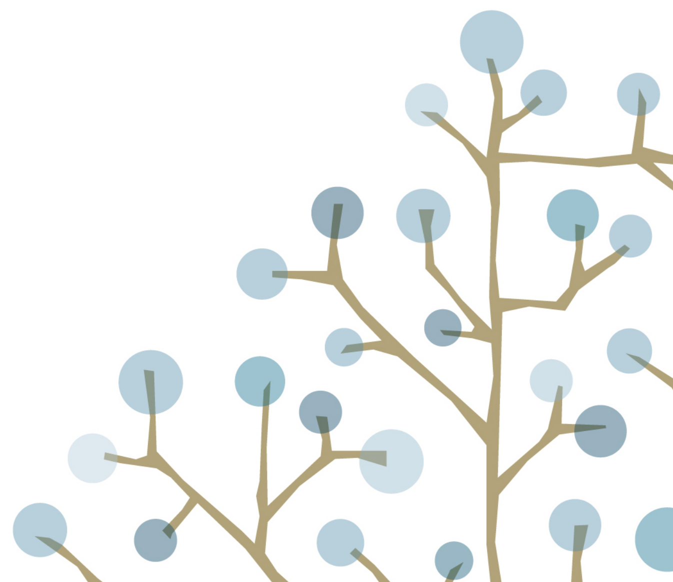
Future Fund Board of Guardians

Statement of Investment Policies

SEPTEMBER 2020



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1. About this document

1.1 The Future Fund Board of Guardians ("**Board**") was established by the *Future Fund Act 2006* ("**FF Act**") to invest the assets of the Future Fund on behalf of the Commonwealth.

1.2 The *Nation-building Funds Act 2008* ("**NBF Act**") , the *DisabilityCare Australia Fund Act 2013 ("DCAF Act"),* the *Medical Research Future Fund Act 2015* ("**MRFF Act**"), *Aboriginal and Torres Strait Islander Land and Sea Future Fund Act 2018* ("**ATSILS Fund Act**")*, the Future Drought Fund Act 2019* ("**FDF Act**") *and the Emergency Response Fund Act 2019* ("**ERF Act**") extended the responsibilities of the Board. The Board now manages the investment of the Future Fund ("**FF**"), the Medical Research Future Fund ("**MRFF**", the DisabilityCare Australia Fund ("**DCAF**"), the Aboriginal and Torres Strait Islander Land and Sea Future Fund ("**ATSILS Fund**", the Future Drought Fund ("**FDF**") and the Emergency Response Fund ("**ERF**").

1.3 Under the relevant legislation the Board is supported by the Future Fund Management Agency ("**Agency**") which operates in accordance with the Board's policies. The Agency advises the Board on the development and implementation of its investment strategies and provides the necessary operational support. The relevant legislation details the responsibilities and duties of the Board and Agency.

1.4 Investment Mandate Directions issued by the responsible Ministers for each Fund in accordance with the legislation provide written directions to the Board about the performance of its investment functions.

1.5 Under the relevant legislation the Board is required to formulate written policies to be complied with by it in relation to the following matters in connection with each of the Funds:

i) the investment strategy;

ii) the benchmarks and standards for assessing performance;

iii) risk management;

iv) a matter relating to international best practice for institutional investment; and,

v) any matters specified in regulations.

1.6 This document addresses these obligations. It should be read in conjunction with the relevant legislation as well as the Annual Report and other material produced by the Board and the Agency. The Annual Report is available at www.futurefund.gov.au.

2. Future Fund investment strategy

The Investment Mandate

2.1 The Future Fund Investment Mandate Direction is the key document that sets out the Government's directions to the Board. The current Investment Mandate was provided to the Board by the Responsible Ministers on 15 May 2017 and took effect from 1 July 2017. In summary, the Investment Mandate:

i) requires the Board to maximise return on the Fund over the long-term;

ii) benchmarks the Fund's return against CPI + 4% to 5% pa over the long term;

iii) requires the Board to determine an 'acceptable but not excessive' level of risk in targeting the benchmark return;

iv) requires the Board to act in a way that:

a) is consistent with international best practice for institutional investment;

b) minimises the potential to impact on the Australian financial markets; and

c) is unlikely to cause a diminution of the Australian Government's reputation in financial markets.

2.2 The benchmark return of at least CPI + 4% to 5% pa implies that the Fund ideally should, if possible, aim to be positioned to have a high probability of achieving the minimum CPI + 4% pa return. This in turn implies a relatively high risk-taking stance on average over market cycles (subject to not taking 'excessive' risk).

2.3 For the purposes of measuring the Fund's outcomes and determining success, the Board considers the reference to the 'long term' to mean rolling 10-year periods.

2.4 The Mandate is framed in an absolute return sense (rather than being relative to some peer group or market benchmark). Given the Board's belief that prospective risks and returns vary over time, the Board regularly assesses whether there is an adequate reward for risk inherent in market prices. When markets appear to offer poor reward for the risk, the Board aims to reduce or hedge risk exposures. Conversely, when there is excess reward available, the Board aims to increase overall risk exposures, targeted towards assets that it believes offer superior long-run returns. When the reward for risk is at normal levels, the Board expected to be biased towards targeting high levels of expected return but seek to control risk through diversification and portfolio level risk management strategies.

2.5 The Board believes it should remain focused at all times on the stated Mandate objectives. Accordingly, the portfolio construction and management does not explicitly manage two investment risks that could translate into meaningful reputation risks for the Fund, being:

i) The possibility of materially underperforming peer funds.

ii) The possibility of failing to keep up with the escalation in the value of the underlying superannuation liabilities due to falling real interest rates.

2.6 While the focus of some stakeholders may be on backward-looking historical returns, the Board's focus in terms of the management of the portfolio is on achieving the mandated benchmark return on a forward-looking basis. Importantly portfolio management does not aim to correct for historical returns in order to achieve the benchmark over a fixed period. Such an approach would imply "locking-in" performance following a period of high returns by reducing risk (without reference to risk conditions) and "chasing" risk (no matter what) after periods when the Fund has performed poorly.

2.7 Under the *Future Fund Act 2006,* the government has the ability from 1 July 2020 to withdraw assets to meet the unfunded superannuation liabilities falling due each year (under the legislation earlier withdrawals are possible but unlikely given the current value of the Fund compared to the unfunded accrued liabilities). However, the government has indicated that it does not intend to make such withdrawals in 2020 and has further indicated its intent to refrain from doing so until at least the 2026-27 financial year. The Board has decided to manage the portfolio on the basis of this commitment, and its best estimates imply that deferring withdrawals for this period of time significantly increases the likelihood that the Fund will exist as a large pool of sovereign capital in perpetuity (absent a material chance in the nature of scale of permitted withdrawals). The Board therefore continues to believe that considering performance over rolling 10-year periods remains an appropriate interpretation of the Mandate's reference to the long-term.

Long term investment considerations

2.8 The *Future Fund Act 2006* states that the Board must seek to maximise the return earned by the Fund over the long term. There are three main comparative advantages to being a long term investor:

i) the ability to take on greater levels of market risk, on the assumption that a long-term investor is able to tolerate the shorter-term losses that come with the greater market risk exposure. The greater market risk ought to (albeit in practice it need not necessarily) be rewarded with higher long-term returns;

ii) the ability to accept capital being locked up in assets or structures that are impossible and/or costly to sell out of within a short period of time. Such investments ought to (albeit in practice they need not necessarily) attract a premium return to compensate for this loss of liquidity; and

iii) the ability to be counter-cyclical, patient and opportunistic. The investor can use its long-term nature to reduce risk when prospective returns are unattractive and wait for more compelling opportunities to buy (or sell). At times of market stress when other investors are selling, the long-term investor is able to step in and provide liquidity to the markets in return for outsized forward looking expected returns. This is often referred to as maintaining "dry powder".

2.9 The balance between these three advantages is controllable. Many funds (for example most pension funds and superannuation funds) emphasise the first, by holding high and relatively fixed levels of equity exposure. Some funds are increasingly supplementing this by seeking to exploit the second advantage, by growing their private markets portfolios (such as property and infrastructure). The use of the third advantage is lower, often limited to a modest rebalancing strategy around the fixed strategic asset allocation. Essentially having a high exposure to market risk (the first advantage) removes the ability to play meaningfully to the patient opportunistic capital approach, because there is no spare capital to invest in times of distress (it is already invested).

2.10 The Board's approach seeks to benefit from all three advantages by:

i) having a meaningful exposure to risky assets, given the expected (but not guaranteed) higher long-term rewards for this risk;

ii) searching hard for opportunities to extract strong excess returns for locking our capital away in less liquid investments; and

iii) seeking to manage portfolio risk dynamically upon substantial changes in conditions. Whilst the portfolio strategy is under regular review and will be adjusted as the relative attractiveness of different sectors changes, meaningful changes to the Fund's risk profile are only expected upon substantial changes in external conditions. One aim of this dynamic approach is to have capital ready to deploy into areas of market weakness. The Board recognises however that there are limits to its ability to maintain and deploy dry powder given its generally pro-cyclical base currency, globally diversified portfolio and currency hedging activities.

Risk profile

2.11 The Board considers the structural risk exposure that is required for the Fund to achieve the Mandate benchmark return over the long-term, or, equivalently, rolling 10-year periods. The Board uses the Equivalent Equity Exposure ("**EEE**") of the portfolio, which converts a portfolio into the equivalent level of broad equity market risk, as the summary measure for this structural risk level.

2.12 While achieving the benchmark return over the long-term is the Board's primary objective, it also considers the 'quality of the journey' over the medium term to ensure that the Fund is not exposed to excessive risk along the path. Given its long-term orientation, the Board views risk management, in terms of understanding and managing the possible incidence of poor return outcomes, to be most appropriately considered in the context of three-year periods.

2.13 The Board therefore defines its primary short-term risk measure as the Conditional Value-at-Risk return over 3 years ("**CVaR3**"). This is a measure of the average return, given a 1 in 20 downside event – essentially a description of how bad the return might reasonably be expected to be over that timeframe. However, the Board views risk holistically and takes into account a broad range of risks as described in 2.18.

2.14 An expression of the required investment risk profile needs to encompass a targeted return to ensure the positioning is not too conservative, as well as a tolerance for risk to ensure our overall risk is not excessive.

2.15 The following statements collectively summarise the Board's preferred risk profile for the Fund. The Board believes these statements are consistent with the mandate requirements to take 'acceptable but not excessive' risk whilst aiming to maximise returns:

i) the Board manages the Fund such that there is a relatively high probability of exceeding the benchmark return on a prospective basis over the long term (noting the high level of uncertainty associated with any return forecast). The Board believes that an EEE of 55 corresponds to a structural risk level for the Fund that is consistent with a relatively high probability of achieving CPI +4% over the long-term, at the lower end of the benchmark return range;

ii) the level of risk exposure in the portfolio is managed dynamically as the expected prospective reward for risk changes. The Board expects the EEE measure to be maintained between 45 and 65 under normal macroeconomic and market conditions;

iii) the Board manages the Fund such that it has a high probability of avoiding a large negative return over any 3-year period. In particular, the Board expects that the CVaR3 of the Fund at its desired structural risk level of EEE 55, will typically be around -5%pa.

2.16 Whilst statements (i), (ii) and (iii) above are achievable together in normal conditions, from time to time conditions will be such that we will not expect to be able to meet them all. At such times the Board will consider what compromise to make (ie reduced return or increased risk). This will need to be informed by the specific conditions at the time.

2.17 Similarly, there may be times when conditions are such that the Board wishes to deliberately depart from this risk profile. For example if risk adjusted returns are assessed to be very high (say after a major market event that causes prices to fall sharply and excessively) it may be prepared to run higher risk exposure levels (given the outsized reward for that risk) and vice versa.

Investment risks

2.18 The Board considers investment risk to be broken down into the following categories:

i) **Macro risks**. These include the risk of macroeconomic variables changing, particularly differently from general market expectations, and the impact this has on the portfolio and achieving objectives.

a) We generally consider four high-level macro factors, being growth, inflation, real interest rates and risk premia. Interactions between these variables are believed to be the most influential driver of investment risk. Although it is desirable in theory to have a balanced exposure to unanticipated changes in these macro factors in constructing the portfolio, this may not be feasible or appropriate.

b) Macro risks also include geopolitical and regulatory risks that can impact on the portfolio. These will generally manifest themselves in changes in macro and market risk factors, although there can also be an impact on the range of instruments available to the portfolio and the cost of managing the portfolio, for example.

ii) **Market risk.** This includes the risks of being exposed to all investment markets. It includes equity risk, credit risk, currency risk, interest rate risk and the risk of price movements in supply-constrained resources (such as commodities and land). To manage the market risks and in doing so give effect to the above requirements the Board undertakes the following steps:

a) It considers what it believes to be the primary measure of market risk, and what it believes to be an 'appropriate but not excessive' level of market risk to target, given the expected returns achievable and the benchmark return stated in the Investment Mandate. This was discussed above.

b) In conjunction with the Agency, it designs a Target Asset Allocation that is expected to maximise the prospective long-term returns given the market risk appetite.

– Given a belief that the prospective returns and risks for markets change through time, and the long lead times associated with the portfolio build of certain asset classes, the Board considers that dynamic management of the Target Asset Allocation is appropriate. The Target Asset Allocation is discussed further below.

– A key principle underlying the Board's approach to designing a Target Asset Allocation is diversification - combining assets that are not perfectly correlated reduces risks without necessarily impacting upon expected returns. Given the single largest risk exposure for a large investment fund seeking relatively high long-term real returns tends to be the equity risk premium, in practice the search for diversification encourages us to search hard for, and implement meaningful exposures to, alternative forms of risk outside of listed equities. This preference for diversification comes with an important caveat however – we must be confident that diversifying investments are accretive to the total portfolio risk adjusted return. Diversification for the sake of diversification alone could see an investor stray into poor investments and must be avoided.

iii) **Liquidity risk.** Liquidity risk can impact the portfolio in two ways: the inability to meet near term cashflow obligations and the loss of control over the strategic composition of the portfolio.

a) Under severe conditions, such as a significant and sharp decline in the AUD, there is a material risk that the Fund could move quickly into a negative cash position and therefore be in breach of the Act (the Fund cannot be levered). There is a risk that the Fund is not able to meet its cashflow obligations as they fall due. As we get closer to the 2026-27 financial year, when the Board understands that the government may commence withdrawing assets, the potential cashflow requirement from the Fund also needs to be managed.

b) The Liquidity Risk Management Framework includes a short-term crash test which is applied to the portfolio to ensure it is able to meet its immediate cashflow obligations under a plausible but very severe market dislocation.

iv) **Inflexibility risk**

a) Illiquidity in the portfolio also reduces the Board's ability to manage the allocations in the portfolio. Significant market moves will distort the portfolio away from the desired strategy and can lead to the forced sale of assets at a price that is disadvantageous and crystallises a loss of value.

b) The Board assesses the aggregate level of liquidity in the portfolio, having regard to the time to divest, the riskiness and currency denomination of the assets, and the level of undrawn commitments. The Board aims to manage portfolio flexibility over the forward planning horizon in a proactive and disciplined manner that is designed to ensure that the investment program is not subject to undue disruption or any erosion of intrinsic value.

v) **Specific risk.** This is the risk that arises from the specific idiosyncratic risk of individual investments, or groups of related investments.

a) The Board's approach to the management of significant specific issuer and counterparty exposure risks is centred on a monitoring and reporting regime, rather than seeking to explicitly regulate or limit such exposures.

b) This approach, particularly in relation to the Future Fund and Medical Research Future Fund, is taken in the context of the Board's mission and structure as a long term investor, seeking to take risk to generate high real returns over a ten year time horizon. As such it is recognised that the overarching market and economic exposures will, at all times, vastly overshadow any realistic individual issuer or counterparty exposure.

c) Nevertheless, in the prudent management of a diversified portfolio, the Board must ensure that any large individual exposures are justified by their risk and return characteristics and their contribution to the quality of the overall portfolio.

d) This approach is therefore focused on providing a transparent reporting framework to ensure management and the Board are knowledgeable and satisfied with all significant exposures. This knowledge can then be incorporated in the portfolio construction decision making process and in the process of holding the Agency to account for the implementation of the Board's strategy. It should be noted that exposure limits are set within individual mandates, whilst exposure to individual assets within private markets are agreed at the time of Board approval. In each case, the objective is to seek an appropriate level of diversification.

vi) **Investment manager risk**. This is the risk that the external investment managers selected to implement the desired market exposures may deliver results which are materially lower than expectations. The Board has a range of processes to ensure that manager selection, monitoring and termination procedures are of the highest quality. Controls are in place to ensure an appropriate level of manager diversification. This approach also recognises the importance of partnering with aligned external firms who are more likely to deliver value over the long term.

vii) **Counterparty risk.** This is the risk that a counterparty fails to deliver on their contractual obligations, resulting in a loss to the Fund. The Board has in place a framework that provides reporting and control procedures to address this risk.

viii) **Operational efficiency risk**. The Board establishes and maintains a set of appropriate authorisations to and controls of the Agency to facilitate operational efficiency in the management of the portfolio.

ix) **Peer group risk.** This is the risk that the Fund is exposed in some way by being different to a particular group of peer funds. In practice the most likely set of comparison funds is the Australian superannuation fund industry. The Board believes it should focus solely on the objectives for the Fund as set out in the Investment Mandate, and as such does not seek to manage peer group risk directly. In doing so it recognises:

a) that any deviation in investment strategy will inevitably lead to short to medium term periods of underperformance at times, as different markets and sectors run through their performance cycles. In particular, given the Fund's expected positioning with a higher than typical exposure to private and/or more intensively managed strategies, such as private equity, tangible assets, private debt and various hedge fund strategies (and a consequently lower exposure to listed equities) the Board expects the Fund to underperform when listed equities are performing very strongly, and vice versa. In a strong equity bull market this underperformance could be 3-5%pa over a 2-3-year period.

b) that the same investment positioning also leads to a higher fee structure than typical funds. Under most circumstances the Fund is likely to have total fees (on a look through basis) of the order of 1-2%pa. Given the Fund makes quite extensive use of performance fee structures, in very strongly performing years a fee level of 3% or more in a year is entirely possible, albeit it is likely that the total fund return will be well in excess of 20% in such a year.

c) that there is a reasonable likelihood that a period of the Fund underperforming superannuation funds would coincide with particularly high realised fee levels for the Fund, given both are driven by strong investment markets.

The Target Asset Allocation

2.19 In framing the Target Asset Allocation the Board focuses on a set of broad asset groupings as follows:

i) **Equities:** This category represents the systematic risk inherent in investing in corporate enterprise. It includes listed Australian equities, listed global equities (including emerging markets) and private equity.

ii) **Tangible assets:** This category represents investments where the bulk of the expected return over the very long term arises from the yield on a specific set of tangible assets, or the realisation of options with respect to the future use of these assets. It includes property, infrastructure, utilities, timberlands and agricultural lands. The yield on these assets would often have an element of inflation linkage embedded in it. These assets could be held in unlisted or listed form.

iii) **Debt:** This category represents the broad range of credit exposures available from debt instruments. Interest rates exposure (i.e. duration) is excluded from this sector and captured separately as a portfolio overlay.

iv) **Alternatives:** This category represents the broad range of other risky assets. Assets considered in this category include skill-based absolute return strategies and niche risk premia investments such as commodities and insurance-based investments. The primary role of this category is to secure returns that are consistent with our long-term objective whilst at the same time diversifying our risk away from the other categories, and in particular the dominant risk exposure which is systematic equity risk.

v) **Portfolio overlays:** There are certain exposures that the Fund obtains that do not form part of a conventional capital allocation. The three such exposures in our Target Asset Allocation are foreign currency exposure, interest rate exposure and option strategies.

2.20 The Board's investment strategy and process, its asset allocation at year end and its perspective on the investment outlook is provided in detail in the Annual Report which is available at www.futurefund.gov.au. Short quarterly updates are also published online.

Geographical location

2.21 The Board has not set a specific target allocation to different geographies, rather it has defined a set of principles that govern the decisions made in respect of the portfolio's geographic allocation:

i) geographic diversification is helpful for reducing overall portfolio risk. While the pursuit of such diversification should not dominate the search for the best available investment opportunities (on a risk adjusted, after tax and costs basis), the Board believes it is important that geographical risk is managed at the total portfolio level.

ii) given the Board's base currency is Australian dollars, allocations to Australia can offer particular advantages in terms of a potentially improved match with our Mandate return benchmark (defined as a real return above domestic CPI), reduced liquidity risks and reduced currency management risks and costs. The Board therefore has a natural preference for domestic investments where they meet its return and risk criteria, particularly for the more illiquid private market sectors.

Control framework

2.22 The Board formally reviews the investment strategy and targeted exposures annually and more frequently as needed. To facilitate the efficient management of the portfolio, the Board has established a set of control ranges within which it authorises Management to implement the exposures.

3. Medical Research Future Fund investment strategy

The Investment Mandate

3.1 The Medical Research Future Fund Investment Mandate Direction is the key document that sets out the Government's directions to the Board. The current Mandate for the MRFF was signed by the Responsible Ministers on 8 November 2015. In summary, the Investment Mandate:

i) requires the Board to maximise return;

ii) benchmarks the Fund's return against the Reserve Bank of Australia's Cash Rate target ("**Cash Rate**") + 1.5% to 2% pa, net of investment fees, over a rolling 10-year period;

iii) requires the Board to determine an 'acceptable but not excessive' level of risk in targeting the benchmark return; and,

iv) requires the Board, in determining the level of risk, to take into account:

a) the principle that the nominal value of credits to the Fund be preserved over the long-term; and

b) the principle to moderate the volatility of the maximum annual distribution.

v) requires the Board to act in a way that:

a) is consistent with international best practice for institutional investment;

b) minimises the potential to effect any abnormal change in the volatility or efficient operation of Australian financial markets; and

c) is unlikely to cause a diminution of the Australian Government's reputation in financial markets.

3.2 The benchmark return of the Cash Rate +1.5% to 2.0% pa implies that the MRFF ideally should, if possible, aim to be positioned to have a high probability of achieving the minimum Cash Rate +1.5% pa benchmark return. This in turn implies a moderate risk-taking stance on average over market cycles while avoiding taking excessive risk.

3.3 As referred to in the Investment Mandate, relevant to the management of the MRFF investment portfolio is the Board's responsibility under the legislation to determine appropriate maximum annual distribution amounts. Once declared these amounts represent the maximum possible withdrawal from the MRFF in the relevant financial year. The Board separately documents its approach to determining maximum annual distribution amounts in the *MRFF Distribution Policy*.

3.4 The two main aspects of managing the MRFF – the management of the investment portfolio and declaration of maximum annual distribution amounts – are intrinsically linked. The risk level assumed in the investment portfolio will have implications for the average level and volatility of declared distributions, as well as the objective of preserving the nominal value of the MRFF.

3.5 The Board understands that there is a strong desire to facilitate stability in distributions, and therefore achieving above benchmark returns with low levels of investment risk is attractive. This suggests that an ideal solution would be the construction of a well-diversified portfolio that is not overly exposed to any one macroeconomic factor, asset class or region – except to the extent that the Australian dollar denomination of the mandate indicates a preference for Australian-domiciled investments. However, this approach is not always feasible or appropriate.

3.6 The Board believes that prospective risks and returns vary over time and regularly assesses whether there is an adequate reward for risk inherent in market prices. While a high degree of portfolio diversity helps to protect the MRFF against adverse market conditions, there may be some circumstances in which the prospective outlook for risk adjusted returns is particularly poor or favourable so that a significant move in the strategy is appropriate. Increasing risk somewhat when markets appear to offer particularly outsized rewards for the risk and reducing risk exposures when rewards are poor is consistent with 'maximising return subject to taking acceptable but not excessive risk'.

3.7 The Board believes it should remain focused at all times on the stated mandate objectives. Accordingly the portfolio construction and management does not explicitly manage the reputational risk of the possibility of materially underperforming peer funds.

3.8 While the focus of some stakeholders may be on backward-looking historical returns and distributions, the Board's focus needs to be on achieving the mandated benchmark return on a forward-looking basis. However, past experience, in terms of returns and distributions paid, will impact on the objective of preserving the nominal value of cumulative contributions, and so must also be taken into account.

Long-term investment considerations

3.9 The *Medical Research Future Fund Act 2015* states that the Board must seek to maximise the return earned by the Fund over the long term. There are three main comparative advantages to being a long term investor:

i) the ability to take on greater levels of market risk, and seek higher returns on average as a result;

ii) the ability to accept capital being locked up in assets or structures that are impossible and/or costly to sell out of within a short period of time. Such investments ought to (albeit in practice they need not necessarily) attract a premium return to compensate for this loss of liquidity; and

iii) the ability to be counter-cyclical, patient and opportunistic, and thereby invest more when risk premia are more attractive.

3.10 The MRFF is unlikely to try and exploit the comparative advantages above to the same extent as a high return objective, long-term fund. In particular:

i) the risk tolerance will be lower than that of a typical long-term fund;

ii) the tolerance for illiquid investment will be lower than that of a typical long-term fund. Nonetheless, the MRFF may still undertake a degree of (adequately rewarded) illiquid investment – particularly where the underlying investments are expected to generate income; and

iii) the preparedness to take large counter-cyclical positions will likely be limited, particularly where risks are elevated. While the MRFF will be managed to seek out the best rewards for risk subject to an appropriate choice of risk tolerance, it is anticipated that there will be a stronger imperative to defend the investment portfolio when prospective risks appear poorly rewarded, rather than to increase portfolio risk significantly above average when risk premia are rich but risk levels are elevated.

Risk profile

3.11 The Board considers the structural risk exposure that is required for the MRFF to achieve the Mandate benchmark return over the long-term, or, equivalently, rolling 10-year periods. The Board uses the EEE of the portfolio, which converts a portfolio into the equivalent level of broad equity market risk, as the summary measure for this structural risk level.

3.12 While achieving the benchmark return over the long-term is the Board's primary objective, it also considers the 'quality of the journey' over the medium term to ensure that the Fund is not exposed to excessive risk along the path. Given the purpose of the MRFF and its long-term orientation, the Board views risk management, in terms of understanding and managing the possible incidence of poor return outcomes, to be most appropriately considered in the context of three-year periods.

3.13 The Board therefore defines its primary investment risk measure as the CVaR3. This measure of the average return, given a 1 in 20 downside event – is essentially a description of how bad the return might reasonably be expected to be over a 3-year timeframe.

3.14 The interaction between the investment strategy, distributions and the objective of nominal capital preservation mean that it is also important to refer to two additional risk metrics. After allowing for the Board's approach to determining maximum annual distribution amounts per the Board's *MRFF Distribution Policy*, the two additional metrics are measured as follows:

i) the expected reduction in the distribution amount payable in the worst 5% of cases (Distribution Downside); and

ii) the expected deficit in the MRFF balance compared to cumulative contributions after a 10-year period in the worst 5% of cases (10-Year Deficit Downside).

3.15 The following statements collectively summarise the Board's preferred risk profile for the MRFF. The Board believes these statements are consistent with the mandate requirements to take 'acceptable but not excessive' risk whilst aiming to maximise returns:

i) We manage the structural risk exposure of MRFF such that there is a relatively high probability of exceeding the benchmark return on a prospective basis over the long term (noting the high level of uncertainty associated with any return forecast).The Board believes that an EEE of 27.5 corresponds to a structural risk level for MRFF that is consistent with a relatively high probability of achieving the Cash Rate +1.5% over the long-term, at the lower end of the benchmark return range.

ii) The level of risk exposure in the portfolio may be adjusted as the expected prospective reward for risk changes significantly. The Board expects the EEE measure to be maintained between 20 and 35 under normal macroeconomic and market conditions.

iii) We manage the risk exposure of the MRFF such that we have a high probability of avoiding a significant negative return over any 3-year period. The Board expects that the CVaR3 of the MRFF at its desired structural risk level of EEE 27.5 (or equivalently the midpoint of the normal operating range for EEE) will typically be around -1% pa.

3.16 Whilst under most conditions (i) to (iii) above are usually achievable together, from time to time conditions will be such that we will not expect to be able to meet them all. At such times the Board will consider what compromise to make (ie reduced return, increased risk, or adjusted maximum annual distribution amounts). This will need to be informed by the specific conditions at the time.

3.17 Similarly, there may be times when conditions are such that the Board wishes to deliberately depart from this risk profile. For example if risk adjusted returns are assessed to be very high (say after a major market event that causes prices to fall sharply and excessively) it may be prepared to run higher risk exposure levels (given the outsized reward for that risk) and vice versa.

Investment risks

3.18 The Board has identified the same investment risks for the MRFF as that set out in 2.18 for the Future Fund.

The Target Asset Allocation

3.19 In framing the Target Asset Allocation, the Board focuses on a set of broad asset groupings as follows:

i) **Equities:** This category represents the systematic risk inherent in investing in corporate enterprise. It includes listed Australian equities, listed global equities (including emerging markets) and private equity.

ii) **Tangible assets:** This category represents investments where the bulk of the expected return over the very long term arises from the yield on a specific set of tangible assets, or the realisation of options with respect to the future use of these assets. It includes property, infrastructure, utilities, timberlands and agricultural lands. The yield on these assets would often have an element of inflation linkage embedded in it. These assets could be held in unlisted or listed form.

iii) **Debt:** This category represents the broad range of credit exposures available from debt instruments. Interest rates exposure (i.e. duration) is excluded from this sector and captured separately as a portfolio overlay.

iv) **Alternatives:** This category represents the broad range of other risky assets. Assets considered in this category include skill or trading rule-based absolute return strategies and niche risk premia investments such as systematic risk premia, insurance-based investments and commodities. The primary role of this category is to secure returns that are consistent with our long-term objective whilst at the same time diversifying our risk away from the other categories, particularly systematic equity risk.

v) **Portfolio overlays:** There are certain exposures that the MRFF obtains that do not form part of a conventional capital allocation. The three such exposures in our Target Asset Allocation are foreign currency exposure, interest rate exposure and protection strategies.

3.20 The Board's investment strategy and process, its asset allocation at year end and its perspective on the investment outlook is provided in detail in the Annual Report available at www.futurefund.gov.au. Short quarterly updates are also published online.

Geographical allocation

3.21 The Board has not set a specific target allocation to different geographies, rather it has defined a set of principles that govern the decisions made in respect of the portfolio's geographic allocation:

i) Geographic diversification is helpful for reducing overall portfolio risk. While the pursuit of such diversification should not dominate the search for the best available investment opportunities (on a risk adjusted, after tax and costs basis), the Board believes it is important that geographical risk is managed at the total portfolio level.

ii) Given our base currency is Australian dollars, and the return objective is based on the Australian cash rate, allocations to Australia can offer particular advantages in terms of a potentially improved match with our mandate, reduced liquidity risks and reduced currency management risks and costs. We therefore have a natural preference for domestic investments where they meet our return and risk criteria, particularly for the more illiquid private market sectors.

Control framework

3.22 The Board formally reviews the investment strategy and targeted exposures annually each year and more frequently as needed. To facilitate the efficient management of the portfolio, the Board has established a set of control ranges within which it authorises Management to implement the exposures.

MRFF as an investment platform

3.23 The Board has approved the use of the MRFF as an investment platform to implement certain new investment programs for additional public asset funds such as the Aboriginal and Torres Strait Islander Land and Sea Future Fund, the Future Drought Fund and the Emergency Response Fund.

3.24 In doing so the Board has is taking advantage of the relative maturity of the MRFF portfolio and building exposure for the ATSILS Fund, FDF and ERF by enabling them effectively to access part of the MRFF portfolio, namely a notional 'Return Pool' of higher returning assets. This is done through a contractual arrangement between each of the three funds and the MRFF. Under this agreement each of the three funds swap a fixed payment for the MRFF's agreement to pay a variable rate of return to each fund based on the performance of the MRFF Return Pool.

3.25 The Board's approach reflects its view that building a standalone portfolio for each of the above funds would take a significant amount of time and expose the portfolios to higher risk levels than desired during the portfolio construction phase. The Board has also noted the relatively small size of the portfolios would inhibit access to a range of diversifying investment strategies or permit access only in an inefficient manner and limit scope for the benefits of economies of scale in investment and operational management.

3.26 The arrangement also provides each portfolio with immediate exposure to a high quality, broadly diversified MRP that the Board expects will consistently generate strong risk-adjusted returns. Furthermore, it ensures that each fund will also immediately benefit from the same investment and risk management policies applied by the Board.

3.27 Portfolios engaged in a co-mingled arrangement with the MRFF have appropriately structured redemption entitlements. The Board expects the Agency to prudently manage liquidity risks that emerge from the existence of any such arrangements, including stress testing of both the overall Fund's liquidity position and the MRP.

3.28 In cases where a transaction under the arrangement is required, (eg to fund a cash outflow or improve the liquidity position of MRP), the Board expects final 30 June valuations to be used wherever possible. The Board recognises, however, that in extraordinary circumstances an intra-valuation date transaction may be required. In this case the Agency will seek Board approval that the proposed transfer values represent an equitable outcome.

3.29 For the MRFF, the co-mingled arrangement provides several benefits. The arrangement provides additional capital to the MRFF to invest. This additional capital increases its scale and ability to invest efficiently in a broad array of opportunities. The additional scale also enhances the scope to secure better access to high quality managers. These benefits increase the ability of the MRFF to build a diversified portfolio of return seeking assets.

3.30 Each of the ATSILS Fund, FDF and ERF has its own Statement of Investment Strategy detailed below.

4. Aboriginal and Torres Strait Islander Land and Sea Future Fund investment strategy

Introduction

4.1 The ATSILS Fund was established to enhance the Commonwealth's ability to make annual indexed payments to the Indigenous Land and Sea Corporation. The Indigenous Land and Sea Corporation is a corporate Commonwealth entity, which assists Aboriginal and Torres Strait Islander people to acquire and manage land, water and water-related rights to achieve economic, environmental, social and cultural benefits.

4.2 The ATSILS Fund was established with a capital contribution of $2bn transferred from the Aboriginal and Torres Strait Islander Land Account. No further contributions to ATSILS are expected at this stage.

4.3 The size of expected debits from the ATSILS Fund is established under the ATSILS Fund Act. Annual payments are an amount equal to $45min 2010 values. Additional payments may be determined by the Finance Minister and Indigenous Affairs Minister having regard to advice from the Board on the impact of such a payment on the sustainability of annual payments.

The Investment Mandate

4.4 The ATSILS Fund Investment Mandate Direction is the key document that sets out the Government's directions to the Board. The initial Mandate was provided to the Board by the Responsible Ministers and took effect on 9 March 2019. In summary, the Mandate requires the Board:

i) to maximise the return of ATSILS Fund over the long term;

ii) to target a benchmark return of CPI + 2% to 3% pa for ATSILS over the long-term;

iii) to, in constructing the ATSILS Fund portfolio,

- determine an 'acceptable but not excessive' level of risk;
- have regard to its obligations under section 17 of the Act to take all reasonable steps to ensure that ATSILS Fund has the balance and liquidity sufficient to cover debits of amounts for the purposes specified in the ATSILS Fund Act;

iv) to act in a way that:

a) is consistent with international best practice for institutional investment;

b) minimises the potential to effect any abnormal change in the volatility or efficient operation of Australian financial markets; and

c) is unlikely to cause a diminution of the Australian Government's reputation in financial markets.

4.5 During the initial transition period, as the Board develops a long-term investment strategy, the Government anticipates a return lower than the benchmark return. The Government understands that this transition period could extend up to 12 months.

4.6 The benchmark return of CPI +2% to 3% pa over the long-term implies that ATSILS Fund should, if possible, aim to be positioned to have a high probability of achieving the minimum CPI +2% pa benchmark return. This in turn implies a moderate risk-taking stance on average over market cycles while avoiding taking excessive risk.

4.7 In determining an acceptable but not excessive level of risk for ATSILS Fund, the Board notes that in the Mandate the Government acknowledges that targeting the long-term benchmark return implies accepting the risk of capital losses, in adverse markets, that may be 15-20% of the portfolio over a 3-year period. The Board has interpreted this statement as including the effect of the annual payments. The Mandate also notes that the Board must have regard to its obligations under section 17 of the Act to take all reasonable steps to ensure that the balance of the ATSILS Fund Special Account is sufficient to cover debits of amounts as set up under the ATSILS Fund Act.

Risk appetite

4.8 In determining its risk appetite, the Board considers the structural risk exposure that is required for ATSILS Fund to achieve the Mandate benchmark return over the long-term. The Board uses the Equivalent Equity Exposure ("EEE") of the portfolio, which converts a portfolio into the equivalent level of broad equity market risk, as the summary measure for this structural risk level.

4.9 The Board manages the structural risk exposure of ATSILS Fund such that there is a relatively high probability of exceeding the benchmark return on a prospective basis over the long term (noting the high level of uncertainty associated with any return forecast). The Board believes that an EEE of 36 corresponds to a structural risk level for ATSILS that is consistent with a relatively high probability of achieving the CPI + 2% over the long term, at the lower end of the benchmark return range.

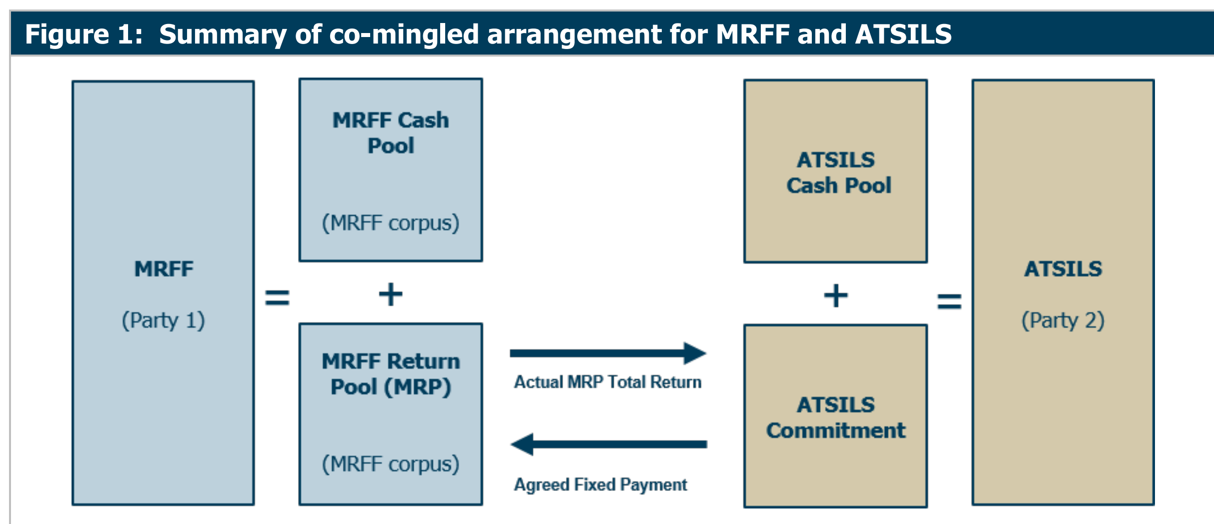
Investment Implementation

4.10 The Board has considered the risk and return parameters set by the Mandate, the size of ATSILS, the expected cashflows and its long-term nature and as noted in sections 3.23 to 3.30 has determined that it will use the MRFF as an investment platform through which to invest the assets of the ATSILS Fund. This is achieved by providing the ATSILS Fund with effective access to a portion of the existing MRFF portfolio – referred to as the MRFF Return Pool ("**MRP**").

4.11 This mechanism provides ATSILS with immediate exposure to a high quality, broadly diversified MRP that we expect will consistently generate strong risk-adjusted returns. Furthermore, ATSILS will also immediately benefit from the same investment and risk management policies applied by the Board.

4.12 The mechanism is shown diagrammatically in Figure 1.

Figure 1: Summary of co-mingled arrangement for MRFF and ATSILS



4.13 The Board will pursue the Mandate risk appetite and benchmark return of the ATSILS Fund by striking an appropriate balance between comingled arrangement and a portfolio of lower risk, highly liquid securities ("ATSILS Cash Pool"). Accordingly, the Board believes that ATSILS should aim to commit 90% of its corpus to the arrangement with the MRFF. The remaining 10% of the corpus will be invested in the ATSILS Cash Pool to ensure that ATSILS has an adequate reserve of liquidity to meet any contingent liabilities that may arise and the fixed annual withdrawals by the Government. This combination of higher risk and lower risk exposures allows the Board to achieve its desired risk exposure.

4.14 As a consequence of this arrangement, ATSILS will be exposed to MRP performance as well as that of the ATSILS Cash Pool.

Control Framework

4.15 The Board formally reviews the investment strategy and targeted exposures annually and more frequently as needed. To facilitate the efficient management of the portfolio, the Board has established a set of control ranges within which it authorises Management to implement the exposures.

5. Future Drought Fund

Introduction

5.1 This Statement of Investment Strategy summarises the background to the development of the asset allocation of the FDF and the associated control framework.

5.2 FDF was established to enhance the Commonwealth's ability to (i) make arrangements with persons or bodies in relation to drought resilience; and (ii) make grants to persons or bodies in relation to drought resilience.

5.3 With the passage of the FDF Act, all of the investments of the now defunct BAF were transferred to FDF on 1 September 2019 and this resulted in an FDF corpus of approximately A$4bn at inception.

5.4 The size of expected debits from FDF is established under the FDF Act. From 1 July 2020, an annual payment of A$100m will be drawn on a specified day of the financial year, or in specified instalments on specified days of the financial year, to fund initiatives that enhance future drought resilience, preparedness and response across Australia.

5.5 The FDF investment Mandate Direction is the key document that sets out the Government's directions to the Board. The initial Mandate was provided to the Board by the Responsible Ministers and took effect on 5 December 2019. In summary, the Mandate requires the Board.

i) to maximise the return of FDF over the long term;

ii) to target a benchmark return of CPI + 2% to 3% pa for FDF over the long-term;

iii) to, in constructing the FDF portfolio,

- determine an 'acceptable but not excessive' level of risk;

- have regard to its obligations under section 18 of the Act to take all reasonable steps to ensure that the balance of the FDF Special Account is sufficient to cover debits of amounts for the purposes specified in the Act;

iv) to act in a way that:

a) is consistent with international best practice for institutional investment;

b) minimises the potential to effect any abnormal change in the volatility or efficient operation of Australian financial markets; and

c) is unlikely to cause a diminution of the Australian Government's reputation in financial markets.

5.6 During the initial transition period, as the Board develops a long-term investment strategy, the Government anticipates a return lower than the benchmark return. The Government understands that this transition period could extend up to 12 months.

5.7 The benchmark return of CPI +2% to 3% pa over the long-term implies that the FDF should, if possible, aim to be positioned to have a high probability of achieving the minimum CPI +2% pa benchmark return. This in turn implies a moderate risk-taking stance on average over market cycles while avoiding taking excessive risk.

5.8 In determining an acceptable but not excessive level of risk for FDF, the Board notes that in the Mandate the Government acknowledges that targeting the long-term benchmark return implies accepting the risk of capital losses, in adverse markets, that may be 15-20% of the portfolio over a 3-year period. The Board has interpreted this statement as including the effect of the annual payments.

5.9 While no further contributions are expected at this stage, the Government has suggested that the benchmark return is consistent with its intention to grow the FDF corpus to A$5bn by the 2028-2029 financial year. However, it is important to note that the Mandate does not require the Board to generate this growth of the corpus.

Risk appetite

5.10 In determining its risk appetite, the Board considers the structural risk exposure that is required for FDF to achieve the Mandate benchmark return over the long-term. The Board uses the Equivalent Equity Exposure ("EEE") of the portfolio, which converts a portfolio into the equivalent level of broad equity market risk, as the summary measure for this structural risk level.

5.11 We manage the structural risk exposure of FDF such that there is a relatively high probability of exceeding the benchmark return on a prospective basis over the long term (noting the high level of uncertainty associated with any return forecast). The Board believes that an EEE of 36 corresponds to a structural risk level for FDF that is consistent with a relatively high probability of achieving the CPI + 2% over the long term, at the lower end of the benchmark return range.

5.12 We manage the structural risk exposure of FDF such that there is a relatively high probability of exceeding the benchmark return on a prospective basis over the long term (noting the high level of uncertainty associated with any return forecast). The Board believes that an EEE of 36 corresponds to a structural risk level for FDF that is consistent with a relatively high probability of achieving the CPI + 2% over the long term, at the lower end of the benchmark return range.

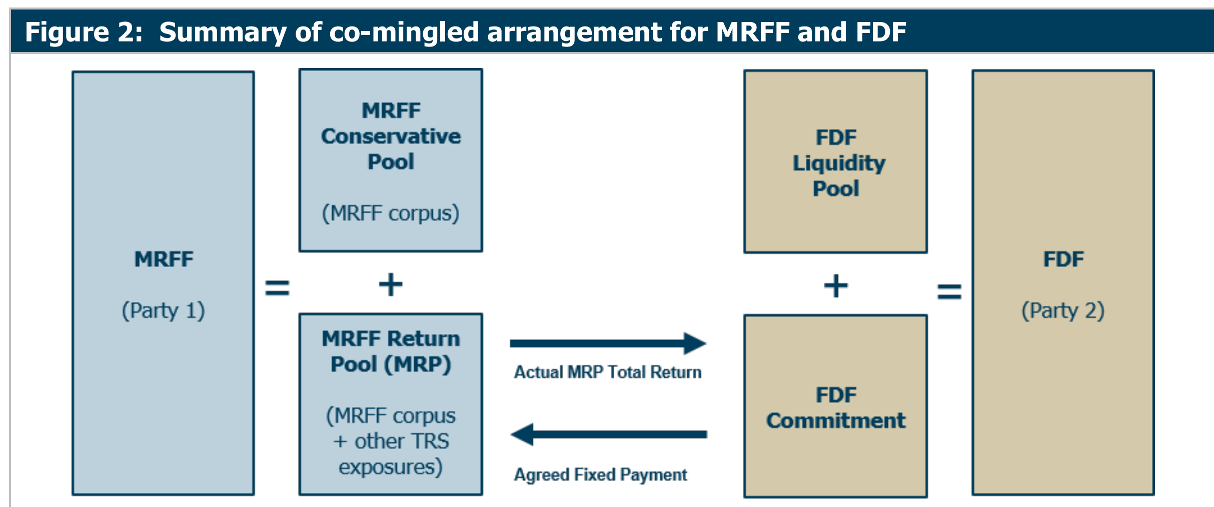
Investment implementation

5.13 The Board has considered the risk and return parameters set by the Mandate, the size of FDF, the expected cashflows and its long-term nature and as noted in sections 3.23 to 3.30 has determined that it will use the MRFF as an investment platform through which to invest the assets of the FDF. This is achieved by providing the FDF Fund with effective access to a portion of the existing MRFF portfolio – referred to as the MRP.

5.14 This mechanism provides the FDF with immediate exposure to a high quality, broadly diversified MRP that we expect will consistently generate strong risk-adjusted returns. Furthermore, the FDF will also immediately benefit from the same investment and risk management policies applied by the Board.

5.15 The mechanism is shown diagrammatically in Figure 2.

Figure 2: Summary of co-mingled arrangement for MRFF and FDF



5.16 The Board will pursue the Mandate risk appetite and benchmark return of FDF by striking an appropriate balance between the co-mingled arrangement and a portfolio of lower risk, highly liquid securities (the "FDF Liquidity Pool"). Accordingly, the Board believes that FDF should aim to commit 90% of its corpus to the co-mingled arrangement. The remaining 10% of the corpus will be invested in the FDF Liquidity Pool to ensure that FDF has an adequate reserve of liquidity to meet any contingent liabilities that may arise and the annual withdrawals by the Government. This combination of higher risk and lower risk exposures allows the Board to achieve its desired risk exposure for the portfolio with the split to be reviewed regularly by the Board.

5.17 As a consequence of this arrangement, FDF will be exposed to MRP performance as well as that of the FDF Liquidity Pool.

Control Framework

5.18 The Board formally reviews the investment strategy and targeted exposures annually and more frequently as needed. To facilitate the efficient management of the portfolio, the Board has established a set of control ranges within which it authorises Management to implement the exposures.

6. Emergency Response Fund

Introduction

6.1 This Statement of Investment Strategy summarises the background to the development of the asset allocation of the ERF and the associated control framework.

6.2 The ERF was established to enhance the Commonwealth's ability to (i) make arrangements with persons or bodies in relation to natural disasters; and (ii) make grants to persons or bodies in relation to natural disasters.

6.3 With the passage of the ERF Act all of the investments of the now defunct Education Investment Fund ("**EIF**") were transferred to the ERF on 12 December 2019 and this resulted in an ERF corpus of approximately A$4bn at inception.

6.4 The size of expected debits from ERF is established under the ERF Act. From inception, during each financial year total payments to persons or bodies of up to:

- $150m may be drawn to aid recovery from a natural disaster or post-disaster resilience initiatives for an area that has been (either directly or indirectly) affected by a natural disaster; and

- $50m may be drawn to foster resilience to; preparedness for; and reduction of the risk of a future natural disaster that could affect an area (either directly or indirectly), along with efforts to promote the long-term sustainability of a community or communities in area that is at risk of being affected (either directly or indirectly) by a future natural disaster.

6.5 In the case of each grant to a person or body, the withdrawal may occur on a specified day of the financial year, or in specified instalments on specified days of the financial year.

The Investment Mandate

6.6 The Mandate is the key document that sets out the Government's directions to the Board. The initial Mandate was provided to the Board by the Responsible Ministers and took effect on 19 February 2020. In summary, the Mandate requires the Board:

i) to maximise the return of ERF over the long term;

ii) to target a benchmark return of CPI + 2% to 3% pa for ERF over the long-term;

iii) to, in constructing the ERF portfolio,

a) determine an 'acceptable but not excessive' level of risk;

b) have regard to its obligations under section 17 of the Act to take all reasonable steps to ensure that the balance of the ERF Special Account is sufficient to cover debits of amounts for the purposes specified in the Act;

iv) to act in a way that:

a) is consistent with international best practice for institutional investment;

b) minimises the potential to effect any abnormal change in the volatility or efficient operation of Australian financial markets; and

c) is unlikely to cause a diminution of the Australian Government's reputation in financial markets.

6.7 During the initial transition period, as the Board develops a long-term investment strategy, the Government anticipates a return lower than the benchmark return. This transition period reflects the fact that there are costs associated with acquiring a diversified pool of high quality assets and that this would also typically take some time to execute. The Government understands that this transition period could extend up to 12 months.

6.8 The benchmark return of CPI +2% to 3% pa over the long-term implies that ERF should, if possible, aim to be positioned to have a high probability of achieving the minimum CPI +2% pa benchmark return. This in turn implies a moderate risk-taking stance on average over market cycles while avoiding taking excessive risk.

6.9 In determining an acceptable but not excessive level of risk for ERF, the Board notes that in the Mandate the Government acknowledges that targeting the long-term benchmark return implies accepting the risk of capital losses, in adverse markets, that may be 15-20% of the portfolio over a 3-year period. The Board has interpreted this statement as including the effect of the annual payments.

Risk appetite

6.10 In determining its risk appetite, the Board considers the structural risk exposure that is required for ERF to achieve the Mandate benchmark return over the long-term. The Board uses the Equivalent Equity Exposure ("**EEE**") of the portfolio, which converts a portfolio into the equivalent level of broad equity market risk, as the summary measure for this structural risk level.

6.11 We manage the structural risk exposure of ERF such that there is a relatively high probability of exceeding the benchmark return on a prospective basis over the long term (noting the high level of uncertainty associated with any return forecast). The Board believes that an EEE of 36 corresponds to a structural risk level for ERF that is consistent with a relatively high probability of achieving the CPI + 2% over the long term, at the lower end of the benchmark return range.

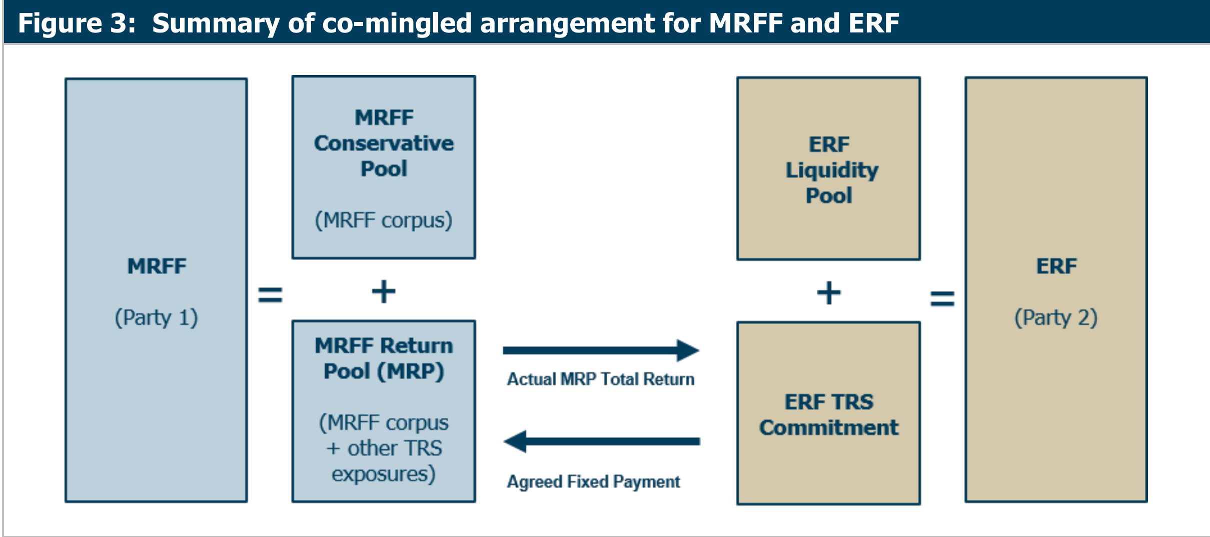
Investment Implementation

6.12 The Board has considered the risk and return parameters set by the Mandate, the size of ERF, the expected cashflows and its long-term nature and as noted in sections 3.23 to 3.30 has determined that it will use the MRFF as an investment platform through which to invest the assets of the ERF. This is achieved by providing the ERF with effective access to a portion of the existing MRFF portfolio – referred to as the MRP.

6.13 This mechanism provides the ERF with immediate exposure to a high quality, broadly diversified MRP that we expect will consistently generate strong risk-adjusted returns. Furthermore, the ERF will also immediately benefit from the same investment and risk management policies applied by the Board.

6.14 The mechanism is shown diagrammatically in Figure 3.

Figure 3: Summary of co-mingled arrangement for MRFF and ERF



6.15 The Board will pursue the Mandate risk appetite and benchmark return of ERF by striking an appropriate balance between the co-mingled arrangement and a portfolio of lower risk, highly liquid securities ("**ERF Liquidity Pool**"). Accordingly, the Board believes that ERF should aim to commit 90% of its corpus to the co-mingled arrangement. The remaining 10% of the corpus will be invested in the ERF Liquidity Pool to ensure that ERF has an adequate reserve of liquidity to meet any contingent liabilities that may arise and the annual withdrawals by the Government. This combination of higher risk and lower risk exposures allows the Board to achieve its desired risk exposure for the portfolio with the split to be reviewed regularly by the Board.

6.16 As a consequence of this arrangement, ERF will be exposed to MRP performance as well as that of the ERF Liquidity Pool.

Control Framework

6.17 The Board formally reviews the investment strategy and targeted exposures annually and more frequently as needed. To facilitate the efficient management of the portfolio, the Board has established a set of control ranges within which it authorises Management to implement the exposures

7. DisabilityCare Australia Fund

The Investment Mandates

7.1 The government sets out its directions to the Board in relation to the expected risk and return characteristics in an Investment Mandate Direction. The Investment Mandate for the DCAF was signed by the Responsible Ministers on 1 July 2014. The Investment Mandates for the Nation-building Funds and the DisabilityCare Australia Fund are the same. In summary the Direction:

i) requires the Board to benchmark returns against the Australian three-month bank bill swap rate + 0.3 % pa on a rolling 12-month net-of-fee basis;

ii) requires the Board to invest in such a way as to minimise the probability of capital losses over a 12-month horizon;

iii) requires the Board to act in a way that:

a) is consistent with international best practice for institutional investment;

b) minimises the potential to impact on the Australian financial markets; and

c) is unlikely to cause a diminution of the Australian Government's reputation in financial markets.

iv) allows for a review of the mandate, including the benchmark return, by the responsible Ministers in consultation with the Board.

Payment schedule

7.2 The payment schedule is a document that sets out the Government's intention to withdraw money in accordance with the legislation and is provided in the form of an estimated monthly drawdown for each Fund.

Investment framework

7.3 The Board has designed an investment framework that aims to meet the investment mandates whilst minimising the probability of capital losses and managing to an appropriate level of liquidity to minimise the impairment of return performance.

7.4 The investment framework separates each fund into two key components. The actively managed alpha component is the market exposure portion of the portfolio while the liquidity component provides liquidity to meet the cash flow requirements in accordance with the payment schedule.

Alpha

7.5 Given the prevailing market conditions, the alpha component invests in a diversified mix of domestic and global securities. It is structured to provide exposure to credit risk premia whilst achieving consistency of returns through the focus on highly rated securities with short credit durations.

Liquidity

7.6 The liquidity component is the very high quality, highly liquid component that will be available to fund the drawdown of capital as required. The liquidity component has been sized at 6-9 months of forward liquidity as advised to the Agency in the payment schedule.

7.7 The liquidity component is restricted to cash and bank bills with maturities no greater than 366 days and from high credit quality financial institutions.

Investment risks

7.8 The Board has identified the same investment risks for the Nation-building Funds and DisabiltyCare Australia Fund as those set out in 2.18 for the Future Fund. The specific controls are tailored to suit the individual Fund's Investment Mandate.

8. Investment manager implementation

Introduction

8.1 The Board engages a broad range of investment management firms as part of the execution of its investment strategy for each of the public asset funds for which it is responsible. The specific nature of investment management services will be dependent on the individual investment structure and may include the following:

i) direct engagement by the Board of an Investment Manager via an Investment Management Agreement ("**IMA**") for wholly or partially discretionary active and passive investment mandates (with the manager appointed as the Board's agent);

ii) investment management/advisory services provided to the general partner, trustee or underlying fund itself, where the fund is the investment vehicle in which the Board participates (for clarity, the manager is appointed by the general partner/trustee/fund, not by the Board directly); or

iii) provision of investment management services for direct asset (Assets) investments. These Assets are those investments (principally in infrastructure, property, timberland or private equity) where the Board has targeted the particular investment and the entity engaged to manage that asset/investment. Here, the manager may be appointed directly by the Board or may be appointed by the holding structure for the Asset.

8.2 For the purposes of this document the term 'Investment Manager' includes entities providing management services under all three scenarios described above.

8.3 Investments in which Assets are specifically targeted by the Board will involve both the selection of, and due diligence on, the Asset and the underlying Investment Manager.

8.4 As discussed in 2.18, the Board identifies Investment Manager risk as: 'the risk that the external Investment Managers selected to implement the desired market exposures may deliver performance which is materially lower than expectations.'

8.5 These risks are managed and controlled through:

i) ensuring a high-quality initial selection decision;

ii) maintaining a rigorous ongoing monitoring program; and

iii) ensuring the portfolio construction does not lead to an excessive concentration of manager risk in any one Investment Manager.

Investment manager and asset selection

8.6 The Chief Investment Officer is ultimately responsible for Investment Manager/Asset selection and ongoing monitoring and will ensure that appropriate resources are in place around Investment Manager appointments, Asset investments and co-investments.

8.7 In undertaking due diligence the Agency will seek to understand whether there are any issues related to the Investment Manager, or Asset that may impact upon the reputation of the Government, Board or Agency, and the Agency will have processes in place to manage and monitor reputation risk.

Investment manager and asset monitoring

8.8 Once a transaction is completed, the relevant investment sector team will undertake a rigorous ongoing monitoring process. This monitoring applied to both the Investment Manager and, where relevant, the specific Asset. The relevant team will report on the performance of the investment Manager and, where relevant, Asset on a regular basis as determined by the Board and/or Agency.

8.9 Sector teams will maintain Investment Manager ratings – with the Investment Committee or its delegate to determine the Investment Manager rating criteria for use by sector teams from time to time.

8.10 The Operations team will also be responsible for investment mandate compliance. Daily post-trade monitoring and detection activities are outsourced to the custodian. Any compliance breaches identified as a result of this monitoring activity are to be reported to the Agency's Operational Risk and Compliance Committee and the Board or Board Audit & Risk Committee as required.

8.11 In the case of Investment Manager selection, appointment and monitoring the Agency assesses new manager proposals according to the following criteria:

Investment Manager evaluation criteria
1. Past performance
2. Business
3. People & Culture
4. Process
5. Fees, terms and governance

8.12 In considering Asset opportunities the following issues are assessed:

Asset opportunities evaluation criteria
1. Risks
2. Returns
3. Structure
4. Manager arrangements
5. Governance

8.13 Co-investments are assessed against the following criteria:

Screening criteria
1. Attractive returns
2. Acceptable risk exposure
3. Core manager expertise
4. No adverse selection
5. Acceptable manager alignment
6. Relationship focused
7. No syndications
8. Acceptable manager concentration
9. Appropriate investment size
10. Acceptable reputation and ESG risk

8.14 The Agency undertakes its operational due diligence via a detailed questionnaire which is forwarded to each Investment Manager for completion. The purpose of the questionnaire is to understand and assess the Investment Manager's internal operational risk and control environment and its investment operations capability. Review of the completed operational due diligence questionnaire may be supplemented by direct inquiry of the Investment Manager and by use of third-party consultants engaged by the Board.

8.15 Operational due diligence regarding a specific Asset will be undertaken as part of the investment due diligence process outlined above, and the relevant investment sector team will manage all due diligence in relation to a specific Asset investment.

Active risks

8.16 The Board's approach to the management of active risks is centred on a monitoring and reporting regime, rather than seeking to explicitly regulate or limit such exposures.

8.17 The Board is alert to the idiosyncratic risks that can arise through the exercise of manager discretion, albeit within the limits defined by individual manager mandates. The Board should be satisfied that these exposures are justified by their risk and return characteristics and their contribution to the quality of the overall portfolio.

8.18 Tracking error is a commonly used measures of the active risk that a particular Investment Manager brings to a portfolio. However, it is recognised that tracking error assumptions are imprecise and as a result any risk metrics calculated based on those assumptions should be considered only as rough estimates and as a means of assessing the relative riskiness of the managers. Therefore, the Agency's management of investment manager risk concentration will be supported by the monitoring and reporting of the assets under management and tracking error of material Investment Manager mandates that involve active management.

8.19 As a control measure the Agency will monitor and report to the Board the assets under management and tracking error of the largest 20 and any other material Investment Manager mandates.

9. Risk management

Introduction

9.1 The Board believes that effective governance of its own operations is essential to the successful pursuit of its objectives. In particular, it is focused on the prudent management of risk.

9.2 The organisation, along with many financial institutions, has adopted the 'Three Lines of Defence' model for risk governance. This model is built around three elements which we have adapted to suit our organisation:

i) The first line of defence is the business. The business 'owns' each risk and must ensure that there are controls in place to appropriately manage the risk within the Board's risk appetite. The business is responsible for identifying, analysing, managing, monitoring and reporting risks.

ii) The second line of defence is the independent Risk Team, led by the Chief Risk Officer. This team develops the organisation's risk management framework to promote effective and consistent risk management across the organisation, assists and supports the business in developing its risk management policies, systems and controls, and provides independent review and challenge of the first line. The Risk Team reports periodically to the Board, Board Committees and Agency Committees. The Risk Team considers organisational risk management from a strategic perspective as well as at the individual key risk level.

iii) The third line of defence is an independent internal audit function which is outsourced. The function provides independent assurance that the risk management framework is appropriate and is operating effectively (including through independent control testing).

Monitoring and managing risk

9.3 Risk is considered in three broad categories: investment risk, operational risk and external risk:

i) Investment risk - risks for which we expect to be compensated. These risks often cannot be eliminated, particularly if they are of a strategic nature, nor are they inherently undesirable if they are compensated by expected returns. We therefore seek to optimise rather than minimise investment risks.

ii) Operational risks - risks for which we do not expect to be compensated. While some level of operational risk is unavoidable in practice, normally we are not compensated for it (ie higher operational risk is not usually expected to produce higher expected returns). This makes operational risk inherently undesirable and hence we seek to take all reasonable measures to minimise it without imposing excessive costs or constraints on our strategy, decision making or operations.

iii) External risks - risks that arise from external events which are outside the organisation's control. These external events usually have a very low probability of occurrence (or at least their form and timing are not predictable) or they are difficult to envisage. They may include natural disasters or terrorism with immediate and major impact, or geopolitical or regulatory change with long-term material impact. These are also likely to be inherently undesirable, but since they are outside our control they cannot be minimised or optimised. We therefore seek to prepare for such events and manage their impact should they occur.

9.4 The Board has overall responsibility for risk management for the organisation. This includes setting the risk appetite and acceptance of the residual risk rating for each key risk identified in the organisation's Risk Register. The Board sets the investment risk appetite (via control ranges, limits and other directions) within which the Agency's relevant investment team should operate.

9.5 The Board's Audit & Risk Committee has been established to provide assurance to the Board that the risks detailed in the organisation's Risk Register are appropriately identified and managed and to provide assurance and assistance to the Board on the organisation's risk, control and compliance frameworks.

9.6 The Agency operates a number of committees which are directly involved in the oversight of risk management as documented in their respective charters, including:

- Management Committee
- Investment Committee
- Operational Risk & Compliance Committee

Each Agency committee considers risk within the scope of its oversight role. For example, the Investment Committee has oversight of investment risks.

Risk culture

9.7 Risk culture is a key component of the broader organisational culture. The Risk Team assists in promoting a positive risk culture by:

- Championing quality risk conversations at key Agency and Board Committees
- Steering the organisation towards appropriate responses to incidents, including any appropriate training or adjustments to controls
- Developing and implementing a framework that facilitates clarity of individual roles, responsibilities and accountabilities.

10. Tax risk management

10.1 Legislation exempts the Board from paying Australian income tax. This reflects the fact that earnings on the Funds are owned by the Australian government. Internationally the Board also benefits from sovereign immunity for tax purposes in the bulk of its investments.

10.2 Tax risk is considered to have two main dimensions:

i) Financial risk – the risk that a Fund has not paid the amount of tax correctly payable under applicable tax laws – whether too little (underpayment) or too much (overpayment). In the underpayment scenario, there is an associated risk of penalties and interest. Tax overpayment can also occur where the investment structure used prevents the Fund accessing tax concessions (for example sovereign immunity) available had the Fund used another structure.

ii) Reputational risk – the risk that the tax structures and positions taken diminish the reputation of a Fund.

10.3 The financial dimension of each Fund's tax risk profile derives principally from its overseas investments. For Australian income tax purposes the Funds are income tax exempt[1], although the Board is entitled to a cash refund for franking credits received.

10.4 By contrast reputational tax risk has both an Australian and an overseas dimension.

10.5 The Board seeks to pay the right amount of tax and comply with its tax filing obligations having regard to applicable tax law requirements in Australia and overseas.

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[1] While the Future Fund Investment Companies (wholly owned within the Future Fund) are subject to Australian income tax, any tax paid is refunded to the Future Fund Board of Guardians when received in the form of a franked dividend.

10.6 The Board also seeks to avoid entering into transactions with tax features that are likely to cause any diminution of the Australian government's reputation in Australian and international financial markets. This has two aspects:

i) Tax Transparency – The Board will not participate in arrangements that conceal assets or income from tax authorities or create false or fraudulent tax deductions (tax evasion); and

ii) Tax Structuring – The Board requires that, at the time of entry into the transaction, the following standards are satisfied:

a) the investment structure is of a type commonly used by institutional investors;

b) the transaction is forecast to provide an adequate pre-tax return and does not have the dominant purpose of generating tax benefits;

c) the transaction does not breach applicable anti-avoidance rules; and

d) where an interposed structure provides a material tax saving in an underlying jurisdiction as compared with a hypothetical direct investment by the Board into the jurisdiction, that tax outcome must be consistent with the tax policy design of the underlying jurisdiction's tax system.

11. Liquidity risk management

Introduction

11.1 A Fund has sufficient liquidity if it is able to meet its future obligations (including potential obligations) when they fall due. An obligation is a requirement, agreement or other arrangement, contingent or otherwise, to make a cash payment or other in-kind contribution. Without management, there may be a risk that a Fund might fail to meet its obligations.

11.2 Funds may incur various obligations in many ways. For example:

i) to meet running costs (such as salaries, rent and utilities);

ii) to meet investment commitments;

iii) to meet investment recall obligations;

iv) to settle contractual financial market obligations (such as derivatives);

v) for margin posting; and

vi) to pay capital withdrawals.

11.3 Some obligations are predictable and reoccurring, but some are contingent or less predictable. For example, margin calls and derivative settlements depend on prices in financial markets. Less directly, some asset managers are more likely to call investment commitments under some market conditions than others (for example distressed asset managers are more likely to call under times of market stress).

11.4 Generally, meeting an obligation means making a cash payment in Australian dollars or another currency. In some cases, such as margin posting, it may be acceptable to deliver another asset in lieu of cash. For some derivative contracts, a specified asset may be required to be delivered when the derivative expires or is exercised.

11.5 To meet an obligation, the cash (or other asset) needs to be readily available and paid or delivered by the agreed time.

Failing to meet obligations

11.6 Some of the consequences and costs of failing to meet obligations can include:

- i) loss of reputation;
- ii) loss of investment opportunities;
- iii) incurring interest charges or other financial penalties;
- iv) causing a breach or other event of default leading to adverse legal, commercial and/or reputational consequences; or,
- v) uncontrolled liquidation of assets;

Asset allocation and liquidity management

11.7 One approach for the Board to ensure that it can always meet its obligations in connection with an investment or other commitment is for the relevant Fund to hold more cash than is sufficient to cover any obligation in any conceivable circumstance. Whilst this approach may be suitable for Funds which naturally have a very high allocation to cash, for more long-term oriented Funds this may alter the asset allocation away from the desired target, potentially impacting long term performance. In such a case, the object of the liquidity management strategy is to balance the requirement to hold cash for liquidity with the desired asset allocation.

11.8 In carrying out its function to assist the Board in its investment and other activities in connection with the funds, the Agency:

- i) assesses and monitors the profile of, and maintains forecasts of, a Fund's future and potential obligations under differing market conditions;
- ii) recognises that different investments are convertible into cash more or less readily and at higher or lower cost under differing market conditions. The Agency assesses the cost and the time required to convert each asset that a Fund holds into cash under differing market conditions;
- iii) ensures it understands the consequences of failing to meet a fund's different obligations and maintains a hierarchy of the severity of such consequences; and
- iv) monitors a Fund's upcoming obligations and available liquidity under different market conditions on an ongoing basis. A Fund's investments are managed so that cash will be available to meet the Fund's payment obligations in a timely manner.

11.9 In addition, the Agency:

- i) maintains a contingency plan in case of an unexpected requirement for liquidity;
- ii) maintains a plan to deal with delivery of specific non-cash assets if this is required;
- iii) actively reviews the alternatives for hedging against adverse liquidity circumstances; and,
- iv) assesses the cost and liquidity implication of obligations before incurring them.

11.10 Fund investments are managed so that the Board can reasonably expect that it will be able to meet the Fund's current or potential payment obligations at the time they may fall due. In order to achieve this aim, the Board ensures that a Fund's asset allocation contains an appropriate mix of assets to cover upcoming obligations, and that this is effectively implemented by the Agency.

12. Management of Environmental, Social and Governance Issues

Integrating ESG factors into investment decision making

12.1 The Board believes that effective management of material financial and reputational risks and opportunities related to environmental, social and governance issues will support its requirement to maximise returns earned on the Funds.

12.2 The integration of ESG factors enables investors and companies to better understand the full spectrum of future risks and opportunities to which assets are exposed. Beyond its impact on the specific investments of the Funds, sound management of ESG factors contributes to the development of more efficient and sustainable markets, in turn enhancing long-term returns.

12.3 The Board builds this perspective into its investment decision-making including the integration of ESG into the process for selecting external investment managers, evaluation of ESG factors in direct investments, and the management of ownership rights.

Partnering with external investment managers

Direct asset investments

12.4 The Agency structurally integrates ESG considerations into the Future Fund's investment decision making process, including assessments of ESG and reputational risk issues for all new investments considered by the Investment Committee as well as the Asset and Manager Review Committees where relevant.

12.5 Where we make direct investments (eg in infrastructure, property, timberland or private equity), an evaluation of ESG and reputational risk factors is undertaken internally. The due diligence supporting direct investments typically features dedicated analysis by our investment managers to review the extent of ESG risk related to the assets under consideration. Where particularly complex or unique risks have been identified, the Agency may procure supplementary third-party research to ensure these issues are accurately integrated in our investment decision making process.

12.6 The Board will review the governance arrangements of an investment vehicle before committing capital. Where applicable, 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 vehicles' governance bodies. The Board will oversee the quality of the governance of the underlying assets held through those vehicles either through its managers or directly as appropriate.

Exercising ownership rights

12.7 The Board believes that there is a positive relationship between good governance and investment value and acknowledges the value of exercising its ownership rights, including voting rights where relevant, across the broad range of its investments. Ownership rights are essential to ensuring the appointment and retention of fiduciaries of the highest quality and motivating those agents to manage value creation over the long term.

12.8 The Board has developed high-level corporate governance principles to enable the consistent and principled exercise of ownership rights. While these principles are primarily tailored to proxy voting in listed equity markets, they also guide our expectations on governance practices in private markets. The principles 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:

12.9 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) the typical issues that are put to shareholders globally to vote upon.

12.10 Ownership rights in the listed equities of Australian companies are exercised by the Agency on behalf of the Board. In determining voting decisions, the Board applies its voting principles, while also drawing on the insight of its external investment managers and research providers. As appropriate, the Agency will engage with companies to clarify issues relating to resolutions and to ensure that it is sending clear and constructive signals through its ownership activities.

12.11 Given the scope and complexity of exercising voting rights in multiple international markets, the exercise of ownership rights in the global (ex Australia) listed equities portfolio is delegated to the Future Fund's external investment managers. These managers are typically in the best position to analyse governance matters concerning the entities in which they invest on behalf of the Board.

12.12 The approach of external investment managers in exercising ownership rights on behalf of their investors is assessed as part of the due diligence process prior to the appointment of a manager. The exercise of those rights is subject to close oversight by the Agency and regular reviews of the managers' ownership policies and practices. The Board retains the right to override managers and determine voting decisions, although in the normal case, it does not expect to have to do so.

12.13 For some investment strategies or structures, our investment managers may be unable to vote our shares on our behalf in a manner that is consistent with our governance principles and expectations. In these cases, we will apply an alternative voting framework (eg insourcing; rules-based; delegation of voting rights) to ensure that the Board continues to exercise these voting rights in a consistent and informed fashion.

12.14 The Board is governed by the Future Fund Act 2006. In particular, Division 8 of the Act outlines specific requirements to prevent conflicts of interest in Board decision making. The Agency is also governed by the Act, as well as the Public Governance, Performance and Accountability Act 2013. In addition to these legislative requirements, the Board has established rules for considering and opining on proxy voting decisions in line with applicable governance standards.

12.15 The Board will disclose, in its annual report, the extent to which it exercised its ownership rights and, in broad terms, the nature of its voting.

Engagement with investee entities

12.16 The Board recognises the value of focussed dialogue with company management, board and relevant fiduciaries to establish a climate of long-term asset stewardship, with active oversight from investors and accountability of management to the provider of capital. Company engagement also complements our voting activities to improve analysis and the signalling power of the votes cast.

12.17 We leverage the engagement activities conducted by our investment managers in making our voting decisions. These managers are the front line of engagement, given their in-depth company knowledge and contacts.

12.18 We also engage directly with key investee entities on pertinent ESG issues where this may promote better practice and yield long term value creation. This direct engagement is conducted mainly with Australian domiciled companies, given the size and influence of our investments in our local market and practical considerations.

12.19 We partner with our investment managers to coordinate engagement activities with investee entities to ensure that a consistent and mutually reinforcing approach is communicated.

Excluded investments

12.20 The Board may invest in any entities and assets where it is lawful do so subject to applicable laws including the Board's own legislative constraints. The Board in turn requires its investment managers to comply with applicable laws in connection with their investment activities on behalf of the Board. Where it comes to the attention of the Board that an investment may be unlawful the relevant investment will be excluded from the portfolio.

12.21 Australia has ratified a number of international conventions and treaties that limit certain activities. Where the Board determines that the activities of an entity or funding activity contravene such a convention or treaty, it will consider the exclusion of the investment from the portfolio.

12.22 Where serious breaches of ESG standards have been identified, the Board prefers engagement over exclusion, working with the entity to improve ongoing performance where appropriate. The Board reserves the option to exclude an investment for the most egregious sustained activities where the entity is unwilling or unable to change its practices.

12.23 The Board publishes the list of exclusions under this ESG Policy on the Future Fund website.

Contributing to a stronger investment system

12.24 The Board believes that it can play a role in advancing good practice for institutional investment, contributing to system integrity, protecting investor rights and building new markets. The Board believes that improving the stability, transparency and efficiency of the markets in which it operates will benefit the Future Fund as a long-term investor. This includes working with other market participants to promote best practice and address some of the systemic challenges to effective corporate governance and ESG integration.

13. Version Control

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

Version	Date approved by Board	Brief description of amendments
1	12 July 2007	Initial document.
2	22 January 2008	Updates to Voting Policy (section 7).
3	26 November 2008	Updates to Investment Strategy (section 3) and Risk Management (section 5).
4	8 April 2009	Update to section 7 and general editing
5	16 September 2010	Updates to Business Model (section 2), Investment Strategy (section 3), Risk management (section 5), Derivatives (section 6), Policy for the management of ownership rights (section 7) and general editing.
6	6 February 2012	Update to section 7.
7	15 December 2015	General editing throughout. Integration of policies relating to all Funds into a single document.
8	7 March 2017	Update to section 9.
9	5 December 2017	Updates to reflect changes to the benchmark return target for the Future Fund as set by the Investment Mandate.
10	10 December 2018	Updates to the risk appetite sections for the Future Fund and Medical Research Future Fund and general editing.
11	19 December 2019	Updates to enhance the 'Risk Management' section and provide detail on the investment strategy for the Aboriginal and Torres Strait Islander Land and Sea Future Fund.
12	28 September 2020	Updates to reflect the investment policies for the Aboriginal and Torres Strait Islander Land and Sea Future Fund, Future Drought Fund and Emergency Response Fund.