

**Meeting of the Finance Audit & Risk Sub-committee**

**LATE ITEM**

**Date:** 2 March 2022  
**Time:** 9.00am  
**Venue:** Council Chamber  
Hawke's Bay Regional Council  
159 Dalton Street  
NAPIER

**Agenda**

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Item	Title	Page
15.	Scope for Fund Manager Review	3

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**HAWKE'S BAY REGIONAL COUNCIL**  
**FINANCE AUDIT & RISK SUB-COMMITTEE**  
**02 March 2022**

**Item 15**

**Subject: SCOPE FOR FUND MANAGER REVIEW**

**Reason for Report**

1. This paper outlines the considerations and presents a draft scope for a review of the fund managers for feedback from the Finance Audit and Risk Sub-committee (FARS).

**Background**

2. Following a robust procurement process Hawke's Bay Regional Council (HBRC) chose to place funds equally split between two fund managers, Jarden and Mercer. Initially circa \$40 million (Long Term Investment Fund) was placed under management in December 2018 followed by a further \$105 million (Port Future Investment Fund) placed under management in June 2019. Funds for the Port Future Investment Fund were derived from the Hawke's Bay Regional Investment Company Ltd.'s (HBRIC) sale of 45% equity stake in the Port of Napier. It is now appropriate, given the duration of the time since the funds were placed under management with the two fund managers, to consider and put in place, a formal review process of the fund managers performance.
3. HBRC's funds under the management of fund managers are managed in line with a Statement of Investment Policy and Objectives (SIPO). HBRC's treasury policy requires that Council formally review and approve the SIPO annually and provide instructions to the fund managers.
4. Currently, PwC as part of the quarterly treasury reporting to Council report on:
  - 4.1. The performance of the individual securities against benchmarks
  - 4.2. Compliance of the funds with the SIPO's asset allocation targets.
5. The FARS requested staff to draft the scope for a review of the performance of the fund managers to date and formalise a review process going forward. Outlined below are questions to consider when determining the nature and scope of a review along with recommendations from staff. Feedback is sought on the following.

**Discussion of Options**

**How often should the performance of the fund managers be reviewed?**

6. The current HBRC SIPO indicates that the fund managers performance will be monitored as follows.
  - 6.1. Investment Managers performance will be monitored quarterly with a view to an annual evaluation of rolling three-year results.
  - 6.2. Returns achieved by the appointed Investment Managers will be assessed by the Council in relation to their stated objectives and the objectives of the Fund. Returns will also be compared with returns earned by a suitable peer group, such as a group of other professional Investment Managers.
  - 6.3. The Investment Manager's role will be reviewed by Council on an annual basis. Factors taken into account in these reviews will include investment style, resources, organisational strength, investment performance relative to objectives, and any other factors considered relevant to the Investment Managers continuing ability to meet the applicable investment objectives.

### *Review frequency recommendations*

7. Staff recommend that Council monitors the performance and fund manager attributes on quarterly or six-monthly basis using the criteria noted following, including the SIPO requirement to compare performance against other fund managers in the market.
  - 7.1. Although analysing longer track records provides a more accurate indication of a fund's true risk profile and minimises the noise created by short-term volatility of returns, quarterly tracking is important though to enable rapid identification of performance outside of a fund's normal risk profile or in an event a fund's performance is significantly different from the peer group/market. Such events would justify requiring an explanation from the fund manager and consideration by the committee for possible divestment.
  - 7.2. A quarterly review of the performance of the fund will highlight any market conditions that will warrant a review or alteration of the SIPO.
  - 7.3. The quarterly review process should include formal meetings with the fund managers, to discuss findings from the review and obtaining feedback.
8. Staff also recommend that FARS:
  - 8.1. Performs a review of the strategic asset allocation (currently 50% Growth and 50% Income) on an annual basis in order to ensure it reflects the risk appetite and earnings expectations of Council where there is flexibility to provide feedback through to the Annual planning process
  - 8.2. Performs a full review of the SIPO every three years to ensure it aligns with expectations of Council's long term plan and Investment strategy.

### **What should the criteria be for a review?**

9. HBRC's current SIPO requires that performance of the funds are monitored to:
  - 9.1. Assess the extent to which the Fund's investment objectives are being achieved
  - 9.2. Compare the performance of the Fund's appointed Investment Managers against the agreed performance benchmarks, performance of other relevant professional Managers and market indices
  - 9.3. Understand the existence of any particular weakness in the Investment Managers or the investment product(s) utilised
  - 9.4. Allow the Finance, Audit and Risk Committee to continually assess the ability of both the Council and the Investment Managers to meet the treasury objectives.

### *Review criteria recommendations*

10. It is considered best practice to monitor investment portfolios across three main criteria, as per the following.

#### *Portfolio Governance and Strategy*

- 10.1. Annual strategic asset allocation review to ensure portfolios are still in line with investment strategies and goals
- 10.2. Full policy review every three years or as required
- 10.3. Quarterly mandate compliance and drift tracking

#### *Performance and Risk Review*

- 10.4. Quarterly comparison of performance to appropriate market indices and peer groups. (See attachment 1 for an example of a PwC peer group analysis report)
- 10.5. Quarterly health check that provides a risk, return and contribution analysis across time. (See attachment 2 for an example of a PwC health check report)

*Fund Manager Due Diligence (qualitative review)*

- 10.6. Quarterly review of the qualitative fund manager attributes of:
  - 10.6.1. Governance and Controls - Risk management functions at all levels of the organisation (See attachment 3)
  - 10.6.2. People and Organisation - Ownership structure, investment beliefs, corporate culture, historical track record and key individuals' functions
  - 10.6.3. Investment Process – portfolio construction process, investment style, stock/manager research capabilities, deal screening criteria and past performance management.

**How many fund managers (funds) is appropriate given the size of the investment?**

11. Currently HBRC has funds placed with two fund managers (Jarden and Mercer).

*Number of fund managers recommendation*

12. A prudent portfolio risk management approach is to spread your investment across providers. However, as HBRC's portfolio risk is already spread across multiple asset classes and jurisdictions the concern is not portfolio diversification but counterparty risk. Most institutions with fiduciary duty invest in at least two diversified managers as HBRC does. Counterparty risk could be decreased further by investing in more fund managers, however the complexity of portfolio monitoring will increase.
13. Regular review of the fund managers' performance against the performance of the peer group will highlight strengths and weaknesses of the current fund managers, while also highlighting other fund managers that are outperforming the peer group.

**Other Considerations**

***Fees***

14. Currently, fund managers deduct fees at source monthly before a net valuation is calculated. This is a standard approach across the industry. It is recommended to review fees on an annual basis, as fund manager fees do and should adjust to market expectation over time. A fee review will include a breakdown of key charges and a comparison to the peer group.

***Returns distribution***

15. HBRC's current SIPO requires returns of the funds to be distributed as follows.
  - 15.1. The amount required to meet the Council's revenue requirements will be informed annually upon adoption of the annual plan
  - 15.2. An amount equal to the New Zealand CPI for the year will be credited to the Inflation Fluctuation Reserve
  - 15.3. Any remaining amount will be credited to the Distribution Reserve.
16. In the event of an insufficient annual return to meet inflation proofing and/or distribution requirements, the amounts required for inflation proofing and/or distribution will be funded from the Distribution Reserve.
17. Staff recommend that Council instructs the fund managers to distribute returns as per above SIPO guidelines twice yearly (In December and June) with appropriate approval from Council.

***Who should perform the review?***

18. While an independent party can be engaged to provide the reporting requirements of the review process, it is prudent for Council officers and staff to maintain a relationship with the fund managers by having regular formal meetings to discuss the findings of the review and seek feedback. Staff therefore recommend:

- 18.1. Council engages an independent party to provide reporting, meeting the criteria and timing outlined above
- 18.2. Council staff hold regular formal meetings with the fund managers to discuss the findings and seek feedback.

### **Next Steps**

19. The next step in this process is for staff to incorporate feedback from the FARS into a formal scoping document with timeframes, objectives and milestones.

### **Decision Making Process**

20. Council and its committees are required to make every decision in accordance with the requirements of the Local Government Act 2002 (the Act). Staff have assessed the requirements in relation to this item and have concluded:
  - 20.1. This agenda item is in accordance with the Finance, Audit and Risk Sub-committee Terms of Reference, specifically “The Finance, Audit and Risk Sub-committee shall have responsibility and authority to (2.4) monitor the performance of Council’s investment portfolio”.
  - 20.2. As this report is for information only, the decision making provisions do not apply.

### **Recommendations**

That the Finance, Audit and Risk Sub-committee:

1. Receives and considers the “*Scope for Fund Manager Review*” staff report
2. Provides feedback, particularly on the staff recommendations made, sufficient to enable preparation of a formal scoping document that includes timeframes, objectives and milestones.

### **Authored by:**


**Kishan Premadasa**  
**MANAGEMENT ACCOUNTANT**

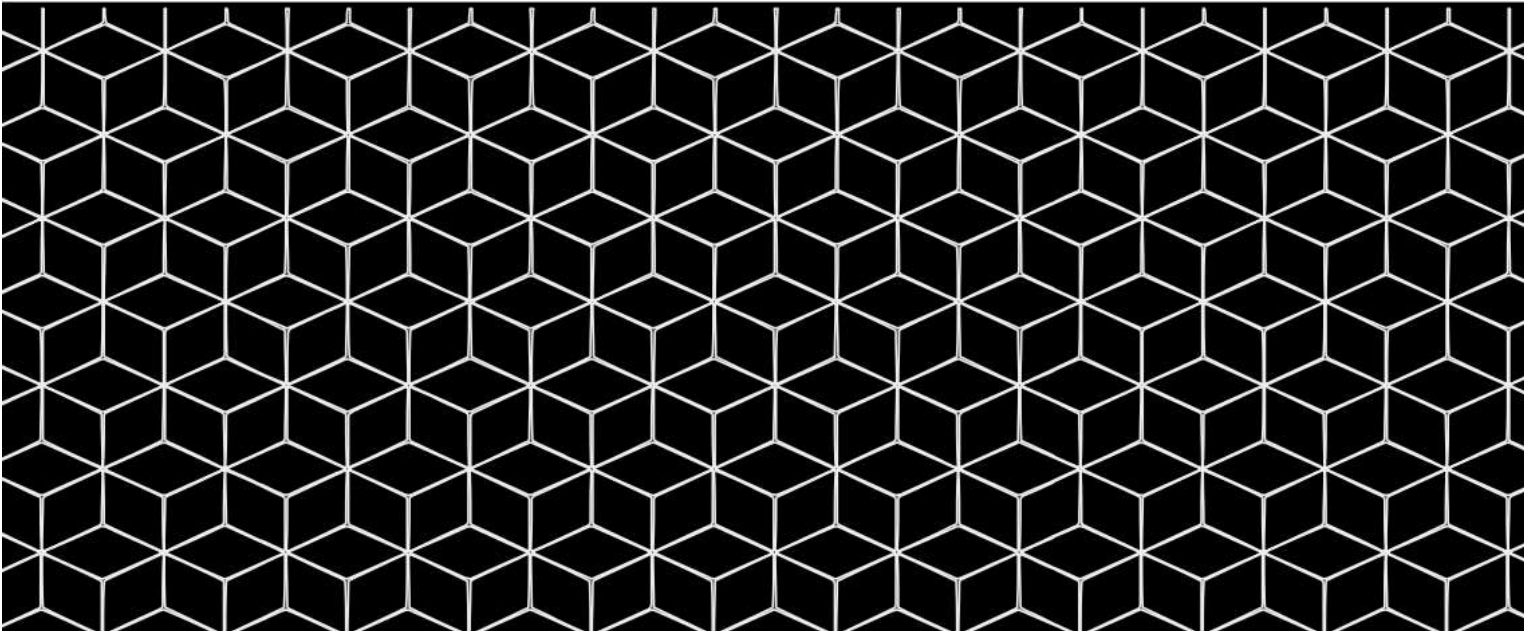
**Christopher Comber**  
**CHIEF FINANCIAL OFFICER**

### **Approved by:**

**Jessica Ellerm**  
**GROUP MANAGER CORPORATE SERVICES**

### **Attachment/s**

- 1  Peer Group Analysis Tool
- 2 Health Check Tool – Power BI
- 3 Qualitative Monitoring – Due Diligence Tool



# Balanced Fund Peer Group *(extract from client report)*

Following our investment strategy and recommendation report in November 2020, we have completed the analysis of New Zealand balanced funds, to benchmark the risk adjusted performance (and other key attributes) of the qualifying funds. The summary results from this analysis are included on the following slides.

Using the Lipper Fund universe (Refinitiv, previously known as Thomson Reuters) we applied the following search criteria to establish the balanced fund peer group:

1. Domiciled in New Zealand
2. Active funds
3. Funds with no leverage
4. At least a 5 year track record
5. Lipper (Thomson Reuters/Refinitiv) Global Classification equal to 'Mixed Assets NZD Balanced' (indicatively classified as 60% equities, 40% bonds) or Mixed Asset Others Flexible (funds self classify as Balanced)
6. AUM > \$40 mil NZD

The search resulted in 21 balanced funds as per below table

1.	Milford Balanced	7.	OneAnswer Multi-Asset Class-Balanced	13.	Castle Point 5 Oceans	19.	Mint Diversified Income
2.	ANZ Investment Funds-Balanced Growth	8.	ANZ Investment Funds-Balanced	14.	AMP Capital Income Generator NZD	20.	AMP Capital Global Multi-Asset NZD
3.	OneAnswer Multi-Asset Class-Balanced Growth	9.	Westpac Active Balanced Trust	15.	OneAnswer Multi-Asset Class-Conservative Balanced	21.	BNZ Balanced Fund
4.	OneAnswer Single-Asset-Class-Balanced Growth	10.	QuayStreet Unit Trusts-Socially Responsible Inv	16.	ANZ Investment Funds-Conservative Balanced		
5.	QuayStreet Unit Trusts-Balanced	11.	ASB Investment Funds-Balanced	17.	Westpac Active Moderate Trust		
6.	AMP Capital Ethical Leaders Balanced	12.	Milford Diversified Income	18.	ASB Investment Funds-Moderate		

Note: Lipper has been a leading provider of independent fund content, analytics, and insight to the global investment community for over 45 years.



# Deriving the Short List *(extract from client report)*

After the peer group identification, we calculated the probability<sup>1</sup> of an asset manager outperforming the peer group across multiple periods: 10, 7, and 5 years. Analysing longer track records provides a more accurate indication of a fund's true risk profile and minimises the noise created by short-term volatility of returns. Longer track records also allow the evaluation of a fund's performance through a complete market cycle.

The table below shows the peer group of balanced funds with performance and volatility calculations across multiple periods. The grey formatted cells in the table identify the funds with more than a 60% chance of outperforming the average peer group return across the relevant periods. ANZ and Milford are consistently at the top of the peer group.

A prudent portfolio risk management approach is to spread your investment across providers to avoid excess counterparty risk. Therefore, only the funds with the highest probability of outperforming the peer group per investment manager were selected (black highlighted names).

	10 Year Ann. Return	10 Year Ann. Volatility	10 YR Probability of outperforming 8.5% Ann. Return	7 Year Ann. Return	7 Year Ann. Volatility	7 Year Probability of outperforming 6.5% Ann. Return	5 Year Ann. Return	5 Year Ann. Volatility	5 Year Probability of outperforming 7.5% Ann. Return
<b>Milford Balanced</b>	11.2%	5.7%	69%	9.5%	6.4%	68%	10.2%	6.7%	65%
Milford Diversified Income	9.9%	4.7%	62%	8.0%	5.2%	61%	7.5%	5.4%	50%
<b>ANZ Investment Funds-Balanced Growth</b>	10.3%	6.9%	60%	8.6%	7.7%	61%	9.7%	8.2%	61%
OneAnswer Single-Asset-Class-Balanced Growth	10.0%	6.8%	59%	8.5%	7.6%	61%	9.7%	8.2%	60%
ANZ Investment Funds-Balanced	8.6%	5.4%	51%	7.2%	6.0%	55%	8.0%	6.3%	53%
<b>AMP Capital Ethical Leaders Balanced</b>	8.5%	6.5%	50%	7.0%	7.4%	52%	8.4%	7.7%	55%
<b>ASB Investment Funds-Balanced</b>	8.4%	5.9%	49%	7.5%	6.7%	56%	7.7%	7.0%	51%
<b>Westpac Active Balanced Trust</b>	8.2%	5.4%	48%	7.1%	6.1%	54%	7.9%	6.5%	52%
<b>QuayStreet Unit Trusts-Balanced</b>	8.0%	5.1%	46%	7.8%	5.7%	59%	8.2%	5.9%	55%
QuayStreet Unit Trusts-Socially Responsible Inv	7.6%	5.4%	43%	6.7%	6.0%	51%	7.5%	6.3%	50%
ANZ Investment Funds-Conservative Balanced	7.0%	3.9%	35%	5.9%	4.3%	45%	6.5%	4.6%	41%
ASB Investment Funds-Moderate	6.2%	4.2%	29%	5.4%	4.7%	41%	5.3%	4.8%	32%
Westpac Active Moderate Trust	6.2%	3.9%	28%	5.4%	4.3%	40%	5.9%	4.6%	36%
AMP Capital Global Multi-Asset NZD				4.2%	4.6%	31%	4.1%	4.8%	24%
AMP Capital Income Generator NZD				6.4%	6.9%	50%	6.8%	7.5%	46%
Castle Point 5 Oceans							7.5%	3.9%	50%
Mint Diversified Income				5.0%	3.7%	34%	5.1%	4.1%	28%
OneAnswer Multi-Asset Class-Balanced				7.2%	6.0%	55%	8.0%	6.4%	53%
OneAnswer Multi-Asset Class-Balanced Growth				8.6%	7.7%	61%	9.7%	8.2%	61%
OneAnswer Multi-Asset Class-Conservative Balanced				5.9%	4.3%	45%	6.5%	4.6%	41%
<b>Average Annualised Return</b>	<b>8.5%</b>			<b>6.9%</b>			<b>7.5%</b>		

**Notes:**  
**Source: Refinitiv**

**Data as of 31 December 2021**

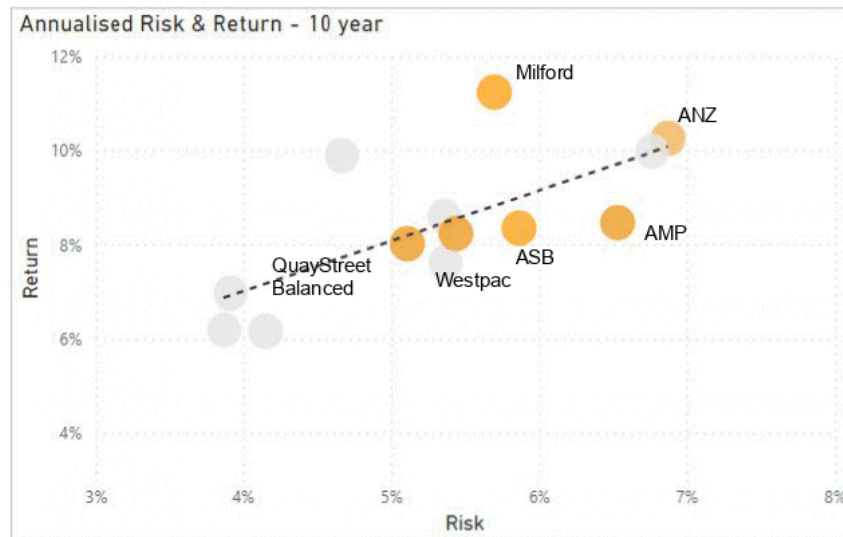
**BNZ Balanced Fund only has a 3 year track record, therefore not included**

**Blank cells indicate a track record shorter than specified period**

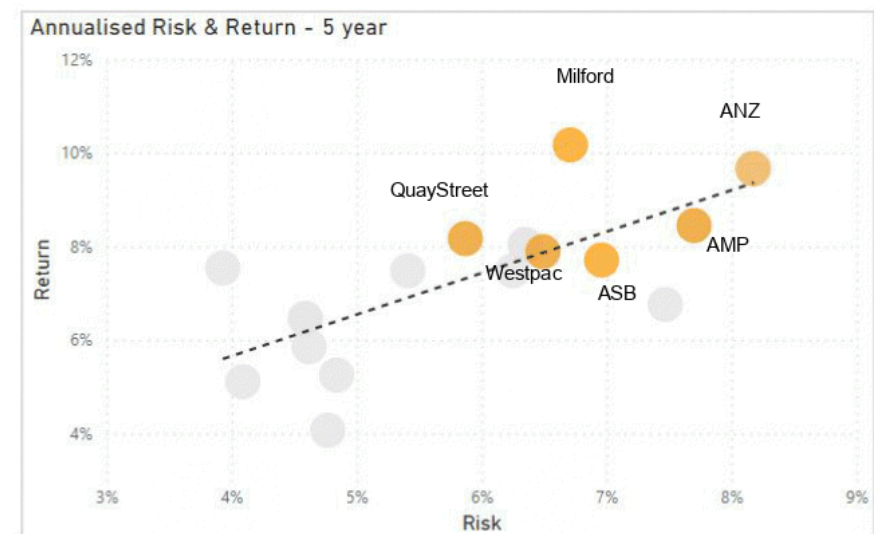
<sup>1</sup>Probability calculations are using a gaussian distribution approach. Annualised return and annualised volatility are calculated using end of month valuations net of fees and gross of tax compliant with GIPS global reporting standard practise. Please note that past performance is not necessarily indicative of future performance.

# Risk and Return Characteristics *(extract from client report)*

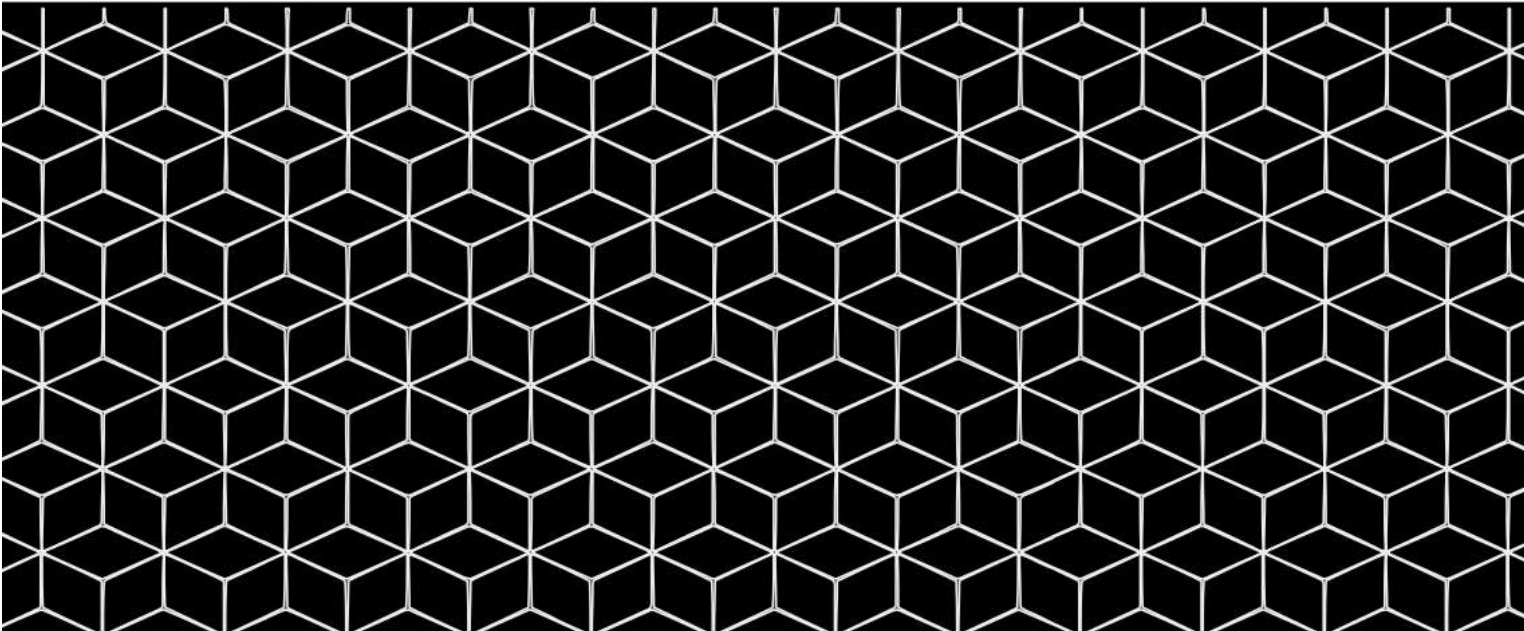
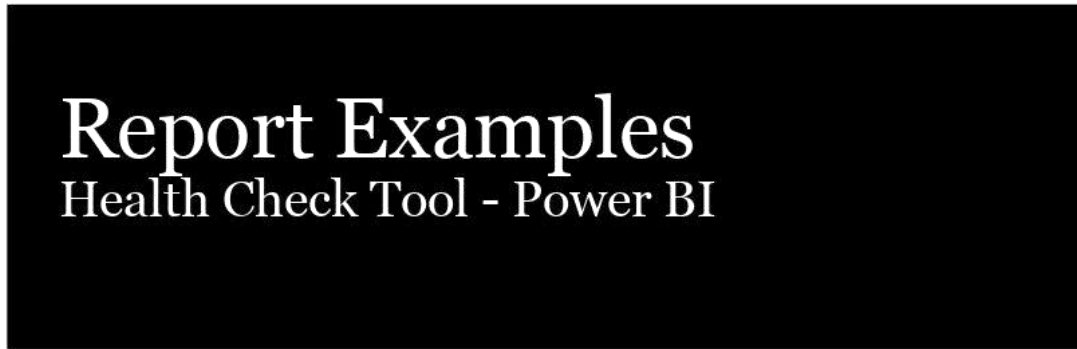
The charts below visualise the 10 and 5 year risk and return characteristics of the peer group. The yellow dots represent the funds we have shortlisted and the grey dots represent the other funds in the peer group.



Source Refiniv



Source Refiniv

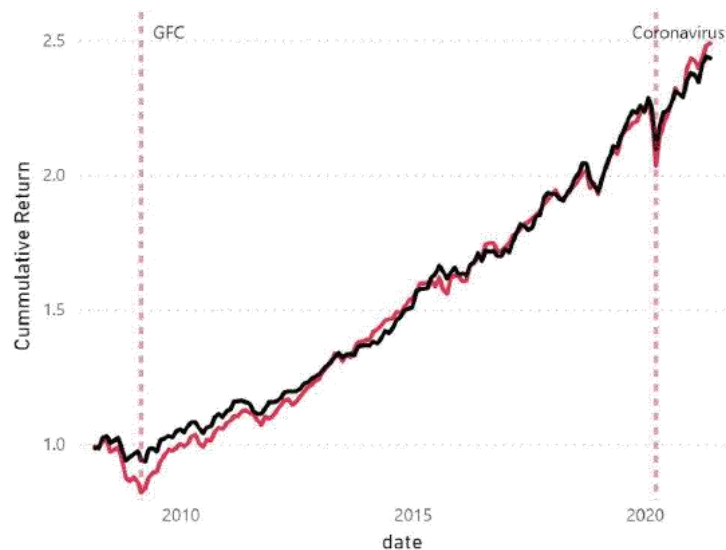




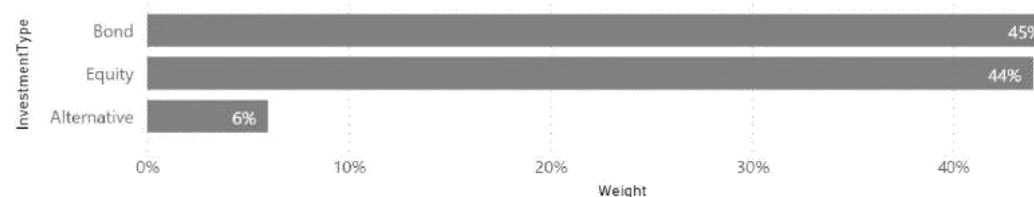
## Portfolio Analysis - Overview

Portfolio Value	Portfolio Type	Portfolio Risk Level	Target Return	Base Currency	Inception Date	Portfolio Fees	
\$1K	Balanced	Medium	6.00%	NZD	Feb 2008	1%	
Portfolios	Annualised Return	Annualised Volatility	Cumulative Return	Annualised 1 Year	Annualised 3 Year	Annualised 5 Year	Annualised 10 Year
Current	7.3%	6.4%	249%	13.8%	8.9%	8.2%	8.4%
Morningstar NZ Balance Tgt Alloc NR NZD	7.1%	5.7%	243%	9.1%	7.9%	7.5%	7.9%

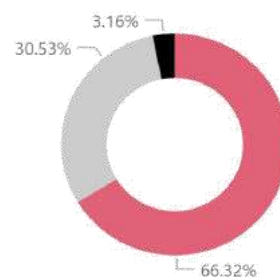
● Current ● Morningstar NZ Balance Tgt Alloc NR NZD



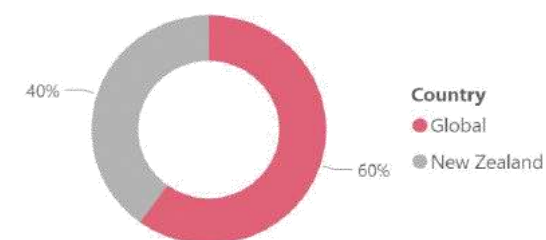
Allocation by Asset Class



Exposure by Currency and Assets



Exposure by Country and Assets



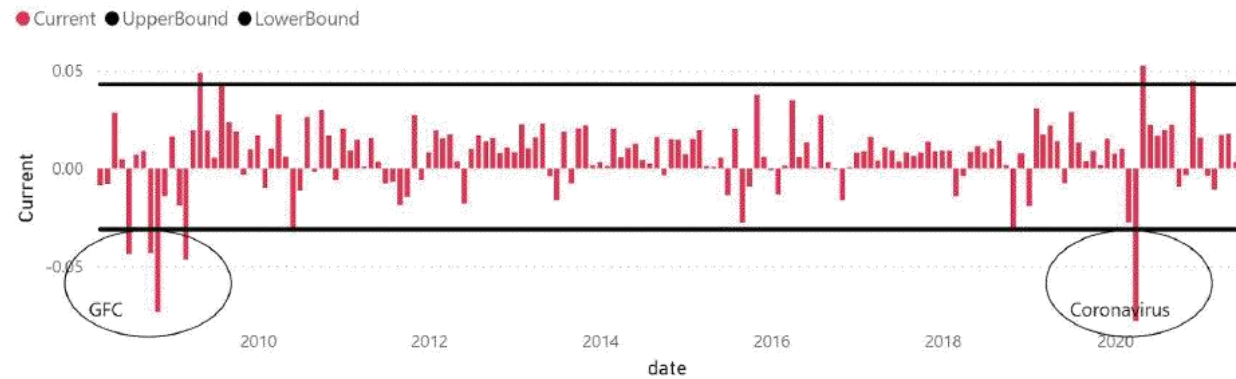




## Portfolio Analysis - Risk

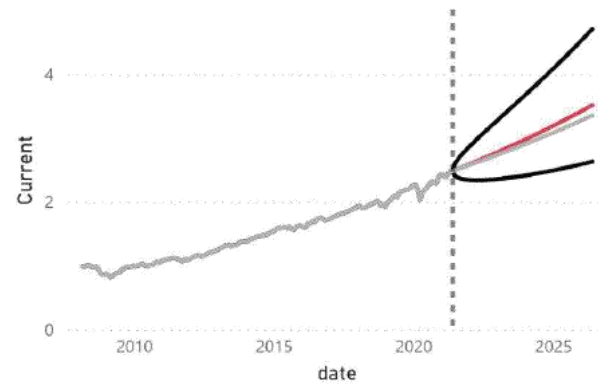
Expected Return	Probability of achieving target
7.3%	58.0%
Expected Volatility	Largest Monthly Loss
6.4%	-7.8%
Maximum Drawdown	Value at Risk
19.3%	-5.8%

Timeseries with 95% Confidence Bands

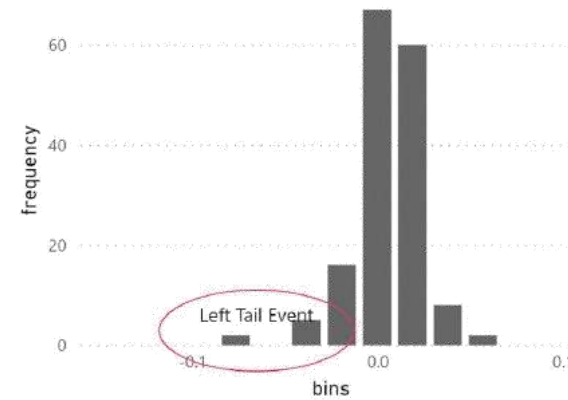


5 Year Wealth Horizon vs Target

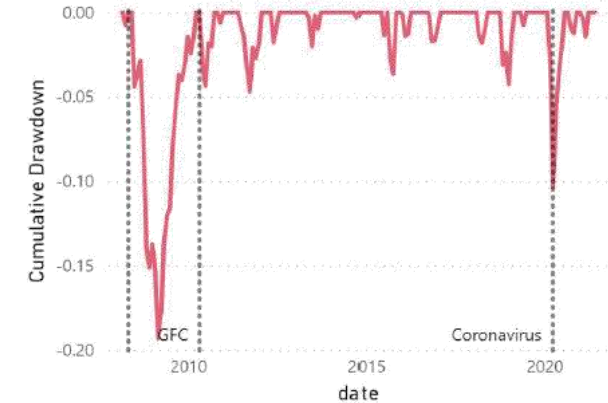
metric ● CumRet\_F ● CumRet\_F\_Target ● F\_LB ● F\_UB



Histogram of Monthly Returns



Portfolio Drawdowns

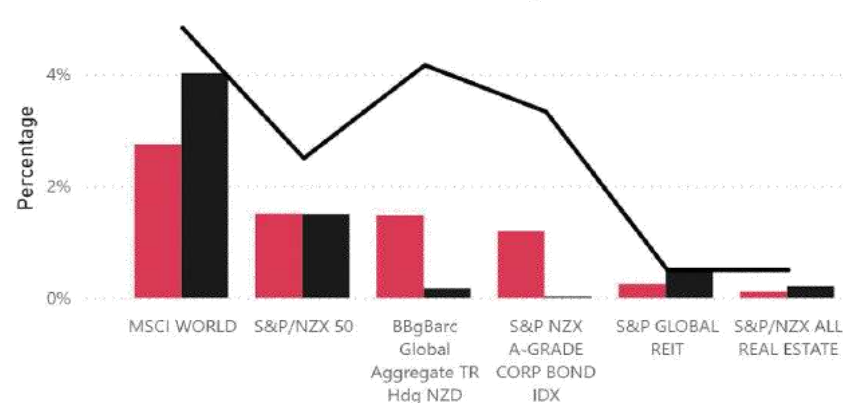




## Portfolio Analysis - Contribution & Correlation

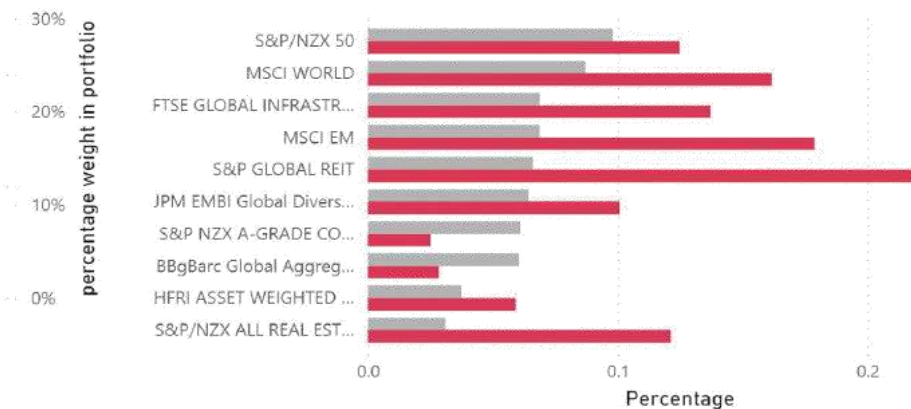
### Risk and return contribution by asset

● Return Contribution ● Risk Contribution ● Portfolio Weight



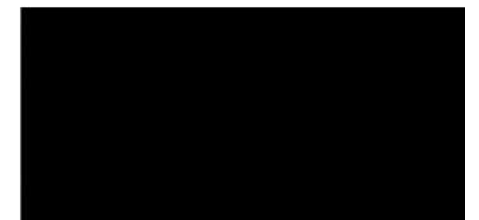
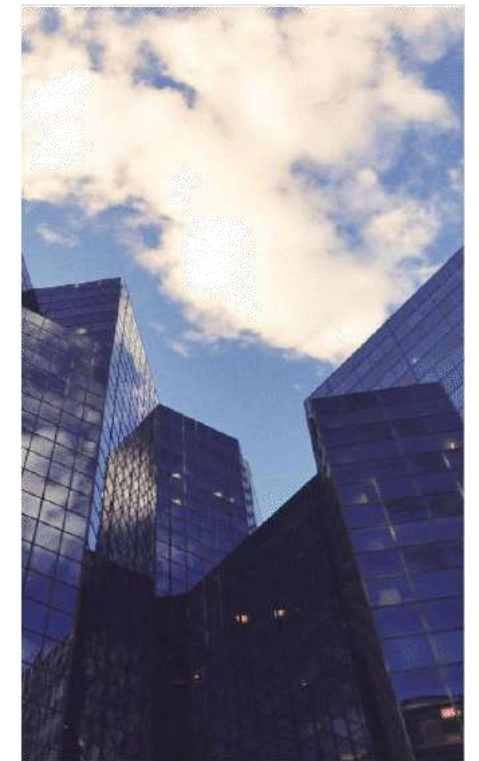
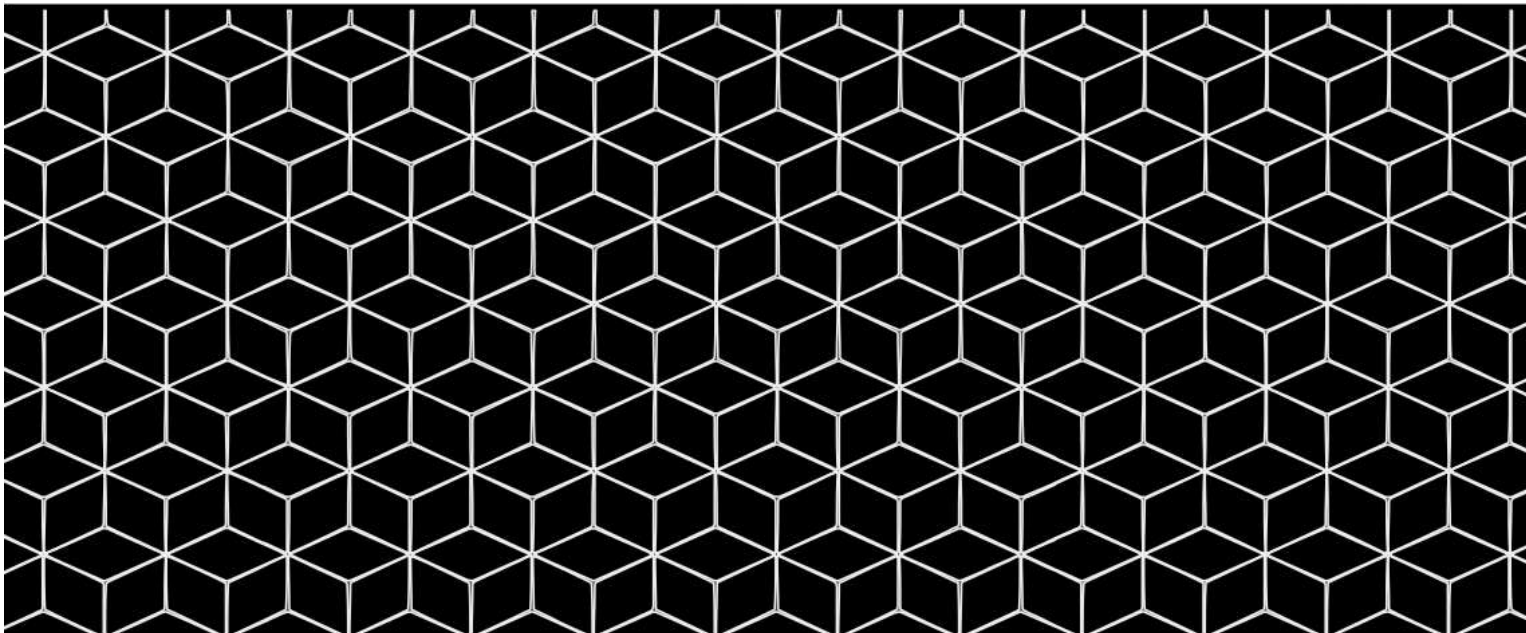
### Asset Ann Return & Vol

● AnnRet\_A ● AnnVol\_A



### Correlation Matrix

Name	BBgBarc Global Aggregate TR Hdg NZD	FTSE GLOBAL INFRASTRUCTURE	HFRI ASSET WEIGHTED COMPOSITE	JPM EMBI Global Diversified TR USD	MSCI EM	MSCI WORLD	S&P GLOBAL REIT	S&P NZX A-GRADE CORP BOND IDX	S&P/NZX 50	S&P/NZX ALL REAL ESTATE
BBgBarc Global Aggregate TR Hdg NZD	100%	23%	7%	50%	8%	-1%	27%	55%	23%	29%
FTSE GLOBAL INFRASTRUCTURE	23%	100%	72%	71%	74%	85%	80%	0%	63%	50%
HFRI ASSET WEIGHTED COMPOSITE	7%	72%	100%	64%	75%	79%	59%	-13%	59%	50%
JPM EMBI Global Diversified TR USD	50%	71%	64%	100%	72%	62%	68%	17%	55%	53%
MSCI EM	8%	74%	75%	72%	100%	82%	66%	-19%	59%	42%
MSCI WORLD	-1%	85%	79%	62%	82%	100%	79%	-18%	70%	44%
S&P GLOBAL REIT	27%	80%	59%	68%	66%	79%	100%	1%	66%	53%
S&P NZX A-GRADE CORP BOND IDX	55%	0%	-13%	17%	-19%	-18%	1%	100%	10%	19%
S&P/NZX 50	23%	63%	59%	55%	59%	70%	66%	10%	100%	65%
S&P/NZX ALL REAL ESTATE	29%	50%	50%	53%	42%	44%	53%	19%	65%	100%



# Qualitative monitoring – our approach

It is prudent to monitor qualitative fund manager attributes which could affect future performance, such as:

- Regulatory concerns
- Strategy shift / drift
- Team changes / key person risk
- Performance contribution / attribution
- Investment process changes

On a quarterly basis, we use our digital due diligence tool, Diligend, to request fund managers to complete a comprehensive set of questions following the sections set out below. This process allows us to identify key changes quickly and allows Council to act proactively, protecting the value of your portfolio.

## Quarterly Questionnaire Topics

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**Governance and controls:** Risk management functions at all levels of the organisation; efficiency of tools used to monitor portfolio risk.

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**People and organisation:** Ownership structure, investment beliefs, corporate culture, historical track record. Key individuals and investment team remuneration, support and function.

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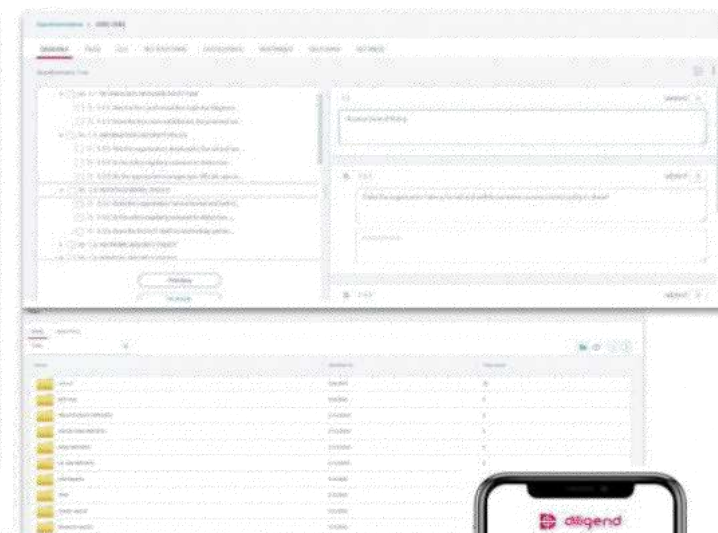
**Investment process:** Competitive edge, portfolio construction process, investment style, stock/manager research capabilities, manager/deal screening criteria, ESG integration, currency management, past performance analysis.

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# Qualitative monitoring - our tools

- Complete solution built specifically for operational and investment due diligence.
- Holistic solution, capturing qualitative and quantitative information for analysis
- Powerful flexibility with import/export capabilities and advanced APIs
- Scalable solution with unlimited managers, documents and projects



CATEGORIES REPORT CHART 1

Products	Companies	Latest Review Date	Governance and organisational structure	Human capital	Fund structures	Regulation, compliance and audit	Risk control
			01/04/2020-30/06/2020	01/04/2020-30/06/2020	01/04/2020-30/06/2020	01/04/2020-30/06/2020	01/04/2020-30/06/2020
Long/Short Equity	Manager X	03/04/2020	Development Required	Meets Standard	Development Required	Development Required	Meets Standard
Merger Arbitrage (Manager Y)	Manager Y	05/04/2020	Meets Standard	Meets Standard	Development Required	Elevated Risk	Development Required
Sarafiin Bond	J Sara Sarafiin	05/04/2020	Development Required	Development Required	Meets Standard	Development Required	Meets Standard
T Rice Prowe	T Rice Prowe	05/04/2020	Meets Standard	Meets Standard	Meets Standard	Meets Standard	Meets Standard
Welliso ESG-Focussed	Far Welliso	05/04/2020	Elevated Risk	Meets Standard	Elevated Risk	Elevated Risk	Elevated Risk

