Improving the Performance of Sovereign Funds in the Pacific

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About NZIPR

The New Zealand Institute for Pacific Research (NZIPR) was launched in March 2016. Its primary role is to promote and support excellence in Pacific research. The NZIPR incorporates a wide network of researchers, research institutions and other sources of expertise in the Pacific Islands. The University of Auckland, Auckland University of Technology and Otago University lead the NZIPR. Its support partners include the New Zealand Institute of Economic Research, the University of the South Pacific, the Australian National University, Peking University, the University of Hawaii, the Secretariat for the Pacific Community, the Ministry of Foreign Affairs and Trade and the Pacific Cooperation Foundation.

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Acronyms and Abbreviations

AUM	Assets Under Management
ETF	Exchange Traded Fund
FTF	Falekaupule Trust Fund (Tuvalu)
FSM	Federated States of Micronesia
IFSWF	International Forum Sovereign Wealth Funds
NITF	Niue International Trust Fund
NZIPR	New Zealand Institute Pacific Research
NZSF	New Zealand Superannuation Fund
NPRT	Nauru Phosphate Royalties Trust
OECD	Organisation for Economic Co-operation and Development
PI	Pacific Island
PNG	Papua New Guinea
RERF	Kiribati Revenue Equalization Reserve Fund
SIPO	Statement of Investment Policies and Objectives
SF	Sovereign Fund
TTF	Tuvalu Trust Fund
TSTF	Tuvalu Survival Trust Fund
TNPF	Tuvalu National Provident Fund
TITF	Tokelau International Trust Fund

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1. Overview of the NZIPR Sovereign Funds Research Program

One of the key projects for the NZIPR is examining the roles of Sovereign Funds (SFs) in the Pacific Islands. This reflects the fact that SFs are often the largest single asset owner and investor in the Pacific Islands, and the income stream from these funds can also be a large part of fiscal revenues. They can be an important part of Pacific Island wealth, and may help promote economic development and buffer Pacific Island economies from shocks such as natural disasters. Particularly in the smaller Island nations, they are also seen as mechanisms to enable greater levels of self-determination, reducing the reliance on foreign aid and remittances.

PI Funds are amongst the longest established SFs in the World (e.g. Kiribati's RERF was established in 1956), and Pacific Island SFs tend to have much more dispersed and innovative funding sources than Funds established by larger nations. While most PI Funds tend to be very small in terms of AUM compared to funds in more populous nations, they can be very large relative to gross national incomes.

Table 1 Features of Select Pacific Island Sovereign Funds

Fund name and year established	Funding sources	Fund size $M USD	Fund as % of GNI (indicative)
Cook Island National Superannuation Fund (2000)	Member contributions	$75	67%
Fiji National Provident Fund (1966)	Member contributions	$2,400	52%
Kiribati Revenue Equalization Reserve Fund (1956)	Mineral royalties (phosphate)	$680	209%
Solomon Islands National Provident Fund (1976)	Member contributions	$331	30%
Niue International Trust Fund (2006)	Foreign donors and Island government revenues	$77	140%
Tokelau Trust Fund (2000)	Foreign donors	$68	150%
Tuvalu Trust Fund (1987)	Foreign donors, internet domain licencing and other Island government revenues	$142	190%
Timor-Leste Petroleum Fund (2005)	Mineral royalties (oil and gas)	$16,500	531%

This report summarises the research that has been undertaken on SFs in the Pacific and draws out key findings, lessons and opportunities for funds to move closer to "best practice". Our coverage of the Pacific Islands included the very small Island nations in Polynesia and Micronesia, as well as the larger and more populous Melanesian Islands such as Papua New Guinea and the Solomon Islands. We also included a broad set of Sovereign owned funds – including Sovereign Trust Funds, Pension Funds, Stabilisation Funds, Development Funds, and other special purpose Funds.

We believe there are insights and lessons from the Pacific Islands experience that will be of interest to other small economies considering the role of SFs (for example in the Caribbean), and the wider SF research community. Despite this, research attention on Pacific Island SFs has been limited, and published cross-country studies tend to be focussed upon Sovereign Trust Funds rather than the broader set of SFs in the Pacific.

Our research program consisted of three phases:

1. A 'desk top' overview of Sovereign Funds in the Pacific, their purposes, and findings from the (relatively sparse) literature on the effectiveness in meeting their purpose.1
2. The development of tools, including an assessment framework and "reference portfolios" to be used in detailed assessments of several PI Funds.[2]
3. Application of the tools to assess the Tuvalu Trust Fund, Niue International Trust Fund and Tokelau International Trust Fund.

The focus of this paper is on phase three, where we draw out from the assessment some of the key common findings and opportunities we see to lift fund performances.

[1] https://cdn.auckland.ac.nz/assets/NZIPR/theroleofsovereignfundsinpacificislandsnations.pdf
[2] https://cdn.auckland.ac.nz/assets/NZIPR/assessmentframeworkforsovereignfundsinpacificislands.pdf

2. Key Findings of the Overview Report and the Assessment Approach

Overview Report

A key finding of our first overview report on SFs in the Pacific is that many serve multiple economic purposes (e.g. to provide short-term macro stabilisation and a source of inter-generational wealth) in practice if not in legislation. For example, Pension Reserve Funds in the Melanesian Islands tend to play an important role in domestic development and investment, even though it is not their primary purpose. The Trust Funds established in the South Pacific also tend to have multiple economic purposes, including budget support, economic development and inter-generational wealth.

In theory, multiple purposes are not ideal given there is potential for these purposes to contradict each other, and in relation, the 'optimal' asset allocation to meet their economic purpose. But in practice factors such as the very small scale, limited resources, lack of domestic financial markets, and huge distances to markets in many Island nations mean that the establishment of multiple funds may not be feasible.

Our high level review of current Funds against what economic purposes might be most beneficial for the Islands given their different economic circumstances suggests that more attention should be given to developing macro stabilisation (budget support) and explicit economic development objectives than is currently the case.

The small number of published studies on SFs, which don't consider the role of Pension Funds, finds mixed outcomes with regards trust funds meeting their economic purposes. These studies show that the establishment of a Fund is not a panacea for Pacific Islands to meet their economic needs and development challenges. Some funds have been broadly successful over a long period. At the other extreme poor governance and investment management, along with a lack of fiscal policy control, have led to very poor fund and fiscal outcomes, which have had broader negative repercussion for living standards.

The lesson we take from this experience, and the broader literature on Sovereign Funds is that the five key conditions for success include:

I. The fund is established with a clear purpose, which is enshrined in legislation;

II. There is a clear and consistent integration of the fund into macro policy settings and the government's budgeting process;

III. There is a commitment to good internal and external fund governance, including clear lines of decision-making authorities between and across the main parties involved in managing it;

IV. There is a good investment process, guided by a clear and comprehensive set of investment and risk policies and procedures; and

V. There is a commitment to providing clear and timely communication of the fund's purpose, performance and investment activities with key stakeholders and the broader public.

Importantly, these elements are not just the responsibility of a fund's staff and Board – they involve to varying degrees all of the main parties involved in the establishment and operation of a fund. This includes key policy agencies (e.g. a central bank and/or Treasury), the judicial and executive arms of government, a fund's Board or oversight committee, and a fund's investment and operational staff.

Assessment Approach

In the second phase of our research we developed an assessment framework for Sovereign Funds in general, designed to test these conditions, whilst also taking into account the circumstances and constraints of small Pacific Island Funds. The starting-point for the assessment framework is IFSWF's Santiago Principles for Sovereign Funds (IWG 2008), which outlines a set of high level principles around the legal establishment of a fund and its objectives; its governance structure; investment and risk management; and a fund's coordination with broader macroeconomic policies.

Our framework uses these principles as a guideline to develop a set of practices the principles can be evaluated against, drawing upon two recognised standard setters in the area of fund investment governance and implementation:

I. The Global Standard of Prudent Investment Practices developed by fi360 Inc. and the Centre for Fiduciary Standards in the United States; and

II. The guidelines for outsourcing and investment governance that have been developed by the Australian Prudential Regulation Authority (APRA).

Application of the framework to assess a fund involves three steps:

1. It requires that all relevant information (policy documents, legislation, external reports, *etc*) are identified and collected.

2. It requires that this information is assessed against clear criteria in order to form an initial assessment of how the fund is meeting these criteria.

3. It requires that there is substantial engagement with fund staff, stakeholders, and other parties to test and refine findings – the assessment will include objective and subjective criteria, and will involve a degree of iteration with stakeholders to arrive at a final conclusion.

The third step reflects that the assessment framework is not intended as a "scorecard" to be applied from afar. It requires substantial engagement with fund stakeholders in order to understand fund nuances, the historic context for decisions taken, capabilities, internal systems and processes, and views on where priorities lie.

The outcome of the assessment is a set of recommendations to the various parties involved in the management of a Fund, including Board of Directors/Trustees, Islands governments, and (if applicable) donor governments and supra-national agencies. We also indicate what recommendations we consider as priorities, and timing of when they could be considered. The opportunities for improvement at the end of the assessment process sit with Fund Boards and management, as well as government.

3. Pacific Island Trust Fund Assessments

Trust Fund Backgrounds

The assessment approach briefly outlined above was applied in mid-to-late 2016 to trust funds in Tuvalu (principally the Tuvalu Trust Fund (TTF), but other Trust Funds that have been 'spun out' of the TTF were also considered), Niue (the NITF) and Tokelau (the TITF). The common elements of these funds are that:

1. They were established jointly by donor and host nations under a similar legal structure. Some donors (principally Australia, New Zealand, and the UK) have ongoing representation as Trustees on Fund Boards (see Box 1 for further discussion on their structure).

2. They were established as a mechanism to increase self-determination via reducing the reliance on foreign aid and remittances.

3. They have multiple economic purposes, including at least budget support (macro stabilisation), inter-generational wealth, and infrastructure and economic development.

4. While the size of these funds in absolute terms is small, they are large relative to their nations GNI (see Table 1).

In addition, the geographic and economic context of these nations are similar. Niue, Tokelau and Tuvalu are all relatively remote and small Pacific Islands nations (even compared to other PI nations) with small population bases and a very limited domestic investment opportunity set.

The key difference between the Funds is that the TTF has been in operation for a much longer time (established in 1987) and it has a relatively sophisticated investment governance structure and investment strategy. The Board of the TTF has the support of an Investment Committee and an independent fund advisor (termed a monitoring consultant).[3] In addition, The Tuvalu government has addressed some of the issues involved with the multiple economic purposes inherent in the TTF's original Agreement by establishing separate funds that meet distinct purposes:

I. The CIF, which is a "buffer fund" to smooth fiscal revenues;

II. The FTF, which is to foster Island development

III. The STF, which is in the process of being established for the purpose of managing natural disaster and/or climate change risks.

In addition, the State managed provident fund, TNPF, utilises the same investment managers and monitoring consultant.

Assessment of the TTF required most elements of the assessment framework to be utilised, including: (i) the political and economic context, (ii) integration with government policy, (iii) enabling legislation, (iv) fund governance, (v) the investment process, (vi) and public and government support.

[3] There is also a separate economic advisory committee that reports to the Board as part of deliberations on its distribution function.

Box 1 Pacific Island Trust Funds

A trust fund is a fund whose assets are managed according to a legal trust arrangement. The basic legal arrangement has three main parties: (i) trustors (grantors, donors or settlors) who create the trust and usually transfers assets into it; (ii) trustees who have the legal responsibility to administer the assets on the behalf of (iii) beneficiaries, who are the benefactors of the trust and are entitled to income and/or principle according to the terms that the trust is established on.

In the case of Pacific Island Trust funds, trustors have included both domestic governments (e.g. from the phosphate resources developed in Tuvalu and Nauru) and foreign donors (e.g. the compact trust funds in Micronesia and the Tokelau and Niue Trust Funds in Polynesia). Trustees comprise of members of national governments and donors, while the beneficiaries are the domestic population base.

The chief aims of the PI Trust Funds that have largely been seeded by external donors is for them to reduce reliance on foreign aid and to grow the domestic economic resource base (see figure below). This is both through their potential to improve macro stability, enabling longer-term planning, and the potential to use the Fund for direct investment projects.

Angelo *et al.* (2016) focus on the legal aspects of a Trust and suggest that the best method for their establishment is via a treaty (c.f. a national statute or private deed) between the Trustors given the international treaty mechanism provides separation from the operation of any national legal system and hence potentially affords more comfort to international donors. The TTF is regarded as a model in this respect.

In contrast, the Trust Funds in Niue and Tokelau are younger and had the constraint over the first five years of their establishment of being only able to invest in New Zealand cash, bank term deposits, and government issued bonds. These funds are yet to develop a more sophisticated investment strategy, and in relation, establish any investment advisory support functions or external managers. Hence assessment of these Funds focussed primarily on fund purpose, the political and economic context, and potential issues with development of their investment strategies.

Key findings and recommendations

Annex A contains the full set of findings and recommendations made to the TTF, the most complex case as outlined above. Here we report some of the key common findings and recommendations.

I. **There is a strong commitment by donor and Island nations to see their funds grow and succeed.**

   Island nations view their funds as key sources of wealth and mechanisms to help them achieve greater self-reliance, as do donor nations. In reflection, the assessments were carried out in a spirit of openness, with frank discussions and willingness to share information and experiences.

II. **More clarity is needed on their economic purposes.**

In the case of the trust funds in Tokelau and Niue this was assessed to be the most critical issue given it is likely a factor that has held back development of their fund's governance structures, policies, and investment strategies. Being invested primarily in NZ bank term deposits over the past five years or so has involved a large investment opportunity cost. This was recognised by stakeholders and a process (at the time of writing) is underway involving Board and island stakeholders to clarify these purposes.

In the case of the TTF the issue was assessed to be less pressing but still important. The establishment of the STF, CIF and STF may imply that the TTF can principally be seen as an inter-generational wealth fund, an interpretation consistent with government objectives to markedly increased the value of the fund over coming years (through capital contributions and/or taking smaller distributions from the fund than is permissible under the funds distribution policy). This being the case, a key recommendation made was for the Board and Government of Tuvalu to consider whether the Fund should be explicitly cast as an inter-generational wealth fund, and if so, whether the current risk profile of the fund and distribution policy remains appropriate.

III. **Opportunities to improve Board investment governance.**

Trustees on the Trust Fund boards typically (but not always) do not have an extensive investment background and there is no requirement in establishment legislation for members to have investment expertise. This reflects the fact that the legislation, instead, contemplates the establishment of an investment support arm (e.g. a consultant and/or investment committee), whilst it is considered essential that Board members have a broader oversight and understanding of the economic, cultural and political context of the nations they serve.

As a consequence, we find in the case of Tuvalu there has been an unusually high level of delegation down of investment governance responsibilities (e.g. asset allocation, benchmarks, permitted asset classes, *etc*) by the Board to Fund Managers, the Monitoring Consultant and Investment Committee representatives. In the case of Niue and Tokelau, lack of specific investment expertise on Boards was not assessed to have been an important factor holding back development of these funds. However, looking forward as these funds seek to better define their investment purpose they will likely similarly heavily rely upon any appointed fund monitors and/or IC.

For this reason, a key recommendation made to all funds is that Board member commit to formal training to increase their awareness of their "fiduciary" responsibilities. We suggest training should focus on fiduciary governance rather than developing investment expertise because the benefit sought is to facilitate confidence in the investment support arm and investment manager roles, and to ensure appropriate skills and alignment of advisors at their appointment. That is, a solid appreciation of how to inquire and hold to account all service providers is crucial when there is a high degree of delegation of asset allocation, monitoring and review functions.

In addition to training, other opportunities identified to improve investment governance included:

- The establishment of formal review periods (a "fiduciary calendar') for key policies, operations, and Board performances.
- The establishment and/or refinement of key Board-owned policies, including SIPOs, outsourcing policies, and risk policies. For SIPOs it is critical they at least establish:
  - investment beliefs (e.g. around investment objectives, asset allocation and the funds time horizon, market efficiency and manager skill, and Responsible Investment.)
  - the investment objective;
  - implementation of that objective into a strategy;
  - function, delegations and responsibilities (e.g. of the investment support arm, Secretariat and any other parties with in on ongoing fiduciary role);
  - benchmarks and any restrictions or constraints on investments;
  - risk management policies (e.g. management of liquidity, management of key person risks, active risks limits, etc).
  - a distribution policy;

Note that the belief around Responsible Investment and how the Funds should take into account in their investment strategies is pertinent given the fact that two of these nations (Tuvalu and Tokelau) are amongst the most vulnerable to climate change in the world.

- The establishment of notional, low cost, reference portfolio governance benchmark (in line with the approach taken by the NZSF) in order to better understand and interrogate actual fund value-add (e.g. from market tilts, diversifying exposures, security selection) and costs. See Drew and Frijns (2017) for further discussion of why Reference Portfolios may be particularly suitable for PI Funds given their relatively small scale and reliance on external managers and advisers.
- The establishment of a Board risk dashboard in order to quickly ascertain whether the funds is within risk limits, its liquidity conditions, and to summarise other enterprise wide risk information.
- The establishment of a formal policy and budget item to be used for Board, Secretariat and Investment arm capacity development (in all the funds assessed there was no such budget or policy).
- Refining Board renewal processes (a responsibility of donor and host governments) so that Board's always have a quorum available to exercise it duties. This was an issue for significant periods of time in Niue and Tokelau, which was likely a contributing factor to retarding the development of their investment strategies.

IV. **That Board Trustees utilise to help them develop, implement and monitor investment strategies.**

Given the discussion above, it is critical that the investment support arms Board's utilise are well supported and are not subject to key person risks, which can be the case, for example, if the arm heavily relies on an eternally appointed monitoring consultant. Recommendations made in this regard (for Tuvalu) were to broaden IC membership and to establish an investment training budget (as above). Increasing membership could include, for example, Fund Secretariats (who typically are an enduring source of institutional memory) and/or a suitably qualified person from the Finance Ministry. The latter would also serve to increase capabilities with regards investment management oversight in the public sector.

V. **Opportunities to improve fund awareness, transparency and record keeping.**

Provision of non-confidential information about a Fund (such as annual reports, investment beliefs, most (if not all) elements in a SIPO, historic returns and fund size, manager details, *etc*) is important for Fund transparency and external accountability. A recommendation made to all Funds was to have a dedicated website where this information could be made available at timely intervals in order to increase Fund awareness and transparency.

We also recommended that Fund Secretariats develops an on-line confidential "fiduciary file" of key documents. This would ensure any new stakeholders have access to appropriate files to come up to speed, have quick access to latest policy and core documents, and where necessary, review previous decisions.

Finally, we recommended that Boards and Island governments devote more time to explain the purpose of the Fund and how its activities are affecting their lives (even if indirectly via the general budget process) in order to foster greater understanding in Island communities.

4. Summary and Concluding Remarks

This paper outlines the NZIPR's Sovereign Fund research program and the application of an assessment framework developed to several Trust funds. We believe the framework could be applied to other funds in the Pacific, and more broadly, given it is anchored in IFSWFs Santiago Principles and focusses on opportunities to improve investment governance and the investment process. This focus reflects several factors:

1. Clear governance and decision-making structures that promote decisiveness, efficiency and accountability may be an important determinant of fund performance. Academic research suggests that good governance can add 1-3% per annum to long-term fund returns (see Drew and Walk 2016).
2. We expect that good investment governance and a commitment to aiming for best practice will provide assurance to Fund stakeholders, current donor nations, and other potential contributors to the Island funds.
3. Good governance and investment processes reduces key person risks and the risk that investment strategies "chop and change" with new people in key governance roles and/or following a large market shock. We assess that key person risks are material for Island funds given the relatively high reliance on external consultants and relatively high turn-over of Board staff.
4. Finally, the current low return environment puts the acid on manager fees and fund administration costs.

A trend observed internationally in the Sovereign Fund community is the insourcing of investment strategies and activities, motivated by desires to reduce external costs, exploit Sovereign advantages (e.g. around local knowledge), increase understanding of the fund's investments and risks, and perhaps most importantly, increase alignment between investment activities and a funds purpose.

We observe a similar high-level desire in Pacific Island sovereign and pension funds to chart their own destiny. An important step that can be made in this regard is to aim for best practice in investment governance and process, which should increase understanding or solidify a conviction in a funds purpose, investment beliefs and investment strategy, low-cost investment options, and current external manager value-add and costs. These elements are much more critical to a fund's success than, say, whether or not a fund has developed an internal investment capability, or whether it has appointed a skilled external manager. They are also elements that can be achieved by Island funds given good investment governance does not require employing people with extensive experience in financial markets, or to be next to a major financial centre.

We also observe in Pacific Island nations a desire to pool resources and learn from experiences. As part of aiming for best practice, committing to publishing key governance documents, fund strategies, and fund returns on a regular basis is a way to facilitate a better understanding of fund experiences.

Overall, PIs Sovereign Funds have the potential to improve PI living standards and reduce PIs' reliance on external funding. Our research has been focused upon how to maximise this potential through applying good investment governance.

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Appendix A Tuvalu Trust Fund Findings and Recommendations

Key Findings

- There are no critical, immediate investment or governance issues that we assess should be addressed in the management of the TTF, CIF, FTF or TNPF. They are relatively well managed and well run.
- The investment managers that have been appointed to execute the main investment strategy for the Funds, a dynamic asset allocation approach termed "objective based asset allocation" (OBAA), are fulfilling the mandates they have been given, and there is a fairly good oversight and understanding of the strategy by the TTF's Investment Committee, which reports to the Board. This is facilitated by good engagement of the managers with the Fund, and regular reporting by the Fund's Monitoring Consultant to the Investment Committee and Board.
- Relative to what is typically seen in Sovereign Funds management, and the Santiago Principles, there is an unusually high level of delegation down of investment governance responsibilities (e.g. asset allocation, benchmarks, permitted asset classes, *etc*) by the Board to Fund Managers, the Monitoring Consultant and Investment Committee representatives.
- We assess that there is key person risks inherent in these delegations. Current key individuals have a high conviction in the OBAA strategy, but given OBAA is not a standard approach in the industry and implementation relies on a small set of fund managers it is quite possible that a replacement Monitoring Consultant or IC appointee would push for an alternative implementation approach. Given the Board is comprised on non-investment experts and is also subject to turnover, this suggests risks to the sustainability of the OBAA strategy (or any other potential strategies).
- There is an unusually high reliance on a single strategy across Funds that have ostensibly both quite different economic purposes and different distribution requirements. The sharing of costs and benefits of scale that come with the shared strategy and managers are important, but they should be seen as second order considerations relative to ensuring that the investment strategies pursued are best aligned with the economic purposes of the Funds.
- There are areas where critical current practices are not explicitly outlined in the documentary record. Two in particular include:
  - > There is no formal establishment documentation for the Investment Committee which outlines clearly roles, responsibilities and delegated authorities.
  - > The decision to only distribute from the TTF if the real value is maintained has the status as an informal "convention". The TTF Deed provides for more flexibility and there are no formal statements or agreements on such a strict

interpretation of distributions from the TTF. In turn, this convention and the desire for annual distributions from the TTF to the Tuvalu Government has been very influential in the adoption of the OBAA strategy, and its attendant relatively low risk profile compared to what is typically seen in an inter-generational fund.

- There are areas where we assess that Fund reporting could be improved, for example, we suggest that a regular Risks Report is developed by the Investment Committee for the Board and that more clarity is provided in the fee structures for the two investment funds.
- We assess that the clarity in the economic purposes of the Funds could be improved. In particular, does the establishment of the CIF, FTF and (in time) STF imply that the TTF should principally be seen as an inter-generational wealth fund? If so, does this have implications for the current investment strategies?
- In relation, whose welfare is the TTF designed to serve? At the moment, the focus on building-up the TTF to a balance of $200m appears to suggest the focus is on future generations rather than current. It is beyond the scope of our assessment to consider the Government of Tuvalu's budget and development priorities. However, we note that the purpose of the TTF, as established in its Agreement, includes improving **existing** levels of social infrastructure and services, and assisting the Government to develop the economy more broadly. As such the natural question that follows is whether the TTF should be put to more use to meet the Government's Te Kakeenga III development priorities?

Finally, we assess that resourcing of the executive function (as currently represented mainly by the Fund Secretariat) is light compared to most Sovereign Funds. As discussed below we think there are opportunities to develop local capabilities, which may be particularly important in the context of supporting other Tuvalu Funds.

Recommendations

Our main recommendations are grouped under the headings of **Fund Purpose and Investment Strategy**, **Fund Policy Development** and **Capability Building**. We note the parties we envisage would have responsibility for meeting the recommendations. We also provide for each recommendation the Santiago Principle (GAPP) that motivates the recommendation.

Fund Purpose and Investment strategy

As noted above, the Trust Agreement of the TTF affords more flexibility in distributions than the assumptions in the Statement of Investment Operations and Procedures (SIPO). It was suggested that the rigidity of applying the maintained real value was a GoT (Government of Tuvalu) preference. The Trust Agreement states, *"The Board <u>shall establish</u>, <u>and revise from time to time</u>, a re-investment and distribution policy. In so doing, the Board, in order to contribute to the long term financial viability of Tuvalu, <u>shall balance the provision of immediate additional revenue for recurrent expenditure against the need to maintain, so far as possible, the value of the Fund's capital at not less than the real value</u>..." (our emphasis underlined).*

The Board thus has discretion to adjust the distribution policy and this specific trust provision should be given renewed consideration given the time that has elapsed since the current 'informal convention' was adopted. Consideration should be given to the likely drawdown of the CIF in periodically examining and revising the distribution policy.

1. We recommend that the Board of the TTF confirms with the GoT this preference, records it in the Board minutes and records the resulting policy in the SIPO. We recommend as part of this confirmation that the Board provides a clear illustration of the risk-return consequences of this preference for the TTF over short and longer term horizons.

The objectives of the TTF are clearly stated in its establishment deed, however, as mentioned above, changing revenues and the establishment of other special purpose funds in Tuvalu may affect the past perception of the TTF as a mixed purpose fund. Its purpose may become more inter-generational, which by inference could consider a more aggressive growth policy than the balanced approach contemplated by the establishment deed.

2. We recommend that the Board and GoT considers whether the establishment of other Funds means more weight can be put on the TTFs inter-generational purpose. The Investment Committee should provide input to this and utilise the Monitor Services to do so.

The TTF establishment agreement states "The Board shall lay down investment guidelines... it shall ensure that the capital of the fund is invested in a balanced portfolio." (our emphasis underlined)

OBAA may be considered an implementation of a balanced strategy (given its CPI plus x% targets corresponds to a balanced portfolio under plausible capital market assumptions), however, this is only implicit as there is no clearly defined balanced portfolio benchmark for the OBAA strategy. In addition, the discretion afforded to the managers to adjust their asset allocations could conceivable breach what could be considered a balanced portfolio.

3. We recommend that the Board defines what is meant by a balanced portfolio using clearly defined and standard listed asset class benchmarks. The Investment Committee should provide input to this and utilise the Fund Monitor services to do so. This should be detailed in the SIPO to avoid confusion between the process of setting a strategy and the preference for OBAA as an implementation approach.

4. We recommend that the 'notional' balanced portfolio constructed is used as an ongoing governance benchmark by the Board to assess the performance and active risk taken by the OBAA strategy. Consideration should be given to whether a formal active risk budget should be adopted by the Board and included in the SIPO (as commonly seen in SWFs and the broader funds management industry).

A standard practice for Sovereign Funds is to develop and own a set of investment facts and beliefs. The TTF has such a set in its SIPO but these are fairly generic and it is not clear that they are comprehensive enough to motivate the OBAA implementation strategy.

In addition, there is no belief on Responsible Investment, and this may be a very important consideration for the Fund and GoT given its susceptibility to climate change risks (we note it is a formal consideration being contemplated for the STF).

5. We recommend that the Board considers whether its current set of investment beliefs are comprehensive enough with respect to the OBAA strategy.

6. We recommend that the Board develops a formal belief (and policy) for Responsible Investment.

The Trust Funds in Tuvalu are heavily reliant on external fund managers. A clear understanding of all costs in these funds, including bundled fees and overlay fee structures, performance fees and margins is critical. Some fees are taken from unit pricing (from returns), others may be concessionary inside tiered arrangements in return for favourable consideration. Discovery is a clear fiduciary function.

7. We recommend that the Investment Committee and Monitoring Consultant investigate and seek clarification on sub-fund costs, overlay fees and any performance fee arrangements. This could include sighting of sub-fund investment management agreements. These should be periodically reported on to the Board.

As noted in the key findings, the purpose of the TTF includes improving existing levels of social infrastructure and services, and assisting the Government to develop the economy more broadly. We heard very mixed views from interviewees on whether the Fund has been successful in meeting this purpose. In part, this reflects that distributions from the TTF (and CIF) are part of general government revenues that then get spent according to government priorities, i.e. there is no clear linkage between Fund distributions and economic and social development spending or infrastructure. In part, it also reflected a view that the standard position of the GoT was to seek external financing for new development projects, rather than use Fund resources.

8. We recommend that the GoT 'earmarks' development expenditures that have in part or whole been financed by distributions from the Fund.

Along with providing more clarity on how it is being used this may also provide local communities with a greater sense of ownership of the development spending.

9. If feasible, we also recommend that the economic advisors to the Board develop a framework that can be used to address (i) conditions under which distributions from the Fund should be used for development spending ahead of other funding sources and (ii) the extent to which distributions should be used to support current generations.

We assess that there is a solid historical case that has been made for the establishment of the TTF and ongoing support for the Fund by the Government of Tuvalu (GoT) and donors. The establishment of the CIF and FTF from the TTF have also been well-considered and their differing purposes *in principle* enable a clearer investment strategy for all of the Funds.

We are less clear that a good case has been made for the establishment of the Survival Trust Fund. The liability stream that this Fund is being contemplated to manage is not as yet well defined. In particular, is its main purpose to provide natural disaster relief, or is to improve resilience to natural disasters and/or climate change and rising sea levels?

10. We recommend that the Government of Tuvalu works with the Consultant being engaged to establish the Survival Trust Fund to clearly define the liability the Fund will be designed to offset (in whole or part), and how this differs from other Funds and insurance options (e.g. the extent to which Falekaupule could be used to improve resilience to storms, and the extent to which the recently established supra-national Pacific Island disaster recovery insurance facility could be used for disaster recovery).

The TNPF has an explicit liability stream that it manages in the form of pension obligations for contributing Tuvaluans. We understand there has not, however, ever been a formal asset-liability study that defines the asset allocation that would best fund this liability stream, or in relation, the level of liquidity that is needed in the TNPF given the withdrawal pattern. Our sense is that for a Fund with a membership base that is relative young and growing (a function of Tuvalu's demographic profile) the level of risk being taken with the current OBAA strategy may be too conservative.

11. We recommend that the Board of the TNPF commission a formal asset-liability study to address the appropriate level of risk and liquidity in the TNPF.

It could utilise the existing Fund Monitor services to do so given the firms actuarial expertise. Note consideration of the liability stream and liquidity issue will also be useful to develop a sense of how much of the TNPFs assets could prudently be allocated to illiquid investments.

Fund Policy Development

The 2008 revised edition of the Trust Agreement clearly establishes the basis of the TTF. This is a principles based document appropriate to purpose, allowing quite generous operating parameters. It describes the role and composition of the Board, and the Advisory Committee, but there is no mention of the IC (Investment Committee) or Secretariat. There are also no specific references in the enabling legislation of fiduciary responsibilities.

The IC appears to have been established as a result of Board decisions in order to address the lack of investment skills and likelihood of regular turnover of member government Board representatives.

Additionally, despite the fact that the TTF Board and IC are only responsible for the TTF investment governance, we observed reliance on their roles by the governors of the other funds. While the Fund Monitor role is also utilised by the CIF, TNPF and FTF, the advice given and monitoring received is in differing formats not consistent with the TTF reporting. The IC is charged with bringing expertise to the investment governance function and is key to monitoring and contesting the OBAA implementation approach that has been adopted by all funds. So, by implication, one could argue that there should be clear accountability and reporting by the IC to the other funds. The Secretariat should have a role here in conveying IC monitoring evaluations and recommendations but currently it only has reporting functions for the TTF and FTF, not the TNPF. Should the implementation approaches differ across the funds in the future, alternative arrangements would need to be considered.

12. We recommend that a document that provides clarity as to the IC and Secretariat roles, functions and delegations is created. It is recommended that this is incorporated into the SIPO for the TTF rather than the enabling legislation.

Consideration of the IC and Secretariat roles in relation to the other funds also needs to be addressed.

13. We recommend that the SIPO also sets out specific fiduciary responsibilities for the Board, IC and Fund Monitor.

14. We recommend that the SIPO is also added to the TTF's website when it becomes operational given it is a key governance document.

15. We recommend that an outsourcing policy is developed by the Fund that clearly outlines (i) conditions when outsourcing is appropriate; (ii) appointment procedures; and (iii) monitoring and review procedures.

16. We recommend that a Risk Policy and Board Risk Dashboard is developed by the Secretariat, Board and IC. This should include policies on the management of operational, supplier, financial, and market risks. The Dashboard should provide clear reporting on how the Fund is managing these risks (e.g. via a traffic light system).

17. We recommend that the Fund Secretariat has the primary responsibility to update the SIPO, or develop and new policies.

18. We recommend that the Fund Secretariat develops an on-line "fiduciary file" of key documents. This would ensure any new stakeholders have access to appropriate files to come up to speed, have quick access to latest policy and core documents, and where necessary, review previous decision-making process.

Capability Building

The Board addresses its broad responsibilities as contemplated in the TTF agreement. The agreement is however light on specific fiduciary responsibilities. Under the Santiago Principles and other fiduciary best practice guidelines one could argue that there is a heavy reliance on the appointment of investment experts on the IC.

There is no formal policy or budget item on capacity development.

19a. We recommend consideration should be given to building specific investment governance capability for any inexperienced directors to enable them to provide effective oversight of the external adviser roles, including the IC. This is important due to the apparent lack of continuity of directors and the short term contracts for IC advisors.

We suggest training should focus on fiduciary governance rather than developing investment expertise because the benefit sought is to facilitate confidence in the IC, monitor and investment manager roles, and to ensure appropriate skills and alignment of IC advisors at their appointment. That is, a solid appreciation of how to inquire and hold to account all service providers is arguably very important when, in the case of the current strategy, significant (complete) delegation over asset allocation, sub-fund selection and cost management has been passed through to the Investment Managers.

Note we also considered and rejected a requirement for Board members to have experience in an investment organisation (as can be found in the establishment documentation for some Sovereign Funds).

This reflects the need for Board members to have a broader oversight and understanding of the economic and political context of Tuvalu.

There have been discussions in the past as to the capacity and resourcing of the Secretariat role. Our view is that better training resourcing of the Secretariat would be beneficial in the context of (i) Board and IC turnover and the need to build 'institutional memory' at the TTF; and (ii) the support the current Secretariat also effectively provides to the CIF and FTF.

20. We recommend that the Secretariat also undertakes any investment governance training

21. We recommend that the budget out of the TTF for the Secretariat is increased to also facilitate shared ownership of the investment monitoring and reporting function (e.g. by funding acquisition of fund performance and monitoring tools).

We note that the cost for the present Secretariat is likely to be quite modest compared to the size of the Fund. External benchmarking studies of Sovereign Fund administration and staff costs can be referred to establish a "reasonable" budget given the Fund's size.

We also note that an alternative approach to build investment governance and monitoring capabilities in Tuvalu could be to develop this function within the Ministry of Finance. We do not consider this alternative as desirable for the TTF given it potentially risks compromising the arms-length separation between the GoT and the investment implementation currently in place. That said, we do think there is a case for officials in the MoF to receive investment governance training, particularly for any staff involved in the oversight of the CIF.

22. Subject to training, we recommend that the Secretariat is added as an Investment Committee member

The international trend is for an entity's investment governance framework to be regularly assessed for effectiveness.

23. We recommend that this assessment model forms a basis for the Secretariat to prioritise workflow on an ongoing basis. The capacity building recommended for the Secretariat could include developing the capability to use this assessment model as a template.

Finally, a more "blue sky" consideration for the Board and GoT to consider is the State investment corporation model seen in Australia (e.g. Queensland Investment Corporation) and Canada (e.g. British Columbia Investment Management Corporation) for the management of the different Tuvalu Funds. In this model there is a single organisation responsible for investment execution and monitoring of different government investment mandates, enabling pooling or resources and achievement of scale benefits.

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Authorship

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