“The role of the Future Fund and its contribution to Australia’s financial position”

Australian Shareholders Association National Conference, Grand Hyatt Hotel, Melbourne.

16 May 2017

Speech by Hon Peter Costello AC,

Chairman, Future Fund Board of Guardians

Check against delivery

The role of the Future Fund and its contribution to Australia's financial position

I'm delighted to be here with you today to give you some insight into the role of the Future Fund - Australia's Sovereign Wealth Fund – in particular the contribution it makes to the Nation's financial position.

You may be aware that last week, as part of its Budget, the Government announced some important decisions that will affect the Future Fund's drawdown timetable and its investment mandate.

These are important and welcome decisions.

I want to take some time to explain why these decisions are so important and how they will enhance the objectives of the Future Fund.

I will also explain how we have built the portfolio and share some of the insights we have developed that may be relevant to your own investment portfolios.

The Future Fund today stands at nearly $130 billion.

It was set up in 2006. From initial contributions of $60.5 billion it has earned $69 billion, more than doubling the money invested within it.

It has performed strongly through its 10 year history, including through the Financial Crisis of 2008.

Today, the Future Fund is an Australian success story on the global stage.

It is one of the world's most well respected Sovereign Wealth Funds.

While I will focus my comments on the Future Fund portfolio today, the Future Fund Board of Guardians in fact manages another four Funds for the Australian Government worth around $20 billion.

The principal additional Fund – certainly in terms of the complexity of the investment challenge - is the Medical Research Future Fund with assets of $5 billion. This Fund is designed to last in perpetuity generating returns each year that will help to fund Australian medical research and innovation. We also operate three simpler low risk portfolios - the DisabilityCare Australia Fund, the Building Australia Fund and Education Investment Fund – together valued at around $15 billion.

Together with the Future Fund this brings the total assets under management to nearly $150 billion.

Reason for the Future Fund – pressures on the Budget

Let me take you back to why the Future Fund was established.

In 2002, the Australian Government published the first ever Intergenerational Report which was designed to provide a long-term lens for economic policy and the federal Budget.

It aimed to assess how current generations were preparing for the needs of future ones.

This exercise required an examination of the country's long term fiscal outlook.

It identified emerging costs that required early attention, particularly the costs associated with an ageing population.

The report found that, on policy settings as they were then, over 40 years a gap would open up between expected spending requirements and expected revenue. This gap represented about 5% of Gross Domestic Product each year.

The message was clear. We needed to get a grip on the long-term drivers of expenditure or leave a massive tax burden on future generations.

This led the Government of the time, to implement a number of measures to reduce longer term drivers of spending and implement policies to boost economic growth. The Government also determined it would pay off debt, to reduce the burden which would otherwise weigh on future generations.

With hard work and discipline, by 2004 the Government was in sight of its goal of eliminating debt and it began to consider how it could go further and build a net financial asset position.

It was this work that led to the idea of a Future Fund. The idea was to build savings to strengthen the financial position of the Commonwealth in preparation for the pressures that were to come.

In 2005 legislation to create the Future Fund was introduced to Parliament and secured Royal Assent in March 2006.

In May the first contribution of $18 billion was made to establish the Fund.

Contributions from the Budget surpluses of 2005/06, 2006/07 and proceeds from the privatisation of Telstra saw a total of $60.5 billion put into the Fund.

Purpose of the Future Fund – strengthen Commonwealth's long-term financial position

So what specifically was the object of the Future Fund?

Clause 3 of the Future Fund Act sets it out. It states:

'The main object of this Act is to strengthen the Commonwealth's long-term financial position by establishing the Future Fund.'

Since the Government owned the money to be invested in the Fund, it could direct the proceeds to any purpose. It chose to direct the proceeds at the completely unfunded public sector retirement liabilities.

These liabilities are a significant pressure on the Government's Budget – today taking around $8 billion of public taxes each year and growing.

With the creation of the Future Fund, the Government hoped to be able to take these payments off the Budget freeing up billions per year for other purposes.

The ambition was to grow the Fund to a size that by 2020 it would relieve the Budget of those pension costs.

This was a mechanism to allow one generation to put money aside for future generations, to bequeath it some assets as well as liabilities.

Future Fund is not a superannuation fund

This highlights an important point and one around which there is sometimes confusion.

The Future Fund is not a superannuation fund.

It is a Sovereign Wealth Fund because the money is owned by the Government. The money is invested for the benefit of taxpayers generally. Subject to legislation it can be used for any purpose.

A superannuation fund receives contributions from members – currently in Australia that is set at 9.5% of members' wages. It is their money. Its assets are owned by them. If it closes down they get the proceeds.

The money in the Future Fund is not owned by any individual. Individuals cannot contribute to the Future Fund. No individual can draw out of it. If and when it is drawn down, the money will go into Consolidated Revenue.

Future Fund performance – the mandate

Since the Fund was established it has performed strongly.

It was given the mandate to earn CPI+4.5 to 5.5% per annum while taking 'acceptable but not excessive risk'.

Over its 10 year life it has exceeded its baseline target rate of return.

The baseline target (CPI+4.5%) has been 6.9% per annum

It has delivered a return of 7.7% per annum.

This has more than doubled the value of the Future Fund.

Given the financial crisis of 2008 and the low yields of more recent years, this is a remarkable performance.

But the world is a different place today to the way it was in May 2006.

Long-term prospective real returns on government bonds are about 2% lower now than when the return objective was set.

Government bonds provide the foundation from which other assets are priced. The historically low yields on 10 and 30 year bonds mean that investors face lower returns across other asset classes.

We believe, and this is a widely held view among investors, that we are in a long-term low-return environment.

This means investors will have to accept lower returns or decide to increase levels of risk to chase historic returns.

The Future Fund is allowed to take 'acceptable but not excessive risk'.

The Board of Guardians has felt increasingly uncomfortable about its ability to achieve a return of at least CPI+4.5% per annum over the next ten years without taking excessive risk.

Taking excessive risk to strive for an unrealistic return target would be a serious matter. Excessive risk would jeopardise large sums of taxpayer money.

Recognising this, the Board asked the Government to reconsider the return objective.

Last week the Government announced it intends to reduce that objective by 50 basis points to CPI +4 to 5% per annum. The requirement that the Board should not take excessive risk remains.

The Board welcomes this decision. It is still a challenging target, but it gives the Board a more realistic objective and a clearer sense of the Government's perspective on the balance between risk and return. It allows us to position for the next decade, our second.

Drawdown of the Future Fund

The other welcome announcement from this year's Budget was that the Government will delay drawing down from the Fund until at least 2027. Contrary to what was intended when the Future Fund was established in 2006, no further money has ever been contributed to the Future Fund after the Budget surplus of 2007.

The earnings of the Future Fund have exceeded expectations. But contributions to the Future Fund have fallen far short of expectations.

What is more is the unfunded pension liabilities have continued to grow.

Slide 1 summarises this.

It shows the original $60.5 billion put into the Future Fund with no other contributions made.

It shows the investment earnings on the Future Fund.

It shows the Future Fund's balance at 31 March 2017 of $129.6 billion.

But it also shows that the unfunded superannuation liabilities in the 2015-16 Budget were around $169 billion.

A few years of additional contributions, even the allocation of the 2008 surplus to the Fund, could have closed that gap. But since the initial allocations, no further contributions were ever made.

The Budget uses a 6% discount rate to value the unfunded pension liabilities The Final Budget Outcome, in accordance with Australian Accounting Standards, uses the actual long-term bond rate of 2.7% as its discount rate.

Under this approach the unfunded liability stands at over $314 billion.

Either way this shows that subsequent to 2007 the Future Fund was underfunded if it was ever to meet all the liabilities it was intended to cover by 2020.

And looking at 2020, [slide 2], assuming a return of 4% per annum above inflation, the Future Fund will be valued at around $159 billion.

But the unfunded liabilities at that time will be valued at $195 billion using the 6% discount rate or as much as $340 billion using the 2.7% discount rate.

More important than a single year is the longer term perspective.

Slide 3 shows that commencing drawdowns in 2020 and assuming a return of CPI+4% per annum, the Future Fund would be exhausted in 2046.

The Government would be left needing to find around $20 billion each year and every year from 2045 for the unfunded liability.

To show this differently, [slide 4] if the Government drew the full amount of the annual liabilities from the Future Fund until the Fund was exhausted, the net liability remaining would still be around $275 billion in 2046 when the Fund was exhausted.

That is a $275 billion bill left to the generations of the 2040s.

Deferring drawdowns to a later date, will allow the Fund to grow to meet all of the unfunded liabilities [slide 5].

So the absence of additional contributions and the size of the liabilities meant that the Government had to decide whether it should exhaust the Fund and leave unfunded liabilities to future generations, or delay drawdowns to the benefit of all generations.

Just before the Budget the Government announced that it would not start to draw on the Future Fund in 2020-21 as it is entitled to do.

Instead the Government has indicated its disposition to defer withdrawals for six years at least until 2027-28.

This should allow the Future Fund to grow to around $300 billion.

It will allow the Future Fund to cover the cost of all unfunded liabilities.

Future Fund boosts the Budget balance

In the meantime the earnings of the Future Fund will contribute to the bottom line of the Budget. These are included in the underlying cash balance from 2020 onwards. Over half of the surplus the Government is now projecting from 2020-21 is made up of the Future Fund earnings.

The Government has decided the right thing to do is to allow the Future Fund to do what it was intended to do and to provision for all generations not just the current one.

So with that overview of why the Future Fund was set up, how it is strengthening the Commonwealth's financial position, and how commitment to the Future Fund's original purpose has been reinforced, let me talk about the investment portfolio and some of the things that have been important to our success which may be relevant for you.

Insights from the portfolio: Diversification

First, we believe in the value of diversification.

We invest in all classes of assets in Australia and internationally. We are broadly diversified across asset classes and geographies.

We have investments in listed equities, fixed interest, credit, hedge funds, infrastructure, property and private equity. We invest in Australia and overseas, including in major developed markets such as the USA, UK and Europe and in emerging markets such as China and India.

We are significant investors in Australia through the Port of Melbourne, Melbourne airport and Perth airport. In the UK we are invested in a water utility, Gatwick airport and Edinburgh airport. In the US our investments include power stations and gas pipelines.

Our property assets include shopping centres, commercial property and office buildings across Australia, in Vienna, on the Champs Elysees in Paris and on New York's 3rd Avenue.

In a private equity program of over $13 billion we have around $2 billion invested in venture capital, including exposures here in Australia. This gives us investments in businesses of the future – we were early stage investors in companies like Uber, Airbnb and Snapchat.

As members of the Australian Shareholders Association you will be interested to know that we are significant investors in listed equities, here in Australia and overseas.

The Australian market is attractive to us. Our mandate is to achieve returns in Australian dollars. The performance target we operate to is based on Australian inflation. So investing in Australia makes sense for us.

At the end of March 2017 we had nearly $8.5 billion invested in Australian listed companies – nearly 10 times more than would be allocated if we merely followed the MSCI All Country World Index.

Balancing return objectives and risk requirements

Second, we adjust the portfolio to reflect how we see the global investment environment – to reflect the rewards and the risks that we see.

This is not about making short term calls and trying to time markets. Instead it about being clear about how much risk we are willing to take and whether we believe we are being rewarded for that level of risk.

We are charged with maximising investment returns over the long term with acceptable but not excessive levels of risk.

We have to balance the return objective of the Investment Mandate and the risk requirement of the Investment Mandate.

We have to be clear that we are not tempted to chase returns by increasing risk to excessive levels.

We will not risk the Fund's capital where the expected return is inadequate.

In practice, this means that we are willing to be patient until we can find the right opportunities.

It also means that we are regularly looking at the portfolio and whether it is positioned the way we want it given the changing environment.

This demands clarity of thinking, accountability and a robust governance process.

By changing our portfolio risk settings we expect to produce a smoother path of returns than many other investors.

We expect that will mean moderation when markets are highly priced and some protection on the downside.

Currently our view is that global equity markets are fully priced with the return for risk relatively low. We are also conscious that the prospects for global monetary policy and global economic growth remain unclear and are potentially vulnerable to upsets in the form of policy miscalculations and geo-political risk.

Debt levels globally remain high and Central Banks have limited capacity to be able to stimulate markets in the event of any renewed crisis however that might arise.

This leads us to have relatively less risk exposure than might normally be the case.

Clarity of purpose

Third, while we invest in order to strengthen the government's long term financial position, we do so without interference from Government.

We are given a clear purpose and objective and are not asked to try to solve multiple challenges at once.

The Government does not tell the Board where to invest. If it did, it would open us up to the risk of allocating capital for political reasons rather than in pursuit of investment objectives.

This independence from political directives has been key to our success and has been respected by both sides of politics.

We focus on generating strong returns without excessive risk.

We are not asked to support particular industries or sectors.

We are not asked to help manage the currency.

We are not asked to support other Government policy objectives.

We are asked to grow the Fund over the long-term and to protect its capital.

We believe that an investor must be very clear about its objective.

My view is that chasing multiple investment objectives runs the risk of achieving none of them.

Non-financial benefits

While our financial purpose is of paramount importance and is the reason the Fund exists, the Future Fund delivers additional benefits to Australia.

It gives weight to Australia's standing in global financial markets.

As one of the world's leading Sovereign Wealth Funds our involvement in, and views about, significant international financial matters is highly sought. Over recent years representatives from the Future Fund have been invited to attend meetings at the White House, 10 Downing Street and other important capitals which have been seeking to promote inward foreign investment.

This helps with our access to investment opportunities and puts an Australian voice in the discussion of what is needed to support the free flow of capital to support global economic growth.

Domestically, the Future Fund's presence here in Australia – we have around 140 staff here – creates an incentive for world leading investment managers and service providers to visit and set up in Australia.

Not only does this strengthen Australia's investment industry, but it creates opportunities for Australian investment firms to develop their business globally.

Conclusion

So let me summarise.

The Future Fund was set up to strengthen the Commonwealth's long term financial position.

Over the last 10 years it has performed strongly growing the initial $60.5 billion it received from government to around $130 billion.

Its success has been recognised internationally by other Sovereign Wealth Funds and institutional investors globally.

The Future Fund's success has been achieved by having a clear objective, patience, diversification, a sharply defined view of risk and good governance.

I hope that you agree that the Future Fund – enhanced by the Government's decision to defer withdrawals from the Fund - is doing what it was set up to do: investing for the benefit of future generations of Australians and strengthening Australia's long-term financial position.