OTAGO
Community Trust

# STATEMENT OF INVESTMENT POLICY AND OBJECTIVES – DECEMBER 2020

## 1. Introduction

This Statement of Investment Policy and Objectives (the "**SIPO**") prepared by the Trustees (the "**Trustees**") of the Otago Community Trust (the "**Trust**") sets out the assumptions, objectives and policies governing decisions about investments of the Trust's assets.

This SIPO takes account of the requirements of:

- The Trust Deed;
- The Trustee Act 1956; and
- The Community Trusts Act 1999.

## 2. Background of the Trust

The Trust's investment portfolio (the "**Fund**") began in its current form following the public listing of Trust Bank in 1994, when around $63m was generated by the sale of 30m shares at $2.10 per share. The base capital of the Fund was formally established at $63m in December 1994 and then increased to $131.4m in June 1996 when the remaining shareholding (24m shares) in Trust Bank was sold.

This original base capital of $131.4m has been adjusted for inflation in the subsequent years. The inflation-adjusted original capital of the Fund as of 30 September 2020 was $218.5m.

## 3. Investment assumptions

The Trust has an established set of investment assumptions that guide its investment of the Trust's assets:

- The strategic asset allocation is the key investment decision as this will have the greatest impact on the Trust's financial outcomes.
- By investing in a portfolio of efficiently diversified financial assets, the Trust is able to achieve returns over the long term that are in excess of the return on cash.
- Higher levels of return are typically associated with higher levels of risk. For instance, equities are expected to outperform bonds in the long term but are likely to be more volatile in the short term. Similarly bonds are expected to outperform cash but exhibit greater volatility.
- Departures from the strategic asset allocation, including the foreign currency exposure, can add significant risk relative to the policy portfolio. Such departures should only be contemplated where confidence in success is commensurate with the risk involved, and there is an appropriate decision making structure in place.
- Markets are highly competitive but not always perfectly efficient. Therefore, the identification and subsequent selection of active managers with genuine skill, while challenging, can add value.
- Diversification across securities, asset classes and investment managers, has the potential to improve the risk/return trade-off.

## 4. Investment objectives and policies

The investment objectives of the Trust are:

- To optimise the total amount of distributions which can be financed by the investment of the Fund over the long term; and
- To preserve the real value of capital; and

- To maintain equity between present and future generations with respect to the amounts available for distribution; and
- To maintain the highest degree of stability of investment earnings that is possible consistent with the preceding objectives.

In addition to meeting these goals, investment policy must also meet the following criteria:

- Investment risk must be minimised for the expected level of return;
- The Fund must be well diversified across various asset classes, across countries, and across individual investments within each asset class;
- An appropriate level of liquidity must be maintained;
- Be sufficiently flexible to accommodate future changes in the Trust's requirements and/or the investment environment;
- Purely speculative investments must be avoided;
- Trustee legal responsibilities must be satisfied;
- Without compromising the long-term return outcomes of the Fund, Trustees should be conscious of the principles of responsible investing as detailed in the Trust's Responsible Investment Policy, and apply those principles as they consider appropriate;
- Investment returns should, from time to time, be considered net of fees and other costs. Costs can be direct or indirect and may include implementation delays, transaction costs, fees, commissions, market impact costs and taxes;
- The Fund's investment returns should, from time to time, be considered relative to the agreed outperformance and tracking error targets.

## 5. Risk

The Trustees regard 'risk' as the likelihood that the Trust fails to achieve the objectives set out in Section 4 above. To mitigate this risk, the Trustees have adopted a series of strategies to manage investment and related risks. The strategies include, apart from those in Section 4:

- Retaining an appropriately resourced and qualified implemented consultant for:
  - I. Strategic investment advice, and
  - II. Fund implementation, incorporating:
    - Investment manager selection
    - Operational due diligence of investment managers
    - Rebalancing transactions as required in accordance with the Trust's rebalancing policy
- Prohibiting leverage of the Trust's assets;
- Maintaining adequate reserves (see Section 6 below);
- Periodically reviewing the Trust's investment objectives;
- Regularly reviewing investment performance.

## 6. Reserving policy

The Trustees have adopted a formal reserving and grants policy. The reserving policy is a key risk management tool to aid the fulfilment of the Trust's objectives.

For this purpose, the value of independently managed funds plus self managed funds less all approved but unpaid amounts to grantees or for special initiatives ("**Available Funds**") is determined monthly. Its adequacy to pay for grants and expenses can then be measured. Adequacy is determined with reference to the reserving bands within which the value of Available Funds falls.

Reserving bands shall be as follows:

Band 1 The Fund has sufficient reserves to ensure continuation of safety of capital.

Band 2 The Fund has a normal level of reserves.

Band 3 The Fund has insufficient reserves.

Band 4 The Fund has fallen below the level of the inflation-adjusted amount of the original capital.

While the value of Available Funds remains within Band 2, normal grants may continue. Where the value moves to Band 1, 3 or 4 action may be required by Trustees including, adjustment of the level of grants or review of asset allocations. Either or both of these options would be designed to restore Available Funds to within Band 2.

The level of the reserving bands referred to above will be determined by the Board from time to time having regard to the Fund's risk and return characteristics. Based on the adopted strategic asset allocation (see Section 7) and current economic assumptions:

- The lower bound of Band 2 equals the value of the original capital plus inflation (as measured by the CPI) plus a factor determined such that the probability (assuming that returns are normally distributed) of falling from this level to real capital in one year's time is approximately 1 in 50.
- The upper bound of Band 2 equals the value of the original capital plus inflation (as measured by the CPI) plus a factor determined such that the probability of falling from this level to the lower bound of Band 2 in one year's time is approximately 1 in 150.

For accounting purposes a capital maintenance reserve is established and maintained which preserves the real value of the initial capital allowing for inflation as measured by the Consumers Price Index (CPI). The total amount of capital and capital maintenance reserve when deflated by the CPI will equal the original capital.

## 7. Asset allocation strategy

The Trustees are responsible for the asset allocation strategy decision which is made after considering the advice of the Trust's implemented consultant. The current strategic asset allocation (see Table 1) was agreed by the Trustees in August 2020.

**Table 1: Strategic asset allocation**

| Asset Class | Current Strategy |
|---|---|
| NZ Equities | 7% |
| Overseas Equities - hedged | 19% |
| Overseas Equities - unhedged | 19% |
| **Total Growth** | **45%** |
| Overseas Fixed Interest | 43% |
| NZ Fixed Interest | 9% |
| Cash | 3% |
| **Total Income** | **55%** |
| **Total** | **100%** |

The strategic asset allocation has the following long-term return and risk characteristics:

**Table 2: Portfolio characteristics (over 10 years)**

| | |
|---|---|
| Expected nominal return per annum | 3.9% |
| - inflation assumption | - 1.7% |
| + value from active management (net of fees) | + 0.4% |
| = Target drawdown rate to fund grant and overheads | = 2.6% |
| Nominal volatility (standard deviation of return) | 7.3% |
| Probability of a negative real return in any year | 1 in 3 years |

It is the Trustees' policy to review the strategic allocation at least every three years. If there is a significant change in the capital markets or in the circumstances of the Trust a more frequent review may be conducted. The next triennial investment strategy review is scheduled for 2023.

The investment strategy review examines the likelihood that different possible asset allocations will meet the Trust's objectives.

## 8. Currency policy

The Trustees have adopted a policy of fully hedging foreign currency exposures of offshore fixed interest and applying a 50% hedge ratio to global equity exposure. Foreign currency exposure is not actively managed at a strategic level. However, at an asset class level, both market movements and, where applicable, active positions taken by the underlying investment managers can result in currency exposures which vary from the strategic position.

## 9. Rebalancing policy

It is recognised that, as a result of market movements and cash flows, the Trust's asset allocation will deviate from the strategic policy. The Trustees have set rebalancing ranges so that the strategic asset allocation will be broadly maintained but without incurring excessive transaction costs. The implemented consultant will monitor the Fund on a monthly basis and, in the event of a breach of these ranges, undertake the necessary transactions to bring the breached exposure(s) to approximately the mid-point between the range limit(s) and policy weight(s). Prior to any rebalancing transaction, the implemented consultant will liaise with the Trust, ensuring that any transaction is coordinated with expected redemptions.

Redemptions made from the Fund to finance the Trust's normal operating activities will be used by the implemented consultant to minimise, to the extent possible, the probability of breaches occurring.

**Table 3: Rebalancing ranges**

| Asset class | Current strategy | Rebalancing ranges |
|---|---|---|
| NZ equities | 7% | ±2% |
| Overseas equities - hedged | 19% | ±2% |
| Overseas equities - unhedged | 19% | ±2% |
| **Total growth** | **45%** | **±3%** |

| | | |
|---|---|---|
| Overseas fixed interest | 53% | ±3% |
| NZ fixed interest | 9% | ±2% |
| Cash | 3% | ±3% |
| **Total income** | **65%** | **±3%** |

## 10. Investment management structure

The Trustees employ an active approach to investing the Fund. Active management provides the expectation of a higher return but also results in higher management fees. The Trustees expect that the added value from active management will outweigh the higher costs. The additional return from active management is uncertain and at times may not occur.

## 11. Performance measurement & reporting

The Trust's investment consultant measures the returns of the Trust and provides the Trustees with monthly summary reporting and quarterly comprehensive reporting.

The returns of the Trust's assets are monitored by the Trustees and compared with that of the strategic asset allocation specified in Section 7 above.

The performance of each of the Trust's managers will be monitored on a quarterly basis against an appropriate benchmark. The Trustees understand that, in the short term, the Fund may under-perform the benchmark. A greater emphasis will be placed on the longer-term (at least three years) performance of the Fund.

## 12. Implemented consultant

The Trustees retain an implemented consultant, which is currently Russell Investments. The services provided by the implemented consultant under the Implemented Consulting Agreement dated 14 March 2017 include implementation services in relation to investing and rebalancing the Fund and advisory services in relation to:

- setting and reviewing investment objectives
- reviewing asset allocations
- making the Trust aware of any relevant investment ideas and products that may be of interest;
- reviewing the performance of the Fund
- providing access to the implemented consultant's research and investment knowledge
- attending meetings with the Trustees, as required, and
- providing general investment advice, as requested

The Trustees shall assess the performance of the implemented consultant on an annual basis and also undertake a formal review once every three years or sooner should circumstances deem it necessary. Such assessments will also compare the investment performance of the portfolio for which the implemented consultant has delegated authority against agreed-upon risk and return objectives. The qualitative and quantitative measures against which the implemented consultant will be assessed are detailed in the Appendix.

## 13. Activities and responsibilities

### Governance - Trustees

- Setting and reviewing investment objectives and policies
- Setting and reviewing on a regular basis a set of investment assumptions

- Setting and reviewing on a regular basis the Trust's reserving policy
- Setting and reviewing on a regular basis asset allocation strategy
- Developing and reviewing on a regular basis asset class strategies
- Selecting and reviewing on a regular basis the implemented consultant
- Setting and reviewing on a regular basis the rebalancing policy
- Determining and reviewing on a regular basis currency hedging levels
- Ensuring processes exist to receive and review the internal controls reports of the investment managers and their respective custodians, where applicable

**Management - CEO**

- Providing performance reports to the Board
- Arranging redemptions to meet the Trust's commitment to grants and expenses
- Developing and implementing the annual investment workplan
- Liaising with the implemented consultant in relation to day-to-day investment matters and the overall performance of the Fund
- Ensuring appropriate documentation of Trustee decisions

## 14. Date for next review of the SIPO

The Trustees intend to review the SIPO annually. It may also be reviewed if there is a significant change in either the Trust's circumstances or the investment environment.

## Appendix: Measures for assessing the Implemented Consultant

Key **qualitative** measures by which the Trust will assess the Implemented Consultant:

(a) Attendance and contribution to regular meetings, including timely supply of materials prior to, and engagement with material during, meetings.

(b) Responsiveness to ad hoc queries.

(c) Maintaining the portfolio in accordance with all aspects of the SIPO, including efficient implementation of rebalancing trades and timely implementation of redemption trades as requested by the Trust.

(d) Quality of general investment consulting advice and recommendations to the Trust in relation to:
- its Statement of Investment Policy and Objectives;
- its strategic asset allocation; and
- its Income Reserving Policy and its Granting Policy.

(e) Provision of reporting in line with agreed time frames.

(f) Relevance and quality of general education and training on investment matters.

(g) Proactive provision to the Trust of new information relevant to its investment programme, including but not limited to such things as new products, strategies or implementation efficiencies.

The key **quantitative** measure by which the Trust will assess the Implemented Consultant is outperformance of the relevant index of 0.90 per cent per annum over rolling 3-year periods.