

Nation-building Funds

Statement of Investment Policies

January 2010

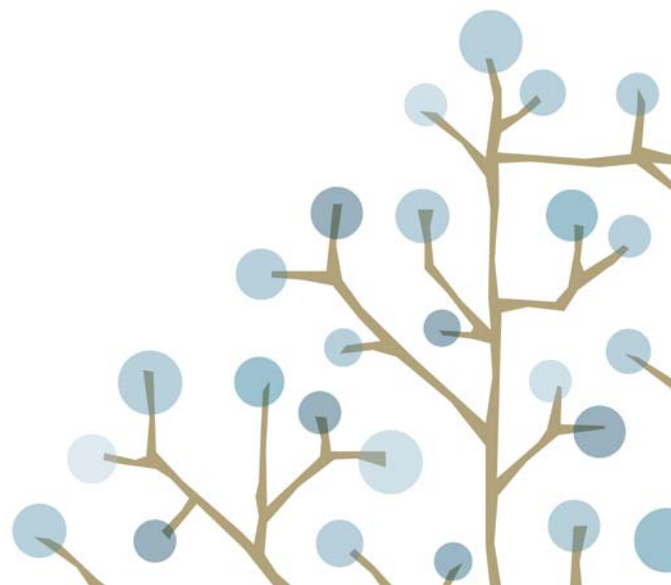


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1. INTRODUCTION

1.1. Purpose

The Nation-building Funds, being the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund, (**Funds**) were established to provide financing resources to meet the Australian Government's commitment to Australia's future by investment in critical areas of infrastructure such as transport, communications, energy, water, education, research and health.

In line with this objective this document is intended to outline the framework set by the Future Fund Board of Guardians (**Board**) for the governance and management of the Funds by providing a statement of the policies that will be adhered to in investing assets.

The Board of Guardians is also responsible for the investment of the Future Fund. A comprehensive view of the Board's responsibilities, its relationship with the Future Fund Management Agency (**Agency**) and its operational governance arrangements can be gained by consulting the Statement of Investment Policies for the Future Fund, the joint Board and Agency annual reports and the *Future Fund Act 2006* and the *Nation Building Funds Act 2008*. All of these documents are available at: www.futurefund.gov.au

1.2. Legislative Requirements

Sections 41, 160 and 235 of the Nation-building Funds Act 2008 require the Board to formulate written policies to be complied with by it in relation to the following matters in connection with each of the three funds:

- (a) the investment strategy;
- (b) the benchmarks and standards for assessing performance;
- (c) risk management;
- (d) matters in relation to international best practice for institutional investment; and,
- (e) any matters specified in regulations. There are currently no such regulations in place.

1.3. Investment Mandate

The legislation requires the Board to maximise the return on each fund subject to the Investment Mandate Directions. The first Directions were issued by the responsible Ministers on 14 July 2009. These have not been superseded and form the basis of the investment mandate the Board is required to meet. These directions are summarised below:

- (1) The Board is to adopt a benchmark return on each Fund of the Australian three month bank bill swap rate + 0.3 per cent per annum, calculated on a rolling 12 month basis (net of fees).
- (2) In targeting this benchmark return, the Board should invest in such a way as to minimise the probability of capital losses over a 12 month horizon.

- (3) In undertaking its investment activities, the Board must act in a way that:
 - (a) minimises the potential to effect any abnormal change in the volatility or efficient operation of Australian financial markets; and
 - (b) is unlikely to cause any diminution of the Australian Government's reputation in Australian and international financial markets.

1.4. Review

A history of the evolution of this document can be found in section 7.

2. INVESTMENT STRATEGY

2.1. Introduction

The Board is responsible for setting the strategic direction of the investment activities of each Nation-building Fund consistent with the *Nation-building Funds Act 2008* and the applicable investment mandate. The Board is supported and advised by the Agency which is responsible for making investment recommendations to the Board and for implementing the Board's decisions.

A common characteristic of successful investment organisations is that they are able to clearly define their investment objectives and articulate principles that they will follow in seeking to achieve their objectives.

The Board has formulated a set of investment beliefs to guide its strategic management of the portfolio. Likewise the Agency has developed its approach to how it will shape specific investment recommendations as part of the Board's overall strategy. These are detailed in the Statement of Investment Policies for the Future Fund and discussed in recent annual reports which are available at: www.futurefund.gov.au

2.2. Portfolio Design

In designing the portfolios for the Nation-building Funds, the Board first considers the target risk and return parameters set by the Investment Mandates. Specifically, this targets a return of the Australian three month bank bill swap rate +0.3% per annum while minimising the probability of capital losses over rolling 12 month periods.

The Board also considers the anticipated schedule of withdrawals from the Nation-building Funds for their mandated purpose: the provision of financing sources to meet the Australian Government's commitment to Australia's future by investment in critical areas of infrastructure such as transport, communications, energy, water, education, research and health.

Accordingly, each fund consists of two broad components: (i) a highly liquid pool of securities, invested primarily in Australian bank bills, which is sufficient to meet the expected withdrawals from the fund over the near term; and (ii) a market-oriented pool of securities which are more exposed to investment risks such as credit, currency, illiquidity and interest rate duration risks in order to generate the excess return above the Australian bank bill swap rate required under the investment mandate.

The specific combination of these two components is adjusted to reflect the level and timing of anticipated payments from each Nation-building Fund as these are advised to the Board.

3. PERFORMANCE BENCHMARKS

3.1. Fund Performance Benchmark

The benchmark for the performance of each Nation-building Fund is set down in the Investment Mandate Directions dated 14 July 2009 and effective from 29 July 2009.

These Investment Mandates set the performance benchmark as follows: to achieve a benchmark return of the Australian three month bank bill swap rate +0.3% per annum, calculated on a rolling 12 month basis (net of fees). The Investment Mandates specify that in targeting the benchmark, the Board should invest in such a way as to minimise the probability of capital losses over a 12 month horizon.

The three Nation-building Funds were established by legislation that came into effect on 1 January 2009. The Building Australia Fund and the Education Investment Fund received funding from that date, while the Health and Hospitals Fund received an initial contribution on 19 February 2009.

Prior to the current Investment Mandate Directions being introduced in July 2009, it was agreed with Government that the Investment Mandate for the former Higher Education Endowment Fund be used on an interim basis for the period from the establishment of the Funds to the issuance of investment mandate. This mandate required the Board to seek to maximise returns with negligible chance of capital loss.

Acknowledging the use of the former HEEF mandate for this period, the performance of the Funds against their benchmark return will be reported from 1 July 2009.

4. RISK MANAGEMENT

4.1. Introduction

The investment mandate requires the Board, in investing the Nation-building Funds, to have regard to maximising return while investing in such a way as to minimise the probability of capital losses over a 12 month horizon. In general the investment strategy adopted for each Fund will have a dominant influence on the returns generated. Investment strategy is primarily influenced by the investment objectives of the Fund and the time horizon over which these are to be achieved.

4.2. Investment Risk

In seeking to maximise returns the Board is mindful of the inherent risks. Those risks are considered because they offer a reasonable expectation of compensation in the form of returns above the risk free rate (**excess returns**) over the time horizon of the Nation-building Funds. Risks accepted in order to pursue the investment objective fall into five categories:

a) Market Risk

The Nation-building Funds hold exposure to a range of assets which the Board expects will produce returns which are superior to the risk-free rate over the medium term. Principal exposures are expected to include:

- broad debt market risk, including interest rate duration, credit spread duration, credit quality migration and default risks; and
- currency exposure, including risks of movement in the value of both the Australian dollar and the foreign currencies held

Market risk is generally managed by:

- adopting an appropriate risk profile that is commensurate with the return objective and time horizon of the Fund. That risk profile is determined after careful analysis of the prospective risk and return characteristics of each asset class in which the Fund might invest;
- avoiding concentration of risk by ensuring there is adequate diversification between and within asset classes; and
- diligent and thoughtful ongoing assessment of the Fund's risk exposures, particularly in the context of the prevailing market environment.

b) Manager Risk

The requirements on external managers to deliver returns above the risk free rate also entail some risks. In particular, appointed managers may exceed or fall short of the objectives set for them by the Board. Manager risk is generally managed by:

- careful selection and monitoring of managers to ensure there is sufficient confidence that each manager warrants the allocation of active risk to them; and

- monitoring the composition of the portfolios of active managers to ensure that there are no unintended biases away from the intended investment strategy.

c) Credit Risk

Credit risk (including counterparty risk) is the risk of default by an issuer on its contractual obligations. At the Fund level, a framework exists to ensure that risk exposures remain within approved exposure limits based on the credit ratings of financial instruments and counterparties. Appointed managers of investments are required to ensure:

- the average credit quality within the manager's portfolio is within agreed guidelines;
- the exposure to different tiers of credit (including unrated debt) are within agreed guidelines;
- the maximum permitted exposure to any one issuer is within agreed guidelines; and
- the long-term debt of all entities in which the manager invests is either rated by an approved recognised rating agency or, if it is not-rated, is constrained to the maximum permitted exposure to such debt.

d) Liquidity Risk

Liquidity risk is the risk that a security cannot be sold when required or the price achieved is significantly different from the quoted price.

Liquidity risk is generally managed by:

- monitoring the liquidity profile of the Fund across all asset classes, under both normal and stressed environments;
- modelling the expected cashflows within the portfolio and undertaking robust planning for when liquidity is required; and
- incorporating into liquidity planning an appropriate margin of safety to ensure that liquidity is always available when required (for example, to meet margin payments on currency hedging contracts).

4.3. Operational Risk

While the main focus of the Board is the most efficient combination of asset classes to optimise the return for market risk, operational risk also needs to be managed. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The Board acknowledges that the quality of its operational risk management procedures must be of best-practice standard. It is committed to achieving this and continues to evolve and enhance its policies over time.

Operational risk is managed by:

- a) Segregation of duties achieved by separating the investing function (undertaken by the managers) from the transaction settlement, recording and reporting of investment activities (undertaken by an independent global custodian);
- b) requiring managers and the custodian to:
 - provide the Board with third party covenants or assurances against these events;
 - have in place insurance arrangements to cover claims in those events; and
 - have in place, and regularly confirm the existence and effectiveness of, internal controls to address operational risks;
- c) establishing appropriate operational, legal and taxation due diligence processes;
- d) establishing a system of compliance reporting by managers and the custodian to the Board;
- e) establishing an Audit Committee of the Board, with responsibility for recognising and controlling operational risk; and
- f) establishing an effective business continuity plan in conjunction with the custodian.

5. DERIVATIVES

5.1. Introduction

Derivatives are financial instruments whose value and marketability are derived from, or linked to, the value of an underlying security, commodity or index that represents either direct ownership of an asset or the direct obligation of an issuer, otherwise known as the physical instrument. Derivatives include a wide assortment of instruments and include futures, swaps, forwards, warrants and all forms of options.

Sections 42, 161 and 237 of the Nation-building Funds Act permit the Board to acquire a derivative for the purpose of:

- protecting the value of an investment;
- protecting the return on an investment ;
- achieving indirect exposure to financial assets; and
- achieving transactional efficiency,

but prohibits the use of derivatives for speculation or leverage.

5.2. Policy

The use of derivatives is subordinate to the investment strategy and must be consistent with the objectives of the investment strategy. Their permitted use may include the following:

- (a) to manage risk in relation to movements in currencies, interest rates or prices of permitted investments;
- (b) to achieve or reduce exposure to all or part of any asset class and foreign currency; and
- (c) to achieve transactional efficiency or reduce the transactional cost of achieving required exposures.

Derivatives will not be used for investment activity where derivative exposure combined with physical exposure results in a net exposure for the portfolio as a whole which is inconsistent with the investment strategy. All derivatives must be in the form of a derivative over the same asset class as the physical instrument.

Managers may be permitted to use derivatives in pursuit of excess returns or to provide market exposure provided such use is consistent with the investment guidelines given to the manager. These will be specified in the agreement with each appointed manager. Managers are required to transact any derivative exposure with approved counterparties under ISDA (International Swaps and Derivatives Association) agreements.

The value of derivative positions measured on an effective exposure basis must not result in portfolio liabilities exceeding portfolio assets. The effective duration of any derivative positions will be taken into account when determining compliance with the duration limits of fixed interest portfolios. The effective exposure of any derivative

positions will be taken into account when determining compliance with portfolio exposure limits.

5.3. Controls

Derivative contracts held will be valued using a mark-to-market methodology, unless otherwise specifically approved. Revaluations will be undertaken on a regular basis. All derivative positions must be covered by collateral in the form of cash or cash equivalent to offset the Fund's exposure.

Appropriate contractual arrangements (for example, an ISDA Master Agreement and an associated Credit Support Annex) must be in place between the manager (or, as the case may be, the Board) and the counterparty in a form satisfactory to the Board.

Each manager is required to have in place appropriate risk management policies and procedures, in a form satisfactory to the Board. On an annual basis, each manager is required to provide the Board with a copy of its current policies relating to derivatives usage and to certify that it is managing its derivative exposures in accordance with those policies.

6. INTERNATIONAL BEST PRACTICE FOR INSTITUTIONAL INVESTMENT

6.1. Introduction

The *Nation-building Funds Act 2008* requires that the Board must seek to maximise the return earned on each Nation-building Fund, consistent with international best practice for institutional investment.

The statutory governance framework established by the *Future Fund Act 2006* and the *Nation-building Funds Act 2008* defines the funds and the relationship between between the Commonwealth, as asset owner, and the Board, supported by the Agency, as asset manager.

Supporting this statutory framework, the Board has established an operational governance framework designed to enhance the Board's capacity to meet its objectives by aligning the way that the organisation and Funds are structured, operated and controlled.

Together the statutory and operational governance frameworks provide a clear and detailed approach to the operation of the organisation and each Fund, consistent with international best practice.

The Board and the Agency participate in a number of international investment organisations and maintain both formal and informal networks to monitor for developments in how other institutional investors structure and control their operations and to ensure good practice is maintained within the context of the statutory framework.

7. VERSION CONTROL

This table records the versions and main changes made to the Statement of Investment Policies.

Version Number	Date Issued	Brief Description of Amendments
1	January 2010	Initial document