Tuvalu Trust Fund

Report of the Investment Committee and results for the year ended September 2016

Highlights

TTF Investment results

- This has been a difficult year for investment with only 7 of the 12 months positive. Over January and February 2016 sharemarkets fell by up to 20% and interest rates on bonds also increased, which meant that market values of bonds also fell. Brexit caused further market falls, but was followed by recovery. While the December quarter had a positive investment return of 1.4%, March was negative -0.4%, but the June quarter was positive 1.9% and September positive 2.9%, giving a net 5.9% return after fees for the year.

- Inflation as measured by the Australian CPI All Groups Index has been 1.3% for the year.

- Market Value of the TTF Investments at 30 September 2016 was $161.58 million while Maintained value was $154.85 million so investments exceeded Maintained Value by $6.73 million or 4.3%.

- The investment target is CPI + 4.5% pa, or 5.8% for the year so the 5.9% result was over target by 0.1%.

- The new investment approach started in March 2012. In the 4½ years since then, the investment return (after fees) has been 7.5% per annum which is 0.8% pa above the target. Overall 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. We continue to consider the approach is well suited to the very uncertain and volatile markets.

- Despite the falls in January/February and June, because of the subsequent recovery many global sharemarkets remain at or near record highs. There is still the expectation that the US Federal Reserve will increase US interest rates for a second time but this is likely to be late 2016. The markets remain very difficult to predict.

- While the target for the year has been met with a distribution at September 2016 the TTF may experience some fall in value over the coming months, but given the OBAA approach, any fall would be expected to be less than the markets as a whole.

World Bank Review

- The Investment Committee has prepared comments the World Bank review and this is attached to this report.

CIF

- Investment of the CIF is in the low risk Schroder's fund that has a target of CPI + 3.5% and allows withdrawals at short notice. A separate quarterly report from the Investment Advisor is prepared on the performance of the CIF investment. The CIF has now been invested for 2½ years and achieved a return of 4.2% pa (net of fees) compared with the target of 4.3% (also net of fees). The returns for the September 2016 year were positive 4.2% for the year. Previously the CIF earned 2% pa though this would have fallen as the Australian cash rate is currently 1.5%.

- Capital preservation and gaining improved returns for the CIF are both important now that it has around $35 million. Despite some quarterly fluctuation, the results are now very close to target. It needs to be acknowledged that achieving the higher return does involve an increase in risk relative to bank deposits. CIF investment strategy will need to be reviewed regularly, especially if Government has a need to draw down a significant portion for budget support.

Recommendation

The Investment Committee recommends the Board:

- Receives and notes the report of the Investment Committee for the year to September 2016.

Committee activities

1. Since the Trust Fund's last meeting in May 2016 in Suva, the Investment Committee held a meeting in Sydney on 17 August 2016 and another by Skype on 4 November 2016 to enable this report to be prepared and distributed a week prior to the Board meeting. (Minutes are in Attachment 3.) The meetings with fund managers are particularly useful and they are very frank about their actions, views on investment markets and future expectations.

2. Quarterly reporting by Eriksens continues to provide the data needed to allow the Investment Committee to monitor fund manager performance. Content also continues to be refined with further improvements made starting with the June 2016 report.

3. The September QIPS traffic light report has been expanded to include an overall TTF section using the SIOP objectives which provides a visual summary of the situation relative to the objectives.

Investment Targets

4. 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 (Trimmed Mean).

   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 (Trimmed Mean).

5. 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.

Contributions and Maintained Value

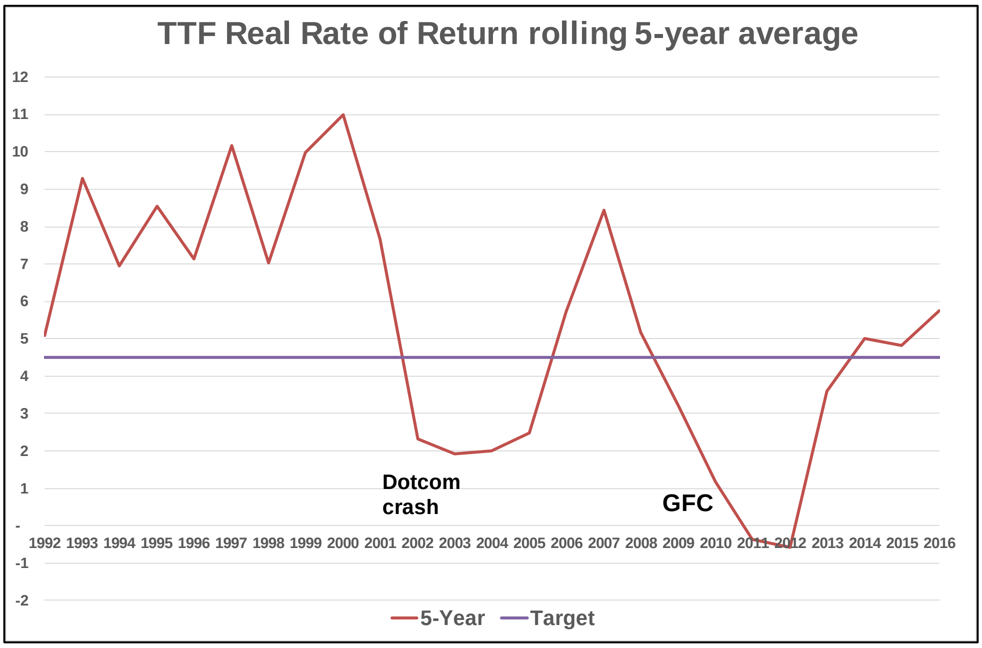
6. During the December 2015 quarter the $4.78 million available for distribution was reinvested and became part of capital. The Government of Tuvalu also contributed an additional $3 million. Further contributions were made by Australia and NZ.

7. The change in Maintained Value for the year has been:

TTF Maintained Value 2015-16		
Maintained value 30 September 2015		**143.22**
Reinvestment of distribution	4.78	
GoT contribution October 2015	3.00	
Australian contribution June 2015	1.43	
NZ contribution June 2015	0.48	
Capital Contributions		9.69
Sep 2015 + Contributions 2015/16		**152.91**
Inflation adjustment		1.94
Maintained Value 30 September 2016		**154.85**

Investment Results

8. The target of CPI + 4.5% is best measured over a rolling 5-year period. For the 5 years to September 2016, the TTF achieved 8.5% pa compared with the target of 6.4%. The first 6 months of this period used the SAA approach and OBAA has been used for 4½ years. This is a good result. The following chart shows the history of rolling 5-year real rates of return:



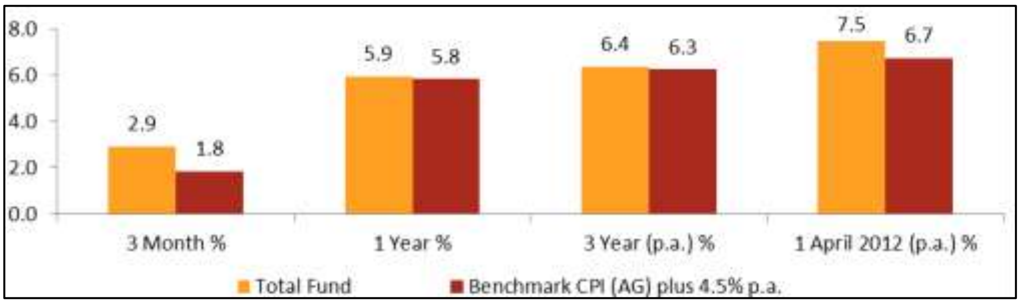
9. The chart shows the impact of the past major market downturns and the slow climb back to target.

10. Despite the difficult markets the target for the current year has been achieved. Looking at results over the year shows the variability for each quarter:

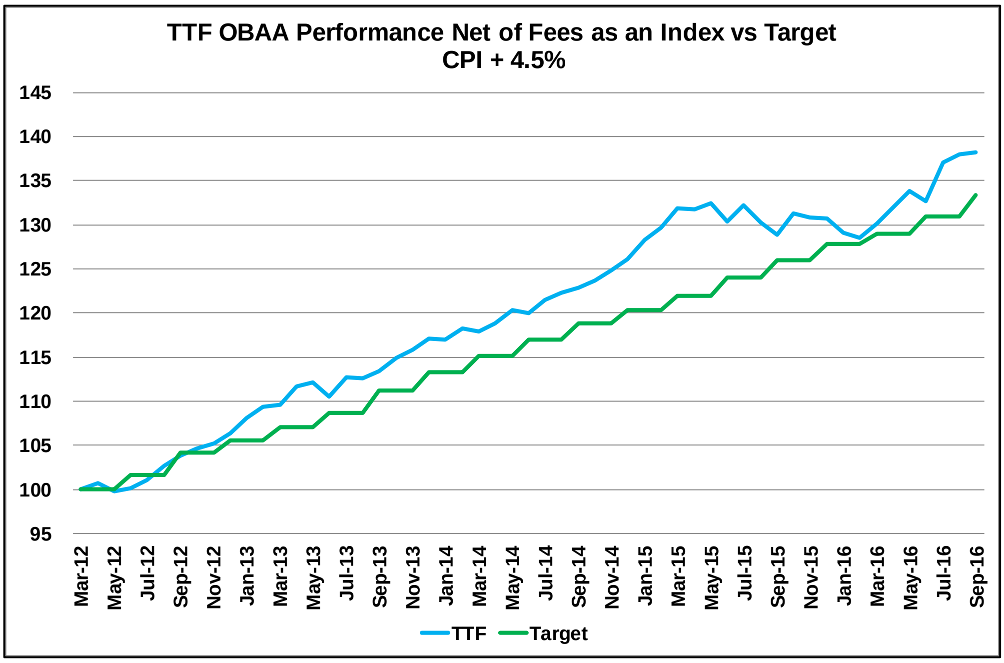
TTF Investment Performance versus Target					
	Quarterly				Year
	Dec-15	Mar-16	Jun-16	Sep-16	2015/16
TTF Investment return after fees	1.4%	-0.4%	1.9%	2.9%	5.9%
Target CPI + 4.5%	1.5%	0.9%	1.5%	1.8%	5.8%
Difference	-0.1%	-1.3%	0.4%	1.1%	0.1%

11. Investment with AMP and Schroders has been since March 2012, a period of 4½ years. Over this time the TTF returned 7.5% per annum (after fees) which was 0.8% 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%)



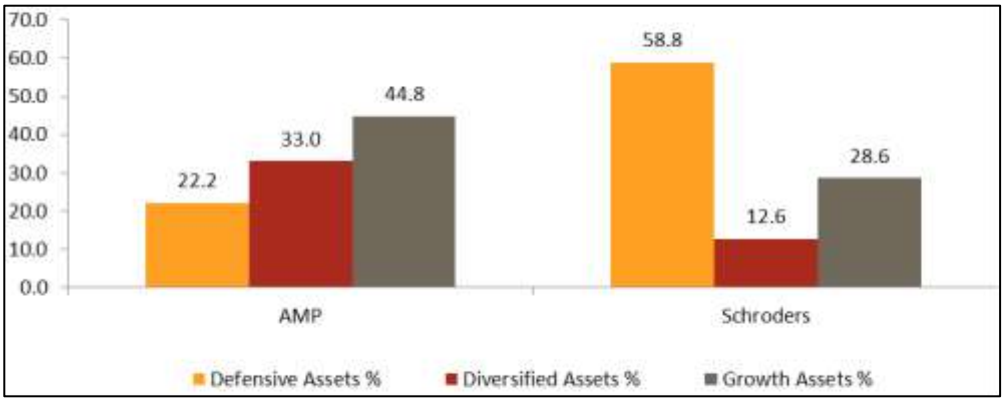
12. Cumulative results since OBAA investment commenced comparing actual after fees returns against the target shows that cumulative out-performance has been achieved since late 2012, though the markets have been difficult since June 2015:



Comparing the two managers

13. The two fund managers, AMP and Schroders, continue to have different approaches to asset allocation.

Asset Allocation Comparison



14. AMP holds more equities and makes greater use of absolute return strategies. Schroders hold more defensive assets including more cash. At 30 September 2016 Schroders had 26.1% in cash while AMP had 6.8% in cash.

15. Both have performed adequately over the past 4½ years with their different approaches but achieved slightly different results.

Comparison between Investment Managers				
	2015/16 Year		Since March 2012	
	AMP	Schroders	AMP	Schroders
TTF Investment return after fees	6.6%	5.2%	8.2%	6.8%
Target CPI + 4.5%	5.8%	5.8%	6.7%	6.7%
Difference	0.8%	-0.6%	1.5%	0.1%

16. 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 should be expected to have slightly higher returns over the longer term. AMP has held more equities than Schroders so have benefited more from the equity bull market.

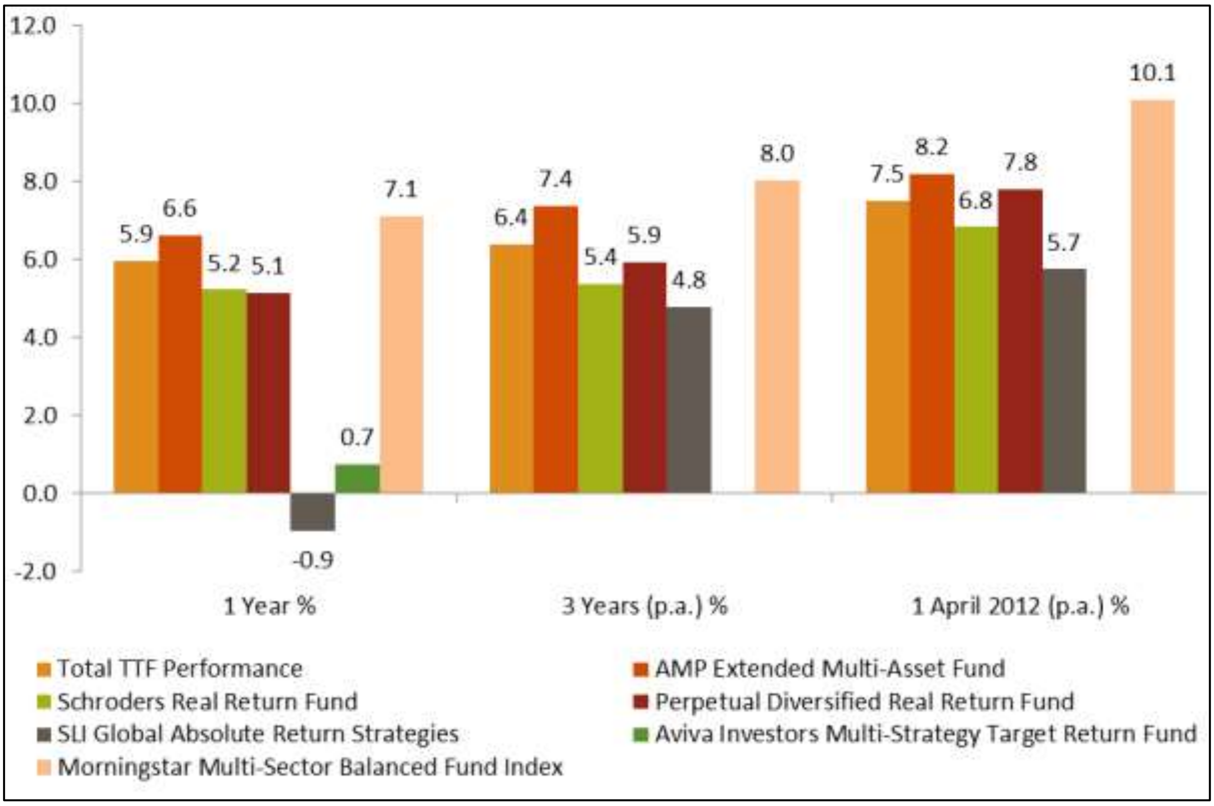
17. It has been interesting to observe both managers' responses to the market fluctuations during the past year, exercising defensive options and buying assets when prices showed opportunity. These actions demonstrate the benefit of OBAA and the ability of the fund managers to respond rapidly to market changes.

18. The Committee considers that the different approaches to investment complement each other and when the different asset allocations are combined, moderate the overall result. Both managers continue to state they are confident that their funds will perform better than traditional approaches during difficult markets and they will achieve their 3-5 year targets.

19. OBAA funds are structured to reduce such volatility while targeting a stated acceptable level of return over inflation. As such, during major market downturns, the TTF funds should generally outperform the strategic asset allocation funds but during periods of equity market gains the traditional funds tend to do better.

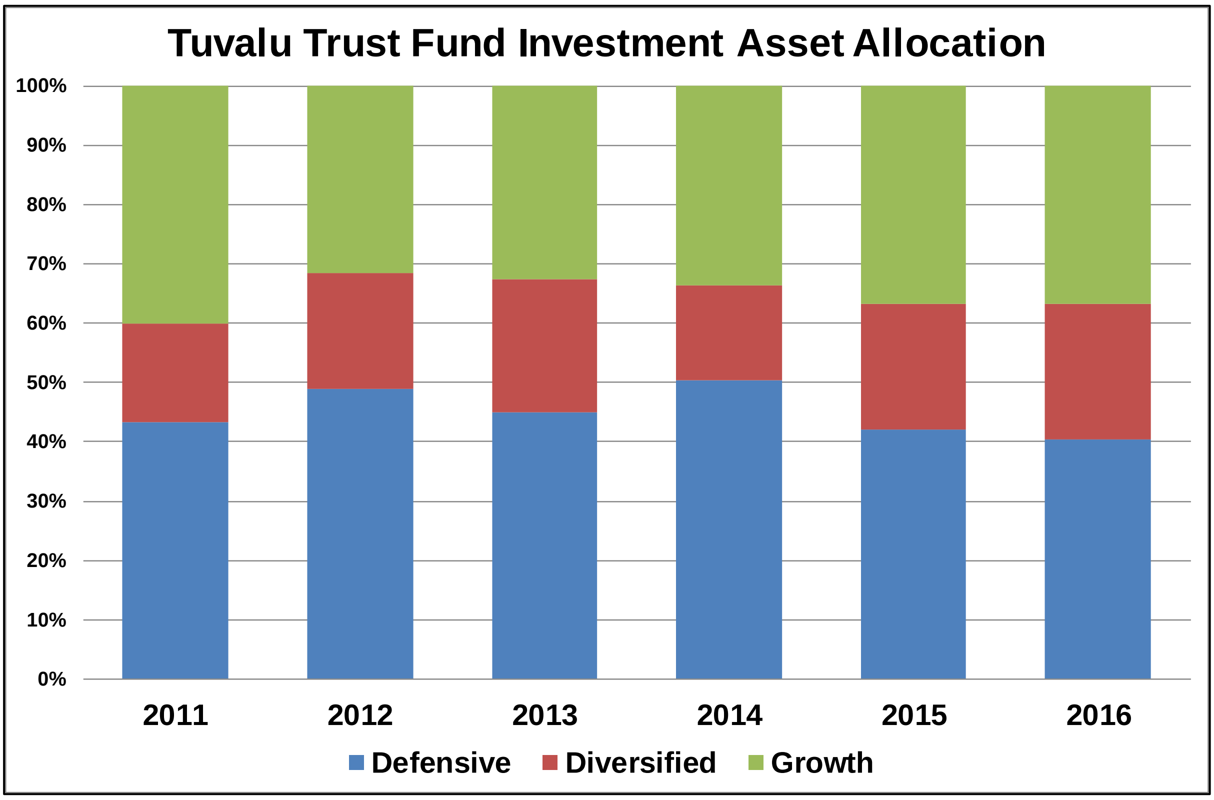
20. The Committee monitors the Fund's performance compared to peers and the Morningstar Multi-sector Balanced index. This can be seen in the next chart which uses net-of-fee) returns. Eriksens have added funds which use a similar approach to OBAA as peers. The Morningstar Balanced Index represents the former strategic asset allocation approach to investment. The funds in this index have a higher proportion of investments in growth assets (70%) 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.

Net Investment Returns



Overall Asset Allocation

21. The chart below shows the overall allocation of investments for the past 6 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.



22. 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 slightly decreased the proportion of defensive assets and increased diversified. This masks the varied approaches being taken by the two fund managers.

Investment Consultant report

23. 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. The performance data is provided by the fund managers but confirmed independently by the Investment Consultant and the risk data provided by the fund managers is reviewed for reasonableness. 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.

24. Despite the difficult markets, AMP has only green lights. Schroder has a red for expected loss and amber for investment returns over the past 3 years – though they exceeded the target for the 4½ years of investment with them. In terms of Schroders "red" for probability of loss, as stated in the QIPS, the Investment Consultant's view is that the reported number overstates the probability of loss: "This is due to the low returns Schroders have applied in their forecast for each major asset class return. The result is a small margin above zero for the overall expected return of the fund and therefore a higher probability of loss. An extra point to note is that the probability of loss figure does not take into account overlay positions which aim to mitigate downside risks (e.g. FX exposure, S&P 500 put options, short duration overlays, curve flatteners); thus the real portfolio probability of loss is lower." Schroders options effectively add perhaps 5% to exposure to equities and this

reduces the probability of loss. Schroders exercised options during both sharemarket downturns (making gains) then repurchased options after the markets recovered.

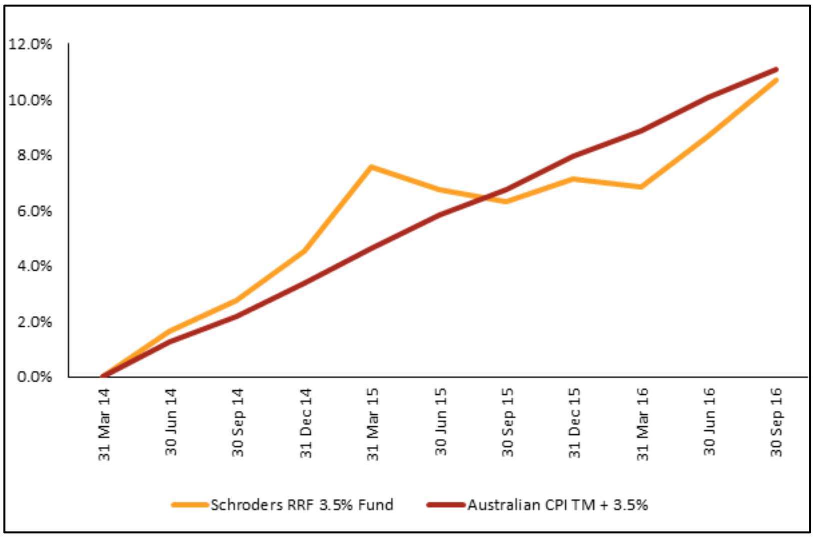
25. From our discussions with the managers, both are reacting positively to opportunities caused by market volatility as well as using risk reduction actions such as options. Our conclusion is that OBAA is a lower risk approach to the current highly volatile markets than SAA and we would not have been able to react as nimbly as the two fund managers to reduce losses.

The CIF

26. The CIF stood at $35.3 million as at 30 September 2016. The CIF 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 lower in risk.

27. As requested by Cabinet, the Committee monitors the returns achieved by the CIF. A separate quarterly report from the Investment Advisor is prepared on the performance of the CIF investment. The CIF has now been invested for 2½ years and achieved a return of 4.2% pa (net of fees) compared with the target of 4.3% (also net of fees). The returns for the September 2016 year were positive 4.2% for the year. Previously the CIF earned 2% pa and the Australian cash rate is now 1.75%.

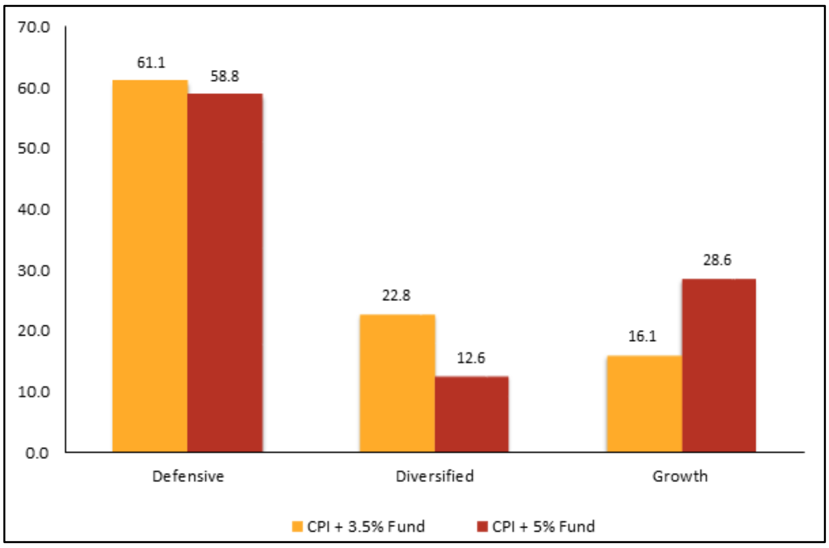
CIF Cumulative Performance (net of fees)



28. 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, but is currently reported as 16.2% (one year in 6) – though as noted earlier, Schroders' options strategy may partly improve upon this. With the difficult markets, a loss over 12 months occurred during 2015, but returns subsequently recovered to be very close to target.

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

Schroder Fund Asset Allocations September 2016



30. Gaining improved returns for the CIF is important now that it has over $35 million.

Westpac Account

31. At 30 September 2016, the Westpac account balance was $60,000. The Secretariat has advised that this is needed to fund Secretariat operating expenses so was not included in Market Value.

Investment Committee comments on the World Bank Review

32. Two separate papers have been prepared that comment on the World Bank Desk Review. These are Investment Committee comments on the World Bank Desk Review of the TTF and the Investment Consultant's Supplementary Report on World Bank Desk Review.

33. While the Committee acknowledges that the WB report statements on general principles relating to governance and investment strategy are well accepted internationally, report does not seem to have taken enough account of factors that are unique to TTF. Further, there are aspects of the WB report that on closer examination did not seem to present a balanced view or use comparable data.

34. Having the WB review the TTF has provided an opportunity to reconsider the approach to TTF investment. In essence, the WB recommended approach is to return to SAA with fixed asset allocations, a higher proportion of growth assets, combined with using index funds to reduce investment management fees.

35. The WB commented on the lost opportunity from not having a higher proportion of equities and therefore missing out during the recent bull market. (Though the data provided was short term and selective "to make a point" as they acknowledged.) The analysis provided by Eriksens for the period September 2008 to September 2015 "shows, that even in a bull phase of markets (AND excluding the negative returns from 2008), the cumulative returns for TTF are similar to that of the model portfolio. The model portfolio "uses the asset classes and weightings the TTF employed prior to its switch to an OBAA investment

strategy." Over this period the target of CPI + 4.5% was achieved. The analysis also shows that this was achieved with much lower risk, as evidenced by significantly lower volatility. Essentially, an acceptable return is being achieved but with lower risk.

36. While the Investment Committee accepts that increasing the proportion of equities may increase long term returns, this would almost certainly also lead to more years with negative returns and longer periods between distributions.

37. If the Board wishes to seek higher long term returns and is prepared to accept greater volatility and longer periods between distributions, then the IC can seek ways to achieve this. But, the short term outlook for markets suggests that there is still a high probability of falls in markets for shares as well as bonds (as interest rates rise from the artificially low levels set by central banks) so a change could have a poor short term outcome.

38. The WB advocated consideration of the investment approaches adopted by the NZ Superannuation Fund, the Australian Future Fund and the Harvard Endowment Fund. This has been done. These three funds are giants relative to the TTF so have significant numbers of full time specialist staff and are able to manage their own investments as well as appoint multiple specialised managers for asset sub-categories. What is very interesting is that all three have objectives which are similar to the TTF – generating a real return at a level similar to the TTF target of 4.5%. The actual investment approach adopted, as published and described, is actually very similar to the dynamic asset allocation approach as part of OBAA used by Schroder and AMP - all three are active managers rather than passive and they do not use index funds.

39. All three compare themselves using reference benchmarks or industry peers. They use rolling long term annual returns (e.g. 10 years for Harvard) as the basis for comparisons, recognising the need to cover a full investment cycle.

40. The NZ and Australian funds have no requirement to distribute funds for some decades, so can take a high risk approach (e.g. NZ uses 80% growth assets as its reference point). The Harvard fund distributes 5% per annum even though this has meant a fall in real capital value since 2008.

41. TTF does not have the resources to self-manage investments nor the structure to make rapid changes in broad asset allocation, let alone tactical changes in sub-category asset classes. The use of the two OBAA fund managers enables such an approach to be adopted.

42. The results of the last 4½ years have been consistent with the approved change in objectives and policy adopted in November 2011 and implemented in March 2012. The markets continue to be challenging and, in the view of the Committee, OBAA is currently preferred to a fixed asset allocation approach with index funds as there would be little ability to offset market falls.

Growing the TTF Maintained Value to $200 million by 2020

43. Attachment 1 is a short paper setting out some scenarios for growing the TTF to $200 million by 2020. The scenarios use the position as at September 2016 as the start point and project the growth of Maintained Value under varying rates of inflation and investment returns, also assuming Government reinvests the annual distribution – but with no allowance for additions to capital from donors.

44. The scenarios suggest that even with modest returns, with reinvestment, the $200 million target for Maintained Value could be probably be met by reinvestment. Obviously, this would not be the case if there was a prolonged downturn in investment markets.

45. AMP and Schroder have both expressed confidence that they will meet their rolling targets for 3 – 5 years. Neither would expect to have significant losses even if there were major market events – as evidenced by the March and June 2016 quarterly results. A significant fall in equity markets would probably be seen as a buying opportunity by the fund managers, likely to result in improved returns in following years. Any additional capital contributions by GoT or donors would of course increase the probability that the $200 million target would be reached.

Conclusion and Future challenges

46. Since 30 September, markets have become more volatile and even less predictable. The uncertainty over the US Presidential election and Brexit are factors as well as a higher probability that the US Federal Reserve will raise interest rates in December 2016.

47. OBAA has worked well over the 4½ years since implementation and the TTF target has been exceeded while volatility has been reduced. There has been a distribution each of the 5 years since 2012.

48. The conclusions of the Investment Consultant are: “Given the ongoing volatility of financial markets and the current situation where stock markets are generally at record highs and interest rates at record lows, we strongly recommend against static asset allocations into passive products which can only reflect the weighted average performances of the various markets and do not mitigate the risks of correlated market downturns. Effectively at present shares in sound companies are safer and less risky than most bonds including some Sovereign bonds. 70 - 90% of a fund’s performance comes from asset allocation. We consider the allocation must be dynamic to protect capital and achieve reasonable rates of return in this challenging environment. Hence the preference for an OBAA approach.” The Investment Committee accepts this view.

David Hutton
Chair, Investment Committee
7 November 2016

Attachments

1. Growing the Tuvalu Trust Fund Maintained Value to $200 million by 2020
2. Minutes of the IC meetings held in Sydney on 17 August 2016 and by Skype on 4 November 2016

As separate documents

3. Investment Committee comments on the World Bank review of the TTF
4. Investment Consultant's Supplementary Report on World Bank Desk Review
5. Quarterly Manager Performance Statement (September 2016)

Growing the Tuvalu Trust Fund Maintained Value to $200 million by 2020

Introduction

1. The Government of Tuvalu (GoT) has approved a target of growing the Maintained Value of the Tuvalu Trust Fund (TTF) to $200 million by 2020. This paper discusses how this target might be achieved and provides some scenarios to test whether or not this target could be achieved through reinvestment of funds available for distribution.

Trust Fund Rules for distribution and reinvestment

2. The TTF Deed requires capital to be maintained in real terms, as measured by the Australian Consumer Price Index (CPI). Any excess of Market Value over Maintained Value may be distributed to GoT. There is provision for GoT to reinvest a sum available for distribution, and if it does so, this becomes part of the capital of the fund. This occurred for the first time in November 2015.

Starting Maintained Value

3. The decision to set the $200 million target was taken in November 2015. At 30 September 2015 the TTF Maintained Value was $143.22 million. GoT decided to reinvest the amount available for distribution and also contributed $3 million from its Budget. As a result the starting point was:

Maintained value 30 September 2015	143.22
Reinvestment of distribution	4.78
GoT contribution October 2015	3.00
Base starting value 2015	**151.00**

4. The result for the year to September 2016 are known. Australia and NZ also made contributions in June 2016 and inflation for the year was 1.3% so Maintained Value grew to $154.55 million. Market Value was $161.58 million, or $6.73 million in excess.

Sources of growth in Maintained Value

5. Maintained value increases may be from three sources:
    - The CPI increase to maintain value
    - Reinvestment of any excess of Market Value over Maintained Value
    - Additional contributions by either GoT or external donors.

6. Of these, the adjustment for the CPI is automatic. The other two sources require decisions by GoT or donors.

Scenarios for growing Maintained Value

7. Effectively there are 5 years from 2015 to meet the 2020 target. While additional donations to capital cannot be predicted, scenarios can be developed for inflation and potential reinvestment of distributions to test the feasibility of meeting the target through reinvestment.

8. Inflation has averaged 2.3% over the past 5 years but only 1.4% more recently. It was 1.3% for 2016. Below are a set of scenarios, with varying assumptions.

Scenario 1: Returns at target 2017 - 2020					
	2016	**2017**	**2018**	**2019**	**2020**
Inflation rate	1.30%	2.00%	2.30%	2.30%	2.30%
Real return by Fund Managers	5.90%	4.75%	4.75%	4.75%	4.75%
Starting maintained value	**152.9**	**161.6**	**172.5**	**184.6**	**197.7**
Inflation	1.9	3.2	4.0	4.2	4.5
Reinvestment	6.7	7.7	8.2	8.8	9.4
Closing maintained value	**161.6**	**172.5**	**184.6**	**197.7**	**211.6**
Investment return - real gain	6.7	7.7	8.2	8.8	9.4

9. Scenario 1 uses 2% inflation for 2017 followed by historical average inflation and target real returns of 4.75% in the 2017 – 2020 years. This shows that the $200 million target is readily achieved through reinvestment.

Scenario 2 - Lower returns, higher inflation					
	2016	**2017**	**2018**	**2019**	**2020**
Inflation rate	1.30%	2.30%	2.30%	2.30%	2.30%
Real return by Fund Managers	5.90%	2.00%	3.00%	4.00%	5.00%
Starting maintained value	**152.9**	**161.6**	**165.3**	**177.4**	**188.6**
Inflation	1.9	3.7	3.8	4.1	4.3
Reinvestment	6.7		8.3	7.1	9.4
Closing maintained value	**161.6**	**165.3**	**177.4**	**188.6**	**202.3**
Investment return - real gain	6.7	3.2	5.1	7.1	9.4
Market Value	**161.6**	**168.5**	**177.4**	**188.6**	**202.3**
Available for reinvestment/(deficiency)	6.7	3.2	8.3	7.1	9.4

10. Scenario 2 assumes lower investment returns but 2.3% inflation. In this scenario, the target $200 million is also met.

Scenario 3 - Poor returns in 2017 and modest in 2018					
	2016	**2017**	**2018**	**2019**	**2020**
Inflation rate	1.30%	1.50%	2.00%	2.30%	2.30%
Real return by Fund Managers	5.90%	0.00%	3.00%	4.00%	5.00%
Starting maintained value	**152.9**	**161.6**	**164.0**	**172.2**	**183.1**
Inflation	1.9	2.4	3.3	4.0	4.2
Reinvestment	6.7		4.9	6.9	9.2
Closing maintained value	**161.6**	**164.0**	**172.2**	**183.1**	**196.4**
Investment return - real gain	6.7	0.0	4.9	6.9	9.2
Market Value	**161.6**	**164.0**	**172.2**	**183.1**	**196.4**
Available for reinvestment/(deficiency)	6.7	0.0	4.9	6.9	9.2

11. Scenario 3 assumes investment returns merely match inflation in 2017 and grow slowly after that. Inflation is also assumed to be low. In this case, the $200 million target is not met but the shortfall is only $3.6 million (1.8%).

Conclusions

12. The scenarios suggest that even with modest returns, with reinvestment, the $200 million target for Maintained Value could be probably be met by reinvestment. Obviously, this would not be the case if there was a prolonged downturn in investment markets. However, scenarios 2 and 3 assume average real rates of return of 3.5% and 3.0% respectively, which are below the target 4.75%.

13. AMP and Schroder have both expressed confidence that they will meet their rolling targets for 3 – 5 years. Neither would expect to have significant losses even if there were major market events – as evidenced by the March and June 2016 quarterly results. A significant fall in equity markets would be seen as a buying opportunity by the fund managers, likely to result in improved returns in following years.

14. Any additional capital contributions by GoT or donors would of course increase the probability that the $200 million target would be reached.

<u>TUVALU TRUST FUND</u>
<u>INVESTMENT COMMITTEE MEETING</u>
<u>Schroders Offices, Sydney</u>
<u>17th August, 2016</u>

1.0 Present

Advisor to the Australian Director – Mr David Hutton (Chairperson)
Advisor to the New Zealand Director – Ms Nalayini Brito

<u>In Attendance:</u>
Investment Consultant /Fund Monitor – Mr Jonathan Eriksen (Eriksens & Associates Ltd)
TTF Secretary – Mr Lee Moresi

2.0 Apologies

2.1 All were present

3.0 Minutes of the previous meeting

3.1 Minutes from the previous minutes had already been approved prior to the previous Board meeting (12 May, 2016), and were presented as part of the IC's report to the Directors.

3.2 Action Points.

The Chairman of the IC went through the status of the Actions points from the previous meeting. These are presented in the table below:

No	Activity	Action by	Status
1.	Change performance metrics to show "net of fees"	Eriksens	Done
2	Wording changes throughout the report to say "target" instead of "self-set" in relation to Fund Managers target objectives	Eriksens	Done
3	Traffic lights indicators to reflect the differences in Managers differing time horizons (i.e 5yrs for AMP and 3yrs for Schroders). Add an additional table to show the TTF overall fund's performance against our own objective.*(Action Point 1)*	Eriksens	Eriksen will incorporate it into the latest QIPS before finalization.
4	Evaluation of shadow OBAA managers as Reserve bench managers for our current Fund managers to be reflected in the QIPS	Eriksens	Done
5.	Add wording to further clarify changes in AMP's equities weighting up to March 2016 and since March 31st.	Eriksens	Done
6	CIF discussions with GoT regarding the rules around the number of Fund managers and the possibility of de-risking the portfolio	Eriksens & Secretariat	Ongoing. Secretariat to follow up.

7	Confirmation of the Secretariat's Operations account balance held at NBT to Eriksens to help with the calculations of the Westpac accounts funds to be included as investments or operations expenses	Secretariat	Done
8	Arrange skype call between the World Bank Reviewer and IC members as well as getting a copy of their final report before the meeting to allow for proper briefing of Board Directors before the meeting.	Secretariat	Done

The Committee also discussed Action Points from the Board of Director's meeting that are relevant to the IC.

Item	Action required	Person Responsible	Status
1.	Tuvalu Government to endorse the IC's recommendation that the current TTF Secretary be appointed to the IC as Tuvalu's representative.	Tuvalu Government	Secretariat to follow
2.	IC to consider and discuss the issue of rotating the IC's Chairmanship.	IC	Deferred - not an issue at this stage
3.	The IC to prepare scenario analysis and present suggestions of how the $200million target size for the Fund could be achieved. IC to update data, finalise the paper then circulate it to Directors just prior to the next Board meeting as a possible discussion paper for the Board.	IC	On the way *(Action Point 2)*
4.	Attendance at the SWF conference in Auckland and discussions of the NZIPR findings.	Available Board members, IC and Secretariat	Dates confirmed as 8-11 Nov, 2016

4.0 Investments

4.1 QIPS:

The committee agreed that the Fund Monitor will re-work the report and provide comments on results since the end of June. Also for the report to include a bit more on forward looking scenarios around likely returns taking into account market conditions and other economic factors. Despite Eriksens concerns about the unpredictable nature of forward predictions, the committee suggested that perhaps giving a range of possible performance outcomes may suffice. Further, these can be accompanied by a caveat stating that while these are possibilities, the nature of the markets suggest that anything is possible.

The committee also agreed that overall the report is an excellent report with great improvements and streamlining from previous ones. The Consultant had ample time to improve the content and to get the structure of the report right so as to make future reports easier and quicker to produce especially around Board meeting times.

Some of the things to amend include a short explanation of the selection criteria and process for Alternative Fund managers and for the CIF report to be done as a separate report. There were a few typing errors to be corrected including date labels for table 2. The issue of the negative cash holdings (overdraft) with AMP needs some addressing in a small explanatory note as to how that came about.

Eriksens will aim to have the final report ready in 2 weeks time. *(Action point 3)*

4.2 CIF

The CIF balance as at 31 July 2016 showed a balance of $35.05 million compared to a previous balance of $32.6 million as at 31 March 2016. The latest balance includes a $1.5 million contribution from the Australian Government as budget support to the Tuvalu Government.

While the Schroders CPI+3.5% fund had a positive return for July (1.11% post-fees), the overall performance for the year has not been that great. Since the CIF is invested in a very conservative fund its equities allocation is minimal and with its large cash holdings in June, when the markets were down, this fund had a low negative return compared with other funds.

From the GoT's perspective, there was concern earlier in the year due to poor performance but since then the fund has had positive returns. Of most concern is the possibility of capital loss during a year, especially when the possibility of loss is running at over 15%. This may be much higher than the GoT risk tolerance.

The Secretariat will try and have discussion with the Permanent Secretary for Finance and the Minister on the issue of de-risking the CIF with Eriksen suggesting that there is an alternative manager in BT with their Enhanced Cash Fund. *(Action Point 4)*

5.0 FUND MANAGERS REPORTS

5.1 Schroders (Simon Stevenson and Clare Offwood)

On rolling 3 year returns, the fund is slightly behind target but compared to the Schroders Balanced Fund (as a comparator), the CPI+5% is doing better. In terms of comparing it to the TTF's own target objective of 4.5%+CPI, the performance has been slightly above target especially if you take cumulative returns since inception.

Given that markets have been extremely volatile with increased risk in a very low yield environment, returns are therefore harder to come by. However there has also been opportunities to harvest returns. Schroders view is that there are 2 ways of generating returns in the current environment:

1. Take more risk and chase returns (by putting most of assets into risky assets), or
2. Reduce risk and be patient and wait for opportunities.

Schroders chose the latter and reduce risk in a risky environment while waiting for opportunities.

Schroders sees improvement in market conditions going forward and while things like bonds have a high probability of loss, their downside risk potential (or magnitude of loss is relatively small).

The NZ Advisor asked if Schroders have had internal discussions around the possibility of lowering the Fund's performance benchmark given the prolonged low returns environment and the challenge of coming up with 5%+CPI returns. Schroders reaffirmed their confidence in their process and stated that this fund was designed with these types of conditions in mind. It was designed to generate returns in very low yield environments requiring the Managers to be active and work around the changing market conditions. Simon Stevenson for Schroders further explained that in the process of designing the Fund they went back 100 years and found that a balanced fund (60/40), over that period returned around 5%+CPI, noting that over that time span there were times of very low return environments or very high inflationary periods. While there may have been discussions around the possibility of lowering return expectations, Schroders remain confident in meeting the performance target. Despite the low return environment, with current volatility there are opportunities to make small gains and the main thing for Schroders is not to give away gains that they've made on the down swing.

Looking ahead the main concern for Schroders is the low global productivity, declining corporate profits and very low growth prospects. While the US has been showing improvements in their recent data such as employment and wages growth, global productivity remains low. Most commentators are saying that monetary policies have not worked but in Schroders' view the issue is not the policies themselves but the lack of coordination amongst the big central banks. For example, in the case of China their money easing program was mainly to prop up their equities market but that money has not filtered through to the economy. Monetary policies generally should lead to a pickup in growth but the global economy is yet to see that.

In terms of the Australian economy, the shock is not really the drop in commodity prices but more the drop in the terms of trade which translates to income. With the terms of trade falling, corporate incomes have taken a hit and wages have been flat-lining. But in say two years' time as wages start to grow again, inflation is likely to be a problem. The RBA seems to have realized this and have adjusted their headline inflation forecasts. Inflation will also be greatly influenced by a change in oil prices.

In terms of Schroders positioning, last year equities became quite expensive so they became quite defensive and held onto cash. When equities fell and became cheap again, high yield credit also fell so they bought High yield credit and a little of equities. Schroders feel that if the Fed starts tightening monetary policies there might be an adjustment in the markets and to cover, Schroders have around 5% of the fund as options cover. Schroders still prefer a conservative approach despite the risk measures showing increased risk recently, for example, probability of loss over 15%, (without the options cover), i.e. the options reduces some of the headline risks.

When asked about their view on interest rates, Stevenson stated that the fundamentals all point to a tightening in the US, meaning interest rates should rise. The Fed has been saying for a long time that they would tighten but are yet to act on it. His view is that the Fed has been preparing the market for a rate rise and is likely to do it soon.

5.2 AMP Capital (Matt Hopkins and Biliana Rajevic)

Straight off AMP were asked about how confident they are of achieving 5.75%+CPI to which they replied that while it has been a difficult year they are still confident of reaching target.

In terms of the various asset classes, some have obviously performed better than others with increasing volatility in global equities some fueled by post-Brexit uncertainties. Emerging markets and global equities have both had negative returns this year, however markets have recovered over the most recent quarter. The search for yields has seen assets like Global REITs and Listed infrastructure move ahead of more traditional asset classes.

Despite all the turmoil and sentiment about recessionary conditions, PMI data, as an indicator of economic activity, shows that while it has been trending downwards, it hasn't collapsed. This points to stable and steady growth.

Bond yields are in negative territory with Japan and Germany leading the trend. The 10-year bond yields are very low and liquidity is an issue. There is also distortion in the bond markets with Central Banks holding substantial Sovereign bond holdings: Bank of Japan has around 30% of the Japanese Bonds while the ECB holds around 15% of German bonds.

Brexit was another event that created uncertainty but one of those with a binary effect. AMP had deliberate limited exposure to Brexit and suffered only about 5 basis points adverse effect. On the whole Brexit now appears to be localized to the UK and Europe after the initial negative reaction from global markets.

Performance wise, for the month of July the EMAF was up 2.1% and for August to date they are up about 65 basis points. Their active managers have been very active with varying results. In that context they have brought in 2 new active managers with strategies that they feel fit in with their overall investing processes. The two new managers are Arrow Street, (an Emerging Markets Active manager), and Vinva, (an Asian markets mutual Fund manager).

Asked about the fees they pay to the Active managers, Matt Hopkins stated that as a rule of thumb you should pay about a third of your total fund fees to external managers but because of AMPs substantial discounts on fees they are paying around a fifth. For managers with a performance based fee, the rule of thumb is that for every 1% in out-performance AMP pays about 10 basis points in performance based fees. He also confirmed that external manager fees are paid by AMP and are not added to investors.

In terms of the portfolio itself, there hasn't been any real standout asset class with mixed expectations. Currently AMP's view is slightly positive on Australian equities, just above neutral on Global equities with some concerns around European banks but good underlying positive valuations in some of the European assets. AMP has a positive in-house view on Emerging Markets. This is due to improved earnings revisions and they have increased their EM exposure. Bonds are rated negative at the moment with very low to negative yields. The fund holds around 10% in cash at present.

Market returns expectations have been lowered compared to 2 years ago when they could have expected 7% to 8% market returns. Now market returns expectations are around 5 to 6% so AMP is working harder with alpha and active strategies expected to add around 1 to 1.5% returns.

While the markets are difficult there are still opportunities to generate returns and AMP is actively pursuing some strategies to take advantage from such opportunities. They remain confident in reaching their fund's return targets.

6.0 Alternative Investment Strategies

6.1 World Bank Report & NZIPR Peer Review

When NZIPR came under discussion, the NZ representative informed the Committee that the review was already underway and that she has seen a first draft of an initial NZPIR report and was able to comment and correct some of the factual errors. Others expressed concern that the report has been produced without, it seems, anyone from NZIPR contacting or speaking to people from the Trust Fund including the Investment Committee or the Secretariat. The NZ member stated that at this preliminary first phase, the report was more academic than practical. It appears that NZIPR is taking an academic global view of SWF trying to apply it to the Pacific funds and hence is sympathetic to some of the World Bank's view as expressed in their recent report into the TTF.

The Committee decided that the best way forward for the TTF is for the committee to prepare its own standalone paper to give the Board a specific TTF centered perspective on the apparently controversial/contradictory issues addressed from a general Pacific perspective by addressing issues raised in both the NZIPR and the World Bank reports and thereby presenting to the Board our own views on this subject as well as alternative approaches that the TTF Board may consider. The Board will have the benefit of the Committee's knowledge and experience and institutional memory with regard to the operations of TTF and also the full benefit of TTF focused updated analysis of the situation and recommendations of its own Investment Consultant to provide perspective as it reviews the NZIPR and World Bank reports.

The Australian member raised the possibility of the Committee having either a skype call or a face-to-face meeting with the NZIPR Review team prior to the final report being released. The NZ member through the NZ Director's involvement with NZIPR will try and coordinate such a discussion.

An important discussion point was, despite the World Bank's view that an SAA type strategy would be better than the current OBAA strategy, that while asset allocation still drives most of the returns, fixed asset allocation does not necessary do that. Especially for a fund like the TTF with its annual distributions aim, an SAA strategy would be too inflexible and not able to adapt quick enough to changing market conditions, unlike OBAA.

The Australian member has already started a paper addressing issues raised in the World Bank's report and all members are encouraged to give feedback and comments on that paper before finalizing, ready for circulation to the Board of Directors in time for the November Board meeting. *(Action point 5)*

6.2 Reserve Fund Managers

The Fund Monitor will include a section on these in the QIPS.

7.0 AOBs

7.1 Secretariat to update the TTF procedures manual. *(Action point 6)*

7.2 Next I^3 Investment Conference likely to be end of February 2017 in Auckland.

Date of the next meeting. 4th November 2016 – Skype.

ACTION POINTS SUMMARY.

No	Activity	Action by	Status
1.	Overall Traffic Lights rating for TTF to be incorporated in the QIPS alongside traffic lights indicators for AMP and Schroders	Eriksens	

2	IC to update the discussion and scenarios paper for the $200 million by 2020 target. The report to include latest data for 2016 and the likely distribution. This paper is to be presented as a separate discussion paper to Directors for the Nov. Board meeting.	IC Chairman	
3	Fund Monitor to finalise the QIPS within 2 weeks and circulate to IC members.	Eriksens	
4	Secretary to discuss with Secretary for Finance and the GoT the possibility of de-risking the CIF with BT Enhanced Cash as a possible second manager.	Secretariat	
5.	Discussion paper to the Board on issues raised in the World Bank report and the pending NZIPR Peer review report. Issues and discussion points from the Fund Monitor to be included as a separate part of the report.	All IC members & Eriksens	
6.	Secretariat to update the TTF's procedures manual with amendments or changes to be brought up to the Board in November	Secretariat	

TUVALU TRUST FUND
INVESTMENT COMMITTEE MEETING
Skype
04 November, 2016

8.0 Present

Advisor to the Australian Director – Mr David Hutton (Chairperson)
Advisor to the New Zealand Director – Ms Nalayini Brito

In Attendance:
Investment Consultant /Fund Monitor – Mr Jonathan Eriksen (Eriksens & Associates Ltd)
TTF Secretary – Mr Lee Moresi

9.0 Apologies

9.1 All were present

10.0 Minutes of the previous meeting

3.1 Adoption of minutes.

(a) By default the minutes have been accepted and approved by members through email circulation. Minutes were accepted as presented.

(b) Action Points Status:
The status of the Actions points from the previous meeting are presented in the table below:

No	Activity	Action by	Status
1.	Overall Traffic Lights rating for TTF to be incorporated in the QIPS alongside traffic lights indicators for AMP and Schroders	Eriksens	Done
2	IC to update the discussion and scenarios paper for the $200 million by 2020 target. The report to include latest data for 2016 and the likely distribution. This paper is to be presented as a separate discussion paper to Directors for the Nov. Board meeting.	IC Chairman	Done
3	Fund Monitor to finalise the QIPS within 2 weeks and circulate to IC members.	Eriksens	Done
4	Secretary to discuss with Secretary for Finance and the GoT the possibility of de-risking the CIF with BT Enhanced Cash as a possible second manager.	Secretariat	Discussion held but de-risking is not applicable at this stage due to GoT's drawdown intentions.

5.	Discussion paper to the Board on issues raised in the World Bank report and the pending NZIPR Peer review report. Issues and discussion points from the Fund Monitor to be included as a separate part of the report.	All IC members & Eriksens	done
6.	Secretariat to update the TTF's procedures manual with amendments or changes to be brought up to the Board in November	Secretariat	Maintained Value Calculations + TTFAC process + Banking procedures

11.0 Investments

11.1 QIPS:

Eriksens will provide a revised QIPS after this meeting taking into account points raised from these discussions. (action point 1)

Issues raised:

i) Add a qualifying sentence in the section using the 5 years performance data to indicate that the first 6 months of that relates to performance under a different strategy to the current OBAA strategy.

ii) Chart 10 needs to be amended to only show asset allocations since April 2012, the time when TTF adopted OBAA strategy and with the current managers.

iii) There needs to be an explanatory note added to the section on comparative funds to explain the basis on which these funds were selected and/or why other funds were excluded.

iv) The NZ Advisor wanted data for Morningstar's Multi-sector Balanced Fund index included on the appendix, Chart 1, (Risk v Return), to make the reporting consistent since this is used and referred to elsewhere in the report and this is being actioned.

v) The Australian Advisor was of the view that using the data for Morningstar's Multi-Sector Growth Index as a comparator was inappropriate to be included in the QIPS since the index is for funds with higher growth allocations than TTF has ever used although the OBAA Fund managers have the freedom to go up to 75% equity. The Investment Consultant agreed. Based on this discussion, this index was not included as a comparator. although Investment Consultant provided the data which had been included in the QIPS in the past 3 years (which he has now changed as this is no longer considered relevant by the Australian Advisor and the Investment Consultant), was made available to the NZ Advisor at her request. The Investment Consultant also clarified that the Balanced Fund Index would consist of Funds ranging from 60/40 equity/other split averaging around 65/35 and the Growth Fund Index would consist of funds with a 70+/30- split.

vi) Eriksens confirmed that they receive monthly performance figures from the Fund Managers which they check through their independent calculations. The Ex-post and Ex-ante volatility figures and the Probability of Loss figures supplied by the Fund Managers to satisfy the traffic lights assessment criteria are reviewed for reasonableness by Eriksens while the Sharpe and Sortino ratios and CVaRs are independently calculated by Eriksens. The NZ Advisor was interested in the CVaR data that has been provided to her by Schroders in the past and will follow that up separately.

vii) NZ Advisor questioned the Fund Monitor on the relationship between volatility and possibility of returns adding that it seems that the OBAA trends the same direction as the markets and the only difference appears to be quantum. The Australian Advisor reflected that looking at 5 to 10 year rolling periods, funds with lower volatility would recover quicker than those with high volatility. There was also discussion about the differences in recovery times versus magnitude of the losses that had to be recovered and the gap between periods of no distributions.

4.2 CIF

Discussions revolved around the CIF's probability of loss rating which is currently reported at 16.2% (though it was noted that this overstates the probability as it does not reflect reductions through options) and whether the Government of Tuvalu can tolerate such a probability. The Secretary stated that for the CIF, the Government's main concern is capital preservation. While returns are important this is not the overriding aim. The earlier discussion around de-risking the portfolio is now les of a concern given the likelihood of a $4million drawdown before the end of the current financial year and more drawdowns next year. It would be more useful at this stage to have alternative investing options for the CIF should the need arise to split or de-risk the portfolio.

The Fund Monitor said that we still have the option of the BT Enhanced Cash Fund and a new possible Fund with a new offering from Blackrock. Currently the Schroders CPI +3.5% fund offers some protection against inflation. The Fund Monitor stated that he needs to know estimates of the likely drawdown before he could make a firm recommendation and the NZ Advisor clarified that any investment strategy should be matched to objectives and it is therefore important for GoT to articulate this through their drawdown intentions.

Currently the CIF balance is $35.3 million. The Australian Advisor asked about the extent to which GoT intends to drawdown from the CIF, since there is a target of 16% of the TTF as part of budget support targets. The Secretary advised that the Financial Instructions are clear on the need to maintain 16% of the Maintained Value in the CIF and that figure currently stands at around $25 million.

12.0 Papers for the Board:

5.1 IC Report:

There were some clarifications needed and a few changes to the draft report suggested including:

i) Clarification on the target returns table whether they should show target returns for the individual Fund Managers or for TTF as a whole, given that they were taking different levels of risks in keeping with different timeframes to meet their objectives. It was clarified that the objective was to show TTF as a whole targets rather than for Fund Managers, just to provide the same comparison.

ii) The rolling 5 year return graph currently only shows data since the GFC which is a particularly exceptional cycle and hence the NZ Representative requested extending it to cover a longer time period to show the returns for the Fund over several market cycles, including the GFC and the Dotcom crash. It was agreed to go back to 1986.

iii) The Net Investment Chart needs to be changed if the figures in this Chart in the Draft QIPS were to change – it was inconsistent with the separate data figures provided as referred in i) above

5**.2 World Bank Report Follow-up**

The Investment Committee report to the Board will include comments and follow up responses to some of the recommendations contained in the World Bank report**.**

Separate Board papers have been prepared and finalized by email exchange by both the Investment Consultant and the Investment Committee on this.

The NZ advisor questioned whether the World Bank Review actually recommended the use of index funds to reduce investment management fees and this was confirmed as being correct by both the Investment Consultant and Australian Advisor and is what has been implemented in Kiribati as recommended by the World Bank.

5.3 NZIPR Review of TTF (and other Pacific Trust Funds)

While the committee has not received a draft report of this review, each of the members of the Investment Committee, the Investment Consultant and the Secretary were individually consulted and had discussions with the review team. There may be an opportunity for comments once the draft report is available.

The Secretary advised that the findings on NZIPR will not be presented at the Sovereign Wealth Fund (SWF) Conference but only to the TTF Board. The Secretary will endeavor to have their draft findings circulated prior to the Board Meeting (action point 3).

He further advised that he had a copy of their generic report on the Pacific SWF which will be the paper presented at the Conference and offered to circulate it (action point 4)

5.4 $200 million target by 2020

The Committee has prepared and finalised by email exchange a conceptual paper for the Board giving possible scenarios for achieving this target. The scenarios are based on likely returns and reinvestment of these returns. It does not take into account additional donor contributions.

13.0 AOBs

13.1 The Secretary sought the IC's views on having a separate item on the Board meeting's agenda to cover the World Bank Report. It was agreed to have it as a separate item to follow immediately after the Investment Committee's report rather than as a later item.

The first draft TTFAC Report had just been released and was subject to feedback from all the Secretaries. With the caveat that this might change, the Secretary offered to circulate this report (action point 5)

14.0 Date of the next meeting

2nd March 2017 in Sydney.

ACTION POINTS SUMMARY.

No	Activity	Action by	Status
1.	Fund Monitor to have a revised QIPS soon after this IC meeting	Eriksens	Done
2	Revised IC report and PowerPoint with some slight wording changes and changes to some of the graphs	IC Chair	Done
3	If possible, circulate NZIPR Draft Report before the Board Meeting	Secretary	
4	Circulate the generic SWF paper by NZIPR	Secretary	Done
5	Circulate the Draft TTFAC Report	Secretary	Done