

FUTURE FUND MANAGEMENT AGENCY

2017-2018 Corporate Plan

August 2017



Future Fund Management Agency 2017-2018 Corporate Plan

Effective 1 July 2017 for the period of four financial years ending
30 June 2021

Introduction

I, Peter Costello, as accountable authority of the Future Fund Management Agency, present the 2017/18 Corporate Plan, which covers the four year period until 30 June 2021, 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

August 2017

1. Purposes of the Future Fund Management Agency

The Future Fund Board of Guardians ("**Board**") has responsibility for investing the assets of special purpose public funds including the Future Fund, the Medical Research Future Fund two Nation-building Funds (the Building Australia Fund and the Education Investment Fund) and the DisabilityCare Australia 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 in section 3 of this Corporate Plan.

The Future Fund Management Agency ("**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 over \$69bn 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

Business strategy

The Board and Agency have defined a business strategy for the organisation that reflects the legislation and the mandates issued by the responsible Ministers as well as an assessment of the organisation's comparative advantages and the current and prospective investment environment.

We have a clearly defined purpose: investing for the benefit of future generations of Australians. This, together with the specific Investment Mandate Directions for each fund, provides a focus for our people, their efforts and our priorities and it reflects that the Future Fund, in particular, is designed to strengthen the Government's long-term financial position.

The governing legislation requires the Board to use external investment managers. 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.

The Board and Agency have developed a set of investment beliefs that define the core principles we apply to investment, including aspects such as risk management, governance, the opportunities available to us as a long-term investor and our perspectives on investment skill and costs.

Reflecting our purpose, the requirements of our legislation and our investment beliefs, our strategy defines three core attributes to our business model. These form the basis for how we operate and develop the Agency, as well as our investment approach:

1. *One Team, One Portfolio* – combining a breadth of experience and skills into a collaborative whole creates a meaningful competitive advantage. For this reason we keep our team all in one place and modest in size.
2. *Leveraging the best in the world* – we focus our internal skills and resources where they add the most value or where it is impractical or inefficient to outsource. Otherwise we put considerable effort and focus into strategically and proactively working with the best external capabilities we can find, in many cases building strong and enduring partnerships.
3. *Flexible, nimble and opportunity-driven* – we are broad and creative in our search for opportunities to improve the portfolio, the organisation and ourselves. Without compromising good governance, we respond to these opportunities as flexibly and nimbly as possible, aiming to avoid the constraints and barriers to this that institutions often construct.

Investment landscape

The investment landscape has changed significantly since the Board and Agency were 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.

The global economy has taken time to grow out of the effects the financial crisis. Interest rates remain at or around record lows albeit that rates have begun to rise. Broader, more fundamental challenges remain in the form of demographics and elevated debt levels that are likely to challenge global growth.

The prolonged application of unconventional monetary policy has pulled future returns forward to the present and in doing so has increased returns for asset owners by inflating asset values. Inflated asset values have depressed forward-looking returns with many investors forecasting a low return environment over the medium to long term. Asset owners face the choice of taking on more risk to chase returns or reducing their return expectations.

In addition, central banks have few tools left available to them to meaningfully respond to further shocks to the financial system. This means that the global economy and markets – and therefore investors – face elevated risks should a shock eventuate.

These developments increase the challenge of meeting the mandate return for the Future Fund. 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 environment, and particularly with institutional investors competing ever more actively to find attractive investment opportunities, finding and executing investments is more time consuming and has a lower hit rate. Even where investments are secured, competition and market dynamics means that they are often smaller-sized.

Given this context, and the fact that the total assets under the Board's management have more than doubled since establishment to \$150 billion, it has become more complex and labour intensive to deliver the quality of investment portfolio that has been delivered to date.

Organisational flexibility and resilience

Alongside the changing investment environment, the organisation has continued to develop and mature, with total funds under management standing at around \$150bn.

The desire to ensure that the Agency retains the ability to be flexible, nimble and able to identify and take-up new opportunities must be balanced with delivering appropriate organisational strength, stability and resilience. This is an important aspect to transitioning the Agency from a successful first decade and ensuring that it is sustainable and high-performing for decades to come.

In line with additional public asset funds being managed and the growth in the value of those funds, the Agency has developed additional monitoring, risk management and reporting resources to ensure that appropriate oversight of these assets is achieved. Continuing to ensure that these resources are appropriate and operating as efficiently as possible presents the opportunity to both enhance returns and mitigate risk.

Similarly, the Agency has historically benefited from the ability to attract and retain highly skilled staff and to provide opportunities and a work environment that has generated high levels of staff engagement. High levels of staff engagement has delivered increased discretionary effort and value add for the portfolios and needs to be maintained.

Moreover, maintaining this level of commitment and leadership will also play a significant role in the delivery of key projects and initiatives to deliver more valuable data and analytics and more efficient processes and systems.

Changing nature of the funds

The five funds overseen by the Board and Agency continue to evolve.

The Future Fund portfolio is well diversified and our focus has shifted increasingly to ensuring it remains efficient and flexible while remaining as robust as possible to a range of investment and economic scenarios.

While legislation permits drawdowns from the Future Fund from 1 July 2020, the Government has indicated that it does not intend to make these withdrawals in 2020-21 and has further indicated that its intent is to refrain from doing so until at least 2026-27.

Investment of the Medical Research Future Fund commenced in the 2014-15 year and we continue to develop and diversify the portfolio. The Medical Research Future Fund is designed to provide annual distributions while the Board is required to preserve the nominal value of the credits to the fund and to moderate the volatility of the maximum annual distribution.

Withdrawals from the DisabilityCare Australia Fund are expected to commence in 2017-18 and the Government has stated that it intends to close the Building Australia Fund and the Education Investment Fund by 31 December 2017.

3. Performance

The achievement of the return and risk objectives set by Government for each special purpose public fund is the key measure of performance for the Board and Agency. 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 (as easily the largest and most complex portfolio) 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 of individual staff members is also assessed against their progress on specific goals relevant to their role and responsibility within the organisation.

Future Fund

Until 30 June 2017 the Investment Mandate for the Future Fund was to achieve an average annual return of at least the Consumer Price Index ("CPI") + 4.5% to 5.5% per annum over the long term with an acceptable but not excessive level of risk. Performance against the mandate is set out in the table below.

Table 1: Future Fund returns		
Period to 31 March 2017	Return	Target return (CPI +4.5%)
From May 2006 (% pa)	7.7	7.0
Ten years (% pa)	7.8	7.0
Seven years (% pa)	9.8	6.7
Five years (% pa)	11.0	6.5
Three years (% pa)	9.9	6.1
One year (% pa)	10.5	6.6
Financial year to date (%)	5.6	5.1

Reflecting the environment described in section 2, the Government announced in May 2017 that it would change the Future Fund's investment mandate. This sees the long-term benchmark return target reduce from CPI + 4.5% to 5.5% per annum to CPI + 4% to 5% per annum with effect from 1 July 2017. The return objective must continue to be pursued with acceptable but not excessive levels of risk.

Even with the reduction in the benchmark return target, the return objective remains challenging.

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).

Table 2: Medical Research Future Fund returns		
Period to 31 March 2017	Return (% pa)	Target return (% pa) (RBA Cash Rate target +1.5%)
From 22 September 2015	3.8	3.1
One year	6.3	3.1

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 2017, the Building Australia Fund and Education Investment Fund each returned 2.5%. The target benchmark return for the two continuing Nation-building Funds during that period was 2.2%. Since inception the Nation-building Funds have generated returns of 3.8% per annum against a target of 3.6% 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 2017, it had generated a return of 2.7% over 12 months against a benchmark target for the period of 2.2%. Since inception it has generated a return of 2.6% per annum against a target of 2.5% per annum.

4. Capability

The Agency has considered the current operating environment as set out in Section 2.

The Agency continues to develop, refine and implement investment strategies, consistent with its legislation and risk-return objectives, for the Future Fund and other special purpose public asset funds. These funds have a collective value of nearly \$150 billion.

Alongside this the Agency is prioritising a number of particular multi-year initiatives that are consistent with the focus of the 2016-17 Corporate Plan which will assist in its ability to add value for the Commonwealth through its operation as a sustainable, high-performing investment institution.

These initiatives focus on three areas with major items of work shows in Table 3:

1. A multi-year program of work to materially upgrade our investment data, systems and analytics capability.
2. Driving greater efficiency and productivity improvements across the business.
3. Continued investment in our people and culture through the provision of training and development and through a well-structured employee environment that attracts and retains high performance.

Table 3: Major items of work

Investment data and analytics	Efficiency and productivity	People and culture
<ul style="list-style-type: none"> a) Deliver a range of projects to progress towards our Initial Target State investment technology environment, with particular focus on total portfolio management tools, listed equities and overlays b) Deliver a range of 'quick wins' to rapidly improve efficiency and effectiveness of the investment teams c) Form a new specialist data management function and establish a new data management operating model and capabilities d) Undertake a review of our performance and analytics capabilities and operating model e) Extend private market data management capabilities 	<ul style="list-style-type: none"> a) Apply the results of the Transaction Implementation Project to improve the way in which investment transactions are implemented b) Design and migrate technology infrastructure to an external data centre c) Implement a 'Unified Communications' platform to enhance collaboration and flexible working d) Extend collaboration, communication and knowledge management tools e) Continue the extension of the HR information system 	<ul style="list-style-type: none"> a) Recruit a learning and development manager to drive enhancements to our training and development capabilities b) Support selective secondments/assignments for high potential staff with partner organisations c) Launch and embed our flexibility strategy d) Improve the recruitment process and skills, in particular to mitigate bias

The implementation of these initiatives will see additional staff added in the Agency's Operations, Information Technology and Investment teams, as well as some additional growth in our People, Culture and Communications team.

The Operations, Information Technology and Investment teams are critical areas that drive the way in which investment and market data is captured, produced and analysed to inform investment decisions.

The People, Culture and Communications function drives organisational change management and the way in which tools and systems are developed and deployed into the organisation as well as supporting high levels of staff development, retention and engagement. With significant new systems being created and introduced to the organisation ensuring that these are well delivered and that take up is strong and effective will be an important contributor to organisational performance and efficiency.

Accordingly, we anticipate further growth in the Agency's Average Staffing level ("ASL") during the 2017-18 year and expect the ASL to level out thereafter.

Table 4: Anticipated ASLs for the Agency					
	Actual 2016-17	2017-18 Estimate	2018-19 Projection	2019-20 Projection	2020-21 Projection
Total ASL	133.8	166.7	166.9	166.9	166.9

The Agency expects that these initiatives and associated resourcing will support its ability to maximise returns on the various portfolios while appropriately managing risk, in accordance with the Investment Mandate Directions for each Fund.

Given the size of the assets managed by the Board, the Agency's ability to improve the management of risk and relatively small improvements in investment returns will deliver significant benefits to the Commonwealth.

For example, on \$150 billion of assets avoiding one potential loss of only 0.1% through the use of more accurate and timely data in decision-making would save \$150m.

Adding 0.5% to investment returns in a single year through access to better data and analytics and through greater efficiency and productivity represents an additional \$750m in earnings.

In addition, the investment program is heavily influenced by the quality and commitment of the people who support the Board. Ensuring this team has the tools to work efficiently and effectively, and remain fully engaged will further increase the quality and timeliness of decision-making.

5. Risk oversight and management

Portfolio Risk Management

As the Future Fund and Medical Research Future Fund have matured and the range of underlying investments have become more diverse, the demands on portfolio risk management have necessarily increased. The Board and Agency have 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.