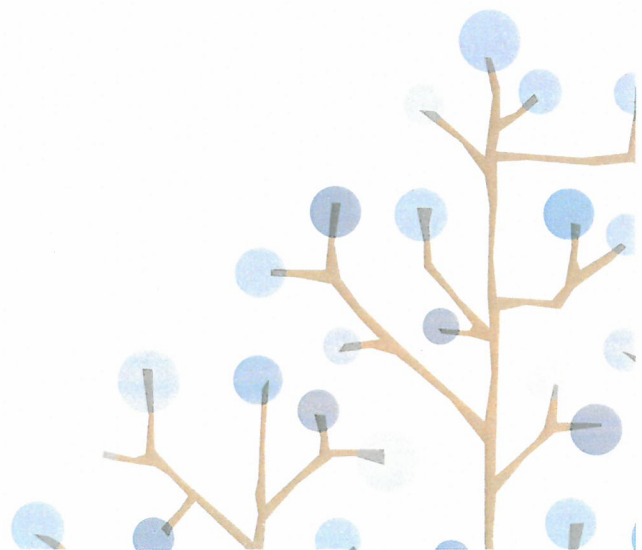


FUTURE FUND MANAGEMENT AGENCY

2016/2017 Corporate Plan

August 2016



Future Fund Management Agency 2016/2017 Corporate Plan

Effective 1 July 2016 for the period of four financial years ending
30 June 2020

Introduction

I, Peter Costello, as accountable authority of the Future Fund Management Agency, present the 2016/17 Corporate Plan, which covers the four year period until 30 June 2020, as required under paragraph 35(1)(b) of the *Public Governance, Performance and Accountability Act 2013*.



Hon Peter Costello AC

Accountable Authority of the Future Fund Management Agency

19th August 2016

1. Purposes of the Future Fund Management Agency

The Future Fund Board of Guardians (the "**Board**") has responsibility for investing the assets of special purpose public funds including the Future Fund, two Nation-building Funds (the Building Australia Fund and the Education Investment Fund), the DisabilityCare Australia Fund and the Medical Research Future Fund. Risk and return objectives for each of these funds are set by Investment Mandate Directions issued by the Treasurer and Minister for Finance to the Board. These objectives are detailed on pages 5 and 6 of this Corporate Plan.

The Future Fund Management Agency (the "**Agency**") was established under Division 2 of Part 5 of the *Future Fund Act 2006*. The Agency supports the Board in maximising the returns on funds for which the Board is responsible in line with the Investment Mandate Directions for each fund.

The Agency has the following functions as described under the Future Fund Act:

- to make such arrangements as are necessary to give effect to the decisions of the Board;
- to provide administrative services to the Board;
- to provide information to the Board;
- to advise the Board about the performance of any of the Board's functions;
- to make resources and facilities (including meeting facilities, communication facilities, secretariat services and clerical assistance) available to the Board;
- such other functions as are conferred on the Agency by the Future Fund Act;
- to do anything incidental to or conducive to the performance of any of the above functions.

In performing its functions, the Agency must act in accordance with any policies determined, and any directions given, by the Board.

The Agency's focus is on supporting the Board in maximising investment returns for the Commonwealth Government, net of costs, consistent with its investment mandates. The Board has added approximately \$57 billion to the assets of the Future Fund alone since inception.

The Board approves the Agency's business plan annually and an associated budget and resourcing to implement the plan. This Corporate Plan reflects the business plan and budget approved by the Board.

The Agency does not have any subsidiary entities.

2. The current operating environment

Operating model

The governing legislation requires the Board to use external investment managers and this is consistent with the Board's preference to operate a modestly sized organisation with internal resources concentrated on the key issues of determining the most efficient allocation of risk across investment markets, and working closely with our external partners to most effectively implement the desired exposures.

The Agency's operating model is *prima facie* to outsource non-investment functions. The Agency has, since inception, applied a contestability test to all functions and has, as a result, outsourced functions where it is considered to be more efficient to do so or to supplement in-house skill sets.

This approach to resourcing is also consistent with the Government's contestability programme which seeks to determine if performance can be improved through alternative structures, processes or provider arrangements.

Total Agency costs represent approximately 0.05% of the value of the assets managed by the Board, and total costs (inclusive of investment fees) are 1.0% - 1.5% and vary with the performance of the Funds as a proportion of manager fees is linked to achieving performance targets.

Mandate-achieving returns on the current portfolio imply revenues to the Government of approximately \$8-9 billion per annum. Given the scale of these revenues, achieving and maintaining long-term investment excellence is of primary importance.

Investment landscape

The investment landscape has changed significantly since the Agency was first established.

In the early years of the portfolio build, the scale of the financial crisis created a series of dislocations that allowed the Board to allocate substantial capital to interesting opportunities. After a number of years of liquidity provision and quantitative easing by central banks, the investment landscape is more complex and challenging. Extremely low interest rates, indeed negative in many parts of the world, have depressed the long term expected return on investments across all asset classes. At the same time stretched monetary policy and constrained fiscal policy on a global scale mean that the global economy and global markets are vulnerable to any set-back, in turn raising risks to investors.

These developments increase the challenge of meeting the mandate return. We believe we need to work harder and at a more detailed level to meet the challenge of pursuing the risk and return objectives of our investment mandates.

In this new environment finding and executing investments is more time consuming and has a lower hit rate, and even when successful is generally for smaller-sized investments than previously. As a result, in order to continue to deliver the quality of investment portfolio that has been generated to date, the required investment activity has become more labour intensive than at any time in our history.

Increased oversight requirements

The size of the assets being managed by the Board has increased significantly since the Agency was established, having grown to in excess of \$133 billion in assets currently being managed across all Funds.

Additional monitoring, risk management and reporting resourcing is required to ensure that appropriate oversight of these assets is achieved.

Future Fund approaching drawdown phase

The Future Fund Act allows for the Government to draw down from the Future Fund to meet its unfunded superannuation liability payments under certain conditions. In practice this is most likely to be from 1 July 2020. The level of potential payments from the Fund is estimated by the Government Actuary to be approximately \$8 billion in 2020/21, and gradually rising over time (reaching \$10 billion by 2024/25).

The Board has taken advantage of the Fund's relatively long time horizon and the absence of cashflows out of the Fund in the first years of its life to invest part of the portfolio in a range of relatively illiquid assets where it believes this illiquidity is rewarded by higher risk-adjusted return. As the Fund approaches 2020, and as decisions regarding the drawdown level are made, the Board needs to ensure there is sufficient liquidity to meet the potential cashflows. In part, this will entail considerable work ensuring these illiquid assets are sold down at appropriate and opportune times, and in an efficient and effective manner. This places an additional workload on the team.

New Funds

During FY2015 the Board took on responsibility for the Medical Research Future Fund. The Medical Research Future Fund was established following the Government's decision to close the Health and Hospitals Fund. The Medical Research Future Fund is a more complex and time-consuming fund to manage and implement than the Health and Hospitals Fund. This reflects the Medical Research Future Fund's purpose, higher risk profile and the requirement to make annual distributions while preserving the nominal value of the credits to the Fund and moderating volatility of the maximum annual distribution. The Board has begun to build this portfolio but will continue to diversify the portfolio in line with its strategy. We also note the Government's intention to close the Building Australia Fund and the Education Investment Fund and to establish a new fund - the Asset Recycling Fund.

3. Performance

As an investment institution, the achievement of the return and risk objectives set by Government for each special purpose public fund is the key measure of performance. These expectations are set out in the Investment Mandates issued by the responsible Ministers.

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

The Agency reports performance of each fund to the Board at each Board meeting and updates performance results and asset allocation each quarter on its website. A detailed review of the performance of the portfolio is also included in the annual report each financial year.

There is a direct link between the performance of the Future Fund and the remuneration of Agency staff. A portion of total compensation of Agency staff is based on the Future Fund performance, reflecting average performance over three year periods. Results are determined on fixed calculations once Future Fund performance is audited and confirmed. It includes assessment of the Fund's absolute return (net of costs) against its mandated target.

Performance is also measured against the policy portfolio implied by the Target Asset Allocation as set by the Board. Outperformance against the Target Asset Allocation measures the skills of Agency staff in implementing the Board's investment strategy.

Future Fund

The Investment Mandate for the Future Fund is to achieve an average annual return of at least the Consumer Price Index ("CPI") plus 4.5% to 5.5% per annum over the long term with an acceptable but not excessive level of risk. Investment Mandate Directions were first issued to the Future Fund Board of Guardians by the responsible Ministers in May 2006 and remain in place with the risk and return objective unchanged. Performance against the mandate is set out in the table below.

Returns – Future Fund		
Period to 31 March 2016	Return	Target return (CPI +4.5%)
From May 2006	7.4% pa	7.0% pa
Seven years	10.7% pa	6.8% pa
Five years	9.5% pa	6.5% pa
Three years	11.3% pa	6.4% pa
One year	0.4% pa	6.1% pa
Financial year to date	0.2%	4.3%
Quarter	-0.9%	1.2%

Nation-building Funds

Investment Mandate Directions for each of the Nation-building Funds were issued by the responsible Ministers on 14 July 2009 and set a target benchmark return of the Australian three month bank bill swap rate + 0.3% per annum calculated on a rolling 12 month basis (net of fees). The Board is required to invest in such a way as to minimise the probability of capital losses over a 12 month horizon.

Over the last 12 months to 31 March 2016, the Building Australia Fund and Education Investment Fund returned 2.5% and 2.4% respectively. The target benchmark return for the two continuing Nation-building Funds during that period was 2.5%. Since inception the Nation-building Funds have generated returns of 4.0% per annum against a target of 3.8% per annum.

The Health and Hospitals Fund was abolished with effect from 29 October 2015. Over its life, it generated a return of 4.1% per annum, in excess of its benchmark return of 3.9% per annum.

DisabilityCare Australia Fund

Investment Mandate Directions for the DisabilityCare Australia Fund were issued by the responsible Ministers on 1 July 2014 and set a target benchmark return of the Australian three month bank bill swap rate + 0.3% per annum calculated on a rolling 12 month basis (net of fees). The Board is required to invest in such a way as to minimise the probability of capital losses over a 12 month horizon.

The DisabilityCare Australia Fund received its first funding late in 2014, and as at 31 March 2016, it had generated a return of 2.4% over 12 months against a benchmark target for the period of 2.5%.

Medical Research Future Fund

Investment Mandate Directions for the Medical Research Future Fund were issued by the responsible Ministers on 8 November 2015 and set a target benchmark return of at least the Reserve Bank of Australia Cash Rate target + 1.5% to 2.0% per annum, net of investment fees, over a rolling 10 year term. In targeting the benchmark return the Board is required to determine an acceptable but not excessive level of risk and to take into the account the principle that the nominal value of the credits to the Fund be preserved over the long term and the principle to moderate the volatility of the maximum annual distribution.

The Medical Research Future Fund received its first funding on 22 September 2015 (\$1.01 billion from the former Health and Hospitals Fund) and prior to the issue of its Investment Mandate Directions was invested in accordance with the mandate for the Nation-building Funds (as requested by the responsible Ministers).

At 31 March 2016 the Medical Research Future Fund had returned minus 0.5% since the first contribution on 22 September 2015.

4. Capability

The Agency has considered the current operating environment as set out in Section 2 above in this Corporate Plan.

As a result, a number of initiatives have been identified which will strengthen the investment, operational and risk management capabilities of the organisation while maintaining its ability to be flexible, nimble and opportunity-driven.

A summary of the initiatives are as follows:

1. Deepen investment capabilities. We will further develop our investment team so that we maintain our ability to monitor and analyse the macroeconomic and market environment and identify and secure opportunities across asset classes. A more competitive investment environment and the need to move nimbly to secure opportunities, often at a smaller size than previously, drives our need to have skilled and focused resources in place to secure attractive investments.
2. Materially upgrade investment data management and analytics capability. This will include establishing a specialist dedicated data management function to provide the strong foundation framework and technology architecture on which to build improved analytical capability. This will see growth in our internal IT resources to support the delivery of these solutions and manage external providers.
3. Bring greater efficiency and effectiveness to our business processes. This will see greater standardisation, simplification and systematisation of our processes, clearer accountability for decision-making and clearer guidance to decision-makers on risk appetite and tolerances. This will include procurement of external systems and bespoke internal automation, and supports the case for growth in technology resources.
4. Invest in employee skills. Ensuring we have the human skills and resources available to turn data and information into knowledge, insight and high quality decisions to the benefit of the portfolios is critical to our program. We intend to enhance our ability to attract and retain high quality staff by enhancing our employee experience with a focus on improving our flexible work arrangements, developing our diversity and inclusion strategy to improve decision-making, focus on training and development of all staff and our leaders and improve communication and collaboration through an improved office environment and intranet.
5. Strengthen core Agency capabilities that support the investment function, improve Agency productivity and reduce operational risks, such as:
 - a. research and knowledge management;
 - b. contract lifecycle management;
 - c. relationship management capability;
 - d. internal communications; and
 - e. project execution.

Over the next four years, these initiatives will be the focus of the Agency to build additional capability and resilience. They directly address the Agency's role to assist the Board in investing the assets of each Fund and achieving the mandated returns.

The investment in resourcing identified above will result in the following beneficial outcomes:

- Increase the return on assets invested. Increasing investment returns by only 0.5% each year through an improved capability to understand the environment and construct a better portfolio would add over \$600 million per annum to the Commonwealth's assets;
- Reduce risk. Mistakes on portfolios with a total value of \$133 billion will be costly, and so sufficient headcount targeted at strong risk management is essential;
- Reduce costs. The Fund invests through external managers, incurring substantial investment management fees in the process. In private markets, the Fund is able to mitigate some of these fees by co-investing with our managers, usually at zero fees on the co-invested amount. The addition of further skilled headcount to support this activity will allow the Board to invest approximately a further \$1 billion in such co-investments, reducing total costs by an estimated \$50 million.

The resourcing plans have been developed to be consistent with the Government's objectives for an agile and sustainable public service. Specifically, Agency resourcing is designed to deliver:

- the functional requirements appropriate to the prudent management of over \$133 billion with high standards of investment efficiency. This includes both generating strong returns and maintaining robust risk management practices;
- the objective of building appropriate infrastructure and capability that enables efficient investment in accordance with the Investment Mandate Directions;
- enhanced returns on the assets invested by the Board which will add materially to the Commonwealth's financial position. Maintaining the ability of the Agency to appropriately support the Board is an important way of helping the Commonwealth address long-term budgetary pressures.
- improved efficiency and enhanced delivery of investment services to the Commonwealth. Given the Agency's unique role, none of the additional resourcing represents duplication of activity elsewhere in the public service. The Agency uses whole of government negotiated arrangements wherever possible (eg in regard to payroll and certain IT services) to avoid duplication.
- sharply focused support by the Agency to the Board in support of its objectives. Planned resourcing does not in any way extend the role or function of the Agency.

5. Risk Oversight and management

Portfolio Risk Management

As the Future Fund has matured and its range of underlying investments has become more diverse, the demands on portfolio risk management have necessarily increased. The Board and Agency has developed a set of investment policies to help with this risk management task by defining acceptable portfolio parameters.

Risk has many dimensions, all of which may vary through time in different ways. As a result, risk is too complex to be defined by a single number and certain risks, like reputational or geopolitical risk for example, are not easy to quantify. We therefore believe that our assessment and management of risk should emphasise qualitative considerations, through a deep understanding of the investment environment and its potential impact on the portfolio. Quantitative measurement is considered an important tool to both support and test this process.

This philosophy underpins our investment risk management framework, which is supported by four primary investment policies that we describe below:

1. Our **Portfolio Risk Exposure Policy** sets an acceptable range for the broad market risk of the Fund. This is measured both by the expected sensitivity of the Fund's performance to equities - our dominant source of market risk – and our expected capital loss in adverse investment conditions over the medium term.
2. Our **Short-term Liquidity Risk Policy** is designed to ensure that the Fund holds enough cash (and/or other highly liquid securities) to meet our short-term cash flow obligations at all times including under severe market stress. If the level of liquidity in the Fund is insufficient to pass our daily stress test, it must be replenished.
3. Our **Portfolio Flexibility Policy** sets an acceptable lower threshold for the level of liquid investment in the portfolio. We have arguably a greater tolerance for illiquidity than many other investors and we expect to be rewarded for well-chosen illiquid investments. However, very high levels of portfolio illiquidity may limit our flexibility to make new investments, and we also expect that our appetite for illiquidity will gradually decrease as we approach 2020 and the drawdown phase of the Fund.
4. Our **Currency Exposure Policy** sets an acceptable range for the currency exposure of the Fund. Along with equities, currency is one of the major drivers of portfolio risk and is an important consideration in liquidity risk management.

These four “pillars” of our investment policy platform are highly interdependent, and their interaction can often be quite complex and challenging to manage. However, we believe we have developed a sufficiently holistic and flexible framework to effectively manage the risk of the portfolio.

Strategic and operational risk

Strategic risk is the risk that the governance framework, Agency operating structure and organisational culture are not fit to deliver the Board approved investment strategy. The selection of people with the appropriate skills and the ability to successfully motivate and develop these people is a focus of the Agency and the Board.

Operational risk is the risk that processes, controls and systems are poorly designed, not fit for purpose or are not operating as intended to protect the organisation against financial, legal or reputational harm. Examples of the operational risks managed by the Agency include: legal risk, fraud risk, business continuity risk, outsourcing risk, information security risk and compliance risk.

These categories of risk shape the governance structure adopted by the organisation and are incorporated into the way the Agency structures and controls its activity.

The Agency maintains a Risk Register which documents the key risks and mitigating controls. The Agency's Operational Risk and Compliance Committee undertakes a detailed review of each of these risks over a rolling twelve month period. Outcomes from these reviews are reported to the Board's Audit and Risk Committee, with recommendations for any material changes presented to Board for approval. On a quarterly basis the effectiveness of these key controls is assessed, with results reported to the Agency Operational Risk and Compliance Committee and the Board's Audit and Risk Committee.

The Agency Operational Risk and Compliance Committee assists the Board's Audit and Risk Committee in the effective identification and management of operational and compliance risks. The Agency's Operational Risk and Compliance Committee meets on a monthly basis and its responsibilities include: maintenance of the Risk Register, monitoring mandate and portfolio compliance, incident reporting, tracking implementation of internal audit recommendations and oversight of key operational outsourcing arrangements.

A strong culture of risk and compliance management exists within the organisation. All staff are required to adhere to the Australian Public Service Code of Conduct and comply with core Agency operational policies which underpin the risk management framework. On an annual basis, staff certify their compliance with the Code of Conduct and these policies.

The Agency seeks out opportunities to identify and share best practice approaches and benchmarks its approach to operational risk and compliance management through engagement with peer organisations. PricewaterhouseCoopers provides internal audit services reporting to the Board's Audit and Risk Committee and has full access to staff and information when conducting its reviews. The Australian National Audit Office undertakes the external audit of the organisation engaging a professional accounting firm to assist in this process.

The Board's Audit and Risk Committee reviews the financial statements, oversees compliance and audit functions and evaluates the efficiency and effectiveness of the risk management framework.

The Board's Audit and Risk Committee receives internal and external audit reports and monitors management action in respect of these reports. During the year, the Board's Audit and Risk Committee has met separately with the internal and external auditors in the absence of management.

The Board's Audit and Risk Committee reviews and approves the Agency's fraud and corruption risk assessment and fraud and corruption control plan at least every two years, or more frequently where material change has occurred. The Agency Operational Risk and Compliance Committee reviews the fraud and corruption risk assessment and fraud and corruption control plan on an annual basis.

Fraud and corruption control initiatives are embedded into the Agency's internal control framework. Fraud risks identified include, but are not limited to: deliberate leaking of sensitive information; incorrect or falsified payment instructions; and theft or misuse of Commonwealth assets. Key controls such as segregation of duties, approval hierarchies, dual signatories and third party due diligence form part of the mitigation strategies. The effectiveness of these controls is assessed on a quarterly basis as part of the internal control assessment referred to above.