Tuvalu Trust Fund

Report of the Investment Committee and results for the 6 months ended March 2015

Highlights

- Market Value of the TTF Investments at 31 March 2015 was $150.48 million while Maintained value was $140.65 million so investments exceeded Maintained Value by $9.83 million or 7.0%.

- Investment performance over the six months has been 7.3% after fees while inflation has been only 0.4%. The target is CPI + 4.5% pa, or 2.6%[1] for the half year so has exceeded the target by 4.7%. The very low inflation – largely from falling world oil prices – has assisted the out-performance. The OBAA managers underperformed traditional funds over the past 3 years while equities have increased strongly, but our managers are considered to be well positioned for the future as shares are unlikely to continue to rise in value and bonds may fall in value as interest market yields rise when the US Federal Reserve raises interest rates.

- The new investment approach started in March 2012. In the 3 years since then, the investment return (after fees) has been 9.7% per annum which is 2.9% pa above the target. The new approach is providing the desired results and the Investment Committee continues to have confidence in the fund managers and their ability to respond promptly to financial markets.

- Global sharemarkets remain at or near record highs though volatility has increased. In the March 2015 quarter Australian equity markets rose 10.3% - a surprisingly high gain. Bond yields fell in many countries as central banks have continued to try to stimulate economies. The fall in world oil prices has reduced inflation. There remains a risk of deflation for some countries and inflation is expected to remain low. There is still the expectation that the US Federal Reserve will increase US interest rates from mid 2015. The expectation of a sharemarket correction of 10-15% in the next year remains probable.

- As the TTF is 7.0% above maintained value, there is a reasonable probability that there will be another distribution at September 2015. The Fund managers have become defensive in their stance in anticipation of possible falls in market values. The TTF may experience some fall in value, but this would be much less than the markets as a whole.

- Investment of the CIF is in the Schroder's fund that has a target of CPI + 3.5% and allows withdrawals at short notice. The quarterly report from the Investment Advisor includes data on the performance of the CIF investment in Appendix 3. The CIF has now been invested for a year and achieved a return of 7.6% (net of fees) compared with the target of 5.2% (also net of fees). Previously the CIF earned 2% pa and the Australian cash rate is currently 2.25%. Gaining improved returns for the CIF is important now that it has around $25 million.

Recommendation

The Investment Committee recommends the Board:

- Receives and notes the report of the Investment Committee for the 6 months to March 2015.

[1] The percentages compound rather than add so the target is slightly higher than adding the CPI rate to 4.5% pa.

Committee activities

1. Since the Trust Fund's last meeting in November 2014 in Funafuti, the Investment Committee held a meeting in Suva on 3 March 2015 (minutes in Attachment 1) and another by Skype on 4 May 2015 to enable this report to be prepared and distributed a week prior to the Board meeting. The Suva meeting enabled committee members and the Secretariat to attend an Investment Conference in Suva. The conference was focussed on investment issues for Pacific countries and featured the TTF as a case study that demonstrated sound governance and the OBAA approach to investment was presented by Schroders. It was a very worthwhile conference and the Committee members are grateful for approvals that enabled the change of meeting location to accommodate attendance.

2. Quarterly reporting by Eriksens has followed the agreed format but as approved by the Board, has been further expanded so Appendix 2 provides more relevant comparisons with external benchmarks. The report is now even more comprehensive and continues to provide the data needed to allow the Investment Committee to closely monitor fund manager performance.

Investment Targets

3. The investment targets for the TTF and its two fund managers are set out below, as a reminder. The TTF's target is lower than the combined fund manager's targets and is higher than the aim of providing an annual distribution of 4% of the value of the fund, after maintaining real value.

   a. **TTF targets**:
      Achieving a return (net of investment expenses) over 5 year periods of at least 4.5% pa in excess of price inflation as quantified by the Australian Consumer Price Index (All Groups) not seasonally adjusted as measured by the Australian Bureau of Statistics (CPI) and so that the likelihood of achieving a negative return (net of investment expenses) over any 12 month period is less than 20% (i.e. less than once every 5 years).

   b. **AMP target**:
      An investment return of CPI + 5.75% pa before fees over a 5 year period subject to the likelihood of a negative year 1 in 6 years. As the fees are 0.75% this is a target of 5.0% + CPI.

   c. **Schroders target**:
      An investment return of CPI + 5% pa before fees over rolling 3 year periods subject to the likelihood of a negative year 1 in 13 years. As the fees are 0.51% this is a target of 4.49% + CPI.

4. The AMP fund takes a slightly more growth-oriented approach than the Schroders' fund, which is reflected in their higher target return and likelihood of a negative year 1 in 6 years compared with 1 in 13 years for Schroders. The two approaches complement each other so that the combined strategy is effectively a target of CPI + 4.75% over 3-5 years with a likelihood of negative returns 1 year in 10.

Investment Results

5. During the December 2014 quarter the approved distribution of $8.7million was made with half this sum from each fund manager.

6. Despite the distribution, Market Value of the TTF Investments at 31 March 2015 was $150.48 million while Maintained value was $140.65 million so investments exceeded Maintained Value by $9.83 million or 7.0%. Investment performance over the six months has been 7.3% after fees while inflation has been only 0.4%. This is a significant achievement and is 4.7% above the target. It has been assisted by low inflation.

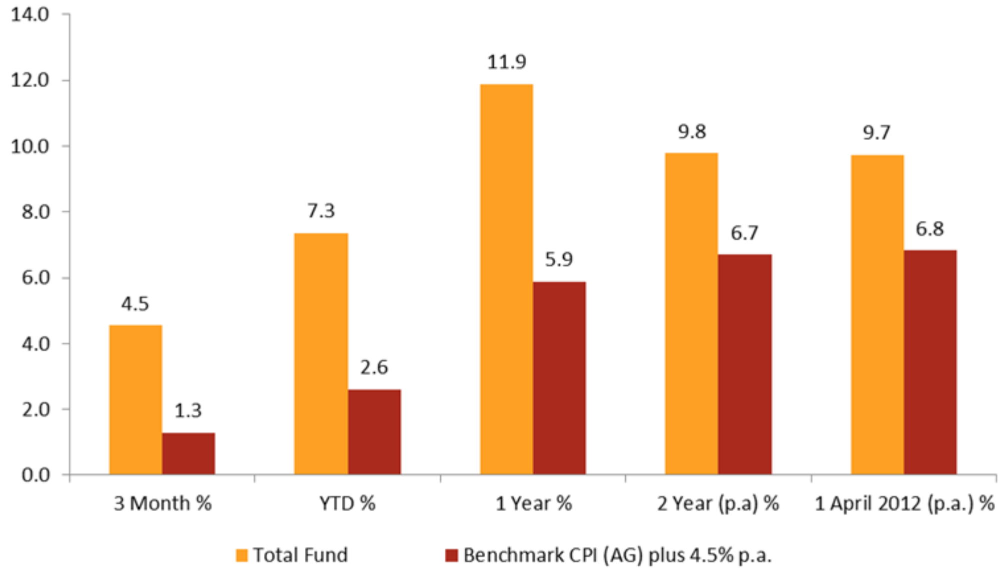
7. Looking at results over the half year shows the variability for each quarter:

Tuvalu Trust Fund Investment Performance vs. Target

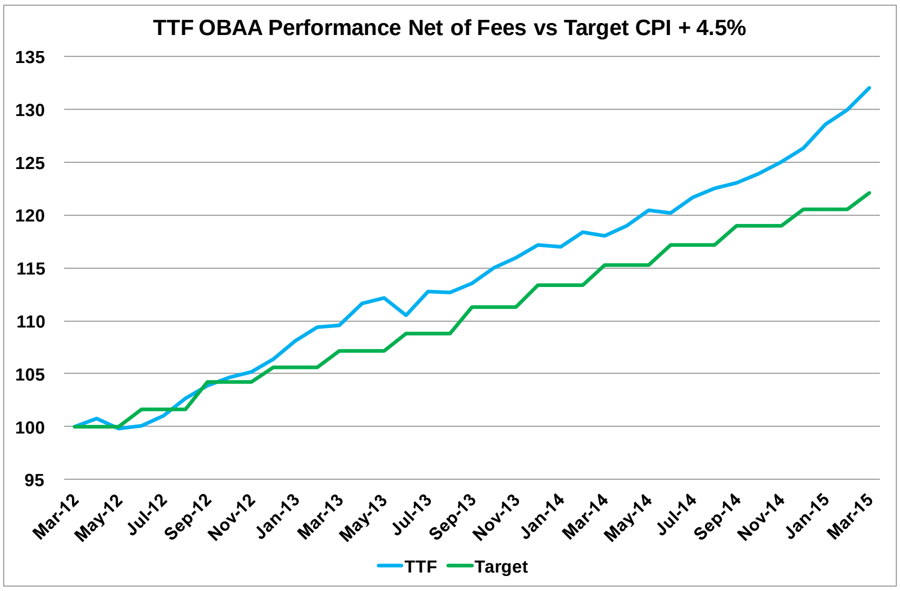
	Dec-14	Mar-15	YTD
TTF Investment return after fees	2.7%	4.5%	7.3%
Target CPI + 4.5%	1.3%	1.3%	2.7%
Difference	1.4%	3.2%	4.7%

8. Investment with AMP and Schroders has been since March 2012. Since April 2012 the TTF returned 9.7% per annum (after fees) which was 2.9% above the target. The chart shows the returns for the TTF as a whole, relative to the target:

TTF Actual Return (after fees) compared with Target (CPI + 4.5%)

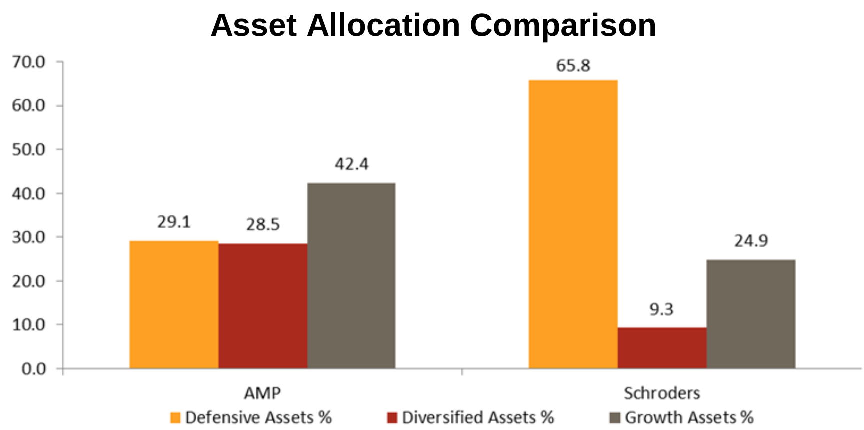


9. Cumulative results since OBAA investment commenced comparing actual after fees returns against the target shows that consistent cumulative out-performance has been achieved since late 2012:



Comparing the two managers

10. The two fund managers, AMP and Schroders, continue to have different approaches to asset allocation and these have diverged further over the past 6 months.



11. AMP holds more equities and makes greater use of absolute return strategies. Schroders hold more defensive assets including more cash. Schroders had 33% in cash while AMP had 19% in cash, so both are well positioned to take advantage of buying opportunities. Both have performed well with their different approaches but achieved slightly different results.

Comparison between Investment Managers

	Half Year to Mar-15		Since March 2012	
	AMP	**Schroders**	**AMP**	**Schroders**
Investment return (net of fees)	8.8%	6.6%	11.0%	9.9%
Target CPI + 4.5%	2.7%	2.7%	6.8%	6.8%
Difference	6.1%	3.9%	4.2%	3.1%

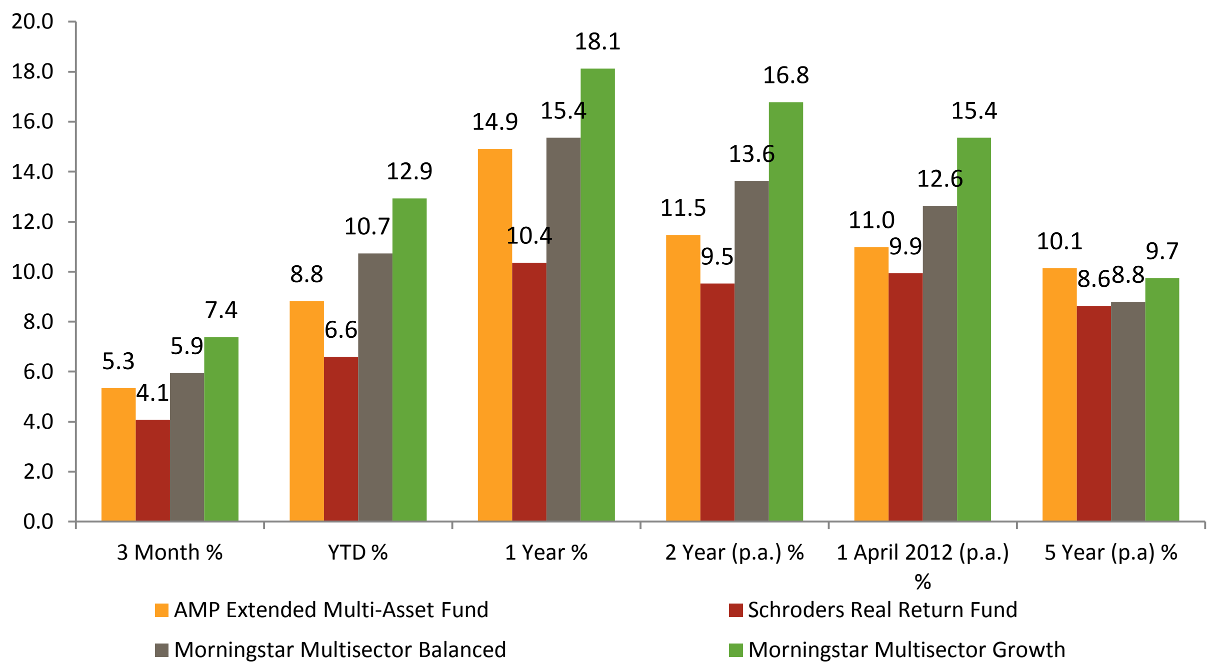
12. This table uses the TTF targets rather than the manager's own targets. But note that AMP has a higher self-imposed target than Schroders and takes a slightly more growth-oriented approach, with their target being over 5 rather than 3 years, so it should be expected that they would have greater variation. It is important to remember that the main

performance objective for AMP/Schroders is a five year/ three year Rolling Return period while the TTF has had investments with these funds for only 3 years. Despite these qualifying comments, the results for the past 3 years have been similar, though AMP has out-performed over the past year as they have had a higher proportion of equities and less in defensive assets.

13. The Committee considers that the different approaches to investment complement each other and when the different asset allocations are combined, moderate the overall result.

14. The Committee monitors the Fund's performance compared to peers as shown by the Morningstar Multi-sector Balanced and Growth indexes. This can be seen in the following chart which uses gross (pre-fee) returns. Note that TTF has only used OBAA for 3 years so the 5 year return is indicative rather than what was achieved – but demonstrates that these OBAA funds have achieved similar results to traditional funds, but with lower volatility.

Gross Investment Returns



15. The Morningstar funds represent the former strategic asset allocation approach to investment. These funds tend to have a higher proportion of investments in growth assets (70% for Balanced and 80% for Growth) than our fund managers have to date, so do better when sharemarkets rise, but worse during downturns due to a lack of flexibility to alter asset allocations. It is worth noting the comments from Eriksens:

> "The Growth and Balanced benchmarks have produced superior returns over the medium term due to the strong gains in equity markets over these time periods. The absolute returns from each of the managers are still very good and have helped the TTF to achieve (and exceed) its outcome of CPI plus 4.5% per annum.
>
> The majority of funds comprising these benchmarks have traditional SAA strategies.

Over the longer term the comparison will provide an objective measure of the success of the OBAA strategy.

By nature these balanced and growth SAA strategies have higher fixed weightings to growth assets, and as a result such funds have benefited from the continuing market rally since 2009.

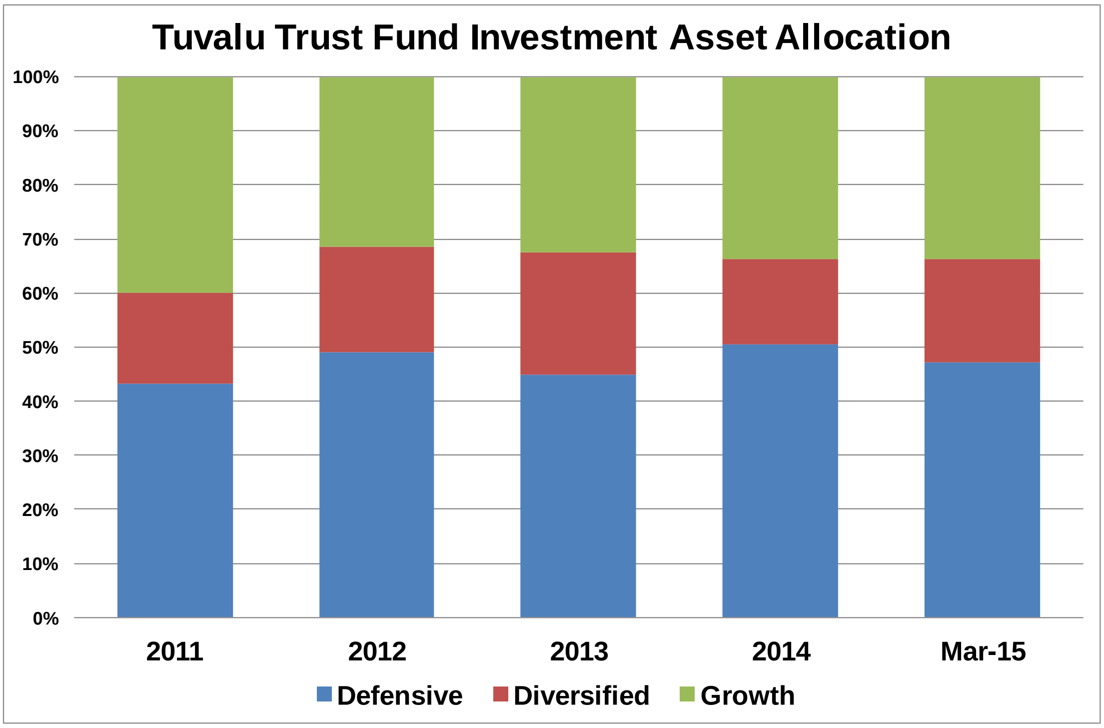
Consequently, the TTF has underperformed the Multi-sector Balanced and Multi-sector Growth benchmarks over these time frames. The results for the TTF however are still good, both in absolute terms and compared to the actual performance objective being CPI plus 4.5% per annum.

The OBAA strategy has thus far been very successful in that it has protected capital and provided distributions to the Tuvalu Government. Over the long term it is expected that this will continue to provide consistent returns with less downside volatility, while still benefiting from much of the upside performance in markets.

At this point, after three years of performance since commencing the OBAA strategy, it is still too early to attribute consistent results. As the time frame for this strategy increases, the performance advantages accruing are becoming clearer and we will be able to comment in more depth. In particular, once the economy has moved through a full cycle the benefits of this strategy will be more evident."

Overall Asset Allocation

16. The chart below shows the overall allocation of investments for the past 4½ years. The 2011 data was under the strategic asset allocation approach and 2012 shows the change when the Fund switched to OBAA. The switch resulted in a lower risk approach with a lower weighting in equities – though managers can have up to 75% in growth assets but have chosen to be more cautious over the past 3 years.

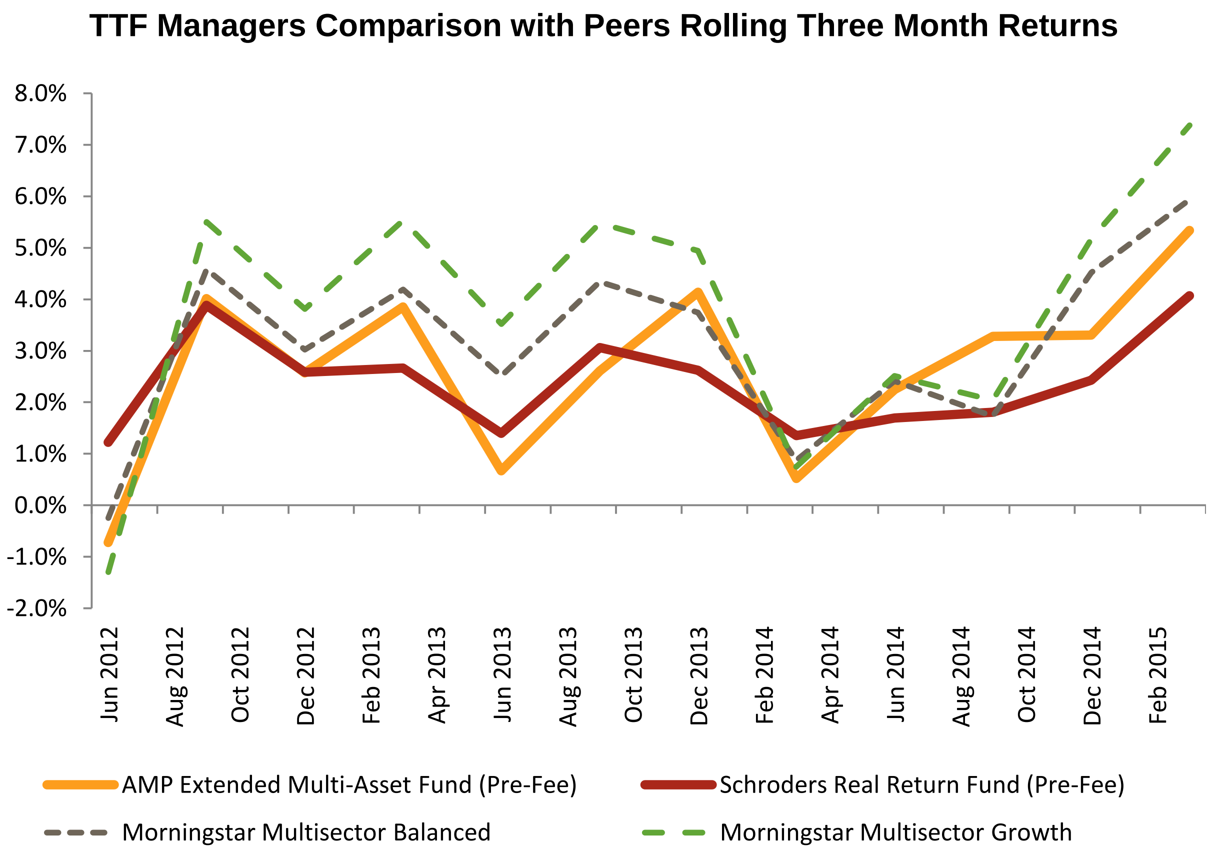


17. Since 2012 the allocation has been relatively stable though the managers have made changes within each category to adapt to the financial markets. In the last year the managers have only slightly increased the proportion of defensive assets. This masks the varied approaches being taken by the two fund managers as demonstrated in the chart after paragraph 10.

18. In addition, in anticipation of rising interest rates the managers have changed the duration of bond investments to reduce the potential loss in value when short term market yields rise. Schroders have 33% in cash and AMP 19%.

Effect of Investment Approach

19. The Objective-based Asset Allocation approach now being used provides less volatility than the previous strategic asset allocation approach, with an acceptable level of targeted returns. This means that it should result in more regular distributions. Volatility refers to the variability in returns. This is illustrated in the chart which compares the TTF managers with other funds that use a fixed asset allocation approach.



20. Note that during major market downturns, the TTF funds should generally outperform the strategic asset allocation funds. During period of gains the traditional funds tend to do better. OBAA funds are structured to reduce such volatility while targeting a stated acceptable level of return over inflation. This has certainly been true for Schroders though AMP's results have been more volatile, reflecting their relatively more growth-oriented approach, with the June 2013, December 2013, March 2014, September 2014 and March 2015 quarters as examples.

Investment Consultant report

21. Accompanying our report is the Investment Consultant's quarterly review. The executive summary covers the essential points that the Board should note. The report provides a detailed assessment of the fund manager's performance. The scorecards cover the managers' investment performances both from a return and a risk aspect in a simple and clear visual way. A green light shows that a target has been exceeded or there is no business change, amber shows on target performance or minor business change and a red light below target performance or major business change.

22. This quarter both managers have two amber measures making 4 out of a total of 14. Both have amber for "ex-post volatility (lower than target)" and "higher probability of loss". AMP's probability of loss is 12.4% vs. 10% target, while Schroders' is 15.3%. These reflect their expectations of future market movements. Note the Investment Consultant's comment on this:

> "Currently the risk of loss is extremely high at present because of very high stock markets, very low interest rates and nervous investors. However, under OBAA the managers dynamically reduce the size of potential losses which improves the performance and shortens the recovery period.
>
> Hence, although both managers probability of loss is over 12% and technically could be rated red we have rated both as amber to reflect the lower impact of the expected market corrections. The overall risk of loss is less than one year in five (or 20%) which is the objective in the SIOP."

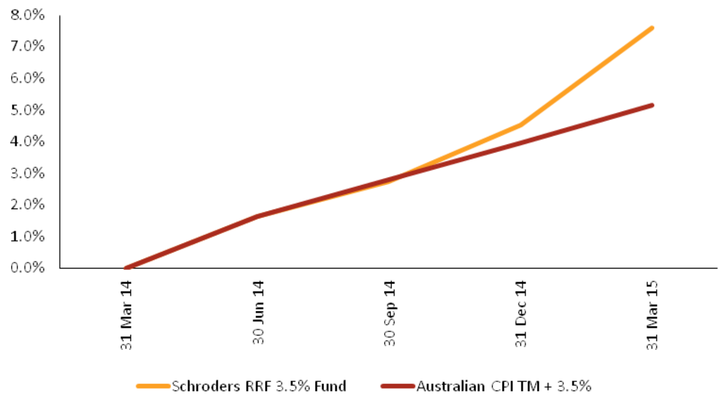
23. The number of amber lights is small. The Committee has no immediate concerns over these amber lights but will continue to carefully monitor these areas with Eriksen. We have agreed that Eriksens should review the parameters for traffic lights, especially those for expected loss.

The CIF

24. The CIF stood at $24.6 million as at 31 March 2015. During the half year, the CIF received $8.4 million as the distribution from the TTF ($300,000 was reserved for Secretariat expenses) and the Government of Tuvalu deposited $1.5 million into the CIF, but withdrew $4.5 million.

25. The CIF now uses a conservative Schroder's fund that has a target of CPI + 3.5% (before fees) and allows withdrawals at short notice. This is similar to the fund used by the TTF, but even lower in risk. The new investment was made on 5 March 2014.

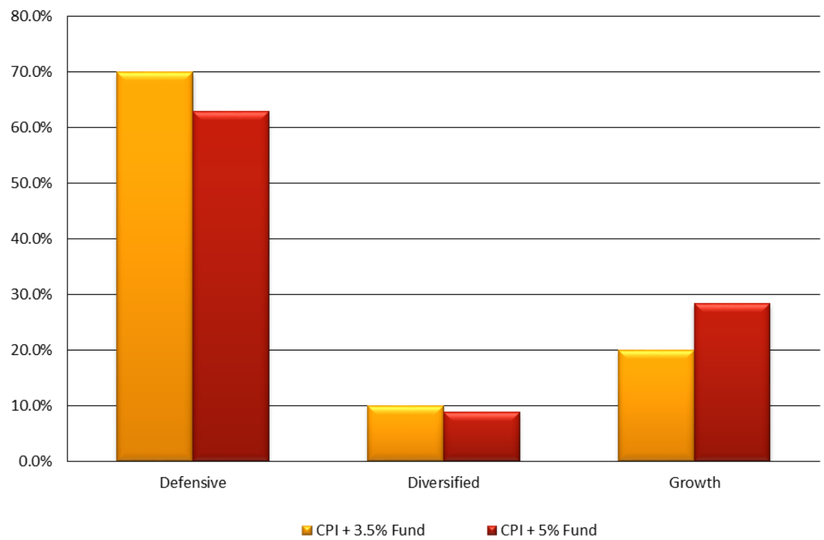
26. As requested by Cabinet, the Committee monitors the returns achieved by the CIF. Since inception to March 2015 (just over 12 months) the CIF achieved a return of 7.6% (net of fees) compared with the target of 5.2% (also net of fees) – see the chart. Previously the CIF earned 2% pa and the Australian cash rate is currently 2.25%.



27. As this investment is a more conservative version of the Schroders fund used by the TTF, the quality and risk monitoring is already covered in the QIPS. The probability of loss is targeted at 1 year in 20.

28. A comparison of the asset allocation between the two Schroder funds shows the difference in approach:

Schroder Fund Asset Allocations March 2015



Westpac Account

29. At 31 March 2015 the Westpac account balance was $394,064. The Secretariat drew $60,000 from the Westpac account to support the office during the first quarter of the 2015.

Future challenges

30. The issues facing the world economy, government budgets, financial markets and investment returns remain challenging. The outlook is:

- Global share markets remain at or close to record highs.
- There are geo-political risks from wars.
- The US economy is improving with increased employment, but lower workforce participation. There is a high probability of the Federal Reserve raising interest rates in mid to late 2015 which will affect fixed interest investments and could cause falls in shares.
- Eriksens and the fund managers continue to expect a share market correction. Both fund managers have defensive strategies.
- Interest rate rises for Australia seem unlikely because the economy is not performing well.
- The European Central Bank (ECB) is expected to maintain their low interest rate environment and may even have to weaken further (by unconventional means) to counter deflation.

31. The Investment Committee agrees with the need for continued caution and notes that the ability to make tactical changes in investment approach is exactly what the OBAA approach enables.

32. The move to the OBAA strategy and appointment of AMP and Schroders as fund managers was aimed at maintaining real growth while reducing volatility and managing the downside risk of such an outlook. While it is too early to be definitive since their objectives are for returns over 3-5 year periods, the results for the first 3 years under the OBAA approach have been very positive. While funds with higher proportions invested in equities have done better than the OBAA approach in the short term, they are vulnerable to the market changes widely anticipated over the next year.

David Hutton
Chair, Investment Committee
4 May 2014

Attachments

1. Minutes of the IC meetings held in Suva on 3 March 2015 and by Skype on 4 May 2015
2. Quarterly Manager Performance Statement (March 2015)

TUVALU TRUST FUND
INVESTMENT COMMITTEE MEETING
Conference Room, Grand Pacific Hotel, Suva, 5:30pm, 3 March 2014

1.0 Present
Advisor to the Australian Director on the TTF Board – Mr David Hutton (Chairman)
Advisor to the New Zealand Director on the TTF Board – Ms Nalayini Brito

In Attendance:

Investment Consultant – Mr Jonathan Eriksen (Eriksens & Associates Ltd)
Staff Member – Ms Rosanne Ede (Eriksens & Associates Ltd)
TTF Secretary – Mr Lee Faiva Moresi
TTF Assistant Secretary – Ms Salai Sualo
Clare Offwood - Schroders

2.0 Apologies

2.1 All were present

3.0 Minutes

3.1 (a) The minutes of the meeting held on 3 November 2014 were adopted as a fair and true record of the previous meeting.

(b) Action Points.

i. *Revise Appendix 2 on CIF for the QIPS*: Completed
ii. *Add text to the QIPS on AMP's self-rating:* Completed
iii. *Clarify point 8 of the Investment Committee Report:* Completed
iv. *Comment/correct TTF Secretariat Budget for FYE 2015:* Completed
v. *Provide information to set-up of the Westpac electronic bank account:* Completed at this ICM
vi. *Circulate all available Board Papers by 5 November:* Completed
vii. *Minutes of the Meeting:* Completed
viii. *Confirm Schroders' and AMP's availability for 2-4 March in Suva*: Completed
ix. *Ascertain Board/donor approval of the cost of holding the ICM in Suva:* Completed

4.0 Investment

4.1 QIPS

The report for the quarter ending 31 March 2015 had been circulated to all members before the meeting. There was no discussion of the report and everything was considered to be working well. AMP Funds under management is $800 million and Schroders funds under management is $7.5 billion.

4.2 CIF

Same is for QIPs in 4.1 above.

5.0 Redemption Procedure
The Acting TTF Secretary had circulated a Paper prior to the meeting. The Investment Consultant had a document proposing some changes to Paper prepared by his office which he presented at the ICM. As he had not prepared the paper himself and the attendees were not prepared having received the document at the meeting, it was decided that this will be resolved outside of the ICM by the TTF Secretary who was very familiar with the issues and given the unavailability of Acting TTF Secretary due to maternity leave *(Action Point 1).*

6.0 Fund Managers

6.1 **AMP** – Matthew Hopkins was unable to attend as previously advised but was prepared to make himself available by Skype but that was not required by the IC.

6.2 **Schroders** – Simon Doyle had presented at the Conference (but left before the ICM) and hence only a brief update was required of Clare Offwood who attended the ICM for a brief discussion.

- probability of loss had increased to 12.6% as at 31 January 2015 (red traffic light being above 12%) but Clare assured the IC that Schroders stress testing shows that the funds could withstand a 20% downturn and still be able to meet the objectives
- Schroders are underweight equity and have around 33% of the fund in cash (this percentage is around 47% for the CIF).

7.0 General/AOB's

i. *Accounts:* The auditors were visiting in April with a view to finalizing the accounts for FY 14 in time for the May Board Meeting.
ii. *Board Papers:* It was emphasized that these need to be circulated 1 week prior to the Board Meeting.
iii. *Budget:* The Acting TTF Secretary confirmed that TTF Secretariat was operating within the approved budget.
iv. *Bank Account*: the Investment Consultant provided the Acting TTF Secretary with paperwork required for the new electronic bank account.

8.0 Date of next meting
Skype conference meeting on the 4th of May.

Meeting finished at 6:45pm

____

David Hutton
Chairman

Action Points Summary

No	Activity	Action by	Status

1	Update Redemption Procedure	Secretariat	

TUVALU TRUST FUND
INVESTMENT COMMITTEE SKYPE CONFERENCE
8am, 4 May 2015

1.0 Present

Advisor to the Australian Director on the TTF Board – Mr David Hutton (Chairman)
Advisor to the New Zealand Director on the TTF Board – Ms Nalayini Brito

In Attendance:

Investment Consultant – Mr Jonathan Eriksen (Eriksens & Associates Ltd)
Acting TTF Secretary – Ms Salai Sualo

2.0 Apologies

2.1 All were present

3.0 Minutes

3.1 (a) The minutes of the meeting held on 3 Mar 2015 were adopted as a fair and true record of the previous meeting.

(b) Action Points.

i. *Update Redemption Procedure*: Secretariat to circulate the updated version – to be considered later.

4.0 Investment

4.1 QIPS

The issue of traffic lights was raised by the NZ advisor regarding whether the Probability of Loss over 12% for both fund managers and should be rated red while Eriksens have rated both as amber. The Investment Consultant stated that his view was that amber was appropriate as under OBAA the managers were better placed to respond to the impact of the expected market corrections. The Investment Consultant agreed with the NZ advisor to add a comment explaining this to the report and circulate the revised wording later that day *(Action Point 1)* and also to recommend the basis for revised traffic light trigger levels appropriate for OBAA funds to be considered at the August ICM. *(Action Point 2)*

4.2 CIF

The NZ adviser commented that the TTF Secretary was keen to make sure that the capital of CIF is preserved as it is the fund of GoT and needs to be easily accessible and requested that the Investment Consultant obtains the Probability of Loss measure for this fund from Schroders. The Investment Consultant agreed to do this. (*Action Point 3*)

5.0 Financial Statements 2014

The Secretariat is still working with the auditor with the aim to produce the first draft before the board meeting.

6.0 **IC Report**

The Committee approved the report except noting that the Maintained Value included does not match the maintained value in the TTFAC report prepared by the Secretariat. The Committee agreed for the Secretariat and the Investment Consultant to confirm on their calculations and submit to him the correct Maintained Value for the quarter of March 2015 *(Action Point 4)*

7.0 General/AOB's

The Investment Consultant noted that Eriksen's 3 year term of engagement expires shortly and that a modest fee increase will be necessary. Eriksens is to submit a proposal to the Board.

8.0 Date of next meting

Thursday; 20th August in Sydney

Meeting finished at 9:11am

____

David Hutton
Chairman

Action Points Summary

No	Activity	Action by	Status
1	Additional QIPS comment on Traffic Lights	Eriksen	
2	Revised Traffic Lights	Eriksen	
3	Probability of Loss Report for the CIF CPI+3.5%	Eriksen	
4	Confirm Maintained Value as at 31 Mar 2015	Eriksen & Secretariat	
5	Proposal for ongoing services by Investment Consultant	Eriksens	