
Explanatory Statement for the *Future Drought Fund Investment Mandate Direction 2019*

Objective of the Direction ('Investment Mandate')

- 1 As stated in the *Future Drought Fund Act 2019* (the Act), the Government has established the Future Drought Fund (the Fund) to enhance the Commonwealth's ability make arrangements with, or make grants to a person or a body in relation to drought resilience.
- 2 Under the Act, the Future Fund Board of Guardians (the Board), who are responsible for deciding how to invest the Fund, must seek to maximise the return earned on the Fund over the long term, consistent with international best practice for institutional investment.
- 3 This investment function is subject to any restrictions placed on the Fund by the Act and to any directions given by the responsible Ministers under subsection 41(1). Directions issued under subsection 41(1) of the Act are known collectively as the Future Drought Fund Investment Mandate.

Notes on the Sections

Part 1 - Preliminary

Section 1 - Name

- 4 The naming convention of this investment mandate follows the Office of Parliamentary Counsel's Drafting Direction No 1.1A, issued 14 November 2016.
- 5 The investment mandate provides 'written directions' under section 41(1) of the Act.

Section 2 - Commencement

- 6 The investment mandate takes effect after a period of 15 days after it has been provided to the Board, pursuant to section 41(6) of the Act.
- 7 This investment mandate is a legislative instrument that is not subject to disallowance or sunset, pursuant to the *Legislation (Exemption and Other Matters) Regulation 2015* made under the *Legislation Act 2003*.

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- 8 This investment mandate will be published on the Federal Register of Legislation, along with any submission on the draft investment mandate by the Board.

Section 3 - Authority

- 9 The Finance Minister and the Treasurer, as responsible Ministers under the Act, are required to issue at least one investment mandate to the Board under section 41(1) of the Act. This is the first investment mandate that will take effect after the commencement of the Act.

Section 4 - Definitions

- 10 Definitions are to be read in conjunction with the relevant Acts, which include the Act and the *Future Fund Act 2006*.

Part 2 - Direction

Section 5 - Object

- 11 The Board is to carry out the investment function as outlined in the Act and in accordance with this investment mandate, in addition to their existing functions outlined in the *Future Fund Act 2006*.
- 12 The investment mandate requires the Board to maximise the return earned on the Fund over the long term, consistent with international best practice for institutional investment.
- 13 The investment mandate provides guidance to the Board on matters of risk and returns, and other matters that are consistent with the Act.

Section 6 - Benchmark return and acceptable level of risk

- 14 The benchmark return is consistent with the Government's intention that the Fund grows to a balance of \$5 billion by 2028-2029, while at the same time drawing down \$100 million per year from 1 July 2020 to fund initiatives that enhance future drought resilience, preparedness and response across Australia.
- 15 For the purposes of this investment mandate the Government has directed the Board to adopt, as the benchmark return for the performance of the Fund, an average return over the long-term of at least the Consumer Price Index + 2.0 to +3.0 per cent per annum net of costs.

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- 16 Implementing a mandate with a range provides the Board with scope to target lower levels of return when they believe the prospective reward for investment risk is relatively low, and conversely, higher levels of return when they believe the prospective reward for investment risk is relatively high.
 - 17 The Government accepts that there will need to be an initial transition period. This period includes the time required:
 - (a) to transfer financial assets comprising the Building Australia Fund;
 - (b) for those financial assets to be able to be invested in other financial assets; and
 - (c) for the Board to implement a long-term strategic asset allocation.
 - 18 During this period, the portfolio will be transitioned from lower risk and return assets, and the long-term benchmark return will therefore not be met. The Government understands this transition period could be up to 12 months.

Acceptable level of risk

- 19 The Government is conscious of the risks inherent in investing financial assets and acknowledges that, in practice, this will involve some volatility in the Fund's returns, including the possibility of material losses in some years.
- 20 To provide the Board with guidance on the limits to the Government's acceptance of risk in pursuing the benchmark rate of return, the Direction states "the Government acknowledges that targeting the long term benchmark return implies accepting the risk of capital losses, in adverse markets, that may be 15-20 per cent of the portfolio over a three-year period".
- 21 The investment mandate requires the Board to have regard to section 18 of the Act. This requires the Board to take all reasonable steps to ensure that the balance of the Special Account is sufficient to cover debits for the purposes of the Future Drought Fund. The Board will need to ensure the portfolio has sufficient liquidity to meet the required cash flows.

Section 7 - Board must consider impacts from its investment strategy

- 22 The Government has a broad obligation to the Australian community to make decisions that are economically and fiscally responsible. In establishing the Fund, it is the expectation of the Government that the investments of the Fund should not disrupt the normal operation of domestic financial markets.

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- 23 The Board, in setting the investment strategy and in instructing the investment of the Fund, must act in a manner that minimises the potential to effect any abnormal change in the volatility or efficient operation of Australian financial markets.
 - 24 The Board is also required to act in a manner that is unlikely to cause any diminution of the Government's reputation in Australian and international financial markets.
 - 25 The Government participates in a number of international organisations which pursue high standards of conduct in financial markets. The Government recognises that the Board will invest in international capital markets as part of a sound investment strategy involving diversification. In doing so, the Government expects that the Board will act in a manner that is unlikely to cause embarrassment to the Government.

Section 8 - Corporate governance

- 26 In undertaking its investment functions, the Board must act consistent with, and establish policies on matters relevant to, international best practice for institutional investment. In particular, the Government would expect the Board's policies to include its approach to corporate governance principles, including its voting policy.

Section 9 – Reporting

- 27 To provide appropriate transparency on the investment performance of the Fund, the Board is required, at a minimum, to publish quarterly reports on its website.
- 28 Consistent with the quarterly reports for the Future Fund, the Medical Research Future Fund and the Aboriginal and Torres Strait Islander Land and Sea Future Fund, the quarterly reports are to include information on the asset allocation of the portfolio by category and the actual returns against the benchmark return.

Consultation

- 29 The Board has been consulted prior to setting this investment mandate, in accordance with section 44 of the Act. Their submission, if made, will be tabled and published on the Federal Register of Legislation.