

Future Fund

Statement of Investment Policies

April 2009

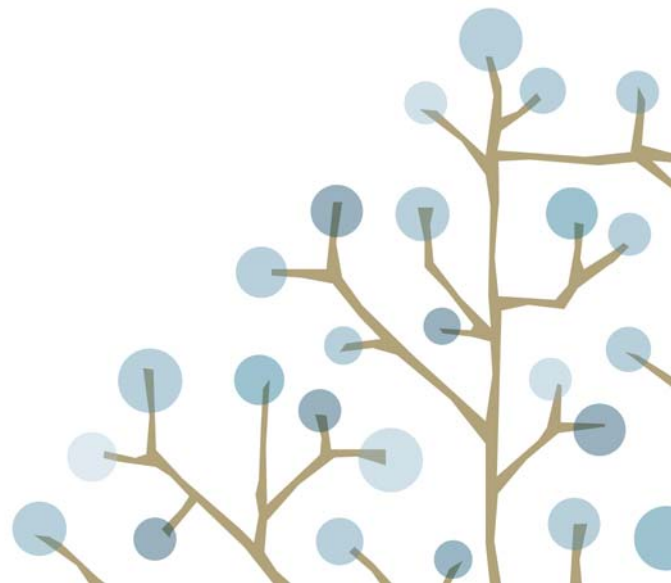


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1. INTRODUCTION

1.1. Purpose

The Future Fund (**Fund**) was established with the aim of accumulating financial assets sufficient to offset the Commonwealth's unfunded superannuation liabilities by 2020.

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

1.2. Legislative Requirements

Section 15 of the Future Fund Act 2006 (**Act**) summarises the objective of the Board acquiring and investing financial assets as being to enhance the ability of the Commonwealth to discharge unfunded superannuation liabilities. The Board, under **Section 16** of the Act, may invest any amount standing to the credit of the Fund in any financial assets in the name of the Board. All income earned from these investments is to be credited to the Fund account.

Section 18 of the Act notes that the responsible Ministers may give the Board written directions about the performance of its investment functions and must give at least one such direction. In giving such directions the responsible Ministers must have regard to:

- (a) maximising the return on the Fund over the long term consistent with international best practice for institutional investment; and
- (b) such other matters as the responsible Ministers may consider relevant.

Section 24 of the Act requires the Board to formulate written policies to be complied with by it in relation to the following matters:

- a) the investment strategy for the Fund;
- b) benchmarks and standards for assessing the performance of the Fund;
- c) risk management of the Fund;
- d) a matter relating to international best practice for institutional investment; and
- e) a matter specified in the regulations.

A copy of these policies must be published on the internet as soon as practicable. This document addresses the requirements as part of a broader statement about the operations of the Fund.

1.3. Investment Mandate

The first Investment Mandate Directions were issued by the responsible Ministers on 3 May 2006. These have not been superseded and form the basis of the investment mandate the Board is required to meet. These directions are summarised below:

a) Benchmark return

- The Board is to adopt an average return of at least the Consumer Price Index (CPI) plus 4.5% to 5.5% p.a. over the long term as the benchmark return on the Fund;
- During the transition period, as the Board develops a long term strategic asset allocation, a return lower than this benchmark is expected; and
- In targeting the benchmark return, the Board must determine an acceptable, but not excessive, level of risk for the Fund measured in terms such as the probability of losses in a particular year.

b) Listed companies

- The Board must establish a limit for holdings on a listed company in order to prevent a breach of the statutory limits imposed by sections 21 and 22 of the Act (i.e. not triggering a takeover under the Corporations Act 2001 and not holding a stake of more than 20% in a foreign listed company); and
- The Board must not acquire a direct holding of voting shares in Telstra Corporation Limited except as a result of a transfer of financial assets or a gift of financial assets by the responsible Ministers.

c) Impacts from investment strategy

- The Board must act in a way that:
 - minimises the potential to effect any abnormal change in volatility or the efficient operation of Australian financial markets; and
 - is unlikely to cause any diminution of the Australian Government's reputation in Australian and international financial markets.

d) Corporate governance

- The Board must have regard to international best practice for institutional investment in determining its approach to corporate governance principles, including in relation to its voting policy.

1.4. Review

This document is effective immediately on adoption by the Board and supersedes all previous versions.

It is recognised that it will be subject to regular review and amendment as the detail of the Fund's strategy is implemented. While the document will be formally reviewed at least once a year, in the early period of the Fund's development it will be updated more frequently. As policies are developed by the Board, they will be added. A history of the evolution of this document can be found in clause 8.

2. BUSINESS MODEL

2.1. Introduction

This clause describes how the Board has structured the operation of the Fund and which activities will be managed internally rather than be outsourced to external investment managers (**managers**) and advisors. It also sets out the broad criteria the Board considers when choosing external investment managers and advisors.

The Board is charged with overall governance responsibilities for the investment of the Fund. The Board's core focus is the development of an investment strategy which takes full advantage of the Fund's characteristics and executing this through partnerships with high-quality and closely aligned organisations.

This means the Board and management will concentrate on building competence in determining the most efficient allocation of risk across investment markets to generate the desired returns. A complementary focus is developing skill in selecting the most appropriate investment partners and closely monitoring their provision of services to ensure the Board's objectives are met.

Roles will be undertaken internally where the Board forms the view external suppliers cannot meet the organisation's specific needs. The quality and cost of an outsourced service are the benchmarks against which these opportunities to build internal capacity will be judged.

The Board has determined that an appropriately resourced management team within the Future Fund Management Agency (**Agency**) is essential to ensure the Fund is managed according to best-practice standards. Management's role includes the following:

- provision of policy advice to the Board;
- making recommendations on the appointment of external investment managers and other service providers;
- monitoring and reporting the performance of the investment portfolio;
- monitoring the ongoing suitability of appointed investment managers and other service providers;
- managing the relationship with the Fund's custodian and other specialist service providers in the outsourced back office;
- managing the financial reporting of the Fund;
- providing a risk management and compliance framework for the Fund; and
- managing communication with stakeholders and external audiences.

2.2. Board Committees

The Board has appointed an Audit Committee to oversee the establishment of the compliance and audit functions, reviewing key financial statements and the evaluation of the adequacy and effectiveness of the risk management plan.

2.3. External Investment Managers

The Act provides that, in the normal course of business, the Board must not invest fund assets unless it does so through an investment manager engaged by the Board. The Board may delegate the power to appoint managers to senior staff of the Agency. Selection of these managers may take into account the following general criteria, as well as specific criteria relevant to each appointment:

- (a) the extent to which the manager demonstrates a sustainable competitive advantage over their competitors in their specialist area;
- (b) the fit between the manager's style and investment process and the investment objectives of the Fund;
- (c) the strategies employed by the manager to control operational and financial risk in their organisation; and
- (d) the expected fees.

Before a recommendation to appoint a manager is made, the Agency will undertake an objective review of potential managers for the relevant mandate and present a report setting out the relevant characteristics of the preferred manager and the reasons why their appointment is favoured.

In determining the allocation of capital to a manager, the relevant issues will be:

- (a) the proportion of the Fund allocated to the specific asset class for which the manager is appointed considered in conjunction with the proportion of active risk to be allocated to that asset class;
- (b) the desired level of active management risk to be allocated to the manager; and
- (c) the capacity of the manager to take on additional assets.

2.4. External Advisors

The Board may appoint advisors in a number of areas including:

- (a) investment policy, including asset allocation, manager research, specialist asset classes;
- (b) legal, including advice on the statutory obligations of the Fund and assistance with contract negotiations with external parties;
- (c) tax, including ensuring the tax obligations of the Board and the Fund are met and advising on the tax implications of particular investment structures (especially offshore); and

- (d) audit, including advice on ensuring that the management controls in place within the Board and around the Fund are of sufficient standard.

Selection of advisors for these roles will take into account, among other criteria specific to the role:

- (a) demonstrated commitment to best-practice portfolio management;
- (b) the skills and experience the advisor brings to the role;
- (c) the substance and viability of the advisor; and
- (d) the costs that can be expected to be incurred.

The Board recognises, however, that in selecting advisors it needs to balance the benefits of a wide market search against the need to develop and implement strategy without alerting other market participants to its plans. Particular emphasis will be placed on objectively selecting advisors whose business models and approach are highly aligned with the Board's interests and who are willing to assist the Fund to build on its internal competency in the relevant specialist area.

3. INVESTMENT STRATEGY

3.1. Introduction

The Board is responsible for setting the strategic direction of the investment activities of the Fund consistent with the Act 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 below.

3.2. Investment beliefs of the Board

The following investment beliefs guide the Board's strategic management of the portfolio.

Mission

The Board believes that:

- the single measure embodying the goal of the Future Fund is achieving at least CPI plus 4.5% p.a. over rolling ten year periods. While the amount of risk taken cannot be captured in one figure, it is best assessed by reference to downside outcomes over rolling three year and ten year periods;
- peer group risk should not be used to shape strategy. The Future Fund Investment Mandate provides an unusually long term investment horizon and this presents a competitive opportunity to add value;
- while quantitative measurement of risk is important, so is building qualitative views of risk through understanding the environment and its potential impact on the portfolio. In addition, operational, counterparty and reputational risk need assessment and management; and
- the amount of risk taken should be conditioned by what strategy is most likely to meet the investment objectives given current conditions.

Governance

The Board believes that:

- high quality governance of the investment process is critical to success. The likelihood of meeting investment objectives is directly related to the time, expertise and organisational effectiveness applied to decisions by the Board

and management. Within this, the clear identification and separation of the Board's and management's responsibilities is particularly important;

- it should ultimately be responsible for all investment decisions. This leads to decisions being tiered with the Board retaining control over top tier decisions, passing over responsibility below this tier to management subject to the Board's oversight;
- its role is to act as a principal, acting in complete alignment with the Fund's mission. It has a critical role in managing agency issues, including those of management, and its influence over compensation levels and incentives is critical to achieving success in this regard; and
- there is value in ensuring adequate time, diversity of view and specialist advice is applied to its deliberations.

Investment strategy

The Board believes that:

- its focus should be on the effective management of beta (market related risk) because it is a stronger driver of long term returns than alpha (skills related risk);
- a flexible approach to asset allocation exposure is appropriate;
- a higher expected return per unit risk (investment efficiency) can be obtained from a broadly diversified allocation across asset classes. In addition, the long time horizon supports a higher tolerance for illiquid assets;
- while the quantification of returns, risks and correlations are necessary inputs in the design and review of investment strategy, the difficulty and limitation of these assumptions means qualitative considerations are also important;
- markets can be inefficient and skilful managers can add value after fees (albeit that the degree of inefficiency varies across markets and over time); and
- alpha is, in general, lowly correlated with market returns. This means its impact on diversification can be large when managers use uncorrelated styles and approaches.

3.3. Investment approach of the Agency

The following principles guide the Agency's approach to developing investment recommendations to put to the Board:

a) An emphasis on long-run, total portfolio risks

Management of the risk of long-run real capital losses is our key consideration rather than shorter term measures of risk such as tracking error. This means we are attracted to an approach which minimises the chances of an adverse total portfolio outcome even though we may run what might appear higher than common risks in some specific asset classes.

b) Recognition of the uncertainty in investing and encouragement of an approach of sceptical enquiry

Relying too much on historical return and risk measurements can, in our view, lead to poor investment decision making. While this has its place it must be supported by a wider, qualitative use of economic information about the world. By being armed with a broad understanding of important investment themes, and sceptical of simplification, we expect to be better prepared to deal with the uncertainty that faces investors.

c) Promotion of portfolio diversity

Consistent with the point above, we cannot know the true risk and return characteristics of an asset and should be wary of a classical approach to diversification (volatilities and correlations). Our preferred approach is to seek to understand the exposure of every asset we review to a set of core long-run factors (inflation, economic growth, interest rates, liquidity conditions, etc) and to access a broad spread of exposures organised into a manageable number of cohorts.

d) Dynamic management of the portfolio

Given the ever-changing nature of the investment universe we believe it makes sense to think in terms of strategies rather than fixed asset classes. We also recognise that if markets are commonly in a state of extended deviation from equilibrium, a static view of prospective risks and return is unlikely to be optimal. This encourages us to continuously monitor whether the policy weight to each type of investment return in our portfolio is ideal. Similarly, recognising that attractive investment opportunities can arise from anywhere in the investable universe, we favour keeping the search process through our managers unconstrained and active as opposed to narrowly defined and focused on short performance horizons.

e) Aiming to be an 'investor of choice'

Recognising that an institutional investor is a supplier of capital in a market where there is a shortfall of genuinely talented and aligned managers, we aim to maximise the value proposition of the service we offer (capital provision) in order to increase payment (improved return). Accordingly, we will emphasise our comparative advantages (scale, investment horizon, mandate, organisational structure, geographical location) together with our patience as an investor and resilience to short term volatility to maximise the opportunities available to us.

3.4. Portfolio Design

The Board has established a long term asset allocation consistent with its investment beliefs and the specific requirements of its investment mandate. The investment mandate sets a return hurdle of at least CPI plus 4.5% p.a. over the long term which is interpreted as meaning rolling ten year periods. The investment mandate stipulates the Board should take acceptable but not excessive levels of risk.

After considering a number of approaches to defining excessive risk, the Board has settled on this in terms of the most pessimistic possible outcomes over three year periods. Specifically, the average return in the worst 5% of modelled scenarios over a rolling three year period is used as the basis to judge whether there is an acceptable level of downside risk compared to the expected upside return from various combinations of assets.

The Board has also chosen to consider investments in broad categories, which have common characteristics, rather than in more narrowly defined asset classes. This minimises the risk of overlooking a potentially attractive investment opportunity simply because it does not meet the narrow definition of an approved asset class. We envisage a high degree of substitutability within these categories but will operate within relatively narrow limits between the categories.

The following table sets out the expected allocation to these broad categories over the long term. It does not indicate the target allocation over the medium term which will reflect the organisation's views regarding valuations in each sector as well as the capacity to access high quality exposure within each category. This will be discussed in the Annual Report of the Future Fund and the actual portfolio can be monitored through our quarterly updates on the website.

Long term asset allocation

Category	Includes	Long term portfolio weighting
Equities (includes exposure to corporate enterprise at various stages of development)	Australian equities, global developed markets equities, developing markets equities, private equity	35%
Tangible Assets (provides exposure to investments where return comes largely from the yield on a physical asset)	Property, infrastructure, utilities. Assets can be held in a listed or unlisted form	30%
Debt (provides exposures to interest bearing securities)	Government and non-government fixed interest securities extending to mortgage backed securities, high yield credit and corporate debt	20%
Alternative assets (provides diversifying exposure relative to the other categories)	A range of risk premia (eg commodities futures and insurance based strategies) and skill based absolute return investments	15%
Cash	Cash or equivalents	0%

3.5. Telstra Shareholding

Following the Telstra 3 share offer and the transfer of the Australian Government's remaining shares, the Fund received approximately 2.1 billion shares in Telstra Corporation Limited (**Telstra**). A set of Ministerial Directions relating to this holding was issued on 28 February 2007. These Directions placed the shares under escrow, subject to limited exceptions, until 20 November 2008.

The Board has managed the holding in line with the Ministerial Directions, its broader Investment Mandate and the Act. Following the disposal of some 126 million shares (as permitted under the Ministerial Directions) and a small further transfer of shares

from Government, the Board's holding totalled approximately two billion shares in November 2008.

With the expiry of the escrow period, the Board expects to reduce its holding over the medium term with a view to maximising long term value with acceptable risk while avoiding causing abnormal volatility in the market. Specifically, the Board will manage the holding in a manner that:

- is consistent with the legislation and Investment Mandate;
- gives consideration, if appropriate to the rights attaching to the shares;
- takes into account the Board's view of Telstra's performance and prospects;
and
- reflects the market and other considerations prevailing from time to time.

4. PERFORMANCE BENCHMARKS

4.1. Fund Performance Benchmark

The benchmark for the performance of the Fund as a whole is set down in the Investment Mandate Directions dated 3 May 2006.

The Board has interpreted these directions to mean that in maximising the return it should target an average real return of at least 4.5% p.a. measured over rolling 10 year periods. Specifically, the investment return over a single year is not a particular focus and the Board believes that assessments about the probability of delivering on the long term objective are best made over at least rolling five year periods.

In reporting the performance of the Fund against the CPI based benchmark, the Board notes the temporary price disturbances that can affect the CPI measure. For portfolio design purposes the Board has adopted an inflation assumption of 2.5% p.a. the mid-point of the Reserve Bank of Australia's target range. This allows the Board to monitor performance against an underlying measure of inflation free of short term fluctuations.

The Board began its investment program late in the 2006/2007 financial year and has adopted 1 July 2007 as the inception date from which to review and assess performance of the Fund. Prior to this date the assets of the Fund were invested with the Reserve Bank of Australia and received the risk free rate of return.

In reporting performance against the benchmark the Board intends to clearly distinguish between the performance of the Telstra portfolio and the performance of the broader portfolio. This reflects both the escrow conditions which applied to the Telstra portfolio until 20 November 2008 and the unusually large proportion of the portfolio that the Telstra holding represents.

Separate reporting of the performance of the Telstra shareholding will enable the performance of the broader portfolio to be appropriately assessed.

The Board will continue this separate reporting until such time as a portfolio has been constructed consistent with the long-term strategic allocation.

5. RISK MANAGEMENT

5.1. Introduction

The investment mandate requires the Board, in investing the Fund, to have regard to maximising return over the long term and taking appropriate but not excessive levels of risk. In general the investment strategy adopted by the Fund, and in particular the mix of growth versus income assets, 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.

The Board's objective is to maximise return to the Fund as a whole within agreed risk parameters and to deliver an average return of at least CPI plus 4.5% p.a. measured over rolling 10 year periods.

In accepting the investment objective set by the responsible Ministers for the Fund, the Board acknowledges that this means that a significant proportion of the Fund will need to be held in assets carrying market risk. This means there will be considerable volatility of returns over shorter periods. The Board's policy is that the mix of assets within the Fund should be as efficient as possible (that is, should offer the highest level of return for an acceptable level of risk). For this reason the Board has adopted a policy of operating a flexible asset allocation which reflects the organisation's view of the market exposures which are more likely to meet the terms of the investment mandate (maximising return without taking excessive risk) given current market conditions.

5.2. 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 Fund. Risks accepted in order to pursue the investment objective fall into five categories:

a) Market Risk

The Fund holds exposure to a wide range of assets which the Board expects will produce returns divergent from, and superior to, the risk-free rate over the long term.

Principal exposures include:

- broad equity market risk, both globally and in Australia;
- broad debt market risk, including interest rate duration, credit spread duration, credit quality migration and default risks;
- currency exposure, including risks of movement in the value of both the Australian dollar and the foreign currencies held;
- non-uniform performance within broad asset markets (e.g. divergence in returns by sector, geographic region, growth vs. value styles, and large vs. small stocks); and
- return uncertainties within the property and private markets.

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 the Fund's external managers to deliver superior returns also entail some risks. In particular, appointed managers may exceed or fall short of the objectives set for them by the Board. Market returns (beta) and manager performance (alpha) should be largely independent (i.e. performance of a manager relative to the broader market should not be impacted by the performance of that market itself).

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 (or counterparty risk) is the risk of default by the counterparty 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. Because of the long-term nature of the Fund, it can tolerate a relatively high degree of illiquidity across the portfolio.

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).

5.3. 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.

6. DERIVATIVES

6.1. 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.

Section 25 of the Act permits the Board to acquire a derivative for the purpose of:

- protecting the value of an investment of the Fund (other than a derivative);
- protecting the return on an investment of the Fund (other than a derivative);
- achieving indirect exposure to financial assets (other than derivatives); and
- achieving transactional efficiency,

but prohibits the use of derivatives for speculation or leverage.

6.2. 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 interest rates or movements in prices of permitted investments;
- (b) to achieve or reduce exposure to assets, 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.

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.

6.3. 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.

7. POLICY FOR MANAGEMENT OF OWNERSHIP RIGHTS

7.1. Introduction

The Board has a statutory obligation to have regard to international best practice for institutional investment in determining its approach to corporate governance (including in relation to its voting policy). The Board believes there is a positive relationship between good corporate governance and investment value. It applies this in the way it governs the Future Fund and recognises that part of its governance framework for the Fund is a policy for the effective management of the ownership rights that accrue to the Board on behalf of the Commonwealth.

The management of the voting rights which are attached to ownership of public equities is covered within the policy as set out below.

7.2. Policy

(a) *General Principles*

- To assist it in maximising returns while managing risk, the Board recognises the value of effectively managing its ownership rights, including voting rights where relevant, across the broad range of investments in the various portfolios.
- The Board believes there is a positive relationship between good corporate governance and investment value. It applies this principle to its governance of the Future Fund and Nation-building Funds and accepts that it has a responsibility to oversee, and if appropriate influence, the approach to corporate governance taken by the entities in which it invests.
- The Board has adopted a broad definition of corporate governance. The Board considers corporate governance in the companies in which it invests in terms of how those companies are structured, operated and controlled with a view to the long term goal of increasing shareholder wealth. This means it covers both the internal policies, processes and culture of the company (including the way it manages the respective rights and responsibilities of owners, board and management) as well as the way in which the company manages its relationships with other stakeholders (including employees, customers, suppliers, governments and the communities in which it operates).
- In assessing the quality of the governance of a company it part owns, the Board will consider whether the company is effectively managing its environmental, social and regulatory responsibilities in order to minimize the likelihood of destruction of shareholder value through poor risk management.
- The Board expects to have part ownership, on behalf of the Commonwealth, of a very large number of entities (primarily through the global public equities program) which derive income from a wide variety of economic activities. While an investment in any company will be determined by the expected financial return for the risks involved, the Board's starting

position is that it will consider investment in any company where the economic activity is legal in Australia and does not contravene international conventions to which Australia is a signatory.

- In undertaking investment decisions and in exercising its ownership rights, the Board will, pursuant to the Investment Mandate Directions issued by the responsible Ministers, act in a way that minimizes the potential to effect any abnormal change on volatility or the efficient operation of Australian financial markets and is unlikely to cause any diminution of the Australian Government's reputation in Australian and international financial markets.

(b) *Application of Principles*

- The Board will exercise its ownership rights as a prudent investor seeking to maximise investment returns over the long term. The Board will also seek to encourage the adoption of accepted principles of good corporate governance in the companies in which it invests while not seeking to intrude unnecessarily upon the legitimate roles of the boards and management of entities it invests in.
- The Board intends to apply this view across both its Australian and international holdings and to both publicly traded securities and private investments. The manner in which the Board exercises its ownership rights will vary depending upon the circumstances and the nature of the investment.
- In public markets this will primarily take the form of exercising its voting rights. In addition, recognising the value of focused dialogue with company management to influence outcomes it will, either directly or through its investment managers, pursue this approach where considered appropriate. Where the Board deems it efficient to do this in conjunction with other investors to more effectively communicate a perspective, it will consider this option. Where warranted, it will communicate its position publicly and assist regulatory authorities to improve overall protection of shareholder rights.
- In relation to private investments, the Board will review the governance arrangements of an investment vehicle before committing capital. The Board will seek appropriate information, engagement, enforcement and termination rights and will ensure its interests are effectively represented through appropriate active representation on the vehicle's governance bodies.
- The Board's initial focus is on implementing its approach to the exercise of its voting rights in public equity markets. It will progressively allocate resources to develop its approach to the other channels of influence.

(c) *Management of Voting Rights in Public Companies*

- The Board believes that the managers engaged in the purchasing and selling of securities on its behalf have a particularly valuable perspective in determining how to vote proxies and should be the starting point for determining how the Board's rights are voted.

- As part of the due diligence process prior to the appointment of a manager, their approach to the exercise of proxy votes on behalf of their investors is assessed in terms of its alignment with the principles determined by the Board. If there is a high degree of alignment, the manager is delegated the right to vote the Board's proxies on its behalf. Presently all voting rights are delegated with the Board retaining the power to override these managers and determine voting decisions directly. The Board intends to bring the management of the voting of proxies in the Australian equity portfolio in-house and use the perspectives of its managers, the Agency and, if relevant, other advisory services to determine its position. For practical reasons it intends to continue to delegate the voting of its proxies in international markets to its managers (if appropriate) with a coordination function undertaken internally to ensure a comprehensive and consistent approach is undertaken.
- The principles developed by the Board have been designed to guide voting on resolutions put to shareholders. They are based on the premise that a corporation's actions should be consistent with the primary objective of generating long-term shareholder value. The principles are:
 - a) ***companies should disclose relevant and material information on a timely basis to allow shareholders to make informed decisions.*** The highest quality international accounting and financial reporting standards should be used and an annual audit should provide an objective external opinion that the financial statements fairly represent the financial position and performance of the entity and are in compliance with applicable laws and regulations. Boards should ensure the corporation complies with a widely recognised national corporate governance compliance code and are responsible for ensuring the corporation conducts its business with integrity;
 - b) ***companies should respect shareholder rights and consult shareholders on major decisions.*** Major corporate changes, which in substance or effect may impact shareholder equity or erode share ownership rights, should be submitted to a vote of shareholders. Sufficient time and information (including a balanced assessment of relevant issues) should be provided to shareholders to enable them to make informed judgments on these resolutions. The Board will not generally support a proposal if there is not sufficient information disclosed in order to make an informed decision;
 - c) ***all shareholders should be treated equally and have the right to vote in proportion to their economic interest in the company.*** Any deviation from this general principle should be examined taking into account economic return;
 - d) ***boards should be fit for purpose.*** Companies should exhibit sound and robust corporate governance by proposing high-calibre, commercially experienced and diverse boards of directors to provide superior business leadership and integrity;
 - e) ***boards of directors should be composed to allow the exercise of objective independent judgment on corporate affairs.***

Directors must be accountable to shareholders and demonstrate skills and commitment to creating shareholder value and taking action, including on compensation arrangements, that are in line with shareholders interests;

- f) ***companies should establish a sound system of oversight, management and control of business risks.*** These may include: operational, strategic, financial, reputational, employee relations, environmental and social risks.
- g) ***boards should appropriately balance measures to protect the capital adequacy of the company with equitable treatment of shareholders.*** Proposals relating to the capital structure of a company should balance the need to ensure adequate capital to protect its financial position and achieve its strategic objectives against the need to protect all shareholders' interests;
- h) ***structures that transfer power from shareholders to management to protect against takeovers are generally undesirable.*** The introduction of any such measures should be subject to shareholder vote and structured to give shareholders the ultimate decision on any proposal or offer; and
- i) ***companies should have appropriate performance evaluation and incentive systems.*** Performance related payments should be aligned with shareholders' interests by being linked to continuous productivity improvement giving rise to growth in earnings and dividends.

- While the above principles are not exhaustive, and may not necessarily represent how voting will occur in any particular situation, they address (either individually or in combination with each other) the typical issues that are put to shareholders globally to vote upon.
- In view of the size of its shareholding in Telstra the Board will manage and direct the voting rights attached to this holding. In doing so, it will be guided by this policy and act in a manner that is consistent with the governing legislation and the investment mandate provided by the responsible Ministers.

(d) *Review and Reporting*

- The Board intends to regularly review its policies in relation to the exercise of ownership rights and will have regard to international best practice including the policies and frameworks used by successful institutional investors. The Board will also refine and develop the implementation of these policies over time.
- The Board will disclose, on an annual basis, the extent to which it exercised its voting rights and, in broad terms, the nature of its voting.

8. VERSION CONTROL

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

Version Number	Date Approved by Board	Brief Description of Amendments
1	12 July 2007	Initial document
2	22 January 2008	Updates to Voting Policy (clause 7)
3	26 November 2008	Updates to Investment Strategy (clause 3) and Risk Management (clause 5).
4	8 April 2009	Update to clause 7 and general editing