Chairperson and Committee Members
OPERATIONS & FINANCE COMMITTEE

16 AUGUST 2018

Meeting Status: **Public**

Purpose of Report: For Decision

INVESTMENT POLICY STATEMENT FOR KĀPITI RESILIENCE FUND AND KĀPITI GROWTH FUND

PURPOSE OF REPORT

1 This report asks the Operations and Finance Committee to approve the draft Investment Policy Statement for the Kāpiti Resilience Fund and the Kāpiti Growth Fund.

DELEGATION

2 The Operations and Finance Committee has the delegation to consider this matter. The current Governance Structure and Delegations for the 2016-19 triennium states that the Operations and Finance Committee has been delegated:

> *the responsibility to deal with monitoring and decision-making on all broader financial management matters as well as responsibility for financial policies*.

BACKGROUND

3 In the recently approved 2018 Long Term Plan, the Council approved the establishment of two investment funds – the Kāpiti Resilience Fund and the Kāpiti Growth Fund.

4 The purpose of the Investment Policy Statement (IPS) is to set out a framework for making investment decisions in relation to the Kāpiti Resilience Fund and the Kāpiti Growth Fund. The IPS considers the Council's general investment goals and objectives and describes the strategies that should be employed to meet these objectives.

5 The Council has engaged a firm of independent investment governance advisers to help set up the appropriate governance protocols for the two investment funds, and to ensure that the Council has robust risk management, monitoring and reporting processes in place.

6 In July, the Council's Treasury Management Policy was amended to ensure that it caters for and supports the establishment of the proposed funds. The next step in the process of establishing the funds is the approval of the IPS.

DISCUSSION

7 The stated objectives of the Kāpiti Resilience Fund and the Kāpiti Growth Fund are to achieve a return of at least 3.5% above the Council's borrowing costs.

8 The targeted surpluses of the Resilience Fund are to be used for funding resilience-focussed projects such as increased insurance costs and Civil Defence costs.

9 The targeted surpluses of the Growth Fund are intended to contribute towards projects that encourage businesses and recreational / visitor attractions to establish an operating presence in the Kāpiti District. An additional objective of the Growth Fund is to invest in strategic assets that directly contribute to the growth of the District.

The Investment Policy Statement

10 The key features of the IPS are to set out:

- investment objectives;
- investment implementation;
- roles and responsibilities;
- due diligence criteria for selecting providers; and
- monitoring and control procedures.

Investment objectives

11 This considers the overall objectives of the funds and also a number of best practice principles (investment beliefs) that guide investment decisions.

Investment implementation

12 This defines the risk / return profile of investments and the associated time horizons. It specifies the preferred asset classes and target asset allocations as well as considering responsible investment and noting any asset classes that should be avoided.

13 Diversification is addressed through the target allocations, which have a minimum and maximum deviation for each class that, when exceeded, will trigger portfolio rebalancing.

Roles and responsibilities

14 The IPS clearly defines the expectations for all parties involved in the investment process, to ensure clarity of the Council's internal governance lines. The Operations and Finance Committee is responsible for approving the IPS and any subsequent amendments to it.

15 Once the investment has been placed, the Committee will receive quarterly performance reports, as well as an annual review of governance effectiveness.

16 Council officers are responsible for the investment implementation, in accordance with the terms of the approved IPS.

Due diligence

17 The IPS recommends the minimum level of due diligence required when selecting all service providers, including investment managers, funds and custodians.

Monitoring and control procedures

18 This addresses the monitoring and control procedures to be followed by everyone involved in the investment process. This includes establishing the frequency of monitoring fund performance and specifying benchmarks for comparison of portfolio returns as well concrete procedures for reviewing and, where necessary amending the IPS.

19 The IPS also outlines procedures for monitoring investment manager performance (including their costs), how to evaluate the reasons for any under-performance and guidance on when to retain or terminate a provider.

Benefits of an IPS

20 A good investment policy statement provides guidance for informed decision-making and serves as a roadmap to successful investing. It's also a safeguard against potential mistakes, for example, seeking to make a significant change in direction when markets start to falter.

21 The IPS provides documentary evidence of why decisions have been made, and by whom. This provides a paper trail in the event of a legal challenge or dispute.

22 The draft Investment Policy Statement is attached as Appendix One to this report.

Next steps

23 If the IPS is approved, Council officers, with the assistance of My Fiduciary will proceed to the next stages of the investment implementation process. The key stages and indicative timelines are outlined below:

Step	Responsibility	Indicative date
Approve IPS	OFC	16 August
Provider due diligence completed with 1-2 providers recommended	My Fiduciary	August
Select provider	Council officers	August
Consider final provider products and adjust IPS	Council officers	August
Address AML regulations and sign contracts	Council officers	August
Implement investments	Council officers	September
Report investments to Council	Council officers	October

CONSIDERATIONS

Policy considerations

24 The Investment Policy Statement is consistent with the Council's recently amended Treasury Management Policy. The Investment Policy Statement will be maintained to ensure that it stays fit for purpose and will be formally reviewed on at least an annual basis.

25 Any changes required to the Treasury Management Policy, as a result of amendments to the Investment Policy Statement, will be undertaken at the same time.

Legal considerations

26 This Policy is in accordance with the Local Government Act 2002.

Financial considerations

27 The financial implications of the proposed IPS are consistent with the Local Government Amendment Act 2012 requirement for a local authority to "demonstrate prudent management of its revenues, expenses, assets, liabilities, investments, or general financial dealings."

28 The Council will fund the costs of implementation from existing approved budgets.

Tāngata whenua considerations

29 Tāngata whenua have not been directly consulted with on the drafting of the Investment Policy Statement.

SIGNIFICANCE AND ENGAGEMENT

Significance policy

30 This matter has a low level of significance under the Council's Significance and Engagement Policy.

Consultation already undertaken

31 No external consultation was undertaken during the development of the IPS. The draft IPS has been discussed with the Council's treasury adviser and a copy of the approved Policy will be given to the Council's auditors.

Engagement planning

32 An engagement plan is not needed to implement this decision.

Publicity

33 There are no publicity considerations.

RECOMMENDATIONS

34 That the Operations and Finance Committee approves the Investment Policy Statement.

Report prepared by	**Approved for submission by**	**Approved for submission by**
Ian Clements **Corporate Advisor**	**Kevin Black** **Acting Group Manager** **Strategy and Planning**	**Janice McDougall** **Acting Group Manager** **Corporate Services**

ATTACHMENTS

Appendix 1 Draft Investment Policy Statement

KĀPITI COAST DISTRICT COUNCIL

Investment Policy Statement

August 2018

MyFiduciary

your partner in investment governance

MyFiduciary Limited
Private Bag 12030, Tauranga Mail Centre 3143 Ph: 07 863 5360

Contents

Purpose of IPS

The purpose of this Investment Policy Statement (IPS) is to assist Kāpiti Coast District Council and the Fiduciary Consultant to supervise, monitor and evaluate the management of the Council's investment funds. The investment programme is defined in the various sections of the IPS by:

1. Stating in a written document the Council's investment philosophy, expectations, objectives and guidelines for the investment of the assets.
2. Setting forth an investment structure for managing the Portfolio. This structure includes various asset classes, investment management styles, asset allocation and acceptable ranges that, in total, are expected to produce an appropriate level of overall diversification and total investment return over the investment time horizon.
3. Establishing formal criteria to select, monitor, evaluate and compare investments.
4. Encouraging effective communications between the Council, Fiduciary Consultant and interested parties.
5. Complying with all applicable fiduciary, prudence and due diligence requirements experienced investment professionals would utilise, and with all applicable laws, rules and regulations that may impact the portfolio.

Background

The Council wishes to establish two funds, a **Kāpiti Resilience Fund** and a **Kāpiti Growth Fund**. Both funds are to invest in financial securities, most likely through one or more managed funds.

The Resilience Fund is expected to be approximately $10m initially. The Growth Fund is expected to be between $10m and $20m in size.

At least initially, both funds are likely to be funded by additional borrowing by the Council.

The goal is to generate a surplus over and above the Council's cost of borrowing. The target is a long term return at least 3.5% above the borrowing cost. In others words, a surplus net of all fees and costs of at least $350,000 per annum for every $10m invested.

The Growth Fund is also able to invest in direct, unlisted Strategic Assets that support growth in the Kāpiti region. Up to 50% of the Growth Fund can be invested in such assets.

The Council is tax exempt.

The Operations and Finance Committee (“the Committee”) has delegated authority to implement and oversee these Funds, as per the Treasury Management Policy, and to amend and approve this Investment Policy Statement.

Governing legislation

Legislation relevant to the establishment and governance of the Council includes the following:

- Local Government Act 2002
- Local Government (Financial Reporting and Prudence) Regulations 2014, in particular Schedule 4; and
- Trustee Act 1956.

Underlying Purpose of the Funds

The Council has determined the following underlying purposes of the Funds:

Kāpiti Resilience Fund

The purpose of the Resilience Fund is to generate a surplus over the long term that can be used to contribute towards resilience-focussed projects including insurance and Civil Defence costs.

Kāpiti Growth Fund

The purposes of the Growth Fund are to:

1. Invest in strategic assets that will directly contribute to the growth of the Kāpiti District; and
2. Contribute to growth-focussed projects that encourage and incentivise businesses and recreational / visitor attractions to establish an operating presence in the Kāpiti District.

Investment Portfolio Objectives

The Investment Portfolio Objective of the **Resilience Fund** and the **Growth Fund** is to:

1. Achieve a long-term return net of fees and costs that exceeds the Council's cost of borrowing by 3.5% per annum; and
2. Invest responsibly and avoid prejudice to the Council's reputation as a responsible steward of ratepayers' assets.

In pursuing the Investment Portfolio Objective, the **Resilience Fund** will:

1. Pursue best practice governance and portfolio management;
2. Hold a diversified, simple, liquid and low-cost portfolio;
3. Maintain the nominal value of the asset base;
4. Maintain an overall risk level that is sufficient to achieve to Objective while having regard to the soundness of the broader Council balance sheet;
5. Maintain an appropriate asset allocation;
6. Have a withdrawal or distribution rule that is based on a total return perspective and which is sustainable over the long term.

In pursuing the Investment Portfolio Objective, the **Growth Fund** will:

1. Pursue best practice governance and portfolio management;
2. Hold a diversified portfolio that includes (a) a simple, low-cost portfolio of financial assets; and (b) Strategic Investments that are consistent with the Growth Fund's objectives.
3. Maintain an overall risk level that is sufficient to achieve the Objective while having regard to the soundness of the broader Council balance sheet;
4. Maintain an appropriate asset allocation;
5. Have a withdrawal or distribution rule that is based on a total return perspective and which is sustainable over the long term;
6. Where possible, ensure that Strategic Investments deliver a total return greater than listed market alternatives;
7. Where Strategic Investments are made that may not pay their way in purely financial terms – for example, because they have partly social or community objectives – then the return objectives for those investments will be clearly defined.

Investment Beliefs

It is considered good practice for entities charged with oversight of a pool of assets to anchor their investment activities by an investment philosophy, as represented by a set of beliefs around markets and investing.

The Council's investment beliefs are listed below. These beliefs should guide the asset allocation and the types of investment products chosen.

Investment Decision	Beliefs
Investment objectives and governance	Investment success cannot be achieved without a sound investment governance framework and decision-making process.
Asset allocation	To earn higher returns, more risk must be taken. The most important investment decision is choosing the right mix of asset classes. Diversifying across asset types, risk factors and securities will improve the risk-return trade-off. Investors with a long time-horizon should out-perform short-term investors.
Asset classes and investment styles	Active management is appropriate in some of the less efficient markets and asset classes. Tilting towards Value, Small and other sub-asset classes should beat the market-cap index over time.
Direct investing	Private markets provide investment opportunities that are not available in public markets. However, direct investing is more difficult and costly and can involve substantial business-specific risk. It requires greater investment governance skills and time, with carries greater reputational risk.
Responsible investment	Responsible investors must take account of environmental, social and governance (ESG) factors because this should lead to better long-term returns.
Manager selection	In large, liquid markets most active managers fail to add value. It is hard to recognise skilled managers in advance. Managing costs is important. Fees should be consistent with the complexity of the strategy and what the manager is trying to deliver.
Portfolio execution	Frequent rebalancing back to the asset allocation adds value over the long term. This is best executed in a disciplined, consistent manner.
Unique Investment Opportunities	Investors should play to their strengths where they have a competitive advantage or have access to unique opportunities.

Investment Implementation

Asset Allocation

The Council believes that for both Funds, a 65% growth/35% income target is appropriate.

With this mix of growth and income assets, the Council expects the portfolios to deliver a total return of approximately 4% above its cost of borrowing over the long term. This provides a safety margin over the Investment Portfolio Objective (which is a long term return equal to the cost of borrowing plus 3.5%). With this safety margin, the Council can have a higher degree of confidence that its long-term objective can be achieved.

The asset allocation is summarised below:

Asset Class	Target (%)	Range (%)
NZ Fixed Income and Cash	15	± 5
Global Fixed Income	20	± 5
Total fixed income	***35***	***± 10***
NZ Equities	10	± 5
Other Developed Markets Equities	40	± 5
Emerging Market Equities	10	± 5
Global Property	5	± 5
Total growth	***65***	***± 10***
Total	**100%**	

Foreign currency hedging

Asset Class	Target hedging ratio (%)	Range (%)
Global Fixed Income	100	..
Developed Markets Equities	75	± 10
Emerging Market Equities	0	..
Global Property	100	..

Time Horizon

The investment guidelines are based upon an investment horizon of at least 10 years. A time horizon at least this long is required for the strategy because financial markets are volatile and can take many years to recover from a major downturn.

Should circumstances change such that more significant withdrawals are likely or there is the possibility of a major withdrawal requirement (e.g., greater than 20% of the portfolio), then the policy may be reviewed with a focus on greater liquidity and lower volatility.

Risk Tolerances

The Council recognises that some risk must be assumed in order to achieve the long-term investment objectives, and there are uncertainties and complexities associated with investment markets.

In establishing the risk tolerances for this IPS, the Council's ability to withstand short-term and medium-term variability was discussed and assessed in the context of the whole-of-Council balance sheet.

The Asset Allocation is expected to have the following risk properties:

1. Volatility, measured by standard deviation of returns, of around 10%. This means that most of the time (indicatively, two-thirds of the time) annual portfolio returns would be in the range of 7% ± 10% (ie, –3% to +17%).
2. A negative annual return about once every four years.
3. An annual return worse than –12% about once every twenty years.

Performance Expectations

The Council anticipates the Portfolio will produce a total rate of return by way of income and capital growth around 7.5% p.a. on average over 10 years (before fees and costs).

Investment costs (including portfolio administration, custody and funds management fees) are anticipated to be between 0.35 – 0.50% p.a. The bulk of this is fees paid to the underlying fund managers.

The target rate of return has been based upon the assumption that future real returns will approximate the long-term rates of return experienced for each asset class in the IPS. The Committee realises market performance varies and so the above expectation may not be meaningful during some periods.

Rebalancing the portfolio

Rebalancing the portfolio back to the Asset Allocation can add significant value because it is a systematic way of selling asset classes that become more expensive (and become a bigger part of the portfolio) and buying asset classes that have become cheaper (and have shrunk as a share of the portfolio).

Rebalancing should occur frequently, subject to the trade-off between transaction costs (for example, brokerage and bid-ask spreads) versus being away from the target asset allocation. Rebalancing decisions should be based on how far away from target the portfolio weights are but should be considered at least quarterly.

The percentage allocation to cash, bonds and equities may vary within the range limits as indicated in the asset allocation table.

Leverage

Neither the Resilience Fund nor the Growth Fund can borrow or otherwise leverage the investments of the Fund. The Council may choose to borrow money in order to establish the Funds, but Council borrowing should be regarded as a separate decision that is part of its overall balance sheet or Asset and Liability management.

Responsible investment

The Council believes that responsible investors must take account of environmental, social and governance (ESG) factors because this should lead to better long-term returns.

By managing ESG risks and adhering to high standards of corporate behaviour, the Council expects that the portfolio performance will be higher over the long term, with less downside risk.

The Council's benchmark for responsible corporate behaviour is the United Nations Global Compact. It supports the six Principles of Responsible Investment developed by the UNPRI. These principles are regarded as the industry benchmark for how to integrate Responsible Investing into all aspects of the portfolio.

In New Zealand, the Council supports the best practice guidelines developed by the NZ Corporate Governance Forum. It expects their local investment managers to actively try to improve corporate governance standards in New Zealand companies. Investment managers are selected with consideration given to their responsible investment policies and capabilities.

All of the Fund's investment managers should have a responsible investing policy and a set of procedures appropriate to their asset class and investment strategy. They must ensure that ESG factors are properly integrated into their investment process and must report on their Responsible Investment activities.

All investment managers must actively vote their shares in line with principles of good corporate governance. They may use their own voting guidelines or those of a reputable proxy voting service.

The Council represents a diverse community that has a wide range of views on ethical questions. As such, it does not think it is appropriate for Council to impose their own personal ethical views on the portfolio. With that said, the Council will endeavour not to invest directly in anything that is widely regarded as abhorrent by the vast majority of the Kāpiti community.

It is necessary for the Funds to use pooled funds and passive index products in order to invest in an efficient and low-cost way and ensure the portfolio is well diversified. In doing so the Council recognises that they have no influence on the securities held in those funds or index products, and so may own shares in companies or activities that some people may not approve of. Generally, these positions will be a very small fraction of the portfolio. The Council acknowledges that regrettably there is often no cost-effective way of excluding these companies from the investment universe. However it will continuously seek cost-effective investment options that minimise the risk of investing in companies that do not meet its Responsible Investing standards.

Asset Class Guidelines

The Council believes that long-term investment performance is primarily driven by the asset class mix.

History shows that while interest-generating investments, such as bond portfolios, have the advantage of relative stability of principal value, they provide little opportunity for real long-term capital growth due to their susceptibility to inflation. On the other hand, equity investments, such as common stocks, clearly have a significantly higher expected return but have the disadvantage of much greater year-by-year variability of return. From an investment decision-making point of view, this year-by-year variability is judged to be worth accepting, provided the time horizon for the equity portion of the portfolio is sufficiently long (ten years or greater).

The performance expectations (both risk and return) of each asset class are contained in Appendix III. The following asset classes were selected:

Cash
New Zealand Fixed Interest
Global Fixed Interest
New Zealand Equities
International Equities
Listed Real Estate

Each of these asset classes may be made up of sub-asset-classes. For example, International Equities may be split into Developed Market and Emerging Market Equities; or into Large-Cap, Small-Cap or Value stocks.

The Committee has considered alternative assets such as Hedge Funds, Private Equity Funds, Unlisted Real Estate and Unlisted Infrastructure. It has decided to exclude these at the present time because they usually do not match the required investment style of being low-cost, liquid and simple.

As the Portfolio gains scale, the requirement for simplicity and liquidity may alter.

Direct, Strategic Investments

The Growth Fund may invest up to half its capital in direct Strategic Investments that contribute to the growth of the Kāpiti District.

The Council recognises that direct investments are considerably more complex to select, manage and undertake due diligence on. As such, the review and governance procedures need to be stronger than for out-sourced managed funds.

Direct investments also expose the Council to greater single-asset concentration risk. As such, it will seek to build a portfolio of Strategic Investments over time and avoid excessive investment in a single business.

Strategic Investments will be subject to the following:

1. A maximum investment of 33% of the Growth Fund (financial and Strategic assets combined).
2. The Committee will maintain a direct investments sub-policy that includes a due diligence checklist.
3. Where the rate of return of a Strategic Investment on a stand-alone basis is expected to fall short of a normal commercial return for that type of business but is nevertheless deemed worth investing in because of the spillover or externality benefits for the District, then the Committee will clearly define the required commercial return of the business (e.g., to break even) so that all parties have clarity on what level of under-performance is regarded as acceptable.
4. The required return of a Strategic Investment should also take into account (a) the concentration risk that the Council becomes exposed to; (b) the rate of return that could be achieved with listed market alternatives; and (c) the greater return required for investments that are not liquid.

5. Where Council is a material investor in a business (20% or more of equity) then it will ensure it has appropriate governance in relation to that business, including a shareholders' agreement and where possible representation on the Board of that business. Council will delegate governance and management of such assets where it does not have the required experience or expertise in house.
6. They must be approved by Council.

Portfolio Responsibilities

The Council

As Fiduciary the primary responsibility of the Council is to set the Underlying Purpose of the Funds.

The Council can delegate implementation of the investment process, but as Fiduciary it is responsible for ensuring that the processes are appropriately:

a) organised;
b) formalised;
c) implemented; and
d) monitored.

The Operations and Finance Committee

The primary responsibilities of the operations and Finance Committee are to

- Determine the overall risk level or tolerance.
- Agree and approve this Investment Policy Statement.
- Monitor and supervise KCDC Officers and ensure appropriate oversight and governance of all service providers.
- Manage conflicts of interest.
- Assess and approve Strategic Investments for the Growth Fund.
- Review performance and other reporting documents.

KCDC Officers

- Prepare and maintain this Investment Policy Statement.
- Prudently diversify the Portfolio's assets to meet the agreed upon risk/return profile.
- Prudently select investment options, including managers and funds, consistent with this IPS.

- Control and account for all investment and administrative expenses associated with the Portfolio.
- Monitor and supervise all service providers and investment options.
- Comply with the conditions of the Constitutional documents.

Fiduciary Consultant

The Council has retained MyFiduciary, an independent investment fiduciary, as an objective third-party to assist in managing the overall investment process.

Responsibilities include:

- Guiding Council through a disciplined and rigorous investment process to enable them to meet their fiduciary responsibilities
- Investment governance training
- Developing and reviewing investment policies
- Portfolio design and asset allocation advice
- Due diligence of providers, including Portfolio Administrators, fund managers and custodians
- Performance monitoring and reporting.

Portfolio Administration

The portfolio administrator will implement the portfolios according to the parameters set in this investment policy.

Their responsibilities include:

- Executing the portfolios, e.g. providing instructions to the Custodian to allocate cash to the external fund managers in line with this Investment Policy Statement.
- Re-balance the portfolio back to target weights when necessary.
- Report any administrative issues to the Fiduciary Consultant.
- Manage regulatory compliance.

Fund Managers

Fund managers are responsible for making investment decisions (security selection and price decisions) on a discretionary basis according to the parameters governing the funds that they operate.

The specific duties and responsibilities of each investment manager include:

1. Manage the assets under their supervision in accordance with the guidelines and objectives outlined in their respective Service Agreements, Prospectus or Trust Agreement.

2. Exercise full investment discretion with regards to buying, managing, and selling securities in their funds.
3. Communicate to the Fiduciary Consultant and the Committee all significant changes pertaining to the fund it manages or the firm itself. These include changes in ownership, organisational structure, financial condition, and professional staff.
4. Effect all transactions subject to best price and execution.
5. Use the same care, skill, prudence, and due diligence under the circumstances then prevailing that experienced investment professionals acting in a like capacity and fully familiar with such matters would use in accordance and compliance with, and all applicable laws, rules, and regulations.

Custodial Services

Fund assets are held in safe keeping by a Custodian, and are held in the name of the Council. The Custodian should:

- Maintain separate accounts (where applicable)
- Value the holdings
- Collect all income and dividends owed to the Portfolio
- Settle all transactions (buy-sell orders) initiated by the Portfolio Administrator or Investment Manager
- Provide reports as required that detail transactions, cash flows, securities held and their current value, and change in value of each security and the overall Portfolio since the previous report.

Summary of responsibilities

Governance Components	Activities	Council	OFC	KCDC Staff	Fiduciary consultant	Portfolio admin and fund managers	Custodian
Strategic objectives	Develop and approve objectives for funds	✓		✓			
IPS development approve and review	Preparation of Investment Policy Statement (IPS) Approve the IPS including risk tolerance		 ✓		✓ 		
Asset allocation, diversification	Establish asset allocation including all investment guidelines and metrics			✓	✓		
Implementation due diligence	Assess investment managers or service providers Evaluation of recommendations			 ✓	✓ ✓		
Implementation	Approve contracts and transition assets			✓	✓	✓	✓
Performance reporting	Quarterly reports, total returns, manager performance, attribution				✓	✓	✓
Rebalancing assets	Maintaining specific policy ranges			✓	✓		
Fund Manager and cost reviews	Quantitative and qualitative reviews of fund managers or service providers				✓		
Annual assessment	Assessment of governance effectiveness		✓		✓		

Withdrawals

Withdrawals may be made from each Fund as long as they are consistent with the underlying purpose of the Fund. Withdrawals may also be made to cover the interest costs of any debt that the Council may have raised to establish the Fund.

The maximum amount that can be withdrawn is based on an approach that follows best industry practice and which is sustainable over the long term. In this context sustainable means a rule that gives a good probability that the Fund's Investment Portfolio Objectives can be achieved over the long term, including maintaining the nominal value of the asset base.

The maximum annual withdrawal is to be based on the following formula:

$$W_t = 0.8 \times W_{t-1} + 0.2 \times (6.5\%) \times V_t$$

(this year's withdrawal) = *(80% of last year's withdrawal)* + *(20% of the long-term sustainable rate, which is 6.5% of the value of the Fund)*

where

W_t is the maximum withdrawal in year t, as a percentage of the Fund's assets;
W_{t-1} is the previous year's maximum withdrawal (in percentage terms);
V_t is the value of the Fund assets at the start of year *t*;

This rule means that the annual release will average approximately 6.5% of Fund value over time. The 80% weight on the previous year's withdrawal provides a smoothing mechanism to ensure that withdrawals are relatively stable, and in particular that withdrawals do not over-react to temporary good years or bad years.

The sustainable withdrawal rate includes the amount required to cover interest on Council borrowings that may have been used to establish the Funds. It is based on a 3% cost of borrowing over the long term plus a 3.5% target annual surplus.

The Committee may choose to withdraw less than the maximum amount, and hold his back for withdrawal at a later date (in addition to the maximum withdrawal calculated for that future year).

Fund Manager Due Diligence

The Committee and the Fiduciary Consultant will use the following due diligence guidelines in selecting each investment manager or fund, or in monitoring the selections made by financial advisers. Where a specific screen is not met, it indicates additional due diligence may be warranted before proceeding:

1. *Regulatory oversight:* Each investment manager should be a regulated bank, an insurance company, a mutual fund organisation, or a registered financial adviser.
2. *Minimum track record:* The product's inception date should be greater than three years.
3. *Stability of the organisation:* There should be no perceived organisational problems – the same portfolio management team should be in place for at least two years.

4. *Assets under management:* The product should have at least $75 million under management. (Note: to be determined separately for international and Australian and New Zealand asset holdings.)
5. *Holdings consistent with style:* The screened product should have no more than 20% of the portfolio invested in 'unrelated' asset class securities. For example, a Large Growth product should not hold more than 20% in cash or fixed income.
6. *Correlation to style or peer group:* The product should be highly correlated to the asset class of the investment option. This is one of the most critical parts of the analysis since most of the remaining due diligence involves comparisons of the manager to the appropriate peer group.
7. *Expense ratios/fees:* The product's fees should not be in the bottom quartile (most expensive) of their peer group.
8. *Performance relative to assumed risk:* The product's risk-adjusted performance (Alpha and/or Sharpe Ratio) should be evaluated in absolute terms.
9. *Performance relative to a peer group:* The product's performance should be evaluated against the peer group's median manager return, for 1-, 3- and 5-year cumulative periods.

Control Procedures

Performance Objectives

Council is aware the ongoing review and analysis of the investment managers and providers is just as important as the due diligence implemented during the selection process. The performance of the investment managers and providers will be monitored on an ongoing basis and it is at the Committee's discretion to take corrective action by replacing a manager or provider if they deem it appropriate at any time.

On a timely basis, but not less than six monthly, the Committee will meet to review whether each manager or provider continues to conform to the search criteria outlined in the previous section; specifically:

1. The adherence to the Portfolio's investment guidelines;
2. Material changes in the provider's organisation, investment philosophy and/or personnel; and,
3. Any legal or other regulatory agency proceedings affecting the provider.

Performance objectives be established for each asset class. Manager or product performance will be evaluated in terms of an appropriate asset class market index (e.g. the MSCI World index for large-cap international equity funds) and the relevant peer group (e.g. an appropriate large-cap growth fund universe for a large-cap growth fund).

The following may be varied from time to time to ensure appropriateness. Sub-asset class benchmarks should be varied as appropriate (eg, a small-cap benchmark for a small-cap equity manager).

Asset Class	*Benchmark*
Cash	90 Day Bank Bill Index
NZ Fixed Interest	ANZ Corporate Bonds – A Grade NZ
Global Fixed Interest	BarCap Global Aggregate (Hedged NZD)
New Zealand Equities	NZX-50 Portfolio
Australian Equities	S&P/ASX 200
International Equities	MSCI World
Emerging Markets	MSCI Emerging Markets
Property	UBS Global Real Estate (NZD)

A manager (or provider) may be placed on a watch list and a thorough review and analysis of the provider may be conducted, when:

- A manager performs below median for their peer group over a 1-, 3- and/or 5-year cumulative period.
- A manager's 3-year risk adjusted return (Alpha and/or Sharpe) falls below the peer group's median risk adjusted return.
- There is a change in the professionals managing the portfolio.
- There is a significant decrease in the product's assets.
- There is an indication the manager is deviating from his/her stated style and/or strategy.
- There is an increase in the product's fees and expenses.
- Any extraordinary event occurs that may interfere with the manager's ability to fulfil their role in the future.

An evaluation may include the following steps:

1. A letter to the manager (or provider) asking for an analysis of their underperformance.
2. An analysis of recent transactions, holdings and portfolio characteristics to determine the cause for underperformance or to check for a change in style.
3. A meeting with the manager (or provider), which may be conducted on-site, to gain insight into organisational changes and any changes in strategy or discipline.

The decision to retain or terminate a manager (or provider) cannot be made by a formula. It is the Council's confidence in the provider's ability to perform in the future that ultimately determines retention.

Measuring Costs

The Committee will review at least annually all costs associated with the management of the Portfolio investment program, including:

- Any investment provider fees.
- Expense ratios of each investment option against the appropriate peer group.
- Custody fees: The holding of the assets, collection of the income and disbursement of payments.

Investment Governance Review

The Committee will review this Investment Policy Statement at least annually to determine whether stated investment objectives are still relevant and the continued feasibility of achieving the same. It is not expected that the IPS will change frequently.

Council will implement procedures to ensure that the fiduciary framework for managing the assets is working effectively. The *Fi360 Prudent Practices* may be used as the benchmark for establishing and reviewing the governance framework.

Internal and external reviews are well-recognised tools to evaluate risks and ensure the effectiveness of policies and procedures. Furthermore, the trend in international best practice is toward more formality in documenting (1) policies and procedures and (2) implementing processes that ensure the policies and procedures are effective.

A periodic (annual) review of the governance practices will be undertaken to confirm effectiveness of governance and to identify any opportunities for improvement. This is consistent with governance best practice.

All governance reviews will be provided to the Council for information.

Approved:

________________ ________________ ________________

Date:

Appendix I – Amendment History

Version	Changes	Approval date
1.0	First draft	[date]

Appendix II – Service Providers

[To be filled in when providers are selected]

Provider Role Names	**Discretion**	**Co-Fiduciary[(1)]**	**Asset classes**
Fiduciary consultant MyFiduciary	n/a	Yes	Overall portfolio
Portfolio Administration XYZ	Yes, subject to this IPS	Yes	
Fund Managers	Yes, subject to fund managers investment policies.	Yes	Cash NZ Fixed Interest Global Fixed Interest NZ Equities Developed Markets Equities Emerging Markets Equities Property Trusts
Custodian: [TBC]	No	No	As above

(1) 'Co-fiduciary' is used to signify that the provider has formally acknowledged a fiduciary role in their service agreement.

Notes:
The column marked 'Discretion' relates to the provider role being one where they make security decisions (Yes), versus requiring trustees or directors to make all decisions based on recommendations and information provided (No).

Where there is discretion, fiduciary acknowledgment in the provider service agreement should ideally be obtained. This is noted in the column as a 'co-fiduciary' acknowledgment.

If marked 'No', this increases the fiduciary responsibilities of trustees or directors in terms of either;

- *properly evaluating the specific investments being recommended, or*
- *periodically undertaking a detailed assessment of the processes leading to recommendations that are accepted.*

- MyFiduciary provides governance support; policy development; provider due diligence and monitoring support, but does not manage securities or provide investment products
- Custodians are generally not acting with discretion.

Appendix III – Risk and Return Assumptions

Asset Class	*Expected Return % pa*	*Standard deviation % pa*	*Benchmark*
Cash	3.7	1.5	90 Day Bank Bill Index
NZ Fixed Interest	4.1	5	ANZ Corporate Bonds – A Grade NZ
Global Fixed Interest	4.1	4	BarCap Global Aggregate (hedged NZD)
New Zealand Equities	6.4	16	NZX 50 Index
Developed Market Equities	6.6	15	MSCI World Index
Emerging Market Equities	8.4	24	MSCI EM Index
Global real estate	6.6	14	FTSE/NAREIT Index

Expected returns are annual geometric returns over a ten-year time horizon, hedged to NZD, before manager fees.

Appendix IV – Glossary

Alpha
The statistical measure of a portfolio's return in excess of the market return adjusted for risk. It is a measure of the manager's contribution to performance with reference to security selection.

Basis Point
1.00% = 100 Basis Points

Beta
The statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security in comparison to a market index. The beta value measures the expected change in return per one percent change in the return on the market. Thus, a portfolio with a beta of 1.1 would move 10% more than the market.

Board Room Risk
The risk that trustees will not ride out short-term volatility (and therefore alter a sound long-term strategy) due to pressure put on them in their role as trustees.

Correlation Coefficient
Correlation measures the degree to which two variables are associated. Correlation is a commonly used tool for constructing a well-diversified portfolio. Traditionally, equities and fixed-income asset returns have not moved closely together. The asset returns are not strongly correlated. A balanced fund with equities and fixed-income assets represents a diversified portfolio that attempts to take advantage of the low correlation between the two asset classes.

Dollar-weighted Rate of Return
Method of performance measurement that calculates returns based on the cash flows of a security or portfolio. This return is also referred to as the internal rate of return (IRR).

Duration
A measure of the average maturity of the stream of interest payments of a bond. The value of a given bond is more sensitive to interest rate changes as duration increases, i.e. longer duration bonds have greater interest rate volatility than shorter duration bonds. Duration is always shorter than maturity except for zero coupon bonds.

Emerging Markets
Managers who primarily concentrate on investments in newly emerging second and third world countries in the regions of the Far East, Africa, Europe, and Central and South America. These portfolios are characterized by aggressive risk/return profiles that generate high volatility in search of high returns.

End Point Sensitivity
The performance of a manager/fund may vary depending on which ending time periods are used to analyse performance. Therefore it is important to look at performance for a number of market cycles or time periods to gain an accurate assessment of the manager/fund's performance.

Equilibrium Spending Rate

Specific to foundations and trusts, the 'spending rate' which offsets inflation and additional cost increases.

9.0% - 3.5% - 1.5% = 4.0%
(Return)-(Inflation)-(Cost increases)=(Equilibrium Spending Rate)

Exit Strategy
Methodology employed by fund managers to sell or close positions in a particular security. In other words the procedure followed to reduce or eliminate the exposure to a particular security when the fund manager has determined that the security has added a maximum value to the portfolio.

Fiduciary
Indicates the relationship of trust and confidence where one person (the fiduciary) holds or controls property for the benefit of another person. For example, the relationship between a trustee and the beneficiaries of the trust.

Any person who (1) exercises any discretionary authority or control over the management of a plan or the management or disposition of its assets, (2) renders investment advice for a fee or other compensation with respect to the funds or property of a plan, or has the authority to do so, or (3) has any discretionary authority or responsibility in the administration of a plan.

Geometric Return
A method of calculating returns which links portfolio results on a quarterly or monthly basis. Suppose a $100 portfolio returned +25% in the first quarter (ending value is $125) but lost 20% in the second quarter (ending value is $100). Over the two quarters the return was 0% - this is the geometric return. However, the Arithmetic Return calculation would simply average the two returns: (+25%)(.5) + (-20%)(.5) = +2.5%.

Asset Class
All stocks that behave in the same way within the market are put into one group called an asset class. In this way a number of asset classes have been defined such as International Value Stocks, Australasian Large Cap Stocks, Emerging Markets, etc.

Market Capitalisation
A common stock's current price multiplied by the number of shares outstanding. It is the measure of a company's total value on a stock exchange.

Market Timing
A form of Active Management that moves funds between asset classes based on short-term expectations of movements in the capital markets. (Not recommended as a prudent process.) It is very difficult to improve investment performance by attempting to forecast market peaks and troughs.

Modern Portfolio Theory (MPT)
Essential to portfolio theory is the relationship between risk and return and the assumption that investors must be compensated for assuming risk. This portfolio approach shifts emphasis from analysing the characteristics of individual investments to determining the statistical relationships among the individual securities that comprise the overall portfolio.

Quality Rating

The rank assigned a security by rating services such as Moody's and Standard & Poor's. The rating may be determined by such factors as: (1) the likelihood of fulfilment of dividend, income, and principal payment obligations, (2) the nature and provisions of the issue, and (3) the security's relative position in the event of liquidation of the company. Bonds assigned the top four grades (AAA, AA, A, and BBB) are considered 'Investment Grade' because they are eligible bank investments as determined by the Comptroller of the Currency.

Risk-Free Rate of Return

The return on a 90-day Government bills. This is used as a proxy for no risk due to its Government issuance and short-term maturity. The term is really a misnomer since nothing is free of risk. It is utilized since certain economic models require a "risk-free" point of departure. See Sharpe Ratio.

R-squared (R^2)

Formally called the coefficient of determination, this statistic measures the overall strength or 'explanatory power' of a statistical relationship. In general, a higher R^2 means a stronger statistical relationship between the variables that have been estimated, and therefore more confidence in using the estimation for decision-making.

Security

A financial instrument that represents: an ownership position in a publicly-traded corporation (stock), a creditor relationship with governmental body or a corporation (bond), or rights to ownership as represented by an option.

Sharpe Ratio

Statistical measure of risk-adjusted return. It is calculated by subtracting the Risk-Free Return (usually Government Stock) from the portfolio return, then dividing the resulting 'excess return' by the portfolio's total risk level (standard deviation). The result is a measure of return gained per unit of total risk taken. The Sharpe Ratio can be used to compare the relative performance of managers. If two managers have the same level of risk but different levels of excess return, the manager with the higher Sharpe Ratio would be preferable.

Short-Term Fixed Income

Fixed income funds of investment grade securities that have a duration of more than 1 but less than 3.5 years or an average effective maturity of more than 1 but less than 4 years.

Standard Deviation

Statistical measure of portfolio risk. It reflects the average deviation of the observations from their sample mean. Standard Deviation is used as an estimate of risk since it measures the width of the range of returns. The wider the typical range of returns, the higher the standard deviation of returns, and the higher the portfolio's risk. If returns are normally distributed (i.e. have a bell-shaped curve distribution), then approximately 2/3 of the returns would occur within plus or minus one Standard Deviation from the sample mean.

Systematic Risk

Attributable to common macroeconomic factors and sometimes referred to as market risk. Systematic Risk is the part of a security's total risk that is related to movements in the market portfolio and therefore cannot be diversified away.

Time-Weighted Rate of Return
Method of performance measurement that strips the effect of cash flows on investment performance by calculating sub period returns before and after a cash flow and averaging these sub period returns. Time-weighted performance removes the impact of cash flows and as a result is widely accepted as the appropriate method of comparison for investment managers and market index returns.

Unsystematic Risk
A risk pertaining to one element in a large environment or system. The risk of one stock is unsystematic, while the risk of the entire market of which it is an element is systematic. See Systematic Risk.