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Speech to the CEDA Vision Series - Mark Burgess, Managing Director, Future Fund

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Global Outlook: Priorities and challenges for investors

Thank you very much for the opportunity to speak with you today.

I might start by thanking CEDA for the opportunity. The Future Fund joined CEDA earlier this year with a view to participating in and contributing to the high quality discussion, debate and insight that characterises CEDA's programs.

Of course as an investor, we are always very focused on what return we get on our investments and I am pleased to report that the return on our investment in CEDA has been strong!

My topic today is "Global Outlook: Priorities and challenges for investors".

What I'd like to do is start by offering a broad overview of the global investment environment and how that has developed and may continue to evolve.

I'll then look at how that is reflected in what we do at the Future Fund given our particular objectives and draw out some points that I think may be of interest to you and other investors and make some broader observations about shaping Australia's future.

Global environment

Everyone in this room will recognise the enormous economic and financial turmoil that was unleashed across the globe in 2008/09. Indeed, the history of the Global Financial Crisis is well documented and will no doubt continue to be dissected in the years ahead.

I don't intent to repeat that history, but I will address the challenges and opportunities that present themselves to investors in the GFC's aftermath.

Many observers have noted that, particularly over the last year or so, we have witnessed a continuing hunt for yield.

There has been an ongoing focus by investors on finding alternative places to invest in search of improved yields and in recognition that global conditions have improved relative to the investment market's previous expectations.

The improved conditions and rally in assets has been supported by active monetary policies designed to stabilise economic activity across most of the major regions.

The gain in asset prices follows a sharp rally in yielding assets cascading from government and sovereign debt, down to corporate and, now, more risk related assets such as equities and long-dated infrastructure. It should be noted, that a decline in yields, particularly if it is perceived that yields will remain low, has a very powerful impact on the capital value of long dated assets. This provides a “one-time” capital gain as they are revalued to the lower levels of yield.

The Future Fund, along with many other investors, has been able to capture these gains. We continue to be able to find new investment opportunities in reasonably valued assets, although perhaps in less quantity than in earlier periods of the investment cycle. However, we would also note that this “one-time” revaluation should not necessarily be seen as the beginning of a continuing period of high rates of return. In fact at the new lower yield, the return environment becomes more difficult, unless supported by other factors such as improved global growth, which will drive returns due to growth, rather than the one off cost of capital decline.

The other feature of a post low yield period is that for those investors focused on yield as the primary component of their returns, the likely returns are now lower. It is critical therefore that at this point of the cycle those investors do not chase undue complexity or risk to find apparent yield – the understanding of what risks need to be taken is more critical than ever.

My point there is that it is precisely at this point in time, that investors, particularly those with a long-term focus, should be assessing the risk settings of their portfolios with a view to the next two to five years.

Let me explain further why I believe that is the case.

Today, investors are faced with a mixed picture. World economic growth remains sluggish although there have been clear signs of recovery, albeit somewhat tepid, in the US economy.

As I mentioned earlier we continue to see unprecedented policy intervention occurring through monetary easing in the US, Europe and Japan. The question of how long such policy intervention is maintained and the speed and manner in which it is withdrawn is one which occupies a great deal of attention. Commentary dissects and analyses every possible nuance on this topic.

At the same time, there are a number of very important cross winds that are playing out in the global economy that, perhaps, attract less attention than they deserve.

These cross winds have differing degrees of importance in different countries and may ultimately play out with greater or lesser significance. But they are all, I believe, matters that will help shape the global environment.

Let me run through some of these issues.

It is clear that emerging economies are increasingly significant, but many - China in particular – appear to be near a turning point that shifts them out of the ‘emerging’ category. The manner in which China manages through its transition towards a consumption driven economy will be important.

The trend towards deregulation has faltered. In fact changes in the regulation of financial markets, in particular the Dodd-Frank arrangements in the United States and the European Market Infrastructure Regulation across Europe, are altering the shape and operation of financial markets. How these changes ultimately effect the way in which markets operate and the efficiency with which regulation achieves its objectives have important implications for how capital will flow.

Meanwhile debt deleveraging, flowing from the great adjustment that the GFC represents, remains a focus in many countries and accordingly credit growth remains anaemic.

Against this, Interest rates globally are at near record low levels and the improvements in the US economy, particularly its financial sector, are real and appear to be growing in strength.

An area of continuing concern is the extent to which countries across the world are able to establish and implement plans for fiscal improvement and, in Europe, the disequilibrium of a fixed exchange rate continues to impact policy. How soon Europe will be able to put itself back on a path to sustainable growth remains uncertain.

More broadly, the commodity cycle appears to have plateaued and in some areas peaked. Globally, we continue to observe significant technological changes that are commoditising many industries while also opening up new opportunities to drive productivity and growth.

Alongside these trends, long-heralded demographic changes are coming into place. This is not simply about ageing populations and the implications of smaller working age populations and larger older populations. The rise in the middle class across significant parts of the world is changing patterns of consumption as well as expectations of how the benefits of growth and political representation should be organised.

My point is that within the broad context of policy action to address the impacts of the GFC there are a myriad of other influences within and external to financial markets that are shaping what investment environment we will face over the medium-to long- term.

What that means is that we should be cautious about simple views of the path ahead.

That is not to paint a bearish picture - there are opportunities in markets globally. I would emphasise that growth is recovering and policy makers are focused on ensuring that it is well established before the stimulatory measures are removed.

Rather I would emphasise that the dynamics in the market are powerful and subject to a mixed set of cross winds that require careful navigation.

What this means for investors, as I alluded to earlier, is that it is more important than ever to think through carefully your appetite for risk, the rewards you expect for taking that risk and the context of your overall objective and timeframe.

Those are the fundamental questions that we should ask and the answers will be the fundamental building blocks for a portfolio.

That is certainly the case at the Future Fund and I would like to move now to talk a little about how we have shaped and continue to manage the portfolio in view of the environment and our long-term objective.

Mandate and purpose/parameters

So let me turn first to briefly describing our purpose and organisation.

The Fund was established in 2006 to help make provision for the Commonwealth's unfunded public sector superannuation liabilities. It was initially funded with around $60.5 billion and set an objective of generating returns of CPI+4.5 to 5.5% per annum over the long term with an acceptable but not excessive level of risk.

Our last update on the portfolio reported it had grown to over $85 billion with three year and five year returns of 8.1%pa and 6.4%pa respectively. The Fund has continued to grow well since then.

We act as a commercial investor in the market pursuing a financial objective while operating at arms length from government.

There are to be no withdrawals from the Fund until 2020 unless the Fund's balance matches the liabilities in any one year before then. Even from 2020, withdrawals can only be up to the size of the liability for that year.

Finally, many of you will also be aware that since its establishment our organisation has also been entrusted with responsibility for managing the three Nation-building Funds and, more recently, the investment of the assets of the Disability Care Australia Fund.

Investment process

Given that brief description of our organisation, let me return to the questions I suggested were critical for investors and discuss how we go about answering them:

- What is our appetite for risk?
- What are rewards we expect for taking that risk?
- What context is provided by our overall objective and timeframe?

Let me start with our mandate. The mandate sets our objective and is a fundamental input to our investment process.

We are required to maximise returns with acceptable, not excessive, levels of risk. Put another way, we have a responsibility to grow the fund and simultaneously protect its assets. We constantly have to balance these aspects.

Not only that, but the mandate clearly articulates a long term objective. This is a critical aspect to the Fund and maintaining a long-term focus is central to our thinking and something that we embrace as we develop, review and refresh the portfolio. Also fundamental are our investment beliefs. We developed these very early in the Fund's life and have revisited and refreshed them since then. I don't intend to go through them in detail, but in summary:

- we believe in creating a diversified portfolio that is robust to a range of scenarios;
- we believe that prospective returns and risks change through time and that therefore we should dynamically manage the portfolio;
- we believe that our long-term horizon presents an opportunity for us to add value;
- we believe that while quantitative risk measurement important, the assessment and management of risk should emphasise qualitative considerations, through a deep understanding of the investment environment.

Alongside these fundamental inputs, we strive to develop a sophisticated view of the macroeconomic environment. Through our internal resources, research activity and relationships with external managers we draw together a top-down view of the environment. In doing so we think about six strategic global themes that we believe are particularly important: debt and deleveraging; the interaction of policy and politics; demographics; globalisation, resource scarcity and inflation.

With this work we also combine the detailed insights from the sector teams in each asset class. This provides an additional richness to the insights we can develop and enhances our ability to identify challenges and opportunities.

At the same time we develop a range of scenarios for how the world may fare.

We think about a central 'muddle through' scenario in which we see global growth at the modest levels of the last year or so with, in general, developed market growth relatively lower than emerging market growth. We also consider other scenarios: an inflationary slowdown, renewed efforts to stimulate economies; recession; significantly slower growth and inflation; higher growth and lower inflation.

What we do not do is try to predict which scenario will eventuate and build the portfolio around that.

Instead, we look at the scenarios and construct a portfolio that is robust across those scenarios – one that is, we believe, better able to meet our dual objectives of maximising returns but also protecting capital.

This approach leads us towards the construction of a highly diversified portfolio. It also leads us to maintain a dynamic and flexible approach to taking risk that allows us to account for changing conditions and opportunities. Again, this is not to say we manage on a short-term basis, but rather that we believe it is prudent, within our overall framework, to adjust our portfolio as conditions change.

To dwell on this briefly, this demands a particular discipline and type of thinking. The ability to resist chopping and changing – which, as will be understood, is costly – and to have the confidence and strength of purpose to maintain a long-term focus even when it may create some unease, is important.

Going back to my questions about risk and reward, we are prepared to take higher levels of risk when strong reward is available and inversely we will reduce our risk levels where we believe it is not appropriately rewarded.

This is, I believe a robust and sophisticated approach to investing. It is one that has a number of implications and I would like to draw out a few of those for you.

First: Good governance adds value. Our ability to assess the environment in a sophisticated way and to dynamically manage the portfolio to reflect changes in the environment, puts a premium on high quality decision-making. Our statutory arrangements establish the roles and responsibilities of government, Board and management very effectively.

The Board itself, since the beginning, has had a sharp focus on good governance and the portfolio has benefited enormously from that. The Board in the last year or so has introduced a greater use of Committees and this has further added to the quality of discussion and decision-making.

Across the management team we organise ourselves in a way that best reflects our investment beliefs and our investment process. We test how well our structures and frameworks serve the portfolio regularly and I think the ability to do this is the hallmark of a healthy organisation.

Importantly, this is not to suggest that we will not sometimes make the wrong decisions. Instead, it's about having a framework and process in place to ensure that you understand the risk you are taking and that you can make an informed judgement based on that. That is something that our management team and the Board, through its Risk Committee for example, is very focused on.

Second: People are critical. I would hope that my previous comments will have illustrated the high expectations we have of our people. To achieve our objective we need to attract, retain and motivate highly skilled people. We also need them to have the right cultural fit. We expect them to be able to bring together diverse perspectives and work together to analyse them and incorporate them into our portfolio decision-making.

I would note at this point that our legislation requires us to use external investment managers but that we also see benefits in doing so. It gives us access to some of the best investors globally and the ability to work with them to tailor opportunities to our particular needs. It gives us flexibility to adjust mandates with managers quickly and so be able to refine the portfolio's settings quickly. Most importantly it allows us to focus on the critically important decisions of the overall portfolio settings rather than the more granular implementation issues and the daily management of an asset or an exposure.

<u>The third implication: Our portfolio will look and behave differently.</u> As I explained earlier, our investment approach emphasises diversity in the portfolio. While others also take this approach our particular mandate and investment process produces a portfolio that has broad based exposure across a range of asset classes. While we have around 40% invested in listed equities, we also have significant exposures across property, infrastructure, debt and alternative strategies such as certain types of hedge funds.

It's worth noting that the shape of the portfolio reflects the environment. As we began to invest and the GFC took hold, we slowed investment into equities, but prioritised investments in the debt and alternatives area where there were many attractive opportunities, particularly in Europe and the USA as a result of the market dislocation. More recently, we have seen opportunities to build our infrastructure program, particularly in Australia.

Not only will our asset allocation differ to that of many other investors, but our commitment to a broadly diversified portfolio, and our use of external managers, means that over time our costs will generally be higher than those of many other investors. We recognise this and have mechanisms in place to manage this appropriately. But in many ways it is a function of our focus on balancing the dual requirements of maximising growth for the Fund while protecting its assets.

I would also note that differences in the objectives, priorities and timeframes of different funds make simple comparisons between investors misleading and for that reason, while the activities of other investors are used to inform our thinking, we remain focused on our own objectives over the long-term.

<u>Fourth: Relationships are important.</u> This brings me to the importance of relationships. As a small organisation, with a global perspective, we believe that the quality of our relationships is vital. We try to build deep relationships with our external managers that allow us to take advantage of their expertise and, in some respects, to use them as an extension of our internal team.

Similarly, our investment process means that we highly value connections with advisors, researchers, policy makers, academics and commentators who can help add to the quality and depth of our insights.

I would also like to make a couple of broader points here that relate less to our investment activities and process and more to how we operate as a participant in financial markets and as part of what you might call "Australia's institutional fabric".

While we have a defined financial purpose which is our clear priority, we hope to be a constructive contributor to achieving sustainable growth and better outcomes in Australia. We do this in a number of ways.

We do it through our engagement with organisations like CEDA, but also through our participation in a range of forums to discuss and debate investment challenges and to explore opportunities. Most recently, for example, we were pleased to be one of a number of supporters of a project by the Australian Centre for Financial Studies titled "Funding Australia's Future". I think this project was an important addition to the understanding of how the financial system is changing.

Both domestically and offshore we've contributed to discussions with a range of investors, industry bodies and policy makers on topics as diverse as governance, regulation, management of environmental risks and operational efficiency and control. In doing so I believe that we, along with many of our peers here in Australia, are contributing to improvements to the overall system in which we and other Australian investors operate.

These are just some of the ways in which I hope the Future Fund can generate some value over and above delivering on our investment objectives.

Closing

Today I have offered you a perspective on some of the challenges and opportunities that I see in the global investment environment and have given an overview of how we at the Future Fund go about our task in that environment.

You will appreciate, I'm sure, that we cannot be certain as to how the environment will evolve nor how the challenges and opportunities will play out.

But I hope that I have been able to offer today a better understanding of our process and approach, of how we answer those key questions about risk, reward for risk and being clear about your objective and timeframe and also given you a sense of the focus we have on being a good contributor to our industry and to Australia.

Thank you.

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