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PENSION FUND MANAGEMENT BOARD – 25TH MAY 2012

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RESTRUCTURING OF GLOBAL INDEX-LINKED PORTFOLIO, CHANGE TO AUSTRALIAN BONDS AND CHANGES TO FX HEDGE POSITIONS - URGENT ACTION TAKEN BY THE DIRECTOR OF CORPORATE RESOURCES

Purpose of the Report

1. To inform the Board of the urgent action taken by the Fund since January 2012, using the delegated powers available to the Director of Corporate Resources.

Background

2. Over the last two years the Pension Fund Management Board has agreed a series of changes to its governance structure and a number of changes to the Fund's strategy which allow a greater degree of flexibility in implementing investment decisions. Part of this is the formation of an Investment Subcommittee (ISC) which, subject to sufficient business, is expected to meet in the months when there is no Board meeting. In most circumstances it is expected that ISC meetings will be sufficient to take pro-active decisions when these are deemed appropriate. However, in circumstances when a decision is required urgently and it is not possible to convene a meeting of the ISC or the Board, the Director of Corporate Resources has delegated powers to take such action subject to consultation with the Chairman of the Board.

Actions taken under delegated power

Restructuring of global index-linked portfolio

3. At the January 2012 Strategy Meeting the Board agreed to increase its holdings in global index-linked bonds from 2 ½% to 5% of total assets. These index-linked bonds are held within a 'facilitation module' of the Kames Capital Asset Allocation Strategy (the company is not paid a management fee for doing so; rather, it is simply an easy way of implementing actions taken by the Fund).

4. This increase in the size of the index-linked holdings gave an opportunity to 're-shape' the portfolio and it was recommended that Canadian and Swedish Index-Linked bonds were added to the portfolio, and that the existing Australian index-linked bonds be switched into conventional Australian Government bonds following a move in values which made conventional Australian bonds appear more attractively priced than their index-linked brethren. The use of conventional bonds is allowed within the terms agreed by the Board for the management of the

portfolio, but the default position is to hold index-linked bonds unless valuations suggest better value can be found in conventional bonds.

5. The Chairman, Vice Chairman and Opposition Spokesperson were consulted on this proposal and the further investment/switch took place in late January and early February 2012.

Switch of Australian conventional bonds back to Australian index-linked bonds

6. The switch into Australian conventional bonds which occurred on 30th January 2012 proved to be successful and the conventional bonds outperformed index-linked by 1% over the three month period to the end of April. By the end of April there were clear signs of likely action by the Australian Central Bank which was likely to promote growth and tolerate inflation, which would be supportive of index-linked bonds and put pressure on conventional bonds.

7. As a result of this change in prospects it was recommended that the conventional Australian bonds be sold and the proceeds used to purchase Australian index-linked bonds. Following consultation with the Chairman, Vice Chairman and Opposition Spokesperson this switch was carried out on 3 May 2012.

Changes to FX hedge positions

8. Due to the changing outlook for the Australian Dollar and the Canadian Dollar (explained more fully on the attached appendix), a recommendation was received from the Fund's Investment Consultants that the hedging positions should be amended – from nil to 100% for the Australian Dollar, and from 100% to nil for the Canadian Dollar.

Following consultation this change was executed on 14 May 2012.

Recommendation

9. The Board is ASKED TO NOTE the following actions taken by the Director of Corporate Resources:

(a) The restructuring of the global index-linked portfolio that took place in late January/early February, which included the purchase of conventional Australian Government Bonds;

(b) The switch back to Australian index-linked bonds from Australian conventional bonds which took place in early May;

(c) The amendment to the currency hedge ratios for the Australian and Canadian dollars which took place on 14 May.

List of Appendices

Appendix– Decision Template – 4 May 2012

Equal Opportunities Implications

None specific

Background Papers

None

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