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The Honourable the Speaker
Legislative Assembly
Parliament House
Melbourne, Vic. 3002

Sir

Under the provisions of section 48A of the *Audit Act* 1958, 1 transmit the Auditor-General's Special Report No. 26 on Investment Management.

Yours faithfully

C.A. BARAGWANATH
Auditor-General

PREVIOUS SPECIAL REPORTS
OF THE AUDITOR - GENERAL

Report No.	*Title*	Dafe *issued*
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2	· Works Contracts Overview - Second Report	June 1983
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FOREWORD

In past years, I have presented a number of Reports to the Parliament addressing the management of various forms of public sector assets. This Report continues the theme by examining the management of investments held by Victorian public sector agencies, an area involving assets valued in excess of $13 billion.

One of the pleasing aspects of the audit examination was the Identification of marked improvements made in public sector Investment management practice since the 1984 review undertaken by the former Economic and Budget Review Committee. In comparison with the poor performance and management practices identified at that time, the returns of many public sector Investing agencies in recent years have been In line with, or above those achieved by, private sector fund managers.

It is important that the agencies covered by the review, in particular the various public sector superannuation schemes which, irrespective of investment performance, provide members with a defined *or* guaranteed benefit, continue to generate improved returns.

Poor investment performance has the potential to create a situation where employing agencies or the Government may be required, in future, to supplement the assets of the fund from earnings or consolidated revenues thereby either minimising dividends payable to the State or requiring additional contributions from Victorian taxpayers.

While the Report focuses on management practices within a number of large investing agencies, it is hoped that the sound practices identified In this Report, In addition to the recommendations for further improvement, will serve as a guide to all public sector agencies responsible for managing investments.

CONTENTS

PART 1

Executive Summary

1.1

OVERALL AUDIT CONCLUSION

1.1.1 The value of investments held within the Victorian public sector at 30 June 1993 was well in excess of $13 billion. Sound management of these investments is critical to the successful operation of a number of agencies responsible for portfolios established to fund superannuation payments or Insurance claims and agencies responsible for the management of funds on a trustee basis. Although investment performance does not necessarily affect the benefits paid to members of defined benefit superannuation funds or amounts paid to insurance claimants, performance does impact directly on the level of government funding necessary to enable future liabilities to be met. In view of the substantial funds invested, **even minor variations in the rates of return achieved can have a marked influence on the income generated. For example, an increase of only 1 per cent across all portfolios would result in increased annual income of over $130 million.**

1.1.2 It was evident during the audit that **significant improvement in investment management practices has occurred since the 1984 review undertaken by the former Economic and Budget Review Committee** which disclosed major discrepancies between public sector investment returns and management practices and those applying in the private sector. While significant variations continue to occur between agencies In the returns achieved and, to a lesser extent, the management practices adopted, **most of the large investment portfolios examined have achieved returns in recent years which are comparable with those of private sector fund managers and which are in line with agency objectives.**

1.1.3 The achievements of the Transport Accident Commission, in particular, have been excellent with returns over the past 5 years exceeding many large and medium-sized private sector funds. The Commission has achieved these returns while maintaining a very low risk profile. By way of contrast, the Gas and Fuel Corporation Superannuation Fund has achieved consistently poor performance over the period.

1.1.4 The decline in the property market has been the major factor contributing to the poor returns experienced by some agencies with many agencies recording significant negative returns on property holdings in recent years.

1.1.5 Audit found that appropriate accountability frameworks and risk management strategies have been adopted by each agency including the diversification of portfolios to various asset classes and fund managers together with the establishment of prudential guidelines for the operations of fund managers. However, **from a Statewide perspective, the measurement and monitoring of risks have been substantially ignored.**

Overall audit conclusion *continued*

1.1.6 Although the Department of the Treasury, the central agency responsible for Investment management, has established guidelines which set exposure parameters within which agencies are to operate, significant deficiencies were found In the central information systems and procedures for monitoring the actual investments made by agencies. Consequently, **the Department has not been in a position to quantify the overall risk exposures of the Government or to promptly measure and evaluate the impact on the Government of any major change in government policy or sudden fluctuation in market conditions, such as a fall in interest rates or a collapse of stock markets.**

1.1.7 Scope exists to build on the Investment management mechanisms now in place within agencies. In this regard, attention needs to be given to:

- achieving greater diversification of some portfolios, particularly In the property area;
- strengthening the central Investment monitoring function;
- improving the procedures for monitoring compliance by fund managers with prudential guidelines; and
- streamlining the procedures for the evaluation and approval of fund manager appointments.

1.2

SUMMARY OF MAJOR AUDIT FINDINGS

INVESTMENT RETURNS

Page 25

- Average annual investment returns of agencies over the past 5 years have ranged from a low of 4 per cent to a high of 13.2 per cent.
  Paras 4.14 to 4.17
- Results in the past 5 years indicate that certain agencies which have recently set quantifiable targets linked to movements in the CPI or growth in wages and salaries are in a strong position to achieve the targets set.
  Paras 4.14 to 4.17
- Returns in individual asset classes were in most cases in line with, or slightly below, industry benchmarks and the returns achieved by private sector fund managers.
  Paras 4.31 to 4.65
- Poor returns in the property area have had an adverse effect on the overall returns of some agencies.
  Paras 4.46 to 4.65
- Total property losses, predominantly unrealised, of all agencies examined amounted to approximately $500 million over the 5 years to 30 June 1993.
  Paras 4.47 to 4.49

RISK MANAGEMENT

Page 47

- Agencies examined had generally established appropriate frameworks to manage the risks associated with investments including the diversification of funds between various asset classes and a greater use of specialist fund managers.
  Paras 5.1 to 5.79
- The specific investment management strategies adopted by agencies over the past 5 years have resulted in significant variations between agencies in their risk/return profiles highlighting the need to regularly measure and monitor investment portfolios from this perspective.
  Paras 5.16 to 5.25
- The benefits of return maximisation and risk minimisation which come from diversification have not yet been fully realised by some agencies. in particular, greater diversification is needed within the property area.
  Paras 5.26 to 5.59
- The diversification process has been restricted, in some agencies, by the large number of public sector redundancies which has necessitated the retention of substantial funds in assets that can be readily converted to cash.
  Paras 5.60 to 5.64
- In many agencies, only limited oversight had been exercised of fund managers' compliance with contractual arrangements. There is a need for procedures to be significantly strengthened in this area.
  Paras 5.72 to 5.79

ARRANGEMENTS WITH FUND MANAGERS AND CUSTODIANS Page 71

- The procedures followed by agencies for the selection and appointment of external fund managers were found to be rigorous and comprehensive.

  Paras 6.5 to 6.13

- Delays within the Department of the Treasury in the approval of fund manager appointments and terminations have inhibited the timely implementation of investment strategies and, in at least one instance, have been costly for the relevant agency.

  Paras 6.14 to 6.21

- The establishment of a centralised approved fund manager listing, from which Boards and Trustees can appoint managers, could add to the efficiency of the appointment process.

  Paras 6.22 to 6.25

ACCOUNTABILITY FRAMEWORK Page 81

- In general, agencies have established appropriate investment management monitoring and reporting mechanisms including the establishment of Investment Committees, the engagement of specialist staff supplemented by consultants and extensive internal reporting processes.

  Paras 7.7 to 7.25

- The Department of the Treasury has provided guidance to agencies through the issue of Treasury Guidelines which include parameters for investment management activities.

  Paras 7.26 to 7.31

- In the absence of adequate reporting and monitoring procedures, the Department of the Treasury has not been in a position to effectively undertake its central agency function of scrutinising the operations of agencies in the investment area.

  Paras 7.32 to 7.46

- Procedures have not been established within the Department of the Treasury to review the management of investment risks which are of primary concern to Government.

  Paras 7.32 to 7.46

COST OF INVESTMENT MANAGEMENT	**Page 93**

- Investment management costs amounted to around $44 million in 1992-93, including over $31 million paid to private sector fund managers.

  Paras 8.4 to 8.6

- Investment costs in 1992-93, as a proportion of net investment income, ranged between 0.8 per cent and 5.1 per cent for most agencies. However, the Gas and Fuel Corporation Superannuation Fund performed extremely poorly with costs of $636 000 incurred on a net investment income of only $921 000, a ratio of 69 per cent.

  Paras 8.17 to 8.18

PART 2

Background

INVESTMENTS UNDER MANAGEMENT

2.1 Data is not readily available to accurately quantify the total value of investments in the form of short-term money market deposits, fixed Interest securities, property and equities held within the Victorian public sector. However, audit established that such holdings are well in excess of $13 billion with the majority managed by superannuation, insurance and trustee agencies.

2.2 Table 2A sets out the value of the Investment portfolios held at 30 June 1993 by agencies included in the audit.

TABLE 2A
VALUE OF INVESTMENT PORTFOLIOS, AT 30 JUNE 1993
($ million)

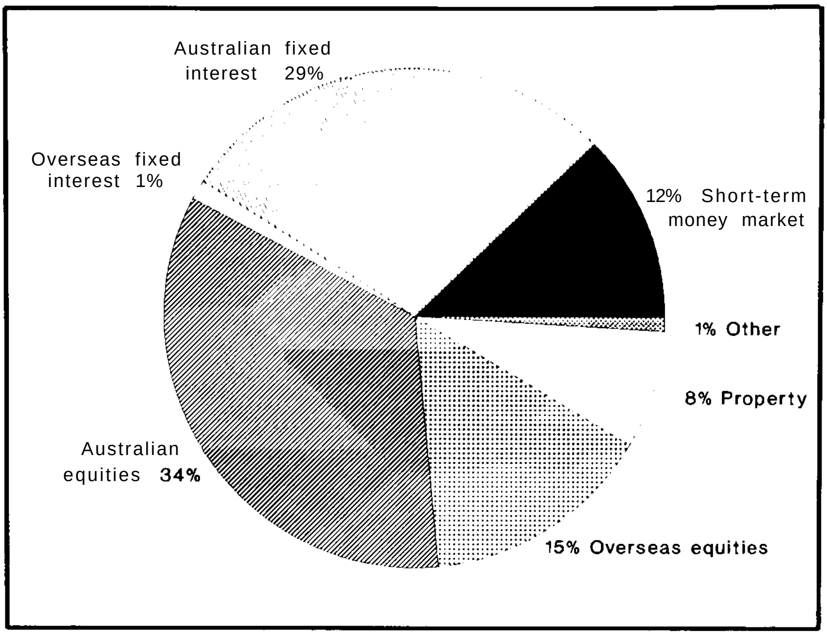
Agency	*Value*
Transport Accident Commission	4 222
Victorian WorkCover Authority	2 165
State Superannuation Board of Victoria	1 754
Local Authorities Superannuation Board	1 370
SEC Superannuation Fund	1 270
Emergency Sen/ices Superannuation Scheme	661
Hospitals Superannuation Board	571
State Trust Corporation *(a)*	301
Gas and Fuel Corporation Superannuation Fund	280
Melbourne Water Corporation Employees' Superannuation Fund	177
Transport Superannuation Board	106
State Employees Retirement Benefits Board	81
Total	**12 958**

(a) Relates to the value of investments held in Common Funds. These Funds represented 56 per cent of the Corporation's total investments of $539 million.

2.3 The net Income received on the above Investment portfolios amounted to approximately $1.4 billion during the year ended 30 June 1993 which is equivalent to an overall return of approximately 11 per cent.

2.4 The composition of the portfolios, by asset class, Is illustrated in Chart 2B.

CHART 2B
COMPOSITION OF INVESTMENT PORTFOLIOS, AT 30 JUNE 1993



2.5 A summary of key Information applicable to each agency Is provided in Table 2C.

INVESTING POWERS

2.6 The enabling legislation of individual agencies generally defines certain powers and responsibilities In relation to investment activity. Prior to 1988, many large agencies were limited to investing in assets defined in the *Trustee Act* 1958, namely, freehold property within Victoria, government fixed Interest securities and mortgages. However, the introduction of the *Borrowing and Investment Powers Act* 1987 significantly increased the range of Investment options available to funds and authorities defined in the Act.

2.7 The Act was introduced following the findings of a review conducted by the former Economic and Budget Review Committee. In Its April 1984 report entitled *A Review of Superannuation in the Victorian Public Sector,* the Committee concluded that:

- The investment performance of Victorian public sector superannuation funds had been so abysmal as to effectively deprive the State of between $575 million and $1.2 billion over the previous 5 years;
- There needed to be greater professionalism in investment decision-making;
- Significant differences existed in the portfolio structures of Victorian public sector funds compared with private sector funds. In many cases, this was due to management practices or legislative restrictions on the investment powers of public sector funds; and
- The average annual investment return achieved by the public sector funds over the Committee's 5 year survey period was 28 per cent less than the average return achieved by some 250 private sector funds.

2.8 The *Borrowing and Investment Powers Act* 1987 was primarily Introduced to provide a consistent framework in which the defined funds and authorities could operate. The Act requires the Treasurer of Victoria to approve the manner In which funds are invested. Approval has been given to each agency to invest In a range of investments on the condition that they comply with *Investment Management Guidelines for Superannuation Funds and Authorities* which were Issued by the Department of the Treasury and are referred to in this Report as the Treasury Guidelines.

2.9 A number of agencies not defined in the Act continue to manage large Investment portfolios within the requirements of their enabling legislation. In the case of agencies responsible for the management of Investments on a trustee basis, such as the State Trust Corporation, authorised investments continue to be those defined in the *Trustee Act* 1958.

MANAGEMENT STRUCTURES

Role of Boards and Trustees

2.10 In most cases, ultimate responsibility for the management of large public sector investment portfolios rests with Boards or Trustees who are required to establish objectives and strategies for investment activities based on the specific nature and objectives of the agency.

2.11 As the portfolios have, in many instances, been established to fund future liabilities such as superannuation payments or insurance claims, successful investment management is critical to the viability of the agencies and to the achievement of their overall organisational objectives. Management needs to be directed towards protecting the asset base while at the same time generating returns which contribute to meeting future entitlements or claims. The projected return on investment portfolios is often a key factor taken into account by such agencies when conducting actuarial assessments of their asset and liability profiles.

2.12 In the case of Investments managed by the State Trust Corporation, objectives are directed to providing a trustee or guardianship service to its clients. In this regard, the primary investment focus is on protecting the assets held and generating regular income to meet the ongoing requirements of individual clients within certain legislative constraints and in accordance with any specific client instructions.

Central agency role

2.13 The investment objectives of the Government, as stated in the Treasury Guidelines, are to ensure that:

- the funds and authorities defined in the Act have access to a wide range of Investment mediums and products;
- Investments are prudently and responsibly managed; and
- maximum advantage is taken of available returns within acceptable risk parameters.

2.14 In the case of defined benefit superannuation schemes, investment performance does not impact on the entitlements of members. However, it is of importance to the Government, particularly where a guarantee is provided, as it affects the level of government funding necessary to enable future liabilities to be met.

2.15 The Department of the Treasury has aimed at achieving a balance between the central control of risk exposures and the decentralisation of transaction decisions to enable the timely implementation of individual Investment strategies by agencies.

2.16 This approach is reflected in the Treasury Guidelines which contain broad parameters for investment management. However, the Guidelines recognise that it is the responsibility of agencies to develop a specific primary investment objective expressed in terms of a target rate of return and acceptable level of risk. The Guidelines indicate that in developing objectives, each agency is to give consideration to the composition of its asset and liability profile, the nature and extent of future Income and outgoings, any relevant tax implications and the preferences of the responsible Board or Trustee and Minister.

TABLE 2C
KEY INVESTMENT INFORMATION RELATING TO EACH AGENCY

Agency	Value of investments at 30 June 1993	Proportion of funds managed externally at 30 June 1993	Net investment income 1992-93	Cost of investment management 1992-93	Overall investment return 1992-93	Average investment return for 5 years to 30 June 1993
	($million)	(per cent)	($million)	($million)	(per cent)	(per cent)
Transport Accident Commission	4 2 2 2	93	479.1	18.1	12.6	13.2
Victorian WorkCover Authority	2 1 6 5	94	271.7	6.2	13.8	11.9
State Superannuation Board of Victoria	1 7 5 4	35	165.0	4.0	11.6	10.9
Local Authorities Superannuation Board	1 3 7 0	86	155.4	4.2	12.2	11.0
SEC Superannuation Fund	1 2 7 0	29	130.3	4.3	9.6	8.3
Emergency Services Superannuation Scheme	6 6 1	60	73.2	2.2	13.7	11.0
Hospitals Superannuation Board	5 7 1	85	65.9	2.2	12.7	9.0
State Trust Corporation	3 0 1	46	27.7	0.2	9.4	12.8
Gas and Fuel Corporation Superannuation Fund	2 8 0	72	0.9	0.6	0.4	4.0
Melbourne Water Corporation Employees' Superannuation Fund	1 7 7	88	20.9	1.0	14.1	10.9
Transport Superannuation Board	1 0 6	96	14.1	0.5	15.8	(a)15.7
State Employees Retirement Benefit Board	8 1	89	8.2	0.4	11.6	11.8

(a) As the Transport Superannuation Board was not provided with investment funds until April 1989, 1989-90 represents its first full year of investment activity.

PART 3

Conduct of the Audit

AUDIT OBJECTIVES

3.1 The overall objective of the audit was to examine the investment management practices within the Victorian public sector with a view to assessing whether the aims of the Government and individual agencies had been achieved. Specifically, the audit focused on whether:

- agencies had established, and complied with, an investment framework which promoted the economic, efficient and effective investment of funds;
- investment performance had been consistent with government objectives, agency targets and Industry benchmarks;
- adequate controls were in place to ensure that investments were not exposed to unacceptable levels of risk;
- administrative structures for investment management represented the most cost-effective arrangement;
- the responsibility for investment management was assigned to appropriately qualified and experienced staff;
- sound accountability processes were in place within agencies; and
- guidelines and monitoring procedures had been established at a central level to ensure investment activity was in line with broad government policies.

AUDIT SCOPE

Agencies subject to detailed examination

3.2 To obtain a cross-section of Investment management practices, the following 5 agencies were selected for detailed examination:

- Hospitals Superannuation Board (HSB);
- State Electricity Commission Superannuation Fund (SECSF);
- State Superannuation Board of Victoria (SSB);
- State Trust Corporation (STC); and
- Transport Accident Commission (TAC).

3.3 In the case of the State Trust Corporation, examinations were primarily directed to the management of investments held in its Common Funds established to facilitate the pooling of certain assets managed by the Corporation on behalf of individual clients.

Areas of examination

3.4 The following areas were examined during the audit:

- relevant objectives, strategies and guidelines established by agencies;
- returns generated on investment portfolios;
- risk assessment and monitoring, including the safeguards used by agencies to reduce the risks of poor investment performance and fund mismanagement;
- impact of the property market downturn on investment capital and returns;
- use of external fund managers, Including selection procedures, contracts with the managers and controls over their operations;
- use of custodians;
- cost of investment management;
- internal reporting to and monitoring by appointed Boards and Trustees;
- the organisational structures for investment management; and
- the qualifications and experience of staff assigned to manage or supervise the investment of funds.

3.5 In addition to examinations within the agencies, discussions were held with a number of external fund managers engaged by the agencies. The systems and procedures within the Department of the Treasury, the central agency responsible for investment management, were also subject to audit examination. Investments managed by the Treasury Corporation of Victoria were not examined as part of the audit.

issue of a questionnaire

3.6 An audit questionnaire was distributed to 7 other public sector agencies responsible for managing large investment portfolios, namely:

- Emergency Services Superannuation Scheme (ESSS);
- Gas and Fuel Corporation Superannuation Fund (GFCSF);
- Local Authorities Superannuation Board (LASB);
- Melbourne Water Corporation Employees' Superannuation Fund (MWCESF);
- State Employees Retirement Benefits Board (SERBB);
- Transport Superannuation Board (TSB); and
- Victorian WorkCover Authority (WorkCover).

3.7 The questionnaire sought details of investment objectives and strategies, returns achieved, management structures, arrangements with fund managers and investment management costs. Responses have not been subject to audit verification with the exception of a small number of areas where significant deviations from usual trends or practices were disclosed.

Period covered by audit examinations

3.8 The audit primarily covered the management of investments during the 5 year period ending 30 June 1993. As data was not available in some agencies for the entire period, statistical information included in a number of areas of this Report is limited to a 3 or 4 year period.

PART 4

Investment Returns

OVERVIEW

4.1 Although many of the agencies examined were similar, in terms of their nature and objectives, marked variations occurred between the agencies In the investment returns achieved, with **average annual returns over the past 5 years ranging from a low of 4 per cent to a high of 13.2 per cent.** Because of the large amounts invested, these variations translated into significant differences in terms of the income generated, on a portfolio basis. **The differences will impact directly on the level of funding required to meet the future liabilities of the agencies.**

4.2 The overall returns generated by all agencies over the last 2 years, **with the exception of the Gas and Fuel Corporation Superannuation Fund,** have been well above movements in the Consumer Price Index and the growth in salaries and wages. **These results indicate that certain agencies which have recently set quantifiable 3 and 5 year return targets linked to these movements are in a strong position to achieve the targets established.**

4.3 Audit found that in individual asset classes, returns were In some cases below industry benchmarks and the returns achieved by private sector fund managers. In particular, comparatively poor returns resulted from property investments.

4.4 The recent decline in the property market, which has resulted In significant losses on property holdings, impacted adversely on the overall returns of some agencies. **Total property losses, predominantly unrealised, of all agencies examined amounted to approximately $500 million over the 5 years to 30 June 1993**.

NATURE OF RETURNS

4.5 In broad terms, there are 4 major classes of investment assets, namely, short-term money market deposits, fixed interest securities, property and equities.

4.6 Returns on investments are derived from both the capital growth in assets and from income received in the form of interest and dividend payments. While fixed interest securities and short-term money market deposits generate returns largely from income, a significant proportion of returns on equities, direct property holdings and units In property trusts is derived from increases in the market value of the assets.

4.7 The overall level of returns generated on diversified investment portfolios is dependent on management decisions made in the following areas:

- strategic asset allocations which involve setting long-term targets for apportioning funds between various asset classes;
- tactical asset allocations involving short-term decisions to apportion funds to well performing asset classes and fund managers;
- selection of fund managers; and
- the amount of funds allocated to each fund manager.

MEASUREMENT OF RETURNS

4.8 The measurement of investment returns is important to any assessment of the performance of a portfolio and evaluating the effectiveness of investment management decision-making processes.

4.9 As the rate of return can be calculated in a number of ways, the use of a generally accepted method and a consistent basis of calculation is crucial to accurate assessment and fair comparison of performance. Within the fund management industry, the **time weighted rate of return** is generally accepted as a suitable method. This method makes adjustments for the timing of cash flows which could otherwise distort investment returns achieved by fund managers. For example, allowance Is made for the receipt of a pool of funds for investment late in a month when assessing a fund manager's performance for that month.

4.10 Audit found that all agencies examined used the time weighted method when calculating returns. Returns were generally arrived at after deducting all investment costs including consultant, custodian and fund manager fees. Both realised and unrealised gains and losses were taken into account in the calculation. All returns included in the Report are calculated on this basis.

RETURN OBJECTIVES

4.11 In measuring the returns achieved, the specific nature and objectives of each agency need to be considered. The returns also need to be evaluated in the context of the agencies overall risk management strategy (further comment on the risk profiles and the risk management strategies adopted by agencies is included in Part 5 of this Report).

4.12 In the past, the investment objectives of most agencies were expressed in general terms such as to *maximise real rates of return subject to acceptable risk.* However, as detailed later in this Report, many agencies have recently moved to setting more specific, quantifiable targets, relating to both returns and risk with return targets linked to:

- movements in the Consumer Price Index (CPI);
- growth in wages and salaries; and
- specific funding requirements.

4.13 The establishment of these targets has assisted management in the development of strategies to meet objectives and in monitoring the performance of investment portfolios. Nevertheless, **there is still a need for a number of agencies to strengthen the accountability framework by including quantifiable targets in their investment objectives.**

OVERALL RETURNS

Returns compared with movements in CPI and increases in wages and salaries

4.14 Of the 12 agencies included in the audit, 7 had established investment objectives of achieving returns ranging from 3 to 6 per cent above movements in the CPI. Two other agencies had also set targets of achieving returns greater than the annual growth in salaries and wages. The targets were generally to be achieved over 3 or 5 year rolling periods. Although the specific targets were, in many cases, only set in recent years, **agencies will be in a strong position to achieve those targets if their performance over the past 5 years is maintained.**

4.15 Details of the returns achieved by each agency over the 5 years to 30 June 1993, together with movements in the CPI and growth in salaries and wages, are set out In Table 4A.

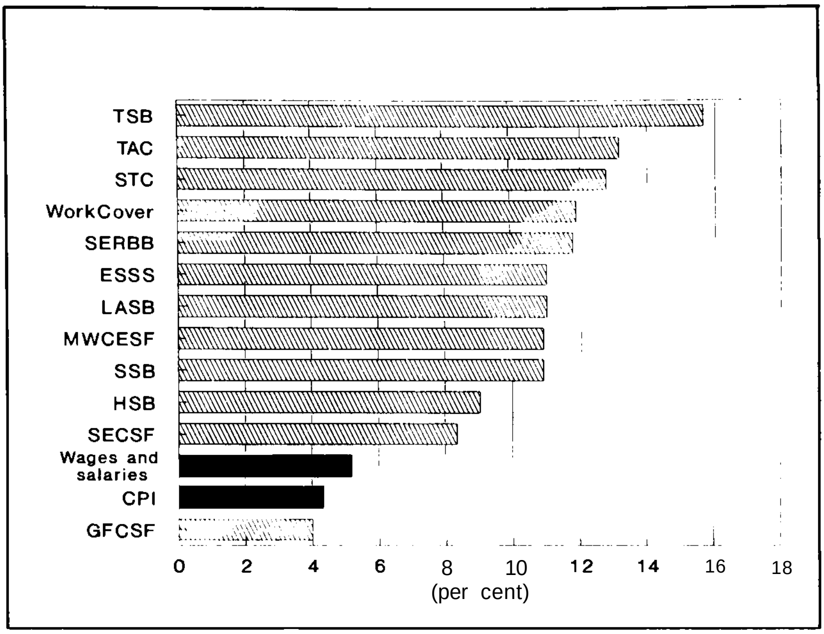
TABLE 4A
OVERALL INVESTMENT RETURNS
(per cent)

Agency	7988-89	*1989-90*	*1990-91*	*1991-92*	7992-93
ESSS	13.3	8.3	8.1	11.6	13.7
GFCSF	8.3	2.1	4.0	6.0	0.4
HSB	11.4	9.6	3.6	8.1	12.7
LASB	11.0	11.7	8.1	12.2	12.2
MWCESF	8.9	11.6	9.4	10.7	14.1
SECSF	10.5	8.7	3.8	8.9	9.6
SERBB	10.8	10.8	14.1	11.9	11.6
SSB	12.3	11.7	8.1	11.0	11.6
STC	14.2	15.0	13.6	11.8	9.4
TAC	11.1	14.5	13.7	14.1	12.6
TSB	*(a)*	16.7	14.0	16.5	15.8
WorkCover	9.5	11.6	12.1	12.5	13.8
Movements In the CPI	7.6	7.7	3.4	1.2	1.9
Growth in wages and salaries *(b)*	6.6	7.7	2.0	3.8	3.0

(a) As the Transport Superannuation Board was not provided with investment funds until April 1989, 1989-90 represents its first full year of investment activity.
(b) *Source:* ABS, *Average Weekly Earnings, States and Australia* (6302.0).

4.16 Chart 4B shows the average return achieved by each agency over the 5 year period, prepared on an annualised cumulative basis, together with the average movement in the CPI and wages and salaries. In the case of the Transport Superannuation Board, the average return relates to the 4 year period of the Board's investment operations.

CHART 4B
ANNUALISED CUMULATIVE PERFORMANCE
OVERALL RETURNS FOR 5 YEARS TO 30 JUNE 1993



4.17 As indicated in the analyses, returns have generally been well above movements in the CPI and the growth in wages and salaries. However, **performance has varied considerably between agencies, ranging from returns of the Transport Accident Commission and the Transport Superannuation Board which have been consistently high over the period to those of the Gas and Fuel Corporation Superannuation Fund which have been significantly below those achieved by other agencies in all years examined.** In 75 per cent of agencies there was a marked improvement in the returns achieved In 1991-92 and this improvement continued in 1992-93 for most of those agencies, reflecting improved investment management practices.

4.18 It is recognised that any comparison of returns needs to be considered in the light of the specific objectives of each agency. For example, the Common Funds of the State Trust Corporation are comprised almost entirely of various forms of fixed interest securities with the aim of protecting the assets of, and providing regular Income to, clients. This factor needs to be taken Into account in any comparisons with other agencies. Timing considerations also need to be considered in any comparisons. For example, agencies such as the Transport Superannuation Board and the Transport Accident Commission which were more recently established were not constrained, to the same extent as other agencies, in the investment options available to them. Consequently, they were not in a position of holding a large proportion of funds in property at the time of the property market downturn.

4.19 Nevertheless, audit found that many of the agencies examined were similar in nature, in Investment objectives and in diversity of portfolios. The differences in returns in these cases can therefore only be partially explained by the nature and objectives of the agencies. In audit opinion, the differences are largely attributable to the alternative strategies adopted in the management of the portfolios.

4.20 In view of the substantial funds invested, even minor variations In the rates of return achieved can have a significant Impact on the Income generated. For example, **if the returns of the 9 lower performing agencies over the 5 year period to 30 June 1993 had been in line with those achieved by the Transport Accident Commission, additional income totalling approximately $1.2 billion would have been generated.** Details of the additional income, together with the percentage increase in income which would have been achieved by each of the agencies, is set out in Table 4C.

TABLE 4C
ADDITIONAL INCOME OVER 5 YEAR PERIOD

Agency	*Additional income*	*Increase in income*
	($million)	*(per cent)*
GFCSF	149	234
SECSF	325	57
HSB	93	49
MWCESF	50	47
ESSS	72	41
SSB	215	29
LASB	134	24
SERBB	14	24
WorkCover	110	13
Total	**1 162**	**35**

4.21 By way of comparison, if all agencies had only achieved returns similar to those of the poorest performer, Gas and Fuel Corporation Superannuation Fund, total income over the 5 year period would have been $3 billion less than that actually generated.

Funding requirements

4.22 In 3 cases, agencies examined in detail had set investment targets linked to funding requirements. Details of progress made by the agencies in achieving these targets follows.

Hospitals Superannuation Board

4.23 The Hospitals Superannuation Board's objectives, effective from 1991-92, included the following funding targets:

- Adoption of an investment strategy which creates a 75 per cent chance of increasing the net assets coverage ratio to 35 per cent or better over 3 years and to 60 per cent or better over 20 years. The coverage ratio Is a measure of funding with a ratio of 100 per cent indicating full funding; and
- Investment of funds in order to have a 75 per cent chance of increasing the vested benefits Index ratio to 1.27 or better over 3 years and to 1.29 or better over 20 years. The vested benefit index ratio is a measure of solvency with a ratio of 1 indicating that all vested benefits could be paid to members at the date of calculation.

4.24 The Board's progress in meeting these objectives was reviewed by a consultant in February 1993. The consultant found that while the Board's coverage ratio had improved from 28 per cent in June 1991 to 47 per cent in June 1992, the vested benefits index ratio had deteriorated from 0.86 to 0.63 over that period. While the decrease in the vested benefit ratio is contrary to the Board's objectives, it would only impact adversely on the Board's liquidity in the unlikely event that all vested benefits were to be paid to members at the same date.

4.25 Funding ratios for the 1992-93 financial year have not yet been assessed by the Board.

Transport Accident Commission

4.26 The Commission commenced operation in January 1987 with a major goal of accumulating sufficient funds by the end of 1997 to fully cover all outstanding liabilities of the Transport Accident Scheme, a scheme established to provide Victorian motorists with personal injury insurance cover. **This funding goal was achieved in 1989-90, 7 years ahead of schedule.**

4.27 The audit review found that although the stock market downturn which occurred in the Commission's first year of operation impacted adversely on investment returns in that year, **excellent returns achieved since that time have made a significant contribution to the achievement of the funding goal.**

SEC Superannuation Fund

4.28 The Trustees of the SEC Superannuation Fund have set a target of ensuring sufficient assets are available to meet present and future benefits of the Fund. Contributions are made by the State Electricity Commission of Victoria to meet any shortfall in funding requirements.

4.29 The Fund's assets and liabilities are reviewed in detail every 3 years by actuaries appointed by the Commission. The Fund's current investment objectives were established partly as a result of the actuarial assessment of January 1990 which forecast Fund earnings of 4 per cent above CPI movements.

4.30 The Trustees subsequently chose a return objective of achieving 5 per cent above movements In the CPI as It was seen as a testing, but achievable, target that would result in a reduction in the Commission's long-term contributions to the Fund, estimated by the actuary as 11.5 per cent, based on achieving an investment return of 4 per cent above CPI movements. **In the 2 years since the objective was set, returns achieved by the Fund have been well in excess of the specified return target.**

RETURNS BY ASSET CLASS

4.31 Most large public sector investing agencies manage diversified portfolios which comprise a mix of Australian and overseas assets. Management of these portfolios is primarily directed towards allocating funds to asset classes and fund managers in a manner which will achieve the maximum overall return while maintaining an acceptable risk profile. As returns in individual asset classes may fluctuate over time, due to factors such as economic conditions, movements in Interest rates or changing market values, it is important that returns in each class are measured against an industry standard.

4.32 Benchmarks utilised within the industry to assess performance are asset class specific and usually take the form of Indices designed to measure Investment returns. For example, the Commonwealth Bank Bond Index is used in some cases to assess performance in the fixed Interest area. The composition of the particular benchmark is critical to its usefulness as a performance assessment tool.

4.33 Within the agencies included in the audit, benchmarks had generally been used, particularly in recent years, as a means of assessing the performance of both individual asset classes and fund managers. Although non-performance against benchmarks did not automatically result in fund manager termination, explanations were sought from managers who performed below the benchmarks. The performance of investment portfolios was also assessed against the results of private sector surveys of the returns achieved by various fund managers.

4.34 Performance of agencies examined in detail, in each asset class, is discussed in the following paragraphs. The returns have been compared with relevant industry benchmarks and the results of a private sector survey conducted by William Mercer Pty Ltd. This survey, which Is well recognised within the investment industry, includes 56 private sector fund managers and provides a measure of median performance by asset class over 1, 3 and 5 year periods.

4.35 While the actual returns achieved by each agency have generally been provided for a 5 year period, the comparisons with survey results and industry benchmarks are restricted to a 3 year period to allow the inclusion of the Hospitals Superannuation Board in the comparisons. In the case of the State Trust Corporation, the comparisons in individual asset classes include only fixed interest securities and short-term money market deposits as the assets held within the Common Funds were limited to these categories during most of the 5 year period.

Short-term money market

4.36 The returns achieved by agencies on funds held in cash or short-term money market deposits over the past 5 years are set out in Table 4D.

TABLE 4D
SHORT-TERM MONEY MARKET RETURNS
(per cent)

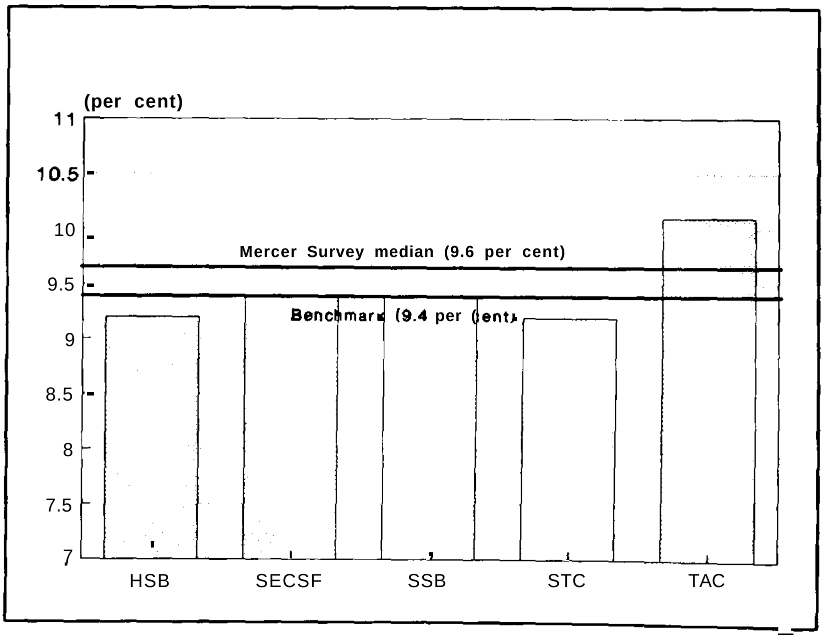
Agency	*1988-89*	*1989-90*	*1990-91*	*1991-92*	*1992-93*
HSB	*(a)*	18.1	12.3	9.9	5.6
SECSF	16.3	16.7	13.8	8.9	5.8
SSB	176	17.8	13.2	9.4	5.6
STC	14.6	17.3	13.1	8.8	5.9
TAC	15.8	18.5	14.0	10.5	6.1

fa) Figure not available.

4.37 As indicated in the above table, returns of all agencies fell consistently over the past 3 years, reflecting the downward trend in nominal interest rates.

4.38 Returns in this asset class varied considerably from the relevant industry benchmark, namely, the SBC Dominguez Barry Bank Bill Index, and the Mercer Survey results. Comparisons for the 3 years to 30 June 1993 are provided in Chart 4E.

CHART 4E
SHORT-TERM MONEY MARKET RETURNS,
ANNUALISED CUMULATIVE RETURN AGAINST BENCHMARKS
FOR THE 3 YEARS ENDING 30 JUNE 1993



Fixed interest securities

4.39 Returns achieved by each agency on fixed Interest securities over the past 5 years are set out in Table 4F.

TABLE 4F
RETURNS ON FIXED INTEREST SECURITIES
(per cent)

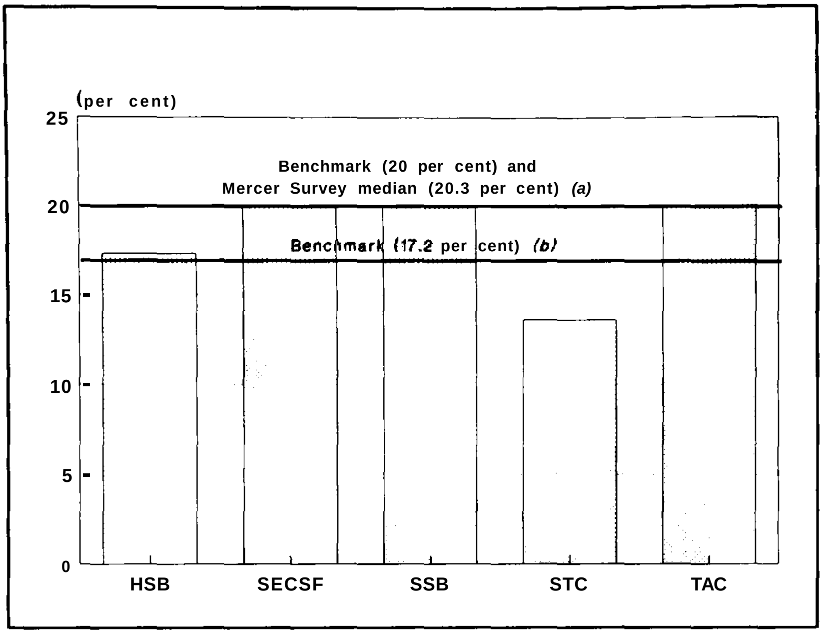
Agency	*1988-89*	*1989-90*	*1990-91*	*1991-92*	*1992-93*
HSB	*(a)*	18.3	16.8	19.0	16.0
SECSF	6.2	16.3	20.2	23.4	15.7
SSB	7.4	14.5	22.8	22.5	15.2
STC	13.6	14.2	13.9	13.8	13.0
TAC	7.8	16.1	23.7	22.5	14.0

(a) Figure not available.

4.40 The consistently high returns achieved since 1989-90 reflect the high interest rates available at the time the funds were invested. The market value of fixed interest securities fluctuates on the basis of changes In prevailing interest rates with values rising as interest rates fall. Consequently, the market value of the securities held by agencies has increased due to the significant decline in interest rates in the last 2 years. The realised and unrealised gains resulting from these increases have contributed to the high returns.

4.41 Although the returns on fixed interest securities have been high, the performance in this asset class has generally been in line with or below the industry benchmarks and the Mercer Survey results. This comparison is illustrated in Chart 4G. The relevant benchmarks used for comparative purposes are the SBC Dominguez Barry 0 to 5 Year Semi-government Index in the case of the State Trust Corporation and the SBC Dominguez Barry Composite Bond Index for all other agencies.

CHART 4G
FIXED INTEREST RETURNS,
ANNUALISED CUMULATIVE RETURN AGAINST BENCHMARKS
FOR THE 3 YEARS ENDING 30 JUNE 1993



(a) Benchmark relevant to all agencies with the exception of STC.
(b) Benchmark relevant to STC.

Australian and overseas equities

4.42 Since 1987, the majority of agencies have expanded their portfolios to include an increasing proportion of Australian and overseas equities. The portfolios of more recently established organisations such as the Transport Accident Commission and Victorian WorkCover Authority have included such equities since their establishment. The returns achieved by each agency on Australian equities are set out in Table 4H.

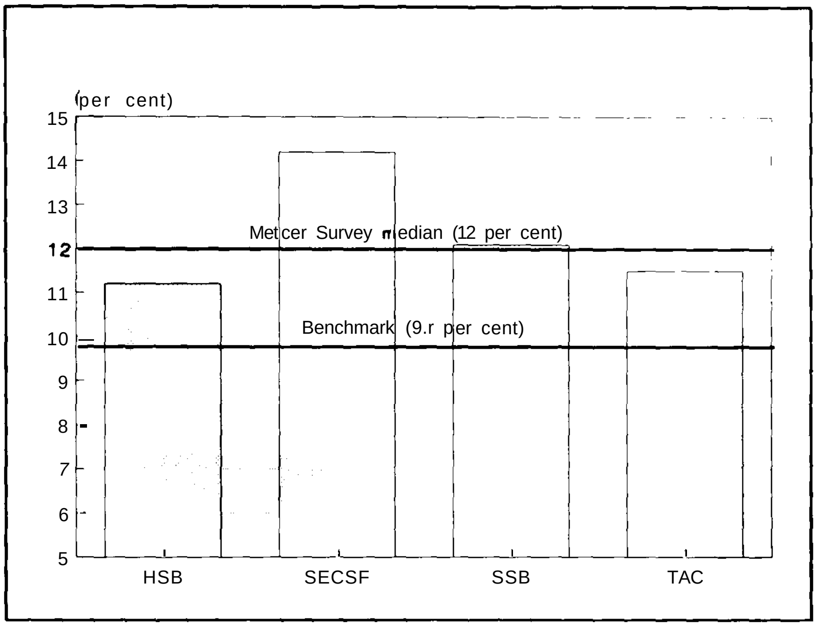
TABLE 4H
RETURNS ON AUSTRALIAN EQUITIES
(per cent)

Agency	*1988-89*	*1989-90*	*1990-91*	*1991-92*	*1992-93*
HSB	*(a)*	10.3	9.4	14.8	9.6
SECSF	7.2	11.9	12.6	18.2	11.9
SSB	(1.2)	9.4	11.1	14.0	11.2
TAC	2.7	8.5	9.0	15.0	10.5

(a) Figure not available.
Note: Figure in brackets represents a negative return.

4.43 The poor returns in 1988-89 primarily reflect the impact of the October 1987 stock market crash. Although the returns have fluctuated since that time, they have generally compared favourably with the benchmark, namely, the All Ordinaries Accumulation Index and with the Mercer Survey results. This comparison is illustrated in Chart 4I.

CHART 4I
AUSTRALIAN EQUITY RETURNS,
ANNUALISED CUMULATIVE RETURN AGAINST BENCHMARKS
FOR 3 YEARS TO 30 JUNE 1993



4.44 In the case of overseas equities the returns fluctuated considerably over the 5 year period. However, as indicated in Table 4J, **the returns in 1992-93 were outstanding.**

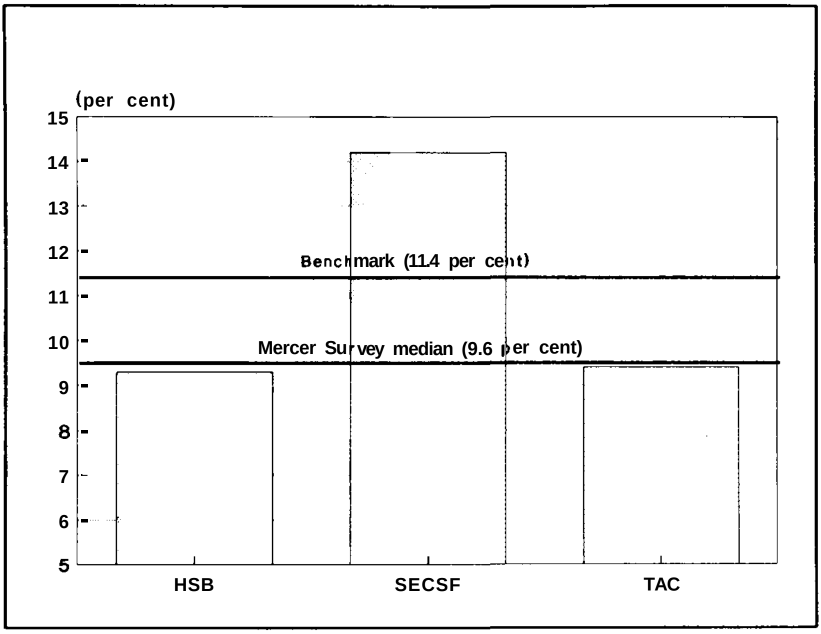
TABLE 4J
RETURNS ON OVERSEAS EQUITIES
(per cent)

Agency	7988-89	7989-90	7990-97	*1991-92*	7992-93
HSB	*(a)*	6.0	1.4	3.4	24.5
SECSF	19.5	11.0	3.6	11.2	29.4
SSB*(b)*	-	-	-	-	15.1
TAC	15.1	7.7	(3.0)	8.6	24.4

(a) Figure not available.
(b) The State Superannuation Board of Victoria did not hold overseas equities prior to December 1992.
Note: Figure in brackets represents a negative return.

4.45 As indicated in Chart 4K, the performance of the Transport Accident Commission and the Hospitals Superannuation Board has been below the industry benchmark, namely, the Morgan Stanley Capital International World (ex Australia) Index, while **the SEC Superannuation Fund's performance has been well above the benchmark and the Mercer Survey results.**

CHART 4K
OVERSEAS EQUITY RETURNS,
ANNUALISED CUMULATIVE RETURN AGAINST BENCHMARKS
FOR 3 YEARS TO 30 JUNE 1993



Property

Nature of property assets

4.46 The investment portfolios of public sector superannuation funds have traditionally included a significant proportion of direct property holdings with the aim of providing long-term capital growth. Such assets have mainly consisted of commercial properties located in the Melbourne Central Business District and suburban areas. More recently established portfolios such as those of the Transport Accident Commission and the Victorian WorkCover Authority have allocated a smaller proportion of funds to property holdings. In the case of the Transport Accident Commission, a significantly larger component of retail property assets have been acquired including the Fountain Gate Shopping Centre, a suburban shopping complex, purchased in July 1992 for $187 million. In more recent years, agencies have also acquired units in property trusts.

Fountain Gate Shopping Centre, purchased by the Transport Accident Commission in 1992 for $187 million.

Decline in value of property assets

4.47 The proportion of the portfolios allocated to property assets, of the 4 agencies examined in detail, is set out in Table 4L.

TABLE 4L
ALLOCATION TO PROPERTY HOLDINGS
(per cent)

Agency	7988-89	*1989-90*	7990-97	*1991-92*	7992-93
HSB	19	21	17	*7*	5
SECSF	28	28	24	19	15
SSB	28	26	19	13	10
TAC	-	2	2	2	7

4.48 The downturn in the property market in recent years has significantly devalued the property assets held. This position, rather than the disposal of properties, has been the major factor contributing to the decrease in property assets, as a proportion of total investment portfolios.

4.49 The losses on properties for the entire 12 agencies included in the audit amounted to approximately $500 million over the 5 year period. As most assets have not yet been sold, the majority of the losses are unrealised.

Returns on property holdings

4.50 After taking account of the decline in the market value of property assets, **many agencies have recorded significant negative returns on property holdings in recent years.** The returns over the past 5 years **of the agencies most affected by the property market downturn,** are set out in Table 4M.

TABLE 4M
RETURNS ON PROPERTY HOLDINGS
(per cent)

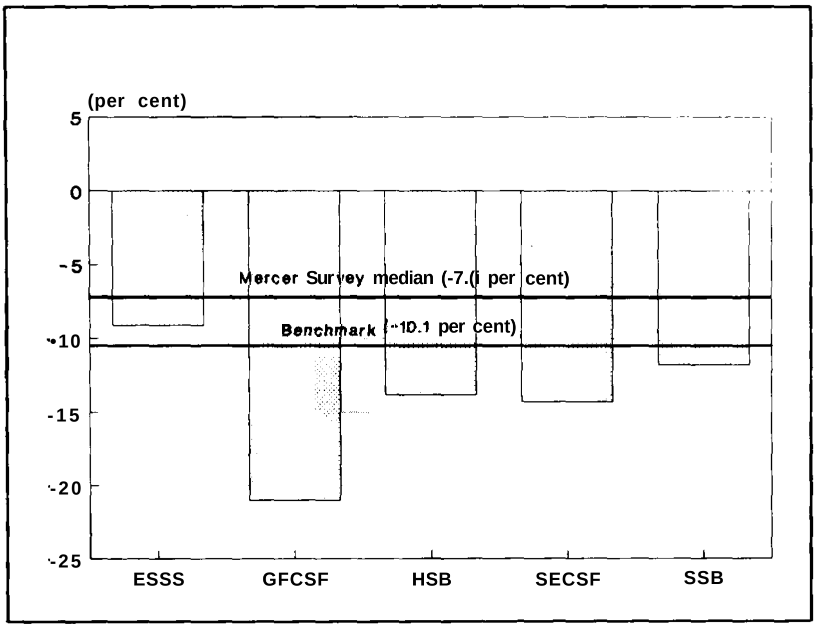
Agency	7988-89	*1989-90*	7990-97	*1991-92*	*1992-93*
ESSS	23.3	(8.2)	(19.5)	(7.2)	0.5
GFCSF	12.9	(8.2)	(14.9)	(19.4)	(28.2)
HSB	*(a)*	10.5	(20.1)	(12.6)	(8.4)
SECSF	12.7	(0.9)	(15.5)	(13.8)	(13.6)
SSB	18.6	3.0	(19.3)	(13.0)	(2.2)

(a) Figure not available.
Note: Figures in brackets represent negative returns.

4.51 By comparison, **the Transport Accident Commission has been largely unaffected by the downturn and has achieved positive returns over the past 4 years ranging from 5.6 per cent to 18.5 per cent.** As the State Trust Corporation took action in recent years to reduce its exposure to property in the form of commercial mortgages, it has also avoided any adverse impacts of the property downturn.

4.52 As the returns on property were measured by each agency against different benchmarks, audit has used the Mercer Property Index, which relates to direct property only, as a benchmark for comparison across all agencies. As Indicated in Chart 4N, the returns achieved by the majority of the agencies listed above have been worse than this benchmark and the Mercer Survey results.

CHART 4N
PROPERTY RETURNS,
ANNUALISED CUMULATIVE RETURN AGAINST BENCHMARKS
FOR 3 YEARS TO 30 JUNE 1993



4.53 In view of the large proportion of funds held by some agencies in property assets, **the poor performance in this area has had a significant negative impact on the overall investment returns achieved by those agencies.**

4.54 Specific details relating to several of the agencies follow.

SEC Superannuation Fund

4.55 Property holdings have traditionally represented a major component of the SEC Superannuation Fund's investment portfolio with property holdings in the 5 years to June 1993 averaging 22 per cent of the total portfolio. The direct property holdings at 30 June 1993 consisted of 3 office buildings located in, or adjacent to, the Melbourne Central Business District and 2 shopping centres and a retail property in suburban Melbourne. In addition to the direct property holdings, valued at $160 million at 30 June 1993, the Fund also held investments in property trusts.

4.56 The Fund reacted to the depressed property market by selling many of its small property holdings with a value of less than $20 million. Between 1986 and 1990, it sold 20 properties realising approximately $50 million. However, during that period, the Fund re-invested $80 million in the property sector through the purchase of units in the Cities of Australia Property Trust.

4.57 Although the Fund has continued to receive a positive income stream from its direct property holdings, both the direct and indirect property assets have suffered significant declines in value since 1989-90. Table 40 shows percentage changes in the value of the Fund's overall property holdings since 1989-90.

TABLE 40
DECLINE IN VALUE OF PROPERTY
(per cent)

Year	*Percentage decline*
1989-90	11.8
1990-91	16.9
1991-92	18.8
1992-93	22.1
Total	**69.6**

4.58 Apart from the sale in 1992 of an office complex in Canberra for $9.1 million, there have not been any purchases or sales of direct or indirect property since June 1990. The reduction in the proportion of total investments represented by the property asset class from 28 per cent to 15 per cent at 30 June 1993 has therefore been almost entirely attributable to a decline in market values.

4.59 The listed price of the Cities of Australia Property Trust units at 30 June 1993 had fallen by over 50 per cent in value since they were purchased by the Fund. Although the Fund has attempted to sell its holdings in the Trust on several occasions, the units have proved to be unsaleable, for a reasonable consideration, due to the large number of units held by the Fund.

- *RESPONSE provided by Chairman, SEC Superannuation Fund*

Property investment performance in cyclical and property investors must be prepared to adopt a long-term time horizon. The audit has concentrated on returns over the last 3 to 5 years, a period coinciding with a downturn in the property cycle.

SECSF's strong investment performance in the latter half of the 1980s (top quartile performance in the Mercers Survey for 5 years) was due almost entirely to the strength in the property cycle over that time.

Clearly, in reviewing property investment performance, a time horizon longer than 3 to 5 years should be adopted.

As you would expect in a diversified investment portfolio, the effects of the downturn in property have been largely offset by SECSF's outstanding investment performance in other asset classes as Illustrated in the Report.

In the September 1993 quarter, the investment In Cities of Australia Property Trust returned 31.4 per cent.

The Fund did anticipate a downturn in the property sector and was a heavy seller of commercial and industrial property between 1987 and 1990. However, the Fund did not expect that the downturn would be so severe.

In addition, in 1989 the Fund had no way of anticipating the dramatic downsizing of the SECV and the implications for asset allocation and the property weighting. In the last 4 years the Fund has paid out nearly $800 million in retrenchment benefits. If this had not occurred and these assets were still held, the Fund's property weightings would be only 9 per cent and the impact of property on the Fund's overall performance would have been significantly diluted.

It should also be noted that the negative returns from property are due entirely to unrealised losses arising from property re-valuations. Despite these book losses, the property portfolio has continued to generate substantial positive cash flow at a time when the Fund has had an urgent need for cash.

Hospitals Superannuation Board

4.60 At 30 June 1993, the property assets of the Board, amounting to $29 million, included a number of commercial properties located in the Melbourne suburb of Camberwell and holdings in a number of property trusts.

4.61 In recent years, **poor returns on property investments have had a significant negative impact on the overall returns achieved by the Board, primarily due to unrealised losses resulting from the downturn in the property market.**

4.62 Recent action was taken by the Board to address a number of problems experienced in this area of activity including the appointment of a specialist property consultant and the implementation of a specific property management strategy. The development of the strategy was based on a number of key principles, including:

- the short-term goal of increasing property assets, as a proportion of the Board's portfolio, to a target of 15 per cent;
- greater diversification of the property portfolio;
- Improving the liquidity of the portfolio;
- assessment of the portfolio to be conducted on the basis of exceeding movements in the CPI by 3 per cent over rolling 3 year periods and against a benchmark based on Australian performance; and
- focusing on low risk and simple investment structures in the initial years, with enhancements in later years.

- *RESPONSE provided by General Manager, Hospitals Superannuation Board*

  Property weightings were reduced to enable the allocated funds to be invested in assets producing higher returns at reduced risk. The reduced weightings of the last 2 years limited exposure to further declines in value. The Board has substantially altered its approach to investing in property since appointing a property adviser. Property investments are characterised by individual large outlays and considerable research has been undertaken in selecting the most appropriate options. The achievement of the property weighting is being actively pursued.

Gas and Fuel Corporation Superannuation Fund

4.63 At 30 June 1993, property assets of the Gas and Fuel Corporation Superannuation Fund amounted to $52 million. The assets comprised predominantly direct commercial property holdings in, or adjacent to, the Melbourne Central Business District and in suburban Melbourne.

4.64 The funds invested in property assets over the past 5 years have represented a very high proportion of the total portfolio, falling from 44 per cent at 30 June 1989 to 18 per cent at 30 June 1993. This reduction reflects a decline in excess of 55 per cent In the market value of the assets rather than the sale of property holdings.

4.65 The high exposure of the Fund to the property market, coupled with a concentration of property holdings in the commercial sector, has resulted In poor returns in this area in the last 4 years which have impacted adversely on the overall returns of the Fund.

- *RESPONSE provided by Chairman, Gas and Fuel Corporation Superannuation Fund*

  We agree that the Fund has achieved a disappointing investment return due, by and large, to negative returns on property holdings over recent years.

  It is perhaps worth making the point that the Fund has almost completed a major restructuring which has resulted in all of its assets, other than the property portfolio, being placed under external professional management

  In respect of the property portfolio, we expect by Christmas to have appointed a professional property manager who will review the property portfolio and recommend any changes in order to meet the investment objectives set by the Trustees on advice from our Asset Allocator.

  These changes, as well as the outsourcing of Fund administration to an external provider, should ensure that, in future, investment returns will be significantly improved and costs reduced.

  In spite of its poor investment record, the Corporation's Fund remains fully funded and, in this regard, is probably unique as far as public sector funds are concerned.

PART 5

Risk Management

OVERVIEW

5.1 While every investment Involves some degree of risk, higher returns are generally associated with increased risk. It is therefore necessary for each agency to achieve a balance, between maximising returns and minimising risk, which best meets its objectives and the needs of its clients and members.

5.2 Audit concluded that **the agencies examined had generally established appropriate frameworks to manage the risks associated with investments.** The techniques adopted included:

- diversification of portfolios among various classes of assets;
- further diversification by the allocation of funds to both internal and external fund managers;
- establishment of prudential guidelines within which fund managers can operate; and
- where appropriate, compliance with prudential guidelines established by the Department of the Treasury.

5.3 However, **the specific investment management strategies adopted over the past 5 years have resulted in significant variations between agencies in their risk/return profiles.** While some agencies achieved higher than average returns and at the same time maintained a lower than average risk profile, others performed poorly in both areas, compared with the average. **These variances highlighted the need for increased emphasis to be placed on the measurement and regular review of the risk profile of each portfolio.**

5.4 Since the increase in 1987 in the investment options available to some agencies, there has been a move away from investments in property and short-term money market deposits with an increasing proportion of portfolios being allocated to Australian and overseas equities. However, the **diversification process has been slow in some agencies and has been inhibited, to some extent, by the large number of public sector redundancies which has necessitated the retention of substantial funds in assets which can be readily converted to cash.**

5.5 Audit concluded that the benefits of return maximisation and risk minimisation from diversification have not yet been fully realised by some agencies. In particular, greater diversification could be achieved within the property area and the procedures for monitoring compliance by fund managers with prudential guidelines could be significantly strengthened.

DEFINITION OF RISK

5.6 In the investment management industry, the term *risk* is not afforded its usual meaning of a *chance or possibility of loss or bad consequence* but is defined as the variability of investment returns. It is recognised within the Industry that the greater the variation in returns, between periods, the greater the risks that have been taken in generating those returns.

5.7 The **standard deviation of returns** is the most commonly used measure of the variability of returns earned on an investment portfolio. A general rule for evaluating performance is that for any given rate of return, the portfolio that achieves the least standard deviation is best, and for any given standard deviation, the portfolio that achieves the highest rate of return is best. For example, a portfolio earning 10 per cent each period is preferable to one that alternates between rates of return of zero per cent in one period and 20 per cent in the next.

RISK AND DIVERSIFICATION

5.8 As indicated previously, there are 4 major classes of Investment assets each with different characteristics in terms of risk, returns and liquidity. In relation to risk, equities are the most volatile class of asset followed by property and fixed interest. Short-term money market deposits are the most liquid of assets as they can be quickly converted to cash. Property holdings, on the other hand, are more difficult to sell at short notice, especially when unfavourable market conditions prevail.

5.9 Over time, not all asset classes perform well, or poorly, at the same time. For example, when the equity markets are booming, interest rates are generally low.

5.10 Consequently, the diversification of investment portfolios among various classes of assets is used as a means of reducing risk. While it Is recognised that factors such as stock market crashes or depressed property markets may impact adversely on a portfolio's performance, diversification can, to some extent, provide opportunities to offset losses in one area against gains in another.

5.11 Diversification is not limited to the selection of different asset classes but also the selection of various forms of assets within each class. For example, a diversified portfolio should include equities in companies operating in different sectors of the economy both locally and overseas. Similarly, property portfolios should include Investments in commercial, retail and industrial properties located in different areas within and outside the State.

5.12 The options for diversification are dependent, to some extent, on the size of the portfolio. In the case of smaller portfolios, for example, insufficient funds may be available to make investments in large retail or commercial properties.

ROLE OF TREASURY GUIDELINES IN REDUCING RISK

5.13 Treasury Guidelines were set in place by the Department of the Treasury to "... *identify the essential features of the fund management system that are considered necessary to ensure that risks are regularly identified, measured and considered by both Government and those responsible for the investments of superannuation funds and authorities."*

5.14 The Guidelines contain maximum net exposure limits for each class of asset (refer paragraph 5.76 of this Report). They also contain limitations and guidance relating to:

- the proportion of portfolios which can be held in overseas investments;
- the acceptable credit ratings of counterparties; and
- the use of financial instruments such as futures, options and swaps.

5.15 These parameters have been established as an indicative framework for defined agencies with the investment strategies of individual agencies intended to address more specific details of the choice of asset classes, the relative allocation of funds to each class and the selection of particular assets within each class.

RISK AND RETURN RELATIONSHIP

5.16 While every investment involves some degree of risk, higher returns are generally associated with higher risk investments. It is therefore Important for agencies to establish strategies which achieve a balance between maximising returns and minimising risks. Boards and Trustees of each agency need to set and regularly review a target risk/return profile which best meets the overall objectives of the agency and the needs of its members or clients.

5.17 The Investment objectives of the agencies covered by the audit contain components which reflect the 2 dimensional nature of investment performance. Examples of such objectives follow.

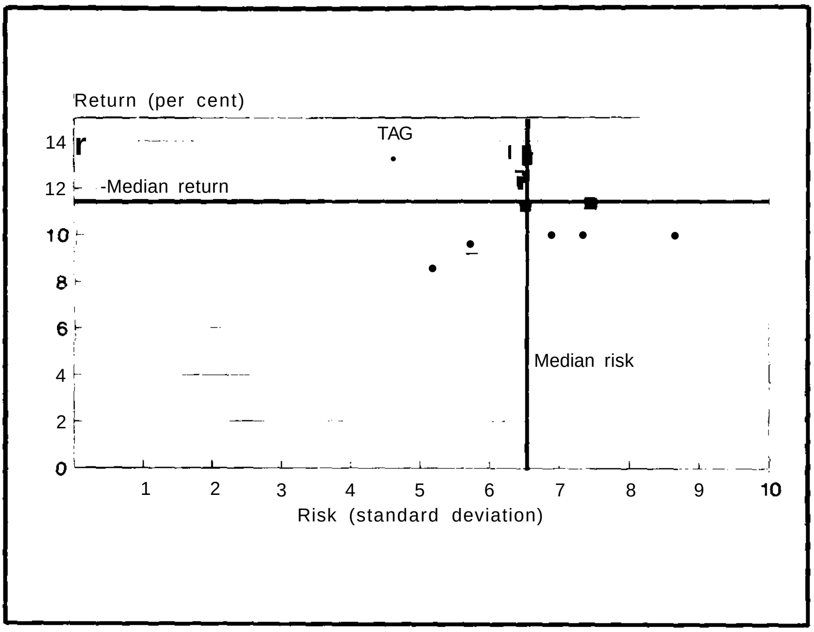
Agency	*Component of objective*
Transport Accident Commission	*Maximisation of returns while maintaining an acceptable risk level within prudential guidelines.*
Hospitals Superannuation Board	*Ensuring that the risk profile of the Fund does not exceed the median volatility of better than average managers.*
State Superannuation Board of Victoria	*To achieve an after tax long-term annual rate of return of between 3 and 6 per cent in excess of the annual percentage change in the Consumer Price Index for Melbourne with a 5 per cent chance of a negative return in any one year.*
SEC Superannuation Fund	*Obtain the highest possible return without increasing risk to an unacceptable level.*
State Trust Corporation	*To maximise returns to clients, while providing low risk investment strategies, within legislative constraints.*

5.18 In the case of the Transport Accident Commission and the Hospitals Superannuation Board, standard deviation analysis has been used by external consultants engaged by the agencies to measure the risk/return profile of their portfolio. This analysis has been undertaken on the basis of variations in returns from month-to-month. Details of the results of these analyses follow.

Transport Accident Commission

5.19 A survey, conducted by the Transport Accident Commission's investment consultant, **of large and medium-sized pooled funds in the Australian private sector** for the 3 and 5 year periods ending 30 June 1992, indicated that **the Commission out-performed all but one of the 10 other funds over both periods.** Chart 5A shows the results for the 5 year period.

CHART 5A
TRANSPORT ACCIDENT COMMISSION
RISK/RETURN COMPARISON

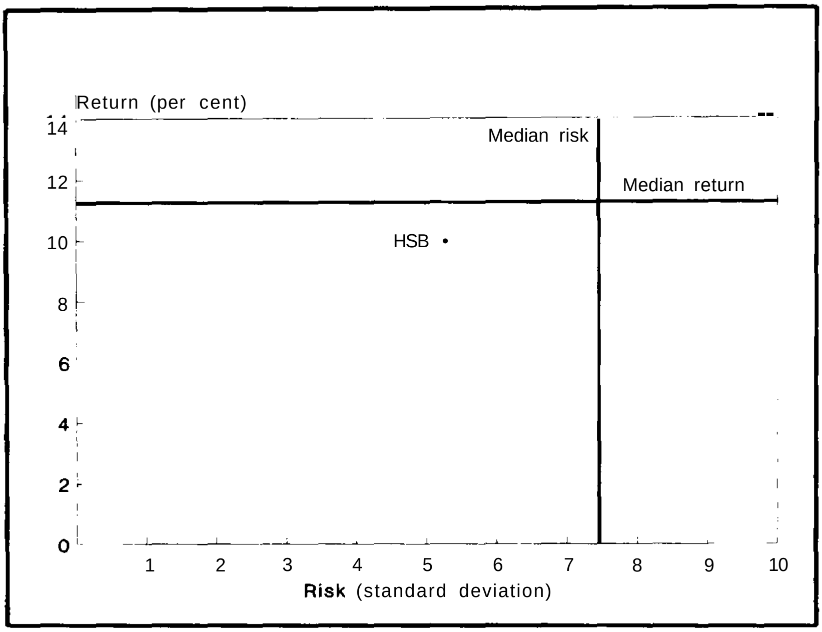


5.20 Although second in terms of return, **the Commission had achieved the lowest level of risk of all funds surveyed.**

Hospitals Superannuation Board

5.21 The Board aims to manage its investments in a manner which ensures the risk profile of its portfolio does not exceed the median volatility of better than average managers. Analysis undertaken by the Board's consultant indicated that **for the 3 years ending 30 June 1993, the risk profile has been below this parameter.** However, as illustrated in Chart 5B which plots the Board's risk/return profile **in relation to the median profiles of 33 other portfolios, returns over the period have also been below average.**

CHART 5B
HOSPITALS SUPERANNUATION BOARD
RISK/RETURN COMPARISON



- *RESPONSE provided by General Manager, Hospitals Superannuation Board*

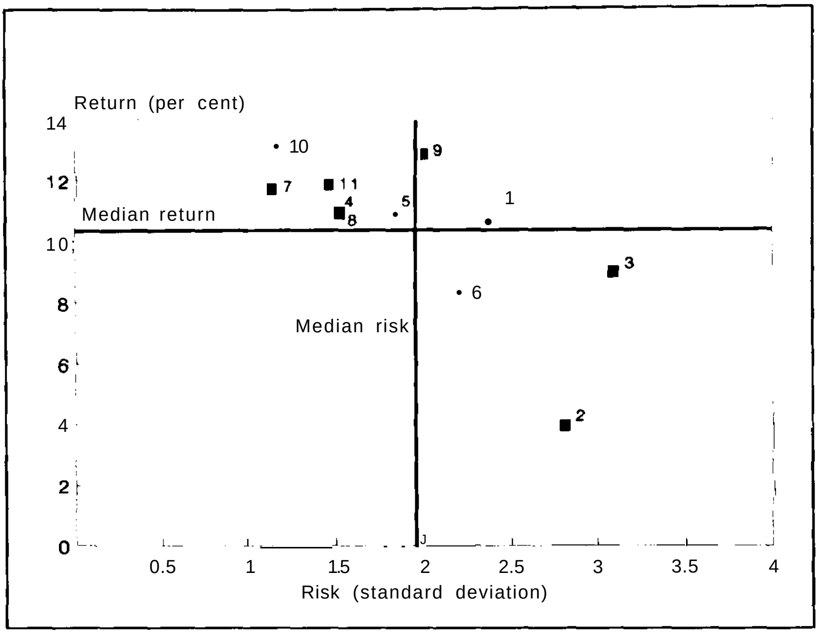
  The Board is aware of its responsibility to ensure that investment activities are undertaken to achieve optimum returns consistent with an acceptable level of risk. Extensive consultation has occurred to ensure compliance with this key objective and the investment strategy reflects this approach.

Profile of other agencies

5.22 Although most other agencies recognised the standard deviation of returns as a suitable measure of risk, they had not regularly analysed the portfolio from this perspective. Information was not available to enable audit analyses to be undertaken of variations in returns on a monthly basis. However, a calculation of the annual standard deviation over the 5 years to 30 June 1993 disclosed significant variations in the risk/return profiles of each agency. Chart 5C plots the profile of each of the 11 agencies in relation to the median return and risk of those agencies' portfolios. As the Transport Superannuation Board has only been involved in investment activities for 4 full financial years, it has been excluded from the analysis.

5.23 While it is recognised that the measurements of standard deviations on an annual basis do not disclose the extent of variations evident in monthly analysis, the chart does provide an indication of the relative positions of each agency.

CHART 5C
RISK/RETURN PROFILES



KEY	
1	Emergency Services Superannuation Scheme
2	Gas and Fuel Corporation Superannuation Fund
3	Hospitals Superannuation Board
4	Local Authorities Superannuation Board
5	Melbourne Water Corporation Employees' Superannuation Fund
6	SEC Superannuation Fund
7	State Employees Retirement Benefits Board
8	State Superannuation Board of Victoria
9	State Trust Corporation
10	Transport Accident Commission
11	Victorian WorkCover Authority

5.24 As indicated in the above chart, a number of agencies such as the Transport Accident Commission and the State Employee's Retirement Benefits Board achieved significantly higher than average returns and lower than average risks over the period. However, the performance of the Hospitals Superannuation Board, SEC Superannuation Fund and the Gas and Fuel Corporation Superannuation Fund have been below the average in both areas.

5.25 Variations of this magnitude highlight the need for each agency to regularly measure and monitor the risk profile of its investment portfolio to ensure that it is in line with the targets set to meet government and agency objectives and the needs of members and clients.

- *RESPONSE provided by General Manager, Hospitals Superannuation Board*

  The chart depicting comparative risk/return profiles is presented on a scale which suggested that the Board has adopted a high risk strategy. This is certainly not the case particularly when compared with the median of other portfolios (refer to Chart 5B).

  Additionally, the chart compares funds which may have quite different long-term objectives, tolerance for risk and liability structures, all of which have an impact on investment strategies adopted and returns achieved.

  A further consideration is the relevance of historical data given the substantial changes adopted by the Board in 1991-92 the benefits of which have only been recognised in the most recent 2 years.

- *RESPONSE provided by Chairman, SEC Superannuation Fund*

  It is prudent for trustees of public sector defined benefit funds with long-term liability profiles to adopt a relatively high tolerance to risk and a long-term investment time horizon. This is consistent with significant asset allocation exposures to higher risk growth assets such as equities and property.

  Based on historical evidence, it is anomalous that, in the 5 years period under review, cash and fixed interest have significantly out-performed higher risk assets. This will not continue, and already in 1993-94 investors are again being paid for taking risk.

  SECSF's return for the year ended October is 29 per cent and the fund is now fully funded.

  A risk/return scatter diagram with the standard deviation determined by 5 annual observations has obvious limitations.

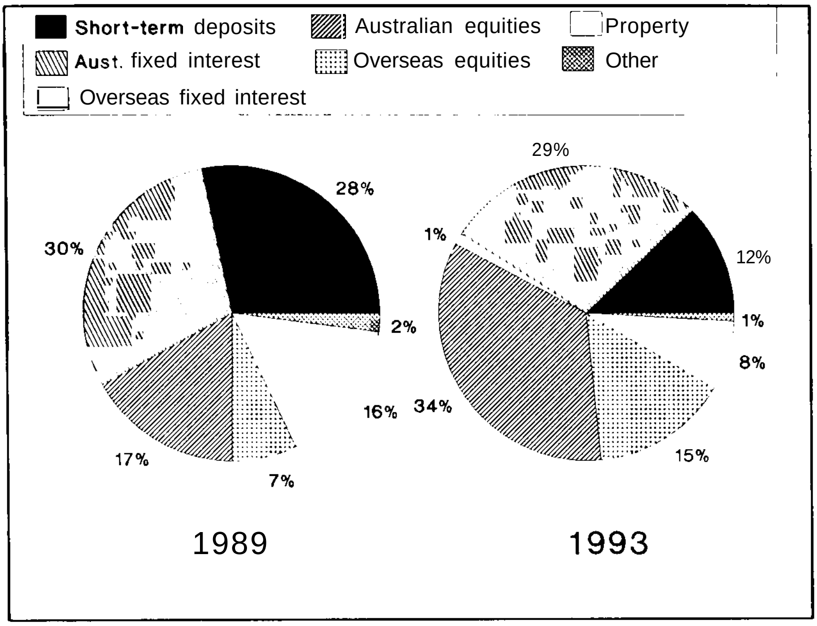
ASSET ALLOCATIONS

5.26 Within the investment management industry, it is recognised that decisions made in relation to the allocation of funds to various asset classes are the major determining factor in maximising returns and minimising risks.

5.27 As indicated in Section 2 of this Report, the introduction of the *Borrowing and Investment Powers Act* 1987 expanded the investment options available to many agencies enabling them to include Australian and overseas equities and a number of other financial instruments within their portfolios. Since that time, there has been a general trend away from short-term money market deposits and property towards investments in equities.

5.28 Chart 5D shows the change in the composition of portfolios over the past 5 years. The assets held by the 12 agencies included in the audit have been used as the basis of this analysis.

CHART 5D
COMPOSITION OF PORTFOLIOS



5.29 Specific findings relating to the diversification process within a number of individual agencies follow.

State Superannuation Board of Victoria

Diversification of portfolio

5.30 In 1989, the Board engaged an investment consultant to quantify an acceptable level of risk for its investment portfolio and to recommend alternative asset allocations to meet various target rates of return within that risk parameter. The target allocations subsequently adopted by the Board in 1990 required a significant increase in the proportion of funds held in equities. Further changes to these targets in November 1991 and April 1993 involved a reduction in the allocation to property assets, the further diversification to overseas equities and a significant reduction in the exposure to Australian fixed interest securities. For example, an initial target allocation of 5 per cent of the portfolio to overseas equities was to be increased to 15 per cent while the Australian fixed interest component was to be reduced to 20 per cent from the original target of 30 per cent.

5.31 Table 5E shows the actual asset allocations made by the Board to each asset class at 30 June in the past 5 years.

TABLE 5E
ACTUAL ASSET ALLOCATIONS
(per cent)

Asset class	*1988-89*	*1989-90*	*1990-91*	*1991-92*	*1992-93*
Australian equities	4	12	16	39	38
Australian fixed interest sec;urities	39	38	44	42	35
Mortgages	14	8	6	3	1
Overseas equities	-	-	-	-	4
Overseas fixed interest	-	-	-	-	-
Property	28	26	19	13	10
Short-term money market	15	16	15	3	12
Total	**100**	**100**	**100**	**100**	**100**

5.32 As shown in the above table, **the Board has adopted a gradual approach to diversifying its investment portfolio to meet its target allocations. It** was not until June 1989 that funds were first allocated to Australian equities and December 1992 that overseas equities were included in the portfolio. In contrast, audit found that a number of other agencies provided with the same increased investment options in 1987 had included assets in these areas as early as 1988.

5.33 Although the Board agreed to make a relatively modest investment in overseas equities in December 1990, a 2 year delay occurred due, in part, to lengthy fund manager approval procedures within the Department of the Treasury and protracted contract negotiations with global equity managers (refer to Part 6 of this Report).

- *RESPONSE provided by President, State Superannuation Board of Victoria*

  There is an implied criticism in audit's Report that the Board should have more rapidly diversified its investments to include overseas investments. The Board does not agree with this criticism. Five years ago, the Board had no equity investments and no experience in those markets in Australia or overseas. At that time, the task was to diversify first into Australian equities; a vast task for such a large fund. This was done gradually and prudently while enhancing investment performance.

Diversification of property holdings

5.34 The Board's current property assets mainly comprise office buildings within the Melbourne Central Business District tenanted by government bodies. In 1990, the Board's investment consultant recommended that property investments be diversified to include other property types such as suburban retail properties with non-government tenants. **The Board is evaluating investment opportunities in this area but is yet to achieve the recommended diversification.**

- *RESPONSE provided by President, State Superannuation Board of Victoria*

  There is an implied criticism that property investment is concentrated in downtown Melbourne. Such investments are efficiently and cost-effectively managed. It is believed that any other form of property exposure would have performed worse. Despite the problems with property investments, the Board did not expose itself to property development or speculation and all the Board's properties are tenanted. Continuation of existing property policies are considered prudent.

Impact of Consolidated Fund debt

5.35 Amounts received by the Board comprise both employer and employee contributions. In the past, where members were paid superannuation benefits by way of a pension, employer contributions from the Consolidated Fund were made at the time the pension was due. However, where members chose to convert part of their benefit entitlements to a lump sum, on retirement, the Government reimbursed the Board on the basis that the payments were made in the form of a pension. As a consequence, the Consolidated Fund accumulated a debt to the Board amounting to approximately $1.3 billion at 30 June 1993. The Board received an annual real rate of return on this debt of 6 per cent from 1988.

5.36 The substantial amount owed to the Board has had a significant impact on its ability to diversify investments. As the Board has not had control of the funds owed by the Consolidated Fund, which increased over many years to a level which represented approximately 46 per cent of the Board's net assets at 30 June 1993, **the proportion of the portfolio held in fixed interest securities has been disproportionate.**

5.37 Table 5F shows the proportion of the total funds held In each asset class at 30 June 1993, when the funds owed by the Consolidated Fund are included as Australian fixed interest securities.

TABLE 5F
ASSET ALLOCATIONS FOR TOTAL INVESTMENTS

Asset class	*Per cent*
Australian fixed interest securities	64
Australian equities	21
Short-term money market	8
Property	5
Overseas equities	2
Overseas fixed interest	0
Total	**100**

5.38 In addition to the reduced flexibility resulting from this arrangement, audit analysis indicated that over the past 5 years it has also resulted in a loss of income to the Board due to low inflation rates. **If the funds had been available for investment in a range of asset classes, in the same proportions as the Board's other asset allocations, additional income of around $51 million would have been received over the 5 year period.**

5.39 The Government ceased the practice of deferring the employers contribution for lump sum payments and began repaying this debt in 1992-93. The balance of the debt, totalling $1.3 million, is to be fully repaid in 1993-94.

SEC Superannuation Fund

Asset allocations

5.40 Long-term asset allocation ranges have been established and are reviewed annually by the SEC Superannuation Fund's Investment Committee. Target allocations in each asset class are adjusted to reflect current conditions such as changes in domestic and international economies.

5.41 Analysis of the Fund's target and actual asset allocations over the past 5 years disclosed that:

- Funds allocated to short-term investments have fallen over the 5 year period from 8.1 per cent to 1.6 per cent reflecting the greater diversification of investments and the decline in nominal interest rates;
- The allocation of funds to traditional fixed interest investments has declined following an increase of funds allocated to a new asset class, namely, indexed bonds;
- Australian equity holdings have increased significantly, as a percentage of the total portfolio, from 23.3 per cent in 1989 to 41.7 per cent in 1993; and
- The major property holdings of the Fund have remained constant over the period. However, market devaluations have reduced the property component of the portfolio from 27.7 per cent to 15.4 per cent.

5.42 In general, the actual asset allocations have been consistent with the ranges set by the Investment Committee.

Diversification of property assets

5.43 The Trustees of the Fund have set guidelines relating to the proportion of funds to be invested in different types of property investments. Property holdings, excluding property trusts, at 30 June 1993, in comparison with the proportions set for the Fund, are shown in Table 5G.

TABLE 5G
PROPERTY HOLDINGS, 30 JUNE 1993
(per cent)

Property sector	*Range*	*Holdings*
Retail	20-60	54.4
Commercial	30-60	45.6
Industrial	0-10	-
Agricultural/Tourism	0-5	-

5.44 In addition, the Trustees decided that to achieve geographical diversity, not more than 80 per cent of property holdings were to be located within Victoria. During late 1988 and early 1989, the Fund invested $80 million in a property trust which has assets comprising office buildings in Sydney and Melbourne. This Investment was aimed at bringing the portfolio into compliance with the geographic target.

5.45 However, despite this investment, over 85 per cent of the property portfolio was still held within Victoria at 30 June 1993.

- *RESPONSE provided by Chairman, SEC Superannuation Fund*

  It is acknowledged that greater diversification of property is desirable, but the Report ignores the practical reality of achieving greater diversification in the heavily depressed and illiquid property market experienced over the last 3 years.

Hospitals Superannuation Board

Asset allocations

5.46 The Board first established target asset allocations in 1988-89. However, it has only been in the last 2 years that the Board conducted detailed analyses, with the assistance of its investment consultant, to identify asset allocation targets which best meet its investment objectives, match its liability profile as determined by actuarial assessment and ensure compliance with Treasury Guidelines. While **the asset allocations in recent years have been largely in line with the targets now established,** significant deviations from the targets occurred in earlier years due to:

- Delays in the selection and appointment of fund managers;
- The use of balanced fund managers. In these cases, a proportion of the portfolio was allocated to particular fund managers who made decisions regarding the amount of funds which were to be invested in each asset class. Although the selection of the managers was made, to some extent, on the basis of the composition of the manager's portfolio, the Board did not have complete control of the actual allocations made by fund managers; and
- Market timing considerations.

Diversification of property assets

5.47 Property assets of the Board at 30 June 1993, amounting to $29 million, included a number of commercial properties located in the Melbourne suburb of Camberwell and holdings in various property trusts.

Location of a number of Hospitals Superannuation Board properties in Camberwell.

5.48 A consultant engaged by the Board in early 1993 to develop a specific property strategy, concluded that **the Board had major problems in the property investment area primarily due to a lack of diversification within the portfolio.** In particular, the consultant noted that the Board had an over-exposure to commercial property (78 per cent) and a concentration on Victorian-based property investments (47 per cent).

5.49 An immediate short-term goal was set to increase the property allocation from 5 to 15 per cent through the injection of approximately $45 million into nominated property trusts. These investments would further diversify the Board's property assets to retail properties and properties outside Victoria.

5.50 In April 1993, the Board sought the necessary approval of the Department of the Treasury for the investments. Although a formal response to the request was not received, the Board was advised that approval would not be granted for the following reasons:

- one of the major investments would not be arms length from the Board's property consultant;
- liquidity would be limited and funds would be difficult to redeem quickly; and
- potential returns would be at the higher end of the risk and return scale.

5.51 Consequently, an initial aim of reaching the 15 per cent allocation by 30 June 1993 was not achieved. At the completion of the audit, the Board was considering alternative means of implementing the proposed property strategy.

5.52 For the long-term success of the Board's investment strategy, **action needs to be taken to ensure that actual exposures between and within the property area closely resemble the position identified by the Board as necessary to reach its diversification objectives.**

- *RESPONSE provided by General Manager, Hospitals Superannuation Board*

Since 30 June 1993, $25 million has been invested in Listed Property Trusts, and approval is being sought for an investment of $25 million in a trust which owns regional shopping centres in several States. These 2 investments will be the initial steps in achieving the strategic asset weighting.

State Trust Corporation

5.53 The objectives of the State Trust Corporation are to ensure that the public has access to trustee, estate administration and will-making services and to provide a range of services to publicly represented persons such as people who are unable or unwilling to manage their own affairs. Investment management is critical to ensuring client needs are met and assets are protected. Common Funds facilitate the pooling of certain assets managed by the Corporation. However, in line with normal Trustee practice, the directions of individual clients are to be followed. As these directions, in some cases, preclude the pooling of assets, funds are also managed by the Corporation on an individual portfolio basis.

5.54 The Common Funds, amounting to $301 million at 30 June 1993, represented around 56 per cent of total investments managed by the Corporation at that date.

Capital Growth Fund

5.55 In accordance with the *Trustee Act* 1958, Common Funds have traditionally been invested in fixed interest securities, commercial mortgages, commercial bills, short-term money market deposits and bank deposits. The concentration on these securities is aimed at providing secure investments to clients and a regular source of income. Share portfolios of individual clients have been managed separately by the Corporation.

5.56 In 1987, the provisions of the *Trustee Act* 1958 relating to authorised investments were amended to include shares in listed companies. The amendment provided the Corporation with an opportunity to expand the range of investments available to those clients whose funds are held in Common Funds.

5.57 Although the Board of the Corporation resolved in October 1990 to establish a Capital Growth Common Fund to be invested entirely in Australian equities, it was not until over 2 years later, in February 1993, that such a Fund was established to provide capital growth opportunities to clients. Consequently, some clients whose funds have been placed entirely in the Common Funds have, until recently, not had the benefits of maximised returns and minimised risks which result from a more diversified portfolio.

- *Response provided by Chairman, State Trust Corporation of Victoria*

  During the period in which the Equity Common Fund was being established, STCV has actively provided the opportunity to many clients for diversification by utilising external financial planning consultants and external investment options. These investment options included external equity investments, as well as insurance bonds, property trusts, debentures etc.

  In addition, in 1993 the introduction of the Equity Common Fund and financial planning services for STCV clients has ensured all clients now have this option available.

  It should be noted that the investment profile of the STCV client base is such that after the introduction of the Equity Common Fund in February 1993 the allocation of client funds to equities remains minimal. The STCV client base is unique, being essentially risk averse and income driven, and should not be seen as a sample of the general population.

Asset allocations

5.58 The Corporation did not address the issue of determining target asset allocations to various forms of fixed interest securities or short-term money market deposits held in the Common Funds until September 1992. While the Corporation's Investment Committee set minimum and maximum parameters for each asset class prior to that time they could not be described as targets as they varied by up to 40 per cent for particular asset classes. In March 1993, the Corporation's Investment Committee approved more specific allocation ranges for Common Fund investments.

5.59 Over the 5 years to 30 June 1993, there were wide variations in the proportion of Common Fund investments allocated to various classes of securities. There was no evidence to indicate whether the allocation, particularly in earlier years, was based on sound decisions by the Board and took into account available returns. In fact, the allocation to some categories was increased at the same time as returns in that category were declining. For example, **the allocation to commercial bills in one Common Fund increased from 6.2 per cent to 35.3 per cent during a 5 year period when returns over the same period decreased from 14.5 per cent to 6.1 per cent.**

- *Response provided by Chairman, State Trust Corporation of Victoha*

The STCV has a unique responsibility in managing client funds, which are predominantly those of clients who are either intellectually or physically handicapped (Common Fund 1), or beneficiaries of deceased estates awaiting finalisation and distribution (Common Fund 2.)

While the importance and relevance of this distinction may not be immediately apparent, it nonetheless is a critical factor in the fund profile and management practices of the STCV. The STCV adopts a hsk averse investment strategy where the preservation of capital is the primary concern of the STCV with the rate of return on the funds of secondary concern.

As there has been uncertainty across all financial markets over this period, the STCV elected to protect the capital value of client funds by re-allocating liquidated commercial mortgages. The commercial bill market provided the highest yield for the lowest risk, and this was seen as the most appropriate re-allocation for the funds at the time.

Notwithstanding this hsk averse strategy the STCV has out-performed all but 2 of the 11 other funds over the 5 year period to 30 June 1993.

IMPACT OF REDUNDANCIES ON DIVERSIFICATION

5.60 Over the past few years, the large number of voluntary resignations and redundancies in the Victorian public sector has affected the diversification strategies of some superannuation funds examined, in particular, the Hospitals Superannuation Board, the SEC Superannuation Fund and the State Superannuation Board of Victoria.

5.61 The large number of State Electricity Commission of Victoria employees accepting a voluntary departure package as part of an award restructuring program has resulted in a reduction in membership of the SEC Superannuation Fund from 21 600 at 30 June 1989 to 12 200 at 31 May 1993. This situation has required the maintenance of **a high level of liquid investments to cater for members leaving the Fund and the sale of assets from all asset classes, sometimes in depressed markets. Retrenchment payments of $800 million from the Fund's liquid assets have increased the proportion of remaining assets held in property. This factor has contributed to the impact of property devaluations on overall returns.**

5.62 As a result of an increased number of redundancy payments in the hospital area in recent years, the Hospitals Superannuation Board's cash outflows have also increased significantly. **While payments to members averaged around $70 million a year between July 1988 and June 1991, these payments increased to $128 million in 1991-92 and $113 million in 1992-93. This factor has necessitated the retention of increased funds in short-term securities.**

5.63 Similarly, the State Superannuation Board of Victoria has, at times, been required to retain funds in fixed interest investments to meet payments relating to Enhanced Resignation Payments, a voluntary resignation package aimed at reducing workforce numbers in the Victorian public sector.

5.64 The Boards and Trustees of these agencies have recognised that in the ongoing process of developing investment objectives and strategies, consideration will need to be given to the effect of retrenchments to date, and any proposed further reductions in members, on the short and long-term liabilities of the funds.

- *RESPONSE provided by Chairman, SEC Superannuation Fund*

Despite the significant reduction in membership, the actuarial review and oven/lews undertaken annually over the last 4 years have not indicated any substantial change in the Fund's liability profile that would Indicate the need to review existing investment objectives.

This question will be raised with the actuary when undertaking the 1994 actuarial overview.

The State Government's proposed initiatives in reforming public sector superannuation will require the establishment of an accumulation fund from 1 January 1994. Investment objectives and policies are currently being developed to cope with these changes.

ALLOCATIONS TO FUND MANAGERS

5.65 The diversification of funds within, as well as between, asset classes is also used as a means of reducing risk. This process has included the allocation of funds to a variety of internal and external fund managers. Many of the initial allocations made to external managers by public sector agencies were to balanced fund managers.

5.66 Although the majority of small superannuation funds continue to engage balanced fund managers, in more recent years, **there has been a move by the larger agencies to the appointment of specialist managers** in each asset class on the basis of their skills in the particular area and the style of the manager. This change has provided the agencies with greater scope to maximise the returns and minimise risk by enabling them to:

- tailor an asset allocation strategy to meet specific objectives;
- retain control of the aggregate risk level of the investment portfolio;
- improve monitoring of the investment program through the use of asset class specific benchmarks;
- employ leading experts in each of the major asset classes;
- use unique or leading edge investment strategies relating to individual asset classes; and
- reduce transaction costs.

5.67 Audit found that there have been different approaches in allocating funds to external managers. While some agencies, such as the Transport Accident Commission and the Victorian WorkCover Authority, have allocated almost the entire portfolio to external managers, others like the SEC Superannuation Fund and the State Superannuation Board of Victoria continue to manage a large proportion of funds internally.

5.68 Table 5H shows the proportion of investment portfolios allocated by each agency to internal and external fund managers at 30 June 1993.

TABLE 5H
FUNDS MANAGED BY INTERNAL AND EXTERNAL MANAGERS, 30 JUNE 1993
(per cent)

Agency	*Internal managers*	*External managers*
SEC Superannuation Fund	71	29
State Superannuation Board of Victoria	65	35
State Trust Corporation *(a)*	54	46
Emergency Services Superannuation Scheme	40	60
Gas and Fuel Corporation Superannuation Fund	28	72
Hospitals Superannuation Board	15	85
Local Authorities Superannuation Board	14	86
Melbourne Water Corporation Employee's Superannuation Fund	12	88
State Employees Retirement Benefits Board	11	89
Transport Accident Commission	7	93
Victorian WorkCover Authority	6	94
Transport Superannuation Board	4	96

(a) Relates to Common Funds.

5.69 Audit found that the agencies managing larger portfolios generally engaged a number of fund managers in each asset class to achieve a diversity of management styles. in most cases, a mixture of passive and active approaches was used with the passive approach generally limited to funds managed internally.

5.70 Managers adopting a passive approach aim to match the performance of an industry benchmark, such as the All Ordinaries Accumulation Index, by constructing a portfolio which mirrors the benchmark in terms of composition and weighting. On the other hand, managers adopting an active approach attempt to out-perform the benchmark by using their own judgement and market knowledge to select an alternative composition and weighting of securities or equities. Although an active approach can result in returns significantly in excess of industry benchmarks, it also has the potential to result in poor performance.

5.71 Audit found that the agencies examined had achieved diversity of management styles in the allocation of funds to internal and external fund managers. However, In the case of the SEC Superannuation Fund the use of different risk profiles and differing styles for internal and external managers in the fixed interest and Australian equities asset classes had been compromised, to some extent, by the following factors:

- A number of the Fund's advisors assisting in managing internal portfolios were also the pnnclpal individuals of the Fund's external fund managers, a situation not found at any other agency. In audit's view this may contribute to the adoption of a similar style for both the external and internal portfolios. **Consequently, potential existed for the intended strategy of diversification, through the adoption of different styles, to be partly negated;** and
- An approach had been adopted of changing the proportion of funds under internal and external management depending on the returns achieved in each area. This approach is intended to maximise investment returns and to provide the Fund with a criterion for increasing or decreasing the volume of funds under internal management. However, to some extent this defeats the purpose of selecting fund managers with a diversity of complementary investment styles as it places Internal and external fund managers in competition. As external fund managers are given a mandate to invest in higher risk Investments and more volatile markets In order to achieve their returns, internal fund managers would also need to invest in these areas to compete successfully.

- *RESPONSE provided by Chairman, SEC Superannuation Fund*

The Fund believes that the best external advice should be used wherever possible In certain cases that may mean using existing fund managers to provide specific advice in managing the internal portfolios of the Fund.

Currently the Fund uses Rothschild for advice on asset allocation and BEM for advice on managing the internal equities portfolio. In our opinion, their advice has been very positive for the overall performance of the Fund as reflected in individual asset class returns, and has not diminished the diversification benefits ahsing from a mix of internal and external managers.

Both these organisations are acknowledged experts and leaders in the funds management industry.

Rothschild manage a domestic fixed interest portfolio for the Fund and provides the Investment Committee with broad asset allocation advice on all asset classes, i.e. domestic equities, international equities, property, currencies, indexed bonds and fixed interest.

BEM manage a 50 Leader domestic equities portfolio for the Fund, and as part of the agreement when BEM was ohginally appointed, provides advice on the internal domestic equities All Ordinaries portfolio. The benchmark and management style of the BEM portfolio is significantly different to the benchmark and management style of the internal All Ordinaries portfolio. Therefore, in the Fund's view there is no risk of any significant reduction in the diversification benefits ahsing from a mix of internal and external portfolios.

In relation to fixed interest where all managers (internal and external) are managing to a similar mandate and an identical benchmark, there is a clear understanding that if the internal portfolio is not performing as well as the external portfolios, then more funds will be placed with external managers.

In relation to domestic equities, the same broad phnciple applies, except the compahson of internal and external portfolios is more complex because management styles, mandates and benchmarks vary across portfolios.

However, it is incorrect to suggest that the internal equities portfolios are disadvantaged because they are lower hsk and therefore will in the long run under-perform higher risk external portfolios. In fact the BEM 50 Leaders portfolio has a lower standard deviation (hsk) than the internal All Ordinaries portfolio.

PRUDENTIAL GUIDELINES

Arrangements with fund managers

5.72 Certain specific risk areas such as interest rate, currency, equity and property market risk are delegated by agencies to external managers who are expected to use their expertise to manage the risks while at the same time adding value to the investments. However, it remains the responsibility of Boards and Trustees to monitor the overall risk management of the portfolio.

5.73 Audit found that, within the agencies examined in detail, **the arrangements with fund managers provided a sound framework for managing these risks.** Contractual arrangements Included:

- prudential guidelines specifying the nature and extent of permissible investments and maximum exposure limits;
- minimum reporting requirements relating to the investments made and the performance achieved;
- rights of agencies to terminate managers at short notice; and
- requirements for managers to arrange adequate insurance against negligence *or* the financial collapse of the fund manager.

5.74 Although the reports provided by fund managers were found to be comprehensive and provided sufficient information for monitoring purposes, **the compliance functions within most agencies were deficient.** In the case of the Transport Accident Commission a Compliance Officer was appointed to specifically identify and promptly action any breaches by fund managers of the Commission's Investment guidelines. However, **in many other agencies, only limited checking was undertaken of fund managers' compliance with contractual arrangements.**

5.75 In view of the importance prudential guidelines play In ensuring that the risk and return parameters of each portfolio are in line with the objectives established by Boards and Trustees, **there is a need for procedures to be significantly strengthened in this area.**

Compliance with Treasury Guidelines

5.76 The Treasury Guidelines specify the maximum proportions of investment portfolios which can be allocated to each asset class (net exposure limits) and specific investment guidelines for individual asset classes. As indicated in Table 5I, the maximum net exposure limits have varied since the Treasury Guidelines were first issued in October 1987.

TABLE 5I
MAXIMUM NET EXPOSURE LIMITS
(per cent)

	Net exposure *limits*	
Asset class	*October 1987*	*December 1992*
Domestic fixed interest	60	100
Domestic equities	50	50
Domestic liquid	40	100
Domestic property	30	30
Overseas portfolio	20	*(a)*20

(a) Includes a maximum exposure of 3 per cent to emerging markets.

5.77 In the majority of agencies examined, the internal prudential guidelines established and the asset allocations made were in line with these parameters. However, in the case of one agency, the proportion of assets held in overseas equities at 30 June 1993 was 27 per cent compared with the maximum level of 20 per cent set within the Treasury Guidelines.

5.78 Although the SEC Superannuation Fund is not specified under the *Borrowing and Investment Powers Act* 1987, for several years the Trustees of the Fund have undertaken to give due regard to Treasury Guidelines in undertaking investment activities. Audit found that generally the Fund invests in accordance with the Act. However, **numerous instances were identified by audit where the Fund's investments were at variance with the Guidelines.** Instances included:

- investment in countries not permitted under the Guidelines;
- investments of greater than 2.5 per cent of the Fund in the single issue of one company or property trust; and
- investment of more than 10 per cent of an asset class in a single company.

5.79 In the case of the Transport Accident Commission, the internal prudential guidelines were found to be particularly comprehensive. A consultant's report provided to the Commission in late 1992 concluded that **the Commission's guidelines impose higher standards of prudential supervision than the Treasury Guidelines.** Unlike the other agencies examined, the Commission's guidelines also contained certain unique ethical standards such as a prohibition on investing in companies that derive more than 20 per cent of pre-tax profit from a range of activities including uranium mining.

PART 6

Arrangements with Fund Managers and Custodians

OVERVIEW

6.1 The **procedures followed by agencies for the selection and appointment of external fund managers were found to be rigorous and comprehensive.** However, significant delays had been experienced by agencies subject to the *Borrowing and Investment Powers Act* 1987 in obtaining the necessary approvals from the Department of the Treasury for fund manager appointments and terminations. These **delays have inhibited the timely implementation of investment strategies and, in at least one instance, have been costly for the relevant agency.**

6.2 Audit concluded that there is a need to review the evaluation and approval procedures in this area with the aim of achieving the benefits from centralised negotiations with fund managers, reducing any duplication and providing greater flexibility to agencies in the engagement of fund managers. in this regard, **consideration should be given to establishing an approved fund manager listing, at a central level, from which agencies can make selections.** Scope also exists to reduce legal costs and delays in the appointment process through the development of standard terms and conditions for inclusion in fund manager contracts.

6.3 The majority of investing agencies have appointed external custodians to provide various functions including physical safekeeping of securities, trade settlements and asset valuations. **These appointments play an important role in ensuring that duties are appropriately segregated thus reducing the risk to agencies of the misappropriation of funds.**

6.4 The reports supplied by fund managers and custodians provide sufficient information to agencies for reporting purposes and to enable investment performance to be adequately measured and monitored.

SELECTION OF FUND MANAGERS

6.5 As indicated in Part 5 of this Report, a significant proportion of investment funds are allocated by agencies to external fund managers. At 30 June 1993, around 82 arrangements were in place, within the 12 agencies included In the audit, for the engagement of fund managers. An examination of a sample of fund manager appointments indicated that the selection process involved input from external consultants, internal specialist staff and, where appropriate, Investment Committees. The following factors were major considerations in the selection process:

- the investment style of the manager;
- the organisational structure of the fund manager and whether it best complemented the investment portfolio to be managed;
- the expertise, skills and knowledge of the personnel within the organisation; and
- the risk profile adopted by the manager and the investment product offered.

6.6 Past investment performance and the proposed fee structures were generally secondary considerations.

6.7 Overall, audit found that the procedures followed in the selection process were rigorous and comprehensive. The framework in this area could be further enhanced within most agencies if the procedures for the selection of managers, and those relating to the ongoing arrangements with fund managers, were fully documented.

6.8 A number of specific issues relating to the engagement of fund managers within individual agencies follow.

SEC Superannuation Fund

6.9 At 30 June 1993, the SEC Superannuation Fund employed 13 external managers with responsibility for the management of 29 per cent of its investment portfolio.

6.10 The turnover of external managers engaged by the Fund, largely in the overseas equities area, was found to be higher than at other agencies, with 15 managers terminated over a 5 year period. While the average period of appointment was around 3 years, in 2 instances managers were terminated in less than 12 months. The reasons given for termination generally related to under-performance by the manager or changes in the personnel assigned within the fund manager organisation.

6.11 While the approach adopted by the Fund has been aimed at promoting high performance of external managers, it has also added to the costs of managing the Fund through increasing costs associated with the assessment and appointment process. The termination of managers on the basis of performance, In less than 3 years, may also encourage a focus on short-term performance rather than on the Fund's objective of achieving target returns over rolling 3 and 5 year periods.

State Trust Corporation

6.12 In March 1987, the then Office of the Public Trustee negotiated an agreement with the former State Bank of Victoria to manage part of the fixed interest securities portfolio held in Common Funds. In April 1988 and August 1989, further fund management agreements were entered into resulting in the Bank managing approximately $190 million in Common Fund assets. Following the sale of the Bank to the Commonwealth Bank of Australia, Commonwealth Management Services Limited, a subsidiary of the Commonwealth Bank, was appointed by the Corporation to manage a portion of the fixed interest portfolio.

6.13 Evidence could not be provided to audit to indicate that the appointment of an external fund manager had ever been the subject of a competitive tender process. A response to previous audit comment on this matter in May 1990 Indicated that management of the portfolio would be put to tender at the expiration of the contract in February 1991. However, at the time Commonwealth Management Services Limited was subsequently appointed, a tender process was not followed. **According to the Corporation, details of the criteria used in the selection process were not available.**

- *Response provided by Chairman, State Trust Corporation of Victoha*

  Although it was the STCV's intention to put the Common Fund management to tender in 1991, significant events influenced the Board's decision at that time. These events included the decision to split the management of the Fund between internal and external managers, and a significantly reduced fund management fee from CMSL.

  The STCV negotiated an agreement with the Commonwealth [Bankj Management Sen/ices Limited for the management of the fixed interest component of the Common Funds, while the STCV took over the management of the short-term money market component.

DELAYS IN APPOINTMENTS AND TERMINATIONS

6.14 While the *Borrowing and Investment Powers Act* 1987 gave the Boards and Trustees of defined funds and authorities the power to engage external fund managers to manage part or all of their investment portfolios, all appointments, terminations and associated terms and conditions are to be approved by the Treasurer.

6.15 Two of the agencies examined in detail, namely the State Superannuation Board of Victoria and the Hospitals Superannuation Board, are required to comply with these provisions. Examinations within these agencies and discussions with several other agencies responding to the audit questionnaire revealed that, while some improvement has occurred in more recent times, significant delays occurred within the Department of the Treasury over a number of years in the process of obtaining the necessary Treasurer's approval of appointments and terminations.

6.16 For example, in 1991 when the Hospitals Superannuation Board resolved to alter its strategy of appointing balanced fund managers, the Board experienced a delay of almost 2 months in obtaining the necessary approval. A more significant delay occurred when the Board sought permission to invest in overseas options and futures contracts, other than through the Sydney Futures Exchange. Although the initial approach was made in May 1992, approval of the Treasurer was not provided until mid-December 1992.

6.17 In the case of the State Superannuation Board of Victoria, the delays in the appointment process were even more significant. Table 6A summarises the timing of the appointment of external fund managers made by the Board up to 30 June 1993.

TABLE 6A
EXTERNAL FUND MANAGER APPOINTMENTS
STATE SUPERANNUATION BOARD OF VICTORIA
AT 30 JUNE 1993

Fund Manager	*Date of Board approval*	*Dafe contract signed*
County Natwest	June 1988	June 1989
Equitilink	June 1988	May 1989
J. P. Morgan	Nov. 1988	June 1989
Rothschild	April 1990	Sept. 1990
B T Asset	Aug. 1991	Aug. 1992
J. B. Were	Dec. 1991	Aug. 1992
Alliance Capital	Aug. 1991	*(a)*
Aust. Mezzanine	Jan. 1993	*(a)*
Hambro-Grantham	Jan. 1993	*(a)*
Advent Management	Jan. 1993	*(a)*
Commonwealth Funds Management	Apr. 1993	*(a)*

(a) Contract signed subsequent to June 1993.

6.18 The delays were predominantly attributable to:

- the lengthy process within the Department of the Treasury in the approval of managers selected by the Board;
- protracted negotiations between the Board and external managers on the terms and conditions of contracts; and
- the excessive time taken by the Department of the Treasury to review fund management contract documents.

6.19 In November 1992, the Treasurer indicated to the Transport Accident Commission that it would also be required to seek his approval prior to appointing or terminating external fund managers. Any impact of this requirement on the Commission's investment management activities is yet to be determined.

6.20 The prompt appointment and termination of fund managers is critical to the implementation of investment management strategies. It is particularly important to the process of diversifying portfolios in line with target asset allocations and changing market conditions.

6.21 As timing considerations are often a critical factor in entering particular markets, any delays in the appointment process can be costly for the agency or expose investment portfolios to unacceptable risks. This situation was particularly evident in the case of one agency where **delays by the Department of the Treasury in approving the termination of a poorly performing fund manager resulted in the agency forgoing at least $2 million in investment income between September 1989 and September 1990.**

- *Response provided by Secretary, Department of the Treasury*

  The review of the proposed appointment of an external manager is normally a straightforward process for which principles and procedures are widely available both in the private and public sectors. The delays in the appointment of the external managers were not, in the majority of the cases, delayed by Treasury's review of the external manager selection. While the delays in the internal approval process within Treasury had an impact on the timeliness of the approval process, a recent review of Treasury's files and the processes followed to obtain the approvals have shown that by and large the delays were attributable to funds and authorities:

  - *proposing fund managers who would have invested funds outside the asset allocation limits set by the Guidelines;*
  - *proposing fund managers which proposed products which were outside the Guidelines;*
  - *failing to present clear investment strategies and the inability of some funds and authorities to provide a clear rationale for investment in some asset classes and appointment of external managers to manage these investments; and*
  - *proposing investments outside their investment powers.*

DUPLICATION OF EVALUATION FUNCTIONS

6.22 In some cases the same fund managers were engaged by several agencies. For example, 3 of the 4 agencies examined in detail which appointed fund managers in the Australian equities area, had engaged the same fund manager. The selection processes followed in these instances were performed separately by each agency. In the case of agencies subject to approval of the Department of the Treasury, a further review was undertaken within that Department prior to appointment. Audit was advised by the Department that the central review process had, on occasions, included discussions with individual fund managers.

6.23 Audit concluded that **the current arrangements result in the duplication of procedures.** In addition, they are not necessarily conducive to taking advantage of the Government's strong position in the negotiation process.

6.24 Given these factors and the previously highlighted delays in the approval process, **there is an urgent need to review the ongoing appropriateness of the procedures followed for the approval of fund manager arrangements.** Such a review should be aimed at assessing alternatives for achieving the benefits of centralised negotiation while at the same time providing greater flexibility to individual agencies in the selection process.

6.25 In this regard, consideration should be given to establishing and regularly updating an approved fund manager listing from which Boards and Trustees can make selections on the basis of the specific objectives and strategies of the agency.

- *Response provided by Secretary, Department of the Treasury*

  For Treasury to establish and maintain a list of approved managers would mean that it would have to have a mechanism for regularly reviewing and monitohng the performance of fund managers. This is not considered to be an appropriate Treasury function.

  Each fund should choose its external fund manager according to the type of management which suits the fund's objectives. Treasury needs to ensure that an appropriate selection process is followed by specialised private sector consulting firms.

  Overall, it is the responsibility of the Boards of the funds and authorities to select fund managers which are appropriate to their adopted investment strategies. The selection criteria will vary between funds, reflecting the different liability profiles and investment objectives. Also, ongoing supervision and assessment of the fund managers is the responsibility of the Boards.

USE OF STANDARD CONTRACTS

6.26 Considerable time has been spent by some agencies in developing and negotiating contract terms and conditions with individual fund managers. This process, which often involves the engagement by both parties of legal representatives, has contributed to further delays in the appointment process.

6.27 A number of agencies such as the State Superannuation Board of Victoria and the Transport Accident Commission have more recently taken the initiative of developing fund manager contracts which incorporate certain standard terms and conditions, including investment management guidelines for particular asset classes, relevant benchmarks, custodial arrangements, reporting requirements and insurance obligations. Negotiations with the managers do not generally proceed unless these minimum terms and conditions are accepted. Subsequent negotiations are then primarily directed towards addressing areas such as fund manager fees and mandates.

6.28 Further scope exists to minimise legal costs and streamline the appointment process through the extension of this practice to other agencies or through the development of a standard contract at a central level.

REPORTING PROCESSES

6.29 As indicated in Part 5 of this Report, fund managers are required to operate within established investment guidelines incorporated into contractual agreements with agencies. To assist agencies in monitoring performance, fund manager contracts also specify monthly and quarterly reporting requirements.

6.30 Although the audit disclosed differences between reporting requirements both between agencies and in some cases between individual fund managers, contractual arrangements included the following reporting components to be provided on a weekly, monthly or quarterly basis:

- details of all transactions conducted during the period;
- an asset valuation report showing the cost and market value of assets held at the end of the period;
- reports on performance comprising return calculations and comparisons with industry benchmarks; and
- market commentaries and predictions of expected future trends.

6.31 Audit examinations indicated that **the reports provided by fund managers complied with contractual requirements and provided adequate information to enable performance to be measured and monitored.**

USE OF CUSTODIANS

6.32 The purpose of a master custodial service is to provide fiduciary and administrative support to Institutional investors by adding value where multiple investment managers are used, when the range of securities held in portfolios is extensive, or when investments are held in numerous domestic or foreign markets.

6.33 The majority of agencies had appointed a master custodian. However, 3 of the smaller agencies relied on custodians nominated by individual fund managers for the following custodial services:

- physical safekeeping of securities such as share scrip and bonds;
- conduct of trade settlements to ensure that assets are controlled at all times;
- management of cash balances in an effort to maximise portfolio returns and control;
- conduct of regular and consistent valuations of the portfolios;
- provision of daily cash transaction statements; and
- supply of realised and unrealised capital gains and losses reports.

6.34 Master custodians in most cases also have a role in monitoring the activities of fund managers and reporting any breaches observed in agency guidelines. Reconciliations between the records held by fund managers and those of the custodian are also required to be undertaken.

6.35 The engagement of master custodians plays an important role in segregating the functions performed by fund managers from those associated with the settlement of transactions and the custody of securities, **thus providing greater protection to agencies against the misappropriation of funds**.

6.36 Audit concluded that **the information and analyses provided by custodians were comprehensive and provided a sound basis for accounting and reporting and upon which investment performance could be measured and assessed.**

PART 7

Accountability Framework

OVERVIEW

7.1 The Government's main objectives in introducing the *Borrowing and Investment Powers Act* 1987 were to ensure that Investments of defined funds and authorities are prudently and responsibly managed, that agencies have access to a broad range of investment mediums and products and that advantage is taken of maximum returns within acceptable risk parameters.

7.2 The increased powers provided to agencies by the legislation was to be supported by a central monitoring framework. The Department of the Treasury was assigned responsibility for this key role within the overall investment accountability framework. The implementation of sound decision-making and reporting procedures within individual agencies is also an essential feature of such a framework.

7.3 Audit found that, **in general, agencies had established appropriate investment management, monitoring and reporting mechanisms** characterised by:

- the appointment of Investment Committees responsible for the overview of investment activities;
- the setting up of Investment Divisions staffed by personnel with appropriate qualifications and experience to undertake the day-to-day management of investments;
- the engagement of specialist investment advisors to complement the knowledge of agency staff; and
- extensive reporting to, and monitoring by, Investment Committees and Boards and Trustees.

7.4 While the Department of the Treasury has provided guidance to agencies through the issue of the Treasury Guidelines, significant deficiencies have existed in the timeliness of Information provided to the Department by agencies and in the procedures within the Department for monitoring compliance with the Guidelines since 1987. Consequently, the Department has not been in a position to effectively undertake its central agency function of scrutinising the operations of agencies in the investment area or ensuring that the Government's objectives in introducing the 1987 legislation have been met.

7.5 Given the substantial funds invested by public sector agencies, coupled with the liabilities of the Government in the form of funding commitments and guarantees, it is essential that the central reporting and monitoring procedures be strengthened. Audit considers that such **procedures should be aimed at ensuring the overall risks of Government are accurately measured and appropriately managed and that the impact of any alterations in government policy or any dramatic changes in market conditions can be promptly evaluated and actioned.**

7.6 The Government has recently announced in the 1993-94 Budget Papers that the framework for supervising and monitoring the performance of major public sector investment portfolios will be reviewed in the current financial year.

MANAGEMENT AND ACCOUNTABILITY WITHIN AGENCIES

Overview by Boards and Trustees

7.7 As the prime responsibility for investment performance rests with the Boards and Trustees of agencies, a sound reporting process to, and monitoring by, appointed members is essential. The majority of agencies examined had established Investment Committees as the primary means of facilitating the regular overview of investment activities. The Committees generally comprised selected members of the Board or Trustees, senior management representatives and the manager responsible for the day-to-day management of the investment portfolio.

7.8 Audit found that within the agencies examined in detail the **Boards or Trustees and their Investment Committees included members with appropriate investment management expertise. An examination of relevant minutes also revealed that the appointed members played an active role in monitoring investment activity.**

Role of Investment Committees

7.9 Audit found that Investment Committees, which usually meet on a monthly basis, made decisions or recommendations to Boards or Trustees on issues such as investment objectives and strategies, asset allocations, investment performance and the selection of external fund managers.

7.10 To assist in this process, the Committees were provided with regular reports containing:

- detailed analyses of the investment portfolio, in total and on an asset class basis, including information on overall performance and asset allocations;
- economic forecasts; and
- analyses of the performance, portfolio composition, and outlook within each asset class including comparisons of performance against benchmarks.

7.11 Key information in these areas was regularly reported by the Committees to Boards and Trustees. While the information provided in the earlier portion of the 5 year period covered by the audit was found to be deficient in some agencies, **a significant improvement in the quality of the reports provided for monitoring purposes was evident in more recent years.**

7.12 This situation was particulariy evident at the State Trust Corporation. An examination of minutes and related documentation prior to the establishment of an Investment Committee by the Corporation in January 1989 revealed little evidence that investment management issues were raised at meetings of the Corporation's Board. The lack of adequate monitoring procedures was primarily due to the absence of available management information at that time.

7.13 Although established in 1989, the Investment Committee of the Corporation undertook relatively limited monitoring of investment activity until June 1992. This was especially evident during 1991 when the Committee did not meet between May and December. However, an audit examination of minutes of Committee meetings indicated that the Committee had taken a more active role in recent times.

Role of investment divisions

7.14 While ultimate responsibility for the management of investment portfolios rests with appointed Boards and Trustees, the audit disclosed that each agency had established a specialist investment division assigned primary responsibility for the implementation of strategies and for the day-to-day monitoring of investments. The specific functions of these divisions included:

- regular contact with fund managers;
- preparation of reports;
- analysis of fund manager returns and other investment information;
- management of property and other internally managed investments;
- provision of assistance in the management of investment strategies; and
- monitoring of the risk profile of the total investment portfolio.

7.15 **Within the 5 agencies examined in detail, suitably qualified staff were engaged to perform these functions.**

Engagement of specialist advice

7.16 The 12 agencies included in the audit had each engaged specialist external investment advisors to complement the knowledge of staff engaged within the agencies. The advisors had been used for a variety of purposes including:

- assisting in the determination of investment strategies;
- selection of external fund managers;
- monitoring of external fund manager performance; and
- provision of advice on specific issues such as the selection of appropriate performance benchmarks.

7.17 The external advisors also provided the agencies with regular reports which included analysis of external fund manager performance, financial market trends and forecasts and other general Information concerning investments.

7.18 Although the agencies made extensive use of the services of specialist advisors, formal contracts were not generally in place between agencies and their advisors. Audit considers that **the formalisation of these arrangements would be advisable to ensure that the rights of agencies in areas such as minimum services, due diligence, confidentiality and the level of fees are adequately protected.**

Information systems

7.19 One of the elements of effective investment management is the maintenance of appropriate recording and accounting systems. **Detailed examinations within most agencies Indicated that appropriate information systems were either in place or, in some agencies such as the State Superannuation Board of Victoria in the process of implementation.**

7.20 The State Trust Corporation, which makes Common Fund investments on behalf of numerous individual clients, has been required by legislation, since it was established in 1987, to distribute investment income to each client. The income is distributed monthly, on the basis of the actual income received and the proportion of funds held in the Common Funds for each client. The Corporation is also required to keep an account for individual clients showing the current amount at credit in each Common Fund. The establishment of an effective information system, in these circumstances, is particularly important.

7.21 However, prior to 1990, the Corporation had not established a system which adequately met these requirements. The systems in place at that time resulted in:

- inefficiencies in recording and processing Common Fund investment transactions; and
- a lack of timely information for management and monitoring purposes.

7.22 As an accurate quantification of actual income was not available from within the systems, distributions to clients were based on income estimates. Over several years, these deficiencies contributed to significant discrepancies in the distributions to clients. Although action was taken in June 1990 to rectify the discrepancies, a further review commissioned by the Corporation in early 1992 identified that $2.3 million had still not been appropriately distributed to clients during the period November 1987 to June 1990. The Corporation has now taken positive action to correct the position with the re-distribution process substantially completed.

7.23 Since it was established in 1987, the Corporation has recognised the deficiencies in the systems used to account for and record Common Fund investments and the development and implementation of a computer based accounting system to address the problems has been regarded as a major priority for a number of years. While interim manual reconciliation systems have been in place since 1990 to ensure income is accurately distributed, it is anticipated that the new computerised system will at last be in place by the end of 1993. The system is expected to improve the efficiency of the process and enhance the information available for investment management and performance monitoring purposes.

- *Response provided by Chairman, State Trust Corporation of Victoria*

  We confirm the computerised Treasury Accounting System will be installed by end of 1993, which will eliminate inefficiencies referred to in the audit report.

  Whilst the manual reconciliation processes have been administratively inefficient it has been necessary to ensure clients receive their proper income entitlement

Procedural documentation

7.24 Documentation of investment management objectives, policies and procedures is important to ensure that a clear framework for investment activities is in place. This is generally accomplished through the development of a document which consolidates policies and procedures in the following areas:

- investment objectives and strategies;
- investment monitoring and reporting framework;
- the use of external fund managers;
- benchmarks by which performance is to be measured;
- risk management strategies; and
- the role and responsibilities of all parties associated with the investment function.

7.25 **Audit found that while some agencies, such as the Transport Accident Commission, had developed a comprehensive, consolidated manual to cover these areas, the documentation in a number of other agencies examined required significant improvement and updating.** Specifically, there was a need to consolidate information currently held in a multitude of separate documents and to formalise procedures to be followed in a number of areas such as the engagement of fund managers.

CENTRAL AGENCY ROLE

Background

7.26 As previously indicated, the *Borrowing and Investment Powers Act* 1987 increased the investment powers of defined funds and authorities. An approval and supervisory process was to be set in place to ensure that funds and authorities did not incur unacceptable risk profiles in exercising these powers. The Department of the Treasury was assigned responsibility for this role which has primarily been facilitated through the issue of Treasury Guidelines which define certain requirements and parameters relating to investment activities within agencies. In addition to the funds and authorities defined in the Act, a number other large investing agencies have provided information to the Department in recent years on investment activities.

7.27 At 30 June 1993, 8 of the 12 agencies examined by audit were subject to supervision by the Department. Table 7A sets out details of those agencies and the value of the investment funds managed by the agencies at that date.

TABLE 7A
INVESTMENTS UNDER MANAGEMENT BY AGENCIES UNDER TREASURY SUPERVISION, AT 30 JUNE 1993
($million)

Agency	*Amount*
Transport Accident Commission	4 222
Victorian WorkCover Authority	2 165
State Superannuation Board of Victoria	1 754
Local Authorities Superannuation Board	1 370
Emergency Services Superannuation Scheme	661
Hospitals Superannuation Board	571
Transport Superannuation Board	106
State Employees Retirement Benefits Board	81
Total	**10 930**

7.28 In 1992, the former Government commissioned a review of the State's finances. A report entitled *State Finance Victoria - Independent Review of Victoria's Public Sector Finances,* September 1992, emanating from that review disclosed a number of deficiencies relating to the accountability framework for investment activities of superannuation funds. in particular, **it highlighted that certain proposed initiatives outlined in the 1987 Treasury Guidelines had not been implemented and that the processes for monitoring investments at a central level were largely inadequate,** mainly due to the resourcing constraints within the Department of the Treasury and the unsuitability of some management information for central monitoring purposes.

7.29 While some improvement has subsequently been made in those areas, the current audit confirmed that the central monitoring function is still largely inadequate.

- *Response provided by Secretary, Department of the Treasury*

  Since the Guidelines were established in 1987, the investment environment has changed and the expertise available to the funds has increased. Some of the initiatives suggested in 1987 are now considered not to be appropriate. Treasury's review of the investment monitohng framework, the Guidelines and the reporting arrangements will develop a revised investment framework which will establish clearly that responsibility for performance and management of hsk rests with the funds and clarify the monitohng and supervisory roles of Treasury. As a result of this review, the Guidelines will be amended accordingly.

Investment management guidelines

7.30 The Treasury Guidelines issued in October 1987 included the following features:

- statement of the Government's objectives;
- a commitment that a regular consultative process would be established to ensure that the Treasury Guidelines and investment powers remain relevant, appropriate and cost-effective;
- guidance on the establishment of investment objectives and strategies by agencies;
- definition of the investment risks which are of primary concern to the Government and an indication that diversification is the primary means of minimising risk;
- maximum net exposure limits for various investment asset classes;
- specific investment guidelines for various asset classes;
- criteria for undertaking hedging transactions;
- required terms and conditions for the appointment of external fund managers;
- a requirement for agencies to develop clear guidelines and interface arrangements with external fund managers in order that effective monitoring and control be carried out on the degree of risk exposure and performance;
- a requirement for agencies to develop specific internal management control systems, policy and procedure manuals and credit exposure policies; and
- details of a quarteriy reporting procedure to be established between the agencies and the Department.

7.31 Although the Treasury Guidelines have subsequently been revised and reissued on a number of occasions, they have primarily continued to address the above issues.

Compliance monitoring

Overview role

7.32 The effectiveness of any guidelines depends, to a large degree, on the effectiveness of compliance monitoring procedures established to support the guidelines. Such monitoring not only provides incentive to agencies subject to the guidelines to achieve compliance but also provides information vital to any assessment of the extent to which the guidelines have met their objectives.

7.33 Although the Treasury Guidelines are structured in a manner which provides clear parameters for investment activities, audit found that the overall compliance monitoring activities within the Department since 1987 have been inadequate in some areas and non-existent in other important areas. In addition, audit found that the Department had not regularly identified, measured and evaluated the investment risk profiles of investing agencies subject to the Treasury Guidelines.

7.34 Consequently, **the Department has not been in a position to quantify the overall risk exposures of the Government or to promptly measure and evaluate the impact on the Government of any variations in government policy or sudden change in market conditions such as a fall in interest rates, a collapse of stock markets or a deterioration in a particular country's economy.** Similarly, it has not been in a position to determine whether the initial objectives of introducing the *Borrowing and Investment Powers Act* 1987 have been met.

- *RESPONSE provided by Secretary, Department of the Treasury*

The overriding aim of the Investment Guidelines is to reduce investment risk by establishing asset class limits on a fund-by-fund basis and by requiring the funds to diversify their portfolios. Limiting risk on a fund-by-fund basis reduces hsk to the State.

The Guidelines require the funds and authorities to include risk/return targets in their investment strategy. They also provide for the establishment of probability levels for negative returns In any one year This emphasises the need for funds to consider risk in establishing their strategies.

It is not the intention to make Treasury the overall manager of the State's investments. Treasury's role is to monitor the performance and hsk of the funds Individually and in aggregate. Treasury can raise any concerns it has with regard to either performance and risk with individual funds or with them collectively. However, except in extreme situations or where there was a clear breach of the prudential framework, Treasury would seek the assistance of the funds to achieve any required adjustment and for this to be accepted as part of the investment strategies of the funds. However, it is agreed that Treasury should have appropriate information reported to it to ensure that it can monitor and respond to developments relating to investment risk and performance.

Investment objectives and strategies

7.35 The Treasury Guidelines require agencies to establish investment objectives and strategies after consideration and analysis of specific factors including:

- the nature of the agency's assets and liabilities;
- the risk and return preferences of the agency's members;
- the preferences of the agency and the responsible Minister;
- quantification of an acceptable level of risk;
- recommended portfolio composition which will maximise returns within the previously defined risk parameters; and
- other considerations associated with the investment process including the use of internal staff and external fund managers.

7.36 The investment objectives were to be established in consultation with the Department.

7.37 Audit found that although most agencies examined had established investment objectives and strategies, **there was no evidence that they had been developed in consultation with the Department or that the Department had reviewed the objectives to ensure that the factors specified in the Treasury Guidelines had been considered and analysed.**

Investment risks

7.38 The Treasury Guidelines specify and define the following investment risks which are of primary concern to the Government and are to be kept within acceptable pre-defined parameters:

- the risk that a fund will suffer loss due to adverse movements in interest rates (interest rate risk);
- the risk that a fund will suffer loss due to adverse movements in stock markets (market risk);
- the risk that a fund with an overseas investment portfolio will suffer financial loss due to adverse movements in the exchange rate (foreign exchange risk);
- the risk that a fund will suffer loss due to the inability of the counterparty to meet its financial obligations (default risk);
- the risk that a fund will suffer loss due to mismanagement, fraud or speculative use of techniques and products designed to manage foreign exchange and interest rate risks (operational risk); and
- the risk that a fund will be penalised through the payment of income tax at maximum rates (tax risk).

7.39 Procedures have not been established within the Department to regularly review the management of these risks by agencies.

Maximum net exposure limits

7.40 The Treasury Guidelines include maximum net exposure limits and specific investment guidelines for individual asset classes (refer to paragraph 5.76 of this Report).

7.41 There was no evidence within the Department to indicate that monitoring of compliance by agencies with these exposure limits had been undertaken between 1987 and 1991. **Although a process of quarterly reporting by agencies against net exposure limits was established during 1991, monitoring procedures have not yet been put in place within the Department to monitor parameters within individual asset classes such as limitations within the Treasury Guidelines on investments in certain countries.**

Investment management documentation

7.42 Agencies are required to provide the Treasurer with a range of specific documents concerning their investment management activities including the following:

- investment objectives, strategies and guidelines;
- policy for the use of financial instruments in hedging transactions;
- an investment Policy and Procedures Manuals; and
- a Credit Exposure Policy.

7.43 Audit found that these specific documentation requirements had not been consistently met by agencies since 1987 and that Treasury had not enforced the requirements.

Quarterly reporting and review

7.44 The Treasury Guidelines issued in October 1987 stated that *"... to facilitate both the implementation of the Act and the consultative process between the Government and superannuation funds, a regular reporting procedure will be implemented".* The reporting procedure was to occur quarteriy and was to include detailed analysis of the investment portfolios at a total and asset class level from various perspectives.

7.45 It was also intended that several measures would be built into the reporting requirements which would indicate the extent and manner in which futures, options and swaps have been used.

7.46 It was not until early 1991 that the Department addressed this issue with the appointment of a private company to carry out the quarterly reporting process in co-operation with the relevant agencies. A review of the reports provided to the Department to June 1993 disclosed that they had not been promptly provided and were in some aspects incomplete. Consequently, comprehensive information was not available to the Department on a timely basis to enable the overall performance or risk exposures of individual agencies, or the public sector agencies as a whole, to be measured and monitored.

- *Response provided by Secretary, Department of the Treasury*

  Over the past 5 years, the increasing professionalism of the investment approach of the funds has occurred to a large extent in response to the enactment of the BIP Act and the requirements of the Guidelines developed by Treasury.

  The level of compliance with the Guidelines is high and the Guidelines have achieved Treasury's main purpose which was to set prudential boundaries around the investment portfolios of the funds and authorities and minimum standards for their investment activities.

  The supervisory framework preferred by Treasury is one in which the Board of each fund or authority has clear responsibility for the management of investment risk as well as the performance of its fund. Where funds and authorities have in place effective processes for the management of their investment portfolios, Treasury could add little value unless it was willing to replicate within Treasury the processes which should be established within each fund or authority. Thus, it is not considered appropriate for Treasury to become involved in the detailed approval of investment strategies or to act, in effect, as an investment adviser Treasury's concern has been to establish approphate guidelines and to ensure that the Boards have in place the appropriate processes to establish responsible investment strategies.

PART 8

Cost of Investment Management

OVERVIEW

8.1 The investment management costs of all agencies amounted to around $44 million in 1992-93 including $31 million paid to private sector fund managers.

8.2 In general, 1992-93 costs as a proportion of funds invested, were higher for agencies allocating a larger proportion of their portfolio to external managers. Audit was advised by agencies that as costs associated with managing funds internally are lower than engaging external managers, higher returns have been required from their external managers. Consequently, in many cases, costs as a proportion of net Income generated were similar for many agencies.

8.3 As minimum fund manager fees often apply to the management of funds up to a certain level, **higher proportional costs were incurred by a number of agencies responsible for managing smaller portfolios.**

TYPE OF INVESTMENT COSTS

8.4 The major expenses associated with investment management comprise:

- fees paid to fund managers;
- custodian fees;
- costs associated with engaging consultants; and
- administrative expenses primarily related to the salary costs of internal investment management staff.

8.5 The investment costs for all agencies over a 5 year period are not readily available. However, as indicated in Table 8A, the costs in 1992-93 alone amounted to approximately $44 million. Costs associated with property management have been excluded from the calculations as the property portfolios of each agency differed significantly.

TABLE 8A
INVESTMENT MANAGEMENT COSTS 1992-93
($'000)

Agency	*Fund manager fees*	*Custodian and consultant costs*	*Administration costs*	*Total*
TAC	14 400	2 400	1 300	18 100
WorkCover	5 998	117	130	6 245
SECSF	2 310	850	1 120	4 280
SSB	1 740	830	1 420	3 990
HSB	1 410	400	380	2 190
ESSS	1 131	295	732	2 158
MWCESF	806	117	83	1 006
GFCSF	432	135	69	636
LASB	2 319	798	1 066	4 183
SERBB	269	-	150	419
TSB	539	-	2	541
STC *(a)*	-	-	-	-
Total	**31 354**	**5 942**	**6 452**	**43 748**

(a) Costs in the above format could not be provided by the State Trust Corporation.

8.6 An examination of available information disclosed a general increase in fund manager fees over the past 5 years reflecting the trend over that period of allocating an increasing proportion of funds to external managers. Higher costs in the consultancy and custodian area in recent years are also in line with the increased engagements in these areas.

FUND MANAGER FEES

8.7 Fund manager fees are the highest component of investment management costs and are obviously dependent on the proportion of funds allocated to external managers. The management of funds through the use of external fund managers is generally more costly than managing funds internally. As a consequence, agencies usually require higher performance from their external managers than from funds managed internally.

8.8 in most cases, fees charged by fund managers are determined either on the basis of a fixed percentage of funds managed or, more often, a percentage which reduces as the amount of funds managed increases. In a limited number of cases, the fees are based on the performance of the managers. In such cases, fund manager fees considered in isolation may appear disproportionately high where good performance is achieved.

8.9 The level of fund manager fees varies for different investment classes with the management of domestic cash the cheapest and international fund managers generally the most expensive.

8.10 The level of fund manager fees is monitored by most large agencies each month through the calculation and reporting of fund manager performance. In the case of some smaller agencies, such monitoring processes are only undertaken annually.

8.11 As investment returns are determined after deducting fund manager fees, comparison of fund manager performance against benchmark performance ensures that managers remain conscious of maximising returns while also minimising costs. In the same way, managers must also minimise transaction costs when seeking higher returns.

COMPARISON OF INVESTMENT COSTS

8.12 A number of measures can be used to compare the costs of managing various investment portfolios, namely:

- costs as a percentage of the funds managed;
- costs as a percentage of net investment income; and
- in the case of superannuation funds, costs per member.

8.13 There are certain limitations in using any of these measures in isolation. For example, costs as a percentage of funds managed may be maintained at a lower level by minimising the use of external fund managers. However, this strategy does not necessarily result in maximised returns within an appropriate risk profile. Similarly, comparisons of costs as a percentage of net investment income does not take into account the risk profile of the portfolio. Consequently, **the following analyses of costs need to be considered within this context.**

Costs as a percentage of funds managed

8.14 Table 8B sets out the 1992-93 investment costs of each of the agencies included in the audit as a percentage of the funds managed.

TABLE SB
COSTS AS A PERCENTAGE OF FUNDS MANAGED, 1992-93

Agency	*Value of investments ($million)*	*Per cent*
MWCESF	177	0.60
TSB	106	0.50
SERBB	81	0.50
TAC	4 222	0.40
HSB	571	0.40
SECSF	1 270	0.30
WorkCover	2 165	0.30
ESSS	661	0.30
LASB	1 370	0.30
SSB	1 754	0.20
GFCSF	280	0.20
STC	301	0.07

8.15 The differences highlighted in the above table, to some extent reflect the proportion of funds managed externally. For example, The Transport Superannuation Board and the Transport Accident Commission each has over 90 per cent of its portfolio allocated to external fund managers.

8.16 The higher costs associated with some agencies such as the Melbourne Water Corporation Employees' Superannuation Fund and the Transport Superannuation Board also reflect the size of the investment portfolios managed. As minimum fund manager fees generally apply to the management of funds up to a certain levels, costs are proportionally higher in the case of small portfolios allocated to external fund managers.

Costs as a percentage of net investment income

8.17 Table 8C sets out the investment costs of each agency as a percentage of net investment income generated in 1992-93.

TABLE 8C
COSTS AS A PERCENTAGE OF NET INVESTMENT INCOME, 1992-93

Agency	*Net of investment income $million*	*Per cent*
GFCSF	0.9	69.1
SERBB	8.2	5.1
MWCESF	20.9	4.8
TSB	14.1	3.8
TAC	479.1	3.8
HSB	65.9	3.3
SECSF	130.3	3.3
ESSS	73.2	2.9
LASB	155.4	2.7
SSB	165.0	2.4
WorkCover	271.7	2.3
STC	27.7	0.8

8.18 As reflected in the table above, costs ranged from 0.8 to 5.1 per cent of net investment Income for all agencies except the Gas and Fuel Corporation Superannuation Fund which, by way of comparison, recorded costs equivalent to 69.1 per cent. **The exceptionally high proportional costs reflect their poor performance in 1992-93.**

Appendix A

Glossary of terms

GLOSSARY OF TERMS

Active management	Managing with a view to out-performing an industry benchmark by using judgement and market knowledge to select a composition and weighting of securities or equities which differs from those of the benchmark.
Annualised cumulative return	The return on an investment portfolio usually calculated on a compound monthly basis and subsequently converted to an annual rate of return.
Asset allocation	Apportioning components of an investment portfolio between different classes of assets such as equities, property, fixed interest securities and short-term money market deposits.
Balanced fund manager	Manager assigned responsibility for making decisions regarding the proportion of the funds allocated to the manager which are to be invested in each asset class.
Capital growth	Increase in the market value of an asset.
Defined benefit superannuation fund	Fund in which members receive a predetermined benefit on retirement. Payouts to members are usually related to salary at, or near, completion of employment.
Direct property holdings	Land or buildings purchased outright either in commercial, industrial, retail or residential sectors of the property market.
Diversification	Spreading an investment portfolio between, and within, different asset classes.
Equities	Shares representing part-ownership of a corporation.
Exposure	Extent of vulnerability of an investment portfolio to particular risks such as fluctuations in interest rates, stock market movements or changes in economic conditions in a country where equities are held.
Fixed interest securities	Investments with a fixed value to be repaid in cash to the holder on a fixed future date. Predetermined interest is received by the holder periodically during the period the security is held. The securities can, in many cases, be traded in the market with market values dependent on the interest rate applicable to the security and the prevailing interest rate at the time of sale.
Industry benchmark	Measure used within the industry to assess performance of investment portfolios. Benchmarks are usually asset class specific and take the form of indices designed to measure investment returns.
Liquidity	The extent to which an asset can be quickly converted to cash.
Management style	The specific approach and philosophy adopted by a fund manager to the management of an investment portfolio. For example, an active or passive approach may be adopted.
Net asset coverage ratio	A funding measure used by superannuation funds to determine the extent to which current net assets match expected future benefit payments.
Passive management	Managing investments with the aim of matching the performance of an industry benchmark by constructing a portfolio which mirrors the benchmark in terms of composition and weighting.

Property trust	A type of unit trust which pools the funds of unit holders for the purpose of investing in property assets.
Prudential guidelines	Parameters set for an investment portfolio with a view to managing risk. Such guidelines include limitations or prohibitions in relation to the amount of funds to be held in particular classes of assets, countries or companies.
Risk	Usually expressed as the volatility or variability of an investment return. In general terms, the more variable an investment's return, the riskier the investment.
Risk/return profile	Relationship between the average return received on an investment portfolio during a particular period and the volatility, or variability, in the returns over the period.
Short-term money market deposits	Investment of money on a short-term basis, generally for less than 12 months. May also include placement of money overnight or 90 and 180 day bills of exchange. Interest received on such deposits is generally dependent on fluctuations in nominal rates.
Specialist fund managers	Fund managers specialising in one sector of investment markets.
Standard deviation	Mathematical formula used to measure the extent to which returns have fluctuated, over a period, from the average return during that period.
Strategic asset allocations	Setting long-term targets for apportioning funds to various asset classes.
Tactical asset allocations	Short-term decisions to apportion funds to well performing asset classes and fund managers.
Time weighted rate of return	Measurement of return which minimises or eliminates the effects of cash flows.
Vested benefits index	A solvency measure used by superannuation funds to determine the extent to which current net assets match the cash flows required if all currently accrued member benefits were to be paid immediately.

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