accrued changes in values, not actual cash flows. For example, dividends are included in the portfolio value (i.e. accrued) as of the ex-dividend date, rather than the payment date (or the declaration date).

Active Management – A form of investment management which involves buying and selling financial assets with the objective of earning positive risk-adjusted returns.

Adjusted R-Squared - The R-squared measure (see R-squared definition) adjusted for additional errors associated with the overall model. The basic R-squared measure will increase simply by adding more variables to the regression model. The Adjusted R-squared factors out this bias.

Alpha – The constant value in a statistical regression equation. Measures the added value by a manager. A positive alpha indicates that a manager has performed better than its beta(s) would predict. In contrast, a negative alpha indicates the fund has underperformed, given the expectations set by beta(s). Alpha is always relative to the underlying factor model (e.g., single or multi-factor).
(synonym(s): added value)

Alternative Investments – These generally refer to institutional blind pool limited partnerships/LLCs which make private debt and equity investments in privately held companies, as well as hedge funds and other publicly traded derivatives-based strategies.

American Depository Receipts (ADRs) – Financial assets issued by U.S. banks that represent indirect ownership of a certain number of equity shares in a foreign firm. ADRs are held on deposit in a bank in the firm's home country.

American Shares – American shares are securities issued in the US by a transfer agent acting on behalf of a foreign firm.

Balanced Fund – An investment strategy which is a combination of equities and bonds.

Basis Point – 1/100th of 1%.

Behavioral Finance - A field of finance that proposes socio-/psychological-based theories to explain investment market anomalies. Within behavioral finance, it is assumed that the information structure and the characteristics of market participants systematically influence individuals' investment decisions as well as market outcomes.

Benchmark Portfolio – A portfolio against which the investment performance of an investment manager can be compared for the purpose of determining the value-added of the manager. A benchmark portfolio must be of the same style as the manager, and in particular, similar in terms of risk.

Best Execution – This is formally defined as the difference between the strike price (the price at which a security is actually bought or sold) and the “fair market price,” which involves calculating opportunity costs by examining the security price immediately after the trade is placed. Best execution occurs when the trade involves no opportunity cost, for example when there is no increase in the price of a security shortly after it is sold.

Beta - Measures a security's or portfolio's sensitivity to movements in a specific risk factor. Various factor betas are determined simultaneously by utilizing a multiple regression model that utilizes return time series for each relevant risk as the explanatory (or independent) variable and the portfolio/security return as the explained (or dependent) variable. Each beta is the slope (or response) coefficient in the multi-linear equation (the “β's” in the following equation: $y = \alpha + \beta_1x_1 + \beta_2x_2 + \dots + \beta_nx_n + \varepsilon$). In a multiple regression, individual factor betas can range from negative to positive, reflecting how a portfolio responds to the behavior of each factor. Importantly, in basic multiple regression models, the beta for each factor assumes that the other factor behaviors are held constant. Beta is most commonly used to refer to an investment's sensitivity to equity market risk per the CAPM or similar model (see below). (synonym(s): exposure, factor exposure)

Boardroom Risk – The risk that Trustees will not ride out short term volatility (and therefore wind up altering a sound long-term strategy) due to pressure put on them in their role as Trustees.

Bottom-up Analysis – An approach to valuing securities which first involves analyzing individual companies, then the industry, and finally the economy and overall capital market.

Capital Asset Pricing Model (CAPM) – An equilibrium model of asset pricing which states that the expected return of a security increases as the security's sensitivity to the market (i.e. beta) increases. That is, as the expected return of a security or portfolio increases (decreases), risk increases (decreases) as well.

Capitalization-weighted Market Index – A method of calculating a market index where the return of a security (or group of securities) is weighted by the market value of the security (or group of securities) relative to total value of all securities.

Carry - The difference between an investment with a lower expected absolute cost and an investment with a higher expected return. For example, if U.S. Treasury Bills have an expected yield of 1% and 30-year U.S. Treasury Bonds have an expected yield of 4%, then the amount of Carry is 3% (i.e., that amount earned if you short (or borrow) U.S. Treasury Bills to finance a purchase of 30-year U.S. Treasury Bonds).

Cash Sweep Accounts – A money market fund into which all new contributions, stock dividend income and bond interest income is placed (“swept”) for a certain period of time. At regular intervals, or when rebalancing is necessary, this cash is invested in assets in line with the strategic allocation stipulated in the IPS.

CFA Institute – The CFA Institute is the umbrella organization for the two large investment management advisers' groups, the Institute of Chartered Financial Analysts and the Financial Analysts Federation. This organization administers the annual examinations for the CFA designation and also publishes industry guidelines for performance measurement reporting and calculations. The CFA Institute instituted a standardized performance reporting format on January 1, 1993.

Commodities - Any basic good exchanged during commerce, which includes goods traded on a commodity exchange. Commodities are most often used as inputs in the production of other goods or services. The quality of a given commodity may differ slightly, but it is essentially uniform across producers. When they are traded on an exchange, commodities must also meet specified minimum

standards, also known as a basis grade. Some traditional examples of commodities include grains, gold, beef, oil, and natural gas.

Commingled Fund – An investment fund which is similar to a mutual fund in that investors purchase and redeem units that represent ownership in a pool of securities.

Commission Recapture – An agreement by which a plan sponsor earns credits based upon the amount of brokerage commissions paid. These credits can be used for services which will benefit the plan, such as consulting services, custodial fees, or hardware and software expenses.

Conditional VaR - A risk assessment technique often used to reduce the probability a portfolio will incur large losses. This is performed by assessing the likelihood (at a specific confidence level) that a specific loss will exceed the value at risk. Mathematically speaking, CVaR is derived by taking a weighted average between the value at risk and losses exceeding the value at risk. This term is also known as "Mean Excess Loss", "Mean Shortfall" and "Tail VaR".

Conditional Value at Risk was created to be an extension of Value at Risk (VaR). The VaR model allows managers to limit the likelihood of incurring losses caused by certain types of risk - but not all risks. The problem with relying solely on the VaR model is that the scope of risk assessed is limited, since the tail end of the distribution of loss is not typically assessed. Therefore, if losses are incurred, the amount of the losses will be substantial in value.

(synonym(s): downside risk, tail risk)

Convertible Bond – A bond which may, at the holder's option, be exchanged for common stock.

Core Bond – A fixed income investment strategy which constructs portfolios to approximate the investment results of the BC Government/Corporate Bond Index with a modest amount of variability in duration around the index. The objective is to achieve value added from sector or issue selection.

Core Equity – An investment strategy where the portfolio's characteristics are similar to that of the S&P 500 Index, with the objective of adding value over and above the index, typically from sector or issue selection.

Correlation Coefficient – A statistical measure similar to covariance, in that it measures the mutual variation between two variables. The correlation coefficient is bounded by the values -1 and +1.

Covariance – A statistical measure of the mutual variation between two variables.

Credit Risk - The risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk is typically measured by the yield differentials between fixed income instruments (e.g., corporate bond yields versus Treasury bond yields; high-yield corporate bond yields versus investment-grade corporate bond yields; etc.). Since credit obligations are typically more senior in the corporate capital structure than equity, credit risk is lower or higher depending on the amount of equity that supports the credit obligations. Since credit risk and equity risk are thus linked, changes in the yields of credit instruments may very well indicate changes in the equity risk of a corporation.

Currency Risk - The risk of an investment's value changing due to changes in currency exchange rates. When a U.S. investor invests in another country, it must first convert its U.S. Dollars to the other country's currency. Once converted this non-U.S. currency can then purchase assets in that other country's markets. The value of those investments will fluctuate in local currency terms, but the value of local currency also fluctuates in relation to the U.S. Dollar. This latter fluctuation relates directly to currency risk. If the U.S. Dollar ends up with a higher value in relation to the other country's currency,

then value will have been lost due to currency fluctuations regardless of how the investment is performing within its country market. The opposite is also true if the U.S. Dollar ends up with a lower value versus the other country's currency. This phenomenon exists across all pairs of currencies across numerous countries.

Current Yield – The annual dollar amount of coupon payments made by a bond divided by the bond's current market price.

Defensive – A fixed income investment strategy where the objective is to minimize interest rate risk by investing only in short to intermediate term securities. The average portfolio maturity is typically two to five years.

Derivative – A financial derivative is a security which derives its value from a more fundamental financial security such as a stock or bond. For example, the value of a stock option depends upon the value from the underlying stock. Because the stock option cannot exist without the underlying stock, the stock option is derived from the stock itself.

Dividend Yield – The current annualized dividend paid on a share of common stock, expressed as a percentage of the stock's current market price.

Down Market Capture Ratio - The portion of the market's performance that was captured by the manager using only periods where the market return is negative. A down market capture of less than 100% is considered desirable.

Duration – A measure of the average maturity of the stream of interest payments of a bond. The value of a given bond is more sensitive to interest rate changes as duration increases, i.e. longer duration bonds have greater interest rate volatility than shorter duration bonds.

Dollar-weighted Measurement – In calculating summary statistics, a process by which performance measures are weighted by the dollar amounts of assets in each time period.

Earnings Per Share – A firm's reported earnings divided by the number of its common shares outstanding.

Economically-targeted Investment – Investments where the goal is to target a certain economic activity, sector or area in order to produce corollary benefits in addition to the main objective of earning a competitive risk-adjusted rate of return.

Efficient Market – A theory which claims that a security's market price equals its true investment value at all times since all information is fully and immediately reflected in the market price.

Efficient Portfolio – A portfolio which offers maximum expected return for a given level of risk or minimum risk for a given level of expected return.

Equity Beta - Measures a security's or portfolio's sensitivity to movements in the broad equity market. The "broad equity market" can be defined from either a domestic or global perspective. Equity beta is often determined by utilizing a simple regression model that utilizes an equity benchmark as the explanatory (or independent) variable and the portfolio/security return as the explained (or dependent) variable. The Equity Beta is the slope coefficient in the simple linear equation ("m" in the basic "y=mx+b" equation we all learned in middle-school math class). In investment finance, the Equity Beta can range from negative to positive, but typically ranges in value from -1.0 to 2.0. Equity Betas of reasonably diversified equity portfolios are usually greater than 0.75.

ERISA – The Employee Retirement Security Act, signed into law in September 1974. ERISA established a strict set of fiduciary responsibilities for corporate pension funds, and some states have adopted the ERISA provisions for public plans. It is recommended that public pension plans use the ERISA regulations as guidelines for managing the plan's assets in a procedurally prudent manner.

Eurobond – An international bond denominated in a currency other than that of the country where the bond is issued.

Exchange Traded Funds (ETF) – ETF's are registered, open-ended unit investment trusts that invest in a basket of stocks designed to track the performance of a given index. However, like a closed-end fund, investors buy shares in ETF's from another shareholder on the open market rather than from a fund company.

Exculpatory – A clause or set of regulations, for example the “safe harbor rules”, which generally frees Trustees from responsibility and liability.

Extended Maturity – A fixed income investment strategy where average portfolio maturity is greater than that of the Barclays Capital Government/Corporate Bond Index. Variations in bond portfolio characteristics are made to enhance performance results.

Fiduciary – Indicates the relationship of trust and confidence where one person (the fiduciary) holds or controls property for the benefit of another person. For example, the relationship between a Trustee and the beneficiaries of the trust.

Fundamental Indexing – A process for building passive investment portfolios that utilizes measures of company size not related to the price of a company's stock, which is used when calculating the market value of company. Company market values, in turn, are used to determine proportional weightings in “cap-weighted” indices (the industry-standard practice). Proponents of fundamental indexing argue that cap-weighted indices have significant biases toward momentum (or trending) risk. Weighting companies on more stable fundamental factors can allow investors to avoid this bias. Detractors of fundamental indexing argue that the construction rules of fundamental indexing simply lead to portfolios exhibiting other biases (such as size and value biases).

Funding Risk – The risk that anticipated contributions to the plan will not be made.

Geometric Returns – A method of calculating returns which links portfolio results on a quarterly or monthly basis. This method is best illustrated by an example, and a comparison to *arithmetic returns*, which does not utilize a time link. Suppose a \$100 portfolio returned +25% in the first quarter (ending value is \$125) but lost 20% in the second quarter (ending value is \$100). Over the two quarters the return was 0%, and the method of calculating the geometric return would indicate this. However, the arithmetic calculation would simply average the two returns: $(25\%)(.5) + (20\%)(.5) = +2.5\%$.

Global Equity – Managers who invest in both foreign and domestic equity securities but excludes regional and index funds.

Going-in Yield - The expected yield-to-maturity on a portfolio going forward. When estimating a regression model of a specific portfolio's expected returns, the regression's estimated constant term (typically referred to as the equation's “ α ” or “alpha” term) represents the going-in yield.

Growth Equity – Managers who invest in companies that are expected to have above average prospects for long-term growth in earnings and profitability.

High Yield – A fixed income investment strategy where the objective is to obtain high current income by investing in lower rated, higher default-risk fixed-income securities. As a result, security selection focuses on credit risk analysis.

Index Fund – A passively managed investment in a diversified portfolio of financial assets designed to mimic the performance of a specific market index.

Interest Rate Risk – The uncertainty in the return on a bond caused by unanticipated changes in its value due to changes in the market interest rate.

Intermediate – A fixed income investment strategy where the objective is to lower interest rate risk by investing only in intermediate-term securities. The average portfolio maturity is typically five to seven years.

Liquidity – In general, liquidity refers to the ease by which a financial asset can be converted into cash. Liquidity is often more narrowly defined as the ability to sell an asset quickly without having to make a substantial price concession.

Liquidity Risk – The risk that there will be insufficient cash to meet the fund's disbursement and expense requirements.

Lost Opportunity Risk – The risk that through inappropriate market timing strategies a fund's portfolio will miss long-run market opportunities.

Manager Search – The selection of specific managers following the manager structure.

Manager Structure – The identification of the type(s) of managers to be selected within each broad class of assets.

Marked to the Market – The daily process of adjusting the value of a portfolio to reflect daily changes in the market prices of the assets held in the portfolio.

Market Anomaly - An investment return distortion that contradicts broadly accepted financial theories such as the Efficient Markets Hypothesis (EMH) and the Capital Asset Pricing Model (CAPM). For example, the CAPM is a theoretical model that says stock returns (above the risk-free rate of return) are a function of only two types of risk: (i) risk of the broad equity market and (ii) unique risk associated with the company the stock represents. The CAPM indicates that, over time, incremental returns associated with (ii) above should cancel out. Empirical evidence reveals, however, that such incremental returns are, in fact, positive. This result indicates that a "market anomaly" exists and/or another risk factor needs to be added to the CAPM to make it more robust.

Market Risk – See Systematic Risk.

Market Timing – A form of active management that shifts funds between strategic classes based on short-term expectations of movements in the capital markets.

Momentum - The rate of increase/decrease of a security's price or volume. The idea of momentum in securities is that their price is more likely to keep moving in the same direction than to change directions. In technical analysis, momentum is considered an oscillator and is used to help identify trend lines. Once a momentum trader sees acceleration in a stock's price, earnings or revenues, the trader will often take a long or short position in the stock in the hope that its momentum will continue in either an upward or downward direction. This strategy relies on short-term movements in a stock's price rather than fundamental value.

Money Markets – Financial markets in which financial assets with a maturity of less than one year are traded.

Passive Management – For a given strategic class, the process of buying a diversified portfolio which attempts to duplicate the overall performance of the strategic class (i.e. the relevant market index).

Performance Attribution – The identification of the sources of returns for a security or portfolio over a particular time period.

Preferred Stock – Preferred stocks actually behaves as a fixed-income investment because the dividend payment is fixed. However, unlike bonds, the dividend payment is not legally binding.

Price-earnings Ratio – A firm's current stock price divided by its earnings per share.

Private Placement – The direct sale of a newly issued security to one or a small number of large institutional investors.

Proxy Voting – A written authorization given by a shareholder to someone else to vote his or her shares at a stockholders annual or special meeting called to elect directors or for some other corporate purpose.

Purchasing Power Risk – The risk that a portfolio will earn a return less than the rate of inflation, i.e., a negative real return.

Real Estate Investment Trust (REIT) – An investment fund whose objective is to hold real estate-related assets, either through mortgages, construction and development loans, or equity interests.

Restatement Third, Trusts (Prudent Investor Rule) – A set of new and more specific standards for the handling of the investment process by fiduciaries. These standards were adopted in 1992 and rely heavily on modern investment theory.

Return On Equity – The earnings per share of a firm divided by the firm's book value per share.

Risk Factors - Key elements that are most influential in explaining a security's or portfolio's return. In a statistical modeling sense, they are the explanatory variables in a regression equation whose behaviors are deemed to influence the behavior of the dependent (or explained) variable based upon fundamental knowledge. Risk factors can be benchmarks or other more fundamental variables (such as GDP growth or changes in the levels of certain interest rates).

Risk Premia - The return in excess of an opportunity cost (e.g., risk-free rate of return) or funding source that an investment is expected to yield. An asset's risk premium is a form of compensation for investors who tolerate the extra risk - compared to that of an opportunity cost/forgone option - in a given investment.

Risk-Adjusted Return - A concept that refines an investment's return by measuring how much risk is involved in producing that return, which is generally expressed as a number or rating. Risk-adjusted returns are applied to individual securities and investment funds and portfolios.

There are five principal risk measures: alpha, beta, r-squared, standard deviation and the Sharpe ratio. Each risk measure is unique in how it measures risk. When comparing two or more potential investments, an investor should always compare the same risk measures to each different investment in order to get a relative performance perspective.

Roll Yield - The amount of return generated in a futures market that is achieved by rolling a short-term contract into a longer-term contract and profiting from the convergence toward a higher spot price. Profiting from roll yield is a common goal for many strategies used by traders in the futures market.

“Backwardation” occurs when a futures contract will trade at a higher price as it approaches expiration compared to when the contract is farther away from expiration. Rolling into less expensive futures contracts allows the trader to consistently profit from the rise in a futures' price as it nears expiration.

The biggest risk to this strategy is that the market will shift to “contango” (opposite as backwardation). This type of changing market has led to major losses by various hedge funds in the past.

R-squared (R^2) – Formally called the coefficient of determination, this measures the overall strength or “explanatory power” of a statistical relationship. In general, a higher R^2 means a stronger statistical relationship between the variables which have been estimated, and therefore more confidence in using the estimation for decision-making.

Sharpe Ratio – This statistic is a commonly used measure of risk-adjusted return. It is calculated by subtracting the "risk-free" return (usually 3 Month Treasury Bill) from the portfolio return and dividing the resulting "excess return" by the portfolio's risk level (standard deviation). The result is a measure of return gained per unit of risk taken. The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance.

(synonym(s): risk-adjusted return)

Skill - Associated with the ability to add value beyond simply tilting the portfolio toward one or more systematic market factors (e.g., tilt toward small cap, value, or an economic sector). From a statistical perspective, a portfolio will exhibit added value due to skill if its “ α ” or “alpha” term is positive after taking into account all relevant “ β ’s” or “betas” (i.e., the contribution(s) associated with the tilt(s) toward certain systematic factors). In addition, skill is associated with consistency of added value over time and typically should be examined over multiple, independent time periods. Typically, evidence of true skill only becomes apparent after several years of investment experience. Other qualitative factors associated with skill include (i) the stability of an investment team, (ii) the integrity of the investment process, (iii) the scale of the assets under management, etc.

(synonym(s): added value, alpha)

Small Capitalization – Managers who invest in equities of companies with relatively small capitalization. The cut-off point for small capitalization varies from manager to manager, but on average targets firms with capitalization of \$200-\$600 million.

Small Cap Effect - A theory that holds that smaller firms, or those companies with a small market capitalization, outperform larger companies. Outperformance of stocks of smaller companies versus stocks of larger companies typically exhibits itself over longer investment horizons. There can be extended periods of time where the inverse condition exists (stocks of large companies outperform stocks of smaller companies). Rationale for the existence of the Small Cap Effect often reflects the idea that such companies exhibit various forms of business distress, on average, versus the average business conditions of larger companies.

“Smart” Beta - Typically refers to a rules-based investment strategy that is largely passive in nature and avoids the pitfalls of market capitalization-based indexes. For example, an investment strategy that simply screens for high dividend stocks on a regular basis and adjusts the portfolio accordingly would be considered a smart beta strategy. Other portfolio construction techniques that rely on basic company fundamentals (e.g., fundamental indexing) would also be considered smart beta strategies. An important pitfall of smart beta strategies is that, even though they are designed to eliminate certain biases associated

with market-cap weighting (e.g., mis-timed overweighting of momentum), they introduce other biases into a portfolio (e.g., value bias, sector biases, etc.).

(synonym(s): fundamental indexing, "low-vol" equity)

Socially-targeted Investment – An investment which is undertaken based upon social, rather than purely financial, guidelines.

Soft Dollars – The portion of a plan's commissions expense incurred in the buying and selling of securities that is allocated through a directed brokerage arrangement for the purpose of acquiring goods or services for the benefit of the plan. In many soft dollar arrangements, the payment scheme is effected through a brokerage affiliate of the investment consultant. Broker-investment consultants servicing smaller plans receive commissions directly from the counseled account. Other soft dollar schemes are effected through brokerages that, while acting as the clearing/transfer agent, also serve as the conduit for the payment of fees between the primary parties to the directed fee arrangement.

Sortino Ratio - A measure of the portfolio's excess return, relative to a target rate, divided by the portfolio's downside variance (semi standard deviation), relative to the target rate.

(synonym(s): downside risk-adjusted return)

Specific Risk – The part of a security's total risk which is not related to movements in the market and therefore can be diversified away.

Standard Deviation (and variance) – A statistical measure of portfolio risk. It reflects the average deviation of the observations from their sample mean. Standard deviation is used as an estimate of risk since it measure how wide the range of returns typically is. The wider the typical range of returns, the higher the standard deviation of returns, and the higher the portfolio risk. If returns are normally distributed (i.e. has a bell shaped curve distribution) then approximately 2/3 of the returns would occur within plus or minus one standard deviation from the sample mean.

(synonym(s): volatility, total risk)

Strategic Allocation – The process of determining the optimal allocation of a fund's portfolio among broad strategic classes. Typically involves rebalancing back to the normal mix at specified time intervals (quarterly) or when established tolerance bands (e.g., + and - 10%) are violated

Strategic Allocation Risk – The risk that a non-optimal strategic allocation will be undertaken which does not meet the fund's return and risk targets.

Systematic Risk – The part of a security's total risk that is related to movements in the market and therefore cannot be diversified away.

Tactical Allocation – Closely related to a strategy of market timing, this strategy uses certain indicators to make adjustments in the proportions of a portfolio invested in stocks, bonds, and cash.

Term-to-maturity – The time remaining until a bond's maturity date.

Time-weighted Return – A method of measuring the performance of a portfolio over a particular period of time. It is the cumulative compounded rate of return of the portfolio, calculated on each date that cash flow moves into or out of the portfolio.

Top-down Analysis – An approach to valuing equities which first looks at the economy and overall capital market, then industries, and finally individual firms.

Treynor Ratio – The portfolio's average excess return over a specified period divided by the beta relative to its benchmark over the same time frame. This is used to measure the excess return per unit of systematic risk taken.

Up Market Capture Ratio - The portion of the market's performance that was captured by the manager using only periods where the market return is positive. An up market capture of greater than 100% is considered desirable.

Value at Risk (VaR) - A statistical technique used to measure and quantify the level of financial risk within a firm or investment portfolio over a specific time frame. Value at risk is used by risk managers in order to measure and control the level of risk which the firm undertakes. The risk manager's job is to ensure that risks are not taken beyond the level at which the firm can absorb the losses of a probable worst outcome.

Value at Risk is measured in three variables: the amount of potential loss, the probability of that amount of loss, and the time frame. For example, a financial firm may determine that it has a 5% one-month value-at-risk of *at least* \$100 million. This means that there is a 5% chance that the firm could lose more than \$100 million in any given month. Therefore, a *minimum* \$100 million loss should be expected to occur once every 20 months.

Value Effect - A theory that holds that value stocks outperform growth stocks. The significance of the Value Effect has been empirically tested by several investment finance practitioners. Value stocks are those stocks that have low market values in relation to their book value of equity and/or offer higher-than-average dividends in relation to their market value. Growth stocks are those stocks of companies that exhibit higher-than-average corporate earnings growth rates over specific periods of time.

Value Equity – Managers who invest in companies believed to be undervalued or possessing lower than average price/earnings ratios, based on their potential for capital appreciation.

Volatility - A statistical measure of the dispersion of returns for a given security, portfolio, or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security, portfolio, or market index. Commonly, the higher the volatility, the riskier the investment.

(synonym(s): risk, variance, standard deviation)