



Auckland Regional
Holdings

**STATEMENT OF INVESTMENT POLICIES, STANDARDS
AND PROCEDURES (SIPSP)**

for the

DIVERSIFIED FINANCIAL ASSETS PORTFOLIO (DFA)

December 2009

Introduction and Background

Auckland Regional Holdings (ARH) is a statutory investment management entity in New Zealand. ARH considers its peers to be the Crown Financial Institutions (CFIs) and, like ARH, as part of their functions the CFIs manage investment funds with a long-term investment horizon. The principal CFIs and approximate New Zealand dollar (NZ\$) value of assets as at 2007 are:

- New Zealand Superannuation Fund \$13.0b
- Accident Compensation Corporation Fund \$9.0b
- Government Superannuation Fund \$4.0b
- Earthquake Commission (Natural Disaster Fund) \$5.0b

The investment of these Crown funds is guided by specific-to-the-Fund pieces of legislation which nevertheless have some common elements. The experiences of these funds in conforming to their legislative requirements provided a useful starting point for the ARH Board to consider in designing:

- a. A governance structure for the management of ARH investments;
- b. A statement about the investment policies, standards and procedures (SIPSP) to be followed by ARH in guiding its investment strategies and processes; and
- c. Risk management processes which satisfy 'best practice' approaches to the day-to-day management of the investment portfolio as well as the demands of medium to longer term investment strategies.

This approach to investment governance is useful because the legislation under which ARH has been established, compared to the legislation governing the CFIs, is not explicit and does not specify how ARH should manage its investment portfolio.

This is an ARH document which has been prepared with the assistance of ARH's investment advisors - Mercer¹. This document is effective immediately on adoption by the Board and supersedes any previous versions.

It is recognised that this is an evolving document and, as such, it will be subject to regular review and amendment as the detail of ARH's investment strategy is implemented or modified.

¹ Mercer is one of the most experienced and leading providers of specialist advice on investment strategies in New Zealand (www.mercer.co.nz).

AUCKLAND REGIONAL HOLDINGS

Auckland Regional Holdings (ARH) is a New Zealand domiciled statutory investment management entity. This Statement of Investment Policies, Standards and Procedures (SIPSP) is specific to ARH's Diversified Financial Asset Portfolio (DFA).

No liability

While ARH has made every effort to ensure that the information contained in this document is accurate, neither ARH nor its advisors will be liable whether in contract or in tort (including negligence), equity or any other cause of action to any persons or person who rely on the information without the prior agreement of ARH.

Change Without Notice

ARH may change the information in this document at any time and without providing any notice to any party of any changes (other than where ARH has obligations with its appointed fund managers).

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MISSION STATEMENT

ARH's Mission Statement is:

“By bringing the best available expertise to bear upon management of its assets, ARH will contribute to the resources with which the Auckland Regional Council (ARC) can address regional infrastructure needs. ARH will do so by owning and managing selected regional assets and investments in accordance with sound business practice and sustainable development principles. It will provide funds to the ARC while protecting those assets under its stewardship.”

ARH has pursued a two-pronged approach to achieving its stated mission:

1. Holding long-term regional investments of significant strategic importance, which also provide financial returns in the form of income and capital gains;
2. Holding a long-term portfolio of Diversified Financial Assets (DFA), which complements its regional investments and is largely uncorrelated with them, and provides its own stream of income and capital gains.²

Further, ARH's investment strategy comprises four macro asset classes to which the above components are allocated, being NZ Equity – Non-listed (POAL³), NZ Property, DFA, and NZ Short-term Cash.

ARH must assess the financial risk profile of its investment portfolio against the long-term funding commitments to the Auckland Regional Council (ARC). The challenge is to monitor and assess the investment characteristics of its regional investments and to deduce from that risk profile, a separate risk profile (and correlation) for the DFA. In this way the general Mission Statement of ARH is able to be applied to the DFA assets.

ARH will continue to pursue this two-pronged approach to achieving its stated mission emphasising that the strategies being pursued under 1 and 2 above are integrated into a single set of financial objectives.

Background to Objectives of Auckland Regional Holdings

Auckland Regional Holdings (ARH) was established under the Local Government (Auckland) Amendment Act 2004 (the Act), which came into force on 1 July 2004. ARH is a statutory entity as well as a council-controlled organisation. It has an independent board of directors and is accountable to the ARC, through its Statement of Intent (SOI).

Objectives of ARH

Clause 19 (1) of the Act provides that:

1. *The objective of ARH is to –*

***(a) act in the long term interests and for the benefit of the Auckland Region; and
(b) without limiting paragraph (a), manage its assets prudently.***

For further details on ARH's objectives, functions and activities, please refer to ARH's current SOI which can be found on its website: www.arh.co.nz.

² In the initial phase of setting up the operations of ARH, these funds were held in short-term NZ fixed interest investments.

³ Ports of Auckland Limited

FUNDAMENTAL BELIEFS AND GUIDING PRINCIPLES: PARTS A AND B

Preamble

Auckland Regional Holdings (ARH) has established a set of fundamental beliefs and guiding principles upon which to base the management of its Diversified Financial Asset Portfolio (DFA). As a tax-exempt entity operating from a New Zealand (NZ) base, ARH acknowledges the constraints of global financial markets placed in the context of a NZ regulatory and economic structure.

The investment constraints, the market structures and the environments within which they operate vary widely and so the beliefs and principles take these realities into account in two sets of statements

The statements are documented as follows:

Part A A brief set of fundamental beliefs is documented. In the main, these fundamental beliefs relate to broad aspects of the way in which investment markets operate.

Part B A number of guiding principles are outlined. These principles are used by Auckland Regional Holdings to guide its investment management. They take into account general principles of investment which may need to be adjusted in practice to take into account New Zealand specific conditions such as the small scale and scope of NZ financial markets, and taxation rules governing NZ resident investment funds.

The beliefs, principles and applications are not set in concrete. All of these statements are expected to evolve over time, although changes to the fundamental beliefs set out in Part A are expected to be very gradual.

PART A – FUNDAMENTAL BELIEFS

1. Risk and return are related

Capital markets are broadly efficient in pricing financial risk in the sense that if the expected return on an asset exceeds that on a second similar asset, there is frequently an additional risk entailed in holding the former asset. Risk is a multi-dimensional concept, however, and thoroughly understanding the risk of an asset will frequently be difficult.

2. Return requires risk but risk does not guarantee return

Achieving a return above that available on high quality money market investments requires that risk of some description be taken. Risk-taking does not guarantee that an additional return will be achieved even over long time periods however – that is what risk is about.

3. Diversification reduces volatility

Combining assets with returns that are less than perfectly correlated reduces the volatility of portfolio returns, all other things being equal. This is amongst the most important tenets of investment management.

4. The real world is complex

The real world is complex and assumptions underlying theories such as the Capital Asset Pricing Model and the Efficient Markets Hypothesis are frequently not realistic in practice. Accordingly, although such theories are of considerable assistance in understanding real world issues, they should not be relied upon on every occasion.

5. Behavioural issues are important

Behavioural issues apply at the security level, at the asset class level and in constructing total investment portfolios. At all of these levels, these issues can have a significant impact on investment outcomes.

6. High quality, proprietary research is essential

Developing best practice investment portfolios requires a substantial commitment to research, both by consultants, fiduciaries and by managers.

PART B – GUIDING PRINCIPLES

Risk and Return

1. At the overall portfolio level, risk is related to failure to meet objectives

For a fiduciary, the ultimate definition of the risk of an investment portfolio is related to failure to meet investment objectives. Relevant dimensions of failure to meet objectives are the chance that it will occur, the circumstances in which it will occur and the extent of a shortfall faced when it does occur.

2. The volatility of returns over short-term periods is frequently an incomplete measure of risk, both at the overall portfolio level and for individual assets

Because risk at the overall portfolio level is related to failure to meet objectives, the volatility of returns over short-term periods may not be a relevant measure of risk. High volatility may, however, be indicative of high failure risk. At the individual asset level, risk-taking will frequently result in volatile returns over short periods but will sometimes be manifested in substantial losses following a period of low volatility.

3. It is useful to think of assets and markets in terms of the underlying risk exposures which they entail

There are a number of premia that are commonly expected over the long term to compensate investors for holding assets other than high quality money market instruments. Examples of risk premia commonly believed to exist include:

- Equity;
- Small stock;
- Default;
- Term;
- Inflation;
- Country (incorporating political and regulatory factors);
- Liquidity; and
- Marketability.

Some of these premia may be related eg small stock and liquidity, equity and default. Whether they exist in practice and if so, their level at any point in time, are matters of conjecture. To the extent that they do exist, such premia reflect the fact that investors require compensation for accepting a characteristic associated with holding an asset or class of assets when they would prefer to avoid that characteristic.

Investment Objectives and Strategic Asset Allocation

4. Investment objectives and, hence, the meaning of risk vary between investors

Factors such as time horizon, liability structure and broader stakeholder objectives are all important in defining investment objectives and, hence, the risk relevant to particular circumstances.

5. History provides a useful starting point for analysis but should not be relied upon excessively

There is information in past returns, volatilities and correlations and frequently it will be difficult to develop sensible estimates of the future without analysing the past. History is an imperfect predictor of the future however. This is partly because the structure and profile of broad asset classes evolves over time, even long-established traditional asset classes, and partly because history represents just one outcome from a distribution of possible outcomes. In any case, excessive reliance on any particular estimates of returns, risks and correlations should be avoided. Of these three parameters, the level of volatility is the most persistent. In terms of specifics, correlations tend to increase both in times of crisis and in boom periods and distributions of investment returns are 'fat-tailed'.

6. Long-term returns are likely to be superior when investors can take a genuinely long-term perspective

Investors who of necessity must strike a balance between short and longer term objectives face an additional constraint not encountered by those who are able to focus exclusively on the long term. Whilst the former group can successfully meet their own set of objectives, their long-term returns are likely to trail those of the latter group. This is because long-term investors are better able to structure their portfolios to take advantage of some of the premia mentioned above e.g. equity and liquidity premia, and to implement their decisions without undue concern about possible short run adverse consequences.

Medium-Term Asset Allocation

7. Prices can deviate significantly away from fundamental value over short or even medium term periods, but will trend towards fundamental value over the long term, fundamental value of an asset depends on cashflows

Deviations away from fundamental value can occur at the individual security level and at the broad market level. Such deviations are often due to behavioural factors. The precise way in which the fundamental value of an asset is determined varies depending on the nature of the asset. Almost invariably, however, fundamental value is based on the cashflows which will be delivered by the asset over time, the timing of those cashflows and the reliability and predictability of them.

8. Overvalued assets represent a risk

Investing in markets or securities at a time when they are overvalued represents a risk; namely, that losses will be sustained when the markets revert to fundamental value. Recognising departures from fundamental value can be problematic however.

9. Market capacity matters

Opportunities for attractive returns within a market segment can be compromised when excessive funds flow into that segment – this can be an issue particularly in alternative assets.

Implementation

10. The Board adopts a responsible approach to investments

Board members and other stakeholders expect that a responsible approach to investment will be followed and this is consistent with the Directors' collective values. Definitions of 'responsibility' vary but typically embrace ethical, social and environmental issues. The Directors believe that responsibility can be integrated into the portfolio without jeopardising long-term investment performance – indeed, it should enhance long-term performance. The Board is committed to implementing responsible investment in ways which enhance the prospects of ARH achieving its investment objectives.

11. Market participants in aggregate receive market returns less costs

'Market participants in aggregate receive market returns less costs' is valid and indicates that passive management will deliver results in many markets which are at least competitive with the average return amongst active managers.

12. But active management can add value

In some markets, participants do not all have return-maximising objectives and/or some participants are predisposed towards underperforming on average. In particular, the objectives and behaviour of retail and institutional investors will frequently differ, with the former being predisposed towards underperformance. Active professional investment management can on average add value in such markets. In cases where active professional managers with broadly similar (return maximising) objectives in aggregate comprise a large part of the market, they will under-perform the market index on average due to costs. Even within such markets, however, individual managers can outperform on a sustainable basis due to superior skill. Luck also plays a part in determining investment outcomes, however, and it can be difficult to distinguish between skill and luck. Superior access to information and superior access to deal flow may also allow individual managers to generate above-normal returns. These characteristics are most likely to apply in alternative assets markets.

13. It is worthwhile thinking about the structure of a market when considering the management approach to be adopted within that market

The scope for adding value will influence the approach which should be adopted in various markets and, in some cases, whether an investment should occur at all. Accordingly, it is advisable to consider the structure of markets before implementation decisions are made.

14. Alignment of interests and principal/agency issues are crucial

Alignment of interests between investors and their agents is crucial in all areas. It is especially pertinent in alternative asset classes where the margin between favourable and unfavourable outcomes is invariably very wide, where the interests of various parties in transactions may be difficult to disentangle and where investors are frequently 'locked in' once an initial commitment is made. Even in traditional asset classes, there is scope for investment management firms' business risk and objectives and/or individuals' career risk to create misalignment of interests with investors.

15. Sector specialist structures are generally superior to balanced structures

It is unlikely that single firms will be able to offer 'best of breed' investment management services in all or even a majority of the portfolio categories of relevance to a large institutional investor. Investment portfolios structured along sector specialist lines are therefore preferable to balanced structures. Specialist structures allow investors to access leading talent in each sector of their portfolio and to determine their approach to implementation in the various sectors depending on assessment of the potential for enhancing returns.

16. Costs and implementation leakage matter

Fees, brokerage, taxes and opportunity costs from being 'out of the market' must all be considered both in ongoing portfolio management and when restructuring portfolios. When a portfolio is being transitioned between asset classes or managers, professional management of the transition is likely to result in an improved outcome.

17. More generally, implementation is crucial

Investors must consider not only the attractions of the various investment opportunities available to them but also their ability to exploit those opportunities successfully. It is better to maintain an uncomplicated structure which can be implemented successfully given the resources available than a theoretically superior structure which is difficult to implement. Possible constraints on a particular investor's ability to implement successfully include human, technical and financial resources, the availability of time and susceptibility to behavioural biases. In the latter regard, common tendencies are to focus excessively on past performance and to project the recent past too far into the future eg termination of managers due to poor recent performance, reluctance to appoint managers unless they have strong recent performance, allocation to asset classes and sub-asset classes which have displayed strong recent returns.

18. Investors should retain most of the post-fee expected added value

Investors bear all of the risk of underperformance and should expect therefore to receive most of the expected additional return from active management. As a yardstick, active management fees should not exceed 25% of expected added value in mainstream asset classes. In alternatives, the lack of an obvious benchmark typically means that the concept of added value is difficult to apply. Nevertheless, the level of fees should be such that the risk/return trade-off is acceptable on a post-fees basis.

Auckland Regional Holdings



Auckland Regional
Holdings

DIVERSIFIED FINANCIAL ASSET PORTFOLIO (DFA)

STATEMENT OF INVESTMENT POLICY AND OBJECTIVES

**Adopted by the Board of ARH with effect from:
28 March 2008**

STATEMENT OF INVESTMENT POLICY AND OBJECTIVES

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EXECUTIVE SUMMARY

This Statement of Investment Policy and Objectives (SIPO) forms part of and should be read in conjunction with the full Statement of Investment Policies, Standards and Procedures (SIPSP).

- The primary goal of the Diversified Financial Assets Portfolio (DFA) is to form part of an overall strategy for managing and investing the entire portfolio of investments for which ARH is responsible under its governing legislation.
- The legislation requires ARH to act in the long-term interests and for the benefit of the Auckland region, and to manage its assets prudently. The DFA has been designed, in conjunction with the Board's management of other investments, to maximise the returns of the entire ARH investment portfolio without undue risk. ARH is required to distribute funds to the Auckland Regional Council.
- Returns will be sought on the total ARH investment portfolio (after investment related fees but before any taxes) that exceed CPI increases by at least 5.5% per annum over rolling 20-year periods. Over rolling ten-year periods, returns of at least 1.5% per annum above the NZ Government Stock Index return will be sought.
- The investment objectives for the DFA take into account criteria for funding distributions and credit criteria for any borrowings required to fund distributions. A full set of objectives and a description of the risk tolerances are included in the full Statement of Investment Policies, Standards and Procedures (SIPSP).
- The DFA is managed by eight (8) Fund Managers each with a different mandate. The benchmark mix of financial assets for the DFA is:

Asset Class	Benchmark %
Global Equities (Overseas Shares)	50
Total Growth Assets	50
Global Bonds (Overseas Fixed Interest)	40
New Zealand Cash	10
Total Income Assets	50
Foreign Currency Exposure	25
- Global Equities – 50% (50% hedged to NZ\$)	
- Global Bonds – NIL (100% hedged to NZ\$)	
- New Zealand Cash - NIL	

- **The investment performance objectives for each Fund Manager are to exceed their respective benchmarks by agreed amounts per annum over rolling three year periods.**
- **The details of the benchmark index for each Fund Manager and the expected out-performance are set out in Appendix 1 of this SIPO.**

SIPO: EFFECTIVE DATE AND REVIEW DATES

Effective Date

- This Statement of Investment Policy and Objectives ('SIPO') took effect from 1 October 2007, and was first updated for certain items in March 2008 and subsequently in December 2008.

Review Dates.

- In December 2009, minor updates were made to reflect changes in names of external organisations and clarification on the foreign currency hedging policy.

DIVERSIFIED FINANCIAL ASSETS PORTFOLIO CHARACTERISTICS

Portfolio's Goal

- The primary goal of the Diversified Financial Assets Portfolio (DFA) is to form part of an overall strategy towards managing and investing the entire portfolio of investments for which ARH is responsible under its governing legislation.

Legislation

- ARH was established by Parliament under the Local Government (Auckland) Amendment Act (2004). Its primary functions are to:
 - Own, directly or indirectly, and manage its investments (including treasury funds) in the long-term interests and for the benefit of the Auckland region, and
 - Provide funds to the Auckland Regional Council in accordance with the ARH's Long-Term Funding Plan.

Investment Strategy

- ARH aims to perform its legislated functions by implementing appropriate investment strategies and by operating in a financially responsible manner. Through applying best business practice and generating optimal returns within acceptable levels of risk, ARH can be confident that it can distribute funds to the Auckland Regional Council in accordance with agreed long-term funding plans.

ALLOCATION OF RESPONSIBILITIES

The **ARH Board** will be responsible for the following:

- Developing and reviewing investment objectives and strategies
- Reviewing this SIPO annually, including any instructions to Fund Managers and the Investment Advisor.
- Determining the appropriate number of Fund Managers, and selecting and changing those managers as appropriate, with the consideration of advice obtained from the Investment Advisor. This includes reviewing the performance of appointed fund managers on a regular basis.

The **ARH Management** will be responsible for the following:

- Providing the ARH Board with advice on investment theories, practice and technical analyses to support the development and review of investment objectives and strategies
- Implementing the ARH Board-approved investment strategies
- Ongoing operational management of the investment portfolio, including executing instructions and transactions
- Managing relationships with Fund Managers, the Custodian and the Investment Advisor
- Monitoring the asset allocations between fund managers, against the ranges specified on page 20 of this SIPO, based on market values at month-end and determining whenever the DFA requires rebalancing
- Performance monitoring and reporting
- Providing cash flow information to each Fund Manager with respect to future deposits and redemptions.

The **Investment Advisor** will be responsible for providing the following services in line with the Relationship Agreement between ARH and the Investment Advisor⁴:

- Proactively advising the ARH Management of events and changes that may affect the manner in which the DFA should be invested.
- Monitoring each Fund Manager's performance and the DFA's total performance relative to the Board's adopted investment performance objectives on an annual basis or as requested by the ARH Board or ARH Management.
- Providing independent input and advice for evaluating the appropriateness, over time, of the long-term asset allocation policy (Benchmark Portfolio) based on an annual review of the Investment Advisor's capital market assumptions. If warranted, the Investment Advisor will advise of the need for a formal Benchmark review.
- Monitoring the asset allocations between Fund Managers, against the ranges specified on page 20 of this SIPO, based on market values at month-end and advising ARH Management whenever the DFA requires rebalancing. The Investment Advisor will also monitor the processes, involving the Custodian, the Global Equity Fund Managers and the Currency Hedge Fund Manager, for the appropriate degree of hedging to be in place and rebalanced at least monthly if required.

⁴ ARH's current appointed Investment Advisor is Mercer Investment Consulting (Mercer).

- Monitoring and reporting ARH's Fund Managers' performance against peer managers and the median manager⁵ on a quarterly basis
- Meeting with the ARH Management, or the ARH Board, to present investment monitoring reports and to discuss topical investment issues at least quarterly.
- Assisting the ARH Management in allocating new money or making redemptions from the Managers by advising which Manager(s) to deposit/redeem money from and drafting the necessary correspondence to the Managers.
- Participating with the ARH Board and the Fund Managers in the annual review of this SIPO.

Each **Fund Manager** will be responsible for the following:

- Managing the DFA's investments in accordance with the investment management agreements and/or governing documents referred to in the application form(s).
- Selecting securities within each asset class, subject to the constraints imposed in this document or by the policies advised to the Board and any applicable legislation.
- Where the Fund Manager's portion of the DFA consists partly or wholly of a portfolio of individual securities, the Fund Manager's investment management agreement with ARH shall include explicit reference to the constraints or guidelines referred to in Appendix 2 to this Statement as these relate to the Fund Manager. Where the Fund Manager's portion of the DFA consists wholly of units in a pooled fund or funds, the Fund Manager shall undertake to advise ARH of any variations that may arise from time to time between the operation of such pooled fund(s) and the constraints or guidelines in Appendix 2 as these relate to the Fund Manager.
- Supplying to ARH and the Investment Advisor any reports of the DFA's investment performance results in advance of regular meetings and at ARH's request, participating in those meetings to review the written reports. The reports shall contain such information and in such format as agreed with ARH, but must contain sufficient information to enable the annual financial statements and any necessary tax calculations to be produced.
- Managing the investments of the DFA in a manner which is consistent with ARH's tax-exempt status.
- Participating, when required by the Investment Advisor, in the annual review of this SIPO.

The **Custodian** will be responsible for the following:

- Monitoring, reconciling and checking the holdings of ARH in the investment pools and in any segregated mandates of the DFA, and checking and reporting the performance of the fund managers, with final performance reported within 8 business days of the end of the previous month.
- Participating with the Global Equities Fund Managers and the Currency Overlay Manager in co-ordinating the flow of information to facilitate the objective of achieving 50% of the Global Equities' foreign currency exposures being hedged back into NZ dollars (NZ\$).

⁵ The median manager refers to the manager whose performance is in the middle of the range of performance of a universe of managers included in a survey measured by the Investment Advisor.

PRINCIPLES

- The DFA's total returns are made up of income from share dividends and bond coupon payments, and capital growth from changes in the market value of investments. Market values change due to share price fluctuations, changes in interest rates affecting the capital value of bonds held, and foreign exchange fluctuations.
- It is the ARH Board's practice to recognise income, expenditure and changes in the market value of equity investments on a monthly basis. This will be based on the investment reports received from the Fund Managers at the end of each month, as verified by the Custodian. Accordingly, the ARH Board looks to the Fund Managers to provide accurate and timely reporting.

INVESTMENT RISK

- Fluctuations in investment returns have been taken into account in the design and construction of the DFA's benchmark mix of assets. Fluctuations in the investment returns from other ARH investments have similarly been taken into account. There remain risks to be managed in the event that the future investment returns on ARH's entire investment portfolio track below the commitment of funds to the Auckland Regional Council (ARC) (under the long-term funding plans). A degree of variability in annual returns has been built into the long-term planning process, so as to avoid too frequent changes in the committed income flow to the ARC.

INVESTMENT OBJECTIVES

- Returns will be sought (after investment related fees but before any taxes) that exceed the Consumer Price Index (CPI) increases by at least 5.5% per annum over rolling 20-year periods. Over rolling ten-year periods, returns of at least 1.5% per annum above the NZ Government Stock Index return will be sought.
- The investment objectives for the DFA take into account criteria for funding distributions and credit criteria for any borrowings required to fund distributions.
- In addition, out-performance will be sought where appropriate (ie where management is active as opposed to passive) relative to the notional return on a benchmark portfolio designed to reflect the risk profile according to which the assets are invested at the time. Performance expectations are specified in Appendix 1.

DISTRIBUTION POLICY

- The ARH Board distributes funds to the Auckland Regional Council in accordance with agreed long-term funding plans, in line with the legislated functions of ARH.

INVESTMENT POLICY

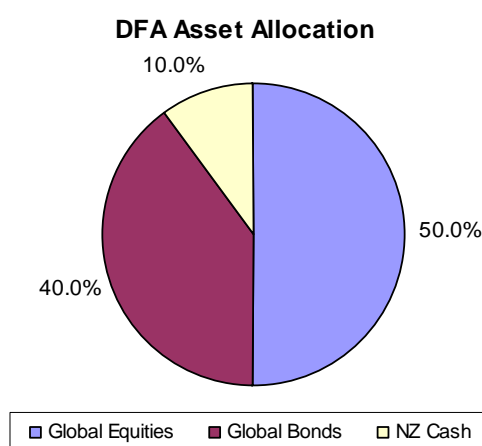
General

- In taking decisions on investment strategy, the ARH Board will have regard to all applicable legislative requirements.
- The DFA's investments will be managed with a view to ensuring that the DFA will have sufficient liquidity to meet expected cash flow requirements.
- Investment risk will be limited by appropriate diversification both within and across asset classes.

Asset Allocation Strategy

- The exposures to the various asset classes will be monitored, taking into account the underlying exposures in any pooled investment vehicles and the impact of futures and options on an effective exposure basis.
- The Benchmark Portfolio that the DFA's returns will be monitored against over the long term is as follows:

Asset Class	Benchmark %	Ranges %
Global Equities	50	45 to 55
Total Growth Assets	50	45 to 55
Global Bonds	40	35 to 45
New Zealand Cash	10	7 to 13
Total Income Assets	50	45 to 55
Foreign Currency Exposure	25	20 to 30
- Global Equities – 50% (50% hedged to NZ\$) - Global Bonds – NIL (100% hedged to NZ\$) - New Zealand Cash - NIL		



- The appropriateness of this Benchmark Portfolio will be formally assessed at least once a year by ARH Executive with the assistance of Mercer and kept under constant review to reflect any fundamental changes in the investment environment and changes to the DFA's investment policy.

INVESTMENT MANAGEMENT STRUCTURE

- The Board has determined that the DFA's investments will be managed under a multi-manager structure and have appointed the following Fund Managers for the specific mandates shown:

Fund Manager	Mandate and as % of Total DFA Value
Newton Investment Management Limited (BNY Mellon Asset Management International Limited) (Newton)	Global Equities –Core 20%
AllianceBernstein New Zealand Limited (AllianceBernstein)	Global Equities –Growth 10%
GMO Australia Limited (GMO)	Global Equities –Value 10%
AXA Rosenberg Investment Management Asia Pacific Limited (AXA Rosenberg)	Global Equities –Small Cap Stocks 7.5%
Lazard Asset Management Pacific Co. (Lazard)	Global Equities –Emerging Markets 2.5%
Goldman Sachs JBVere Managed Funds Limited (Goldman Sachs)	Global Bonds – Macro 20%
BlackRock Investment Management (Australia) Limited (BlackRock)	Global Bonds – Credit/Micro 20%
ING New Zealand Limited (ING)	Cash 10%; combined with Currency Hedge on Global Equities as follows:
ING New Zealand Limited (ING)	Currency Hedge on 50% of the total NZ\$ value of the Global Equities' foreign exchange exposure

- DFA investment funds will be allocated between the Fund Managers as follows:

Manager	Benchmark %	Ranges %
Newton	20	17⇔23
AllianceBernstein	10	8⇔12
GMO	10	8⇔12
AXA Rosenberg	7.5	6⇔9
Lazard	2.5	1.5⇔4.0
Goldman Sachs	20	17⇔23
BlackRock	20	17⇔23
ING	10	7⇔13

- If the difference in the relative performance of the Fund Managers causes a Fund Manager to exceed the ranges shown above, then sufficient assets are to be transferred, on the Board's authority, between the Fund Managers to return the weights to benchmark. These allocations will be monitored at month-end by the ARH Management and the Investment Advisor.
- The mandates for these Fund Managers are described in Appendix 1 to this SIPO, including the Currency Hedging of 50% of Global Equities (via ING).

TAXATION

- ARH is exempt from paying tax in New Zealand on income and capital gains earned on the assets of the Diversified Financial Assets Portfolio.

INVESTMENT PERFORMANCE MONITORING

The principal goals of performance monitoring are to:

- Assess the extent to which the DFA's investment objectives are being achieved;
- Compare the performance of the DFA's appointed Fund Managers against the performance of other relevant professional managers and market indices;
- Ascertain the existence of any particular weakness in the Fund Manager or the Managers' product(s) utilised; and
- Allow the Board to assess the ability of each Fund Manager(s) to successfully meet the DFA's objectives.
- Returns achieved by the appointed Managers will be assessed by the Board in relation to their stated objectives and the objectives of the Diversified Financial Assets Portfolio. Returns will also be compared with returns earned by a suitable peer group, such as a group of other professional fund managers.
- Returns on the overall DFA will be monitored by the Board in relation to the Benchmark Portfolio nominated in this SIPO. The Benchmark Portfolio is a performance monitoring tool intended to reflect the Board's adopted investment policy.
- Performance for individual asset classes will be measured against the appropriate indices for each asset class such as those indicated in the following table:

Asset Class	Index
Global Equities	MSCI World Index with net dividends reinvested, 50% hedged back into \$NZ.
Global Bonds	Barclays Capital Global Aggregate Index (fully hedged back into NZ\$)
New Zealand Cash	NZX NZ 90-day Bank Bill Index

MSCI = Morgan Stanley Capital International

NZX = New Zealand Stock Exchange

- Fund Manager performance will be monitored quarterly with a view to an annual evaluation of rolling three year results but in the context of the Fund Manager's own specific mandate.
- Fund Managers' roles will be reviewed by the Board on a regular 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 Fund Managers' continuing ability to meet the applicable investment objective.
- The Fund Manager will report at least quarterly in accordance with a format agreed with the Board.

Appendix 1 (SIPO)

FUND MANAGER MANDATES

1. *Newton*

1.1 Benchmark Allocation

Asset Class	Benchmark %
Global Equities - Core	100

1.2 Performance Objective

Newton is expected to exceed the return of the MSCI World (ex-Australia) Index with net dividends reinvested, by **2.5% per annum** (in A\$⁶) over the long term and using rolling **3 year periods** as a general metric. Separately, 50% of the NZ\$ value of the foreign exchange exposure will be hedged back into NZ\$.

2. *AllianceBernstein*

2.1 Benchmark Allocation

Asset Class	Benchmark %
Global Equities – Growth	100

2.2 Performance Objective

AllianceBernstein is expected to exceed the return of the MSCI World (ex-Australia) Index with net dividends reinvested, by **3.0% per annum** (in A\$) over full market cycles (3 to 5 years) and using rolling **3 year periods** as a general metric. Separately, 50% of the NZ\$ value of the foreign exchange exposure will be hedged back into NZ\$.

3. *GMO*

3.1 Benchmark Allocation

Asset Class	Benchmark %
Global Equities - Value	100

3.2 Performance Objective

GMO is expected to exceed the return of the MSCI World (ex-Australia) Index with net dividends reinvested, by 3.0% per annum (in A\$) over the market cycle and using rolling 3 year periods as a general metric. Separately, 50% of the NZ\$ value of the foreign exchange exposure will be hedged back into NZ\$.

⁶ A\$ = Australian dollars

4. **AXA Rosenberg**

4.1 **Benchmark Allocation**

Asset Class	Benchmark %
Global Equities – Small Cap Stocks	100

4.2 **Performance Objective**

Axa Rosenberg is expected to exceed the return of the S&P Developed (ex-Australia) SmallCap Index, (in A\$) over rolling 3 year to 5 year periods as a general metric. Separately, 50% of the NZ\$ value of the foreign exchange exposure will be hedged back into NZ\$.

5. **Lazard**

5.1 **Benchmark Allocation**

Asset Class	Benchmark %
Global Equities – Emerging Markets' Stocks	100

5.2 **Performance Objective**

Lazard is expected to exceed the return of the MSCI Emerging Markets Index, by 3.0% per annum (in A\$) over rolling 5 year periods as a general metric. Separately, 50% of the NZ\$ value of the foreign exchange exposure will be hedged back into NZ\$.

6. **Goldman Sachs**

6.1 **Benchmark Allocation**

Asset Class	Benchmark %
Global Fixed Income - Macro	100

6.2 **Performance Objective**

Goldman Sachs is expected to exceed the return of the Barclays Capital Global Aggregate Index, with foreign exchange exposures hedged 100% back into NZ\$, by 1.00% per annum (in NZ\$) over the market cycle and using rolling 3 year periods as a general metric.

7. **BlackRock**

7.1 **Benchmark Allocation**

Asset Class	Benchmark %
Global Fixed Income – Credit/Micro	100

7.2 **Performance Objective**

BlackRock is expected to exceed the return of the Barclays Capital Global Aggregate Index, with foreign exchange exposures hedged 100% back into NZ\$, by 0.75% to 1.00% per annum (in NZ\$) over the market cycle and using rolling 3 year periods as a general metric.

8. **ING**

8.1 **Benchmark Allocation**

Asset Class	Benchmark %
New Zealand Cash	100

8.2 **Performance Objective**

ING is expected to exceed the return of the NZX NZ 90-day Bank Bill Index by 0.14%pa over the market cycle and using rolling 3 year periods as a general metric.

9. **ING**

9.1 **Benchmark Allocation**

Asset Class	Benchmark %
Passive Currency Hedging of 50% of the foreign exchange exposure in the form of Global Equities, back into NZ dollars	100

9.2 **Performance Objective**

ING is expected to carry out passive currency hedging of 50% of the foreign exchange exposure in Global Equities, back into NZ dollars (NZ\$), within the constraints and guidelines set out in detail in the agreement between ARH and ING for managing this mandate.

Mandates 8 and 9 have been awarded by ARH to a single fund manager to facilitate the effectiveness of managing New Zealand Cash and carrying out the role of passive currency hedging manager for Global Equities, in the context of the current New Zealand market for such services.

Appendix 2 (SIPO)

INVESTMENT GUIDELINES AND CONSTRAINTS

The guidelines and constraints required by the Board to be observed by each Fund Manager, as applicable, are set out in detail in the specific product legal documentation and summarized below. For the purposes of these constraints, "Portfolio" shall relate to the portion of the Diversified Financial Assets Portfolio's (DFA) investments under the management of the Fund Manager.

In most asset classes ARH is invested in pooled products rather than in segregated mandates. In selecting appropriate products ARH has studied the investment guidelines and constraints of each product. The principles behind ARH judgments in this regard are:

- Investment of the Portfolio shall be made in compliance with all laws and regulations governing tax-exempt fund investments.
- Each Fund Manager is entitled to make use of derivative contracts for the following purposes, where there is specific provision within the product disclosure documents, or similar documents, for the use of derivatives:
 - to alter the Portfolio's country and/or currency allocations within the given exposure ranges;
 - as a hedge to manage exposure to foreign currency or other investment risks; and
 - to reduce transaction costs and improve liquidity by using derivative contracts to take a position which would otherwise have been taken by buying or selling physical stock.
- The Fund Manager must not use derivatives, physical securities or any combination of the two to produce financial exposures that would result in the leverage of the Portfolio. That is, the Portfolio's net exposure to investment markets exceeding the value of the Portfolio's physical assets. 'Leverage' means expanding the effective value of the investment exposure, such as, for example, using a mortgage to purchase a higher valued house so that the value of the investment (asset) may be several times the value of the equity (investment funds). Derivatives offer an alternative to borrowing to achieve the same result. Derivatives should only be used to produce financial exposures which would be otherwise obtained through the use of physical securities in the absence of leverage.
- The Fund Manager must not use derivatives, physical securities or any combination of the two to produce financial exposures that would be effectively net short positions. A net short position is considered to be the taking and maintenance of a position in respect of one asset whereby the value of the Portfolio will be enhanced if the price of that asset falls without a corresponding effective long position on the same or a highly correlated asset. Where a short position is effectively taken over more than one asset, as in the case of a basket of index derivatives, the corresponding long exposure may be a basket of physical or derivative securities which could reasonably be considered as a proxy for those assets.
- Not more than 10% of the DFA's investments may be invested in any one investment without specific consideration and approval by the Board.
- The DFA's interest in any pooled fund domiciled offshore shall not exceed 10% of the assets of that pool, unless a larger investment is specifically authorised by the Board.
- Capital Protection Strategies, that is the use of derivatives in an attempt to preserve asset values during significant market falls, are not permitted.

ARH promotes responsible investment policies and over time will be working with Fund Managers to align ARH's investment strategies with specific policies towards designing and implementing enhanced responsible investment procedures.

OTHER INVESTMENT CRITERIA

The following investment criteria adopted by Auckland Regional Holdings (ARH) are based on matters required under legislation for Crown Financial Institutions:

- A. CLASSES OF INVESTMENT, SELECTION CRITERIA**
- B. BENCHMARKS AND INVESTMENT PERFORMANCE**
- C. REPORTING STANDARDS**
- D. RESPONSIBLE INVESTMENT**
- E. BALANCED BETWEEN RISK AND RETURN**
- F. FUND MANAGEMENT STRUCTURE**
- G. USE OF OPTIONS, FUTURES, OTHER DERIVATIVES**
- H. MANAGEMENT OF CREDIT, LIQUIDITY, OPERATIONAL, CURRENCY, MARKET, AND OTHER FINANCIAL RISKS**
- I. VOTING RIGHTS**
- J. VALUATION OF ASSETS NOT REGULARLY TRADED**
- K. PROHIBITED INVESTMENTS, CONSTRAINTS**

A CLASSES OF INVESTMENT, SELECTION CRITERIA

The Board of ARH (the Board) has determined that the Diversified Financial Assets Portfolio (DFA) shall be invested in the following general asset classes:

- Global Equities
- Global Bonds
- New Zealand Cash

Currency hedging and derivative instruments will form part of the strategy.

Selection criteria for investments within the above asset classes are:

Global Equities

- Listed securities on the international share markets.

Global Bonds

- Debt instruments denominated in foreign currencies that are issued or guaranteed by foreign governments or government agencies that are satisfactory to the ARH Board; and
- Corporate credit and asset-backed or collateralised instruments denominated in foreign currencies that are issued or guaranteed by entities that are satisfactory to the ARH Board.

New Zealand Cash

- New Zealand dollars and, as specifically provided for in the relevant investment management contracts, foreign currencies held for liquidity and transactions purposes; and
- Fixed interest securities and short dated money market instruments with a short-term debt rating, as rated by a recognised international rating agency, satisfactory to the ARH Board.

Currency Hedging

- Global Equities

Foreign exchange hedging contracts relating to the currencies in which the securities that comprise international equities portfolio are denominated.

Foreign exchange hedging contracts where the counterparties have an appropriate short-term credit rating measured by a recognised rating agency.

- Global Bonds

Foreign exchange hedging contracts relating to the currencies in which the securities that comprise international fixed interest portfolio are denominated;

Foreign exchange hedging contracts where the counterparties have an appropriate short-term credit rating measured by a recognised rating agency.

Derivatives

The Fund Managers are permitted to use derivative instruments, recognising that there are very positive roles which can be played by derivative instruments. The specific policies, standards and procedures with respect to derivative instruments, which guide the design of the investment mandates for the Fund Managers, are presented in Section G below.

B BENCHMARKS AND INVESTMENT PERFORMANCE

The benchmarks for the Diversified Financial Assets Portfolio (DFA) as a whole and for individual asset classes are selected to be consistent with the risk, return and correlation assumptions used to determine the strategic asset allocation for the DFA.

The Board recognises that investment performance objectives relative to the benchmarks are expected to be met over the medium to longer term. From year to year, investment returns may not meet the longer term objectives.

Investment performance relative to benchmarks is measured:

- Before the deduction of any fees to be paid to the Fund Managers;
- After transactions costs such as brokerage have been deducted (but before custodian costs are deducted). Standard practice is for fund managers to report their gross investment performance net of transactions costs and to charge their own fees, including custody, directly to clients; and
- Investment performance of each fund manager is also measured relative to fees, to the returns achieved against the benchmark compared to expected returns, and adherence to investment guidelines and constraints.

The performance of the DFA as a whole will be assessed by comparing the DFA's return (after tax) with the NZX New Zealand Government Stock Gross Index (after tax) plus 1.5% per annum over rolling ten year periods.

The DFA is a long-term investment portfolio with an investment horizon beyond ten years. Over rolling twenty-year periods the DFA is expected to achieve a real after-tax return of at least 5.5% per annum. Behind this target lies an assumption of a 2% per annum long-term CPI inflation rate for New Zealand. The DFA has also been assumed to be tax-exempt in New Zealand and to have its tax-exempt status made as effective as possible in overseas jurisdictions.

At the asset class level, performance may involve several Fund Managers with diverse mandates. At the mandate level, performance will be assessed by comparing the actual performance of the Fund Managers for that mandate with the benchmark for each mandate. Each mandate will generally have an out-performance target, set by the Board, over rolling three years to five year periods. Compliance with the mandate criteria is essential since the characteristics of the total DFA are determined by its components through a complete cycle. Each component has been designed to perform a very specific role. For this reason Fund Managers are generally not permitted, within the mandate, to hold Cash beyond a minimum level.

The investment performance of a Fund Manager is also monitored in the context of other fund managers operating similar mandates. Care has to be taken in making sure that comparisons are genuine.

C REPORTING STANDARDS

Reporting standards have been negotiated with each of the appointed Fund Manager to take into account the requirements of ARH with respect to:

- Effective monitoring of the investment performance of the Fund Managers relative to their own specific mandates with ARH;
- Facilitating the accounting processes which ARH follows in order to fulfil its own reporting responsibilities; and
- Facilitating any other reporting requirements which ARH may feel is necessary.

In general terms ARH has sought from Fund Managers commitments that they provide monthly 'flash' reports of performance for each month as soon as practical after month-end, followed by a final monthly report when full information is at hand.

Full quarterly reports on performance are sought from Fund Managers. The quarterly reports will encompass quarterly performance data and commentary on key developments relevant to the performance of the Fund Manager relative to the benchmark index.

D RESPONSIBLE INVESTMENT

The application of responsible investment standards in the management of investment portfolios is an area which has developed rapidly in the last decade and which continues to evolve with a range of standards and procedures being adopted. Responsible investment is increasingly being separated into three parts:

1. Environmental;
2. Social; and
3. Corporate Governance.

There is a growing view among institutional investors that investing in entities that incorporate environmental, social and corporate governance (ESG) issues into their business can affect the performance of investment portfolios positively. This position is recognised by ARH and is stated as one of ARH's investment beliefs (refer to page 10 of this SIPSP).

Additionally, ARH holds the view that taking an active interest in environmental, social and corporate governance issues related to investments will enhance to ability to manage and mitigate investment risk.

ARH currently takes a responsible approach to managing its non-DFA investments, being regional investments of significant importance – Ports of Auckland Limited and the Wynyard Precinct Investment Property. ARH intends to enhance its policy on responsible investment, over time, for its entire investment portfolio, with the intent of being able to incorporate a more active approach to responsible investment within its DFA investment criteria.

At this time, ARH does not have the scale of investment necessary in order to be highly prescriptive with DFA Fund Managers and investments. However, when appointing fund managers ARH does assess managers that have been assigned ratings by ARH's investment advisor⁷ that signify an assessment of the standards that the managers' meet in each of the following three areas relating to responsible investment:

- Voting and engagement on corporate governance issues;
- Voting and engagement on environmental and social issues; and
- Integration of environmental, social and corporate governance (ESG) issues into mainstream investment decision-making processes.

ARH will continuously review current literature on responsible investment and, where possible, will endeavour to assess and understand the impact of responsible investment on investment performance.

⁷ Mercer Investment Consulting.

E BALANCE BETWEEN RISK AND RETURN

The balance between risk and return within the Diversified Financial Assets Portfolio (DFA) has been determined in relation to the entire investment portfolio for which ARH is responsible, which also includes strategic direct equity and property investments. The investment characteristics for the DFA have been discerned from analysis of the overall objectives of ARH (related to its Long Term Funding Plan (LTFP)) for the entire investment portfolio taking into account the investment characteristics of the strategic investments (direct equity and property), which include Ports of Auckland Limited and investment property in the Wynyard Precinct at Auckland's downtown waterfront.

The long-term objectives for ARH's entire investment portfolio are:

Primary investment objectives:

- i. To outperform the NZ Government Stock Index by 1.5% pa, over ten-year rolling periods;
- ii. To maintain the real revenue earning capabilities of total assets by outperforming inflation, as measured by the Consumer Price Index, by 5.5% pa over 20-year rolling periods;
- iii. For distributions, on a rolling ten-year basis:
 - Short Term, to pay to the Auckland Regional Council (ARC) 100% of the planned distributions per the first three years of each LTFP, with a 95% probability of achievement,
 - Long Term, to pay to the ARC at least 90% of the planned distributions per years four to ten of each LTFP, with a 75% probability of achievement; and
- iv. To maintain the fund in a satisfactory financial condition, by not exceeding the credit criteria for borrowings used to finance distributions:
 - Interest costs at no more than 40% of total expected earnings;

Associated objectives and criteria

- The maximum strategic risk budget objective was initially set at 9% pa, and this has been reset at 10% pa.

The desired risk and return characteristics of the DFA have been set in context of a low correlation with the direct New Zealand equity and property investments. On balance it was determined that, where the DFA has a very low correlation with the non-DFA investments, the required risk and return characteristics of the DFA are of the same order of magnitude as for the entire ARH investment portfolio.

The DFA has been designed to have a low correlation with ARH's non-DFA investments and comprises 90% international financial markets' securities. The DFA has a maximum risk budget of 9% pa, with an expected gross return of 10.15%⁸ pa which includes provision for fund manager value-added and excludes fund manager expenses.

⁸ This is the maximum possible expected return for an active management strategy for the DFA. ARH may adopt a lower expected return in its LTFP so that it can have a greater level of certainty over achieving the stated return.

F FUND MANAGEMENT STRUCTURE

Policy

The ARH Board has determined that the following components of the DFA management structure should be out-sourced:

- advisory services – legal, tax advisory, actuarial, investment advisory;
- audit services;
- investment management; and
- custodian / investment back office.

Secretariat and management services to the Board, under a 'manager of fund managers' structure, will be carried out by the ARH Management, working with the Board.

Procedures

Selection of managers and suppliers for the above roles will take into account, among other criteria specific to the role:

- best-practice portfolio management;
- the skills and experience the manager brings to the role;
- the substance and viability of the manager;
- the costs that can be expected to be incurred;
- the potential for cost savings and other efficiency gains; and
- the existence of appropriate risk management structures.

Generally, unless specific circumstances require a different approach, the selection of Fund Managers will be contestable and subject to a rigorous process of rating fund managers for specific mandates in order to establish a short list for further analysis and ranking.

Investment management mandates and guidelines shall be prescribed in a manner most likely to achieve the investment objectives of the ARH Board. In particular, mandates shall include: eligible investments, performance measurements, constraints and exposure limits including country and issue exposures, use of derivatives, and reporting requirements. Managers will be regularly reviewed against the criteria above to determine their suitability for their roles.

Governance

The ARH Board is charged with overall governance responsibilities for the investment of the DFA.

The ARH Board retains the responsibility to appoint managers, custodians and suppliers within the Investment Management Structure.

G USE OF OPTIONS, FUTURES, OTHER DERIVATIVES

Derivative financial instruments (derivatives) are financial contracts whose value depends on, or is derived from underlying assets, and includes futures contracts, forward currency contracts, swaps, forward interest rate contracts and options.

In relation to derivatives, “effective exposure” means the exposure to the underlying asset or liability that arises from holding the derivative. For futures and forward contracts, the effective exposure is the value of the underlying asset or liability at current market rates. For options contracts, determination of the effective exposure takes accounts of the ‘delta’ of the option (the sensitivity of the option value to changes in the value of the underlying asset or liability).

DERIVATIVES (EXCLUDING FORWARD FOREIGN EXCHANGE CONTRACTS)

Policy

Derivatives may only be used for the purposes of managing, lessening, hedging or protecting against movements in interest rates, discount rates, values or prices in relation to permitted investments;

Derivative transactions must be in the form of a derivative over the same asset class as the physical position;

Derivatives are not to be used to leverage the portfolio;

The holding of derivatives must be fully supported by cash, short-term debt instruments readily convertible to cash or permitted investments (but excluding derivatives) under the relevant mandate when measured on an effective exposure basis;

At all times, the value of all derivative positions measured on an effective exposure basis must not result in portfolio liabilities exceeding portfolio assets;

The effective duration of any derivatives, shall be taken into account for the purposes of determining compliance with the duration limits of fixed interest portfolios;

The determination of the exposure to any company, security or market shall take into account the exposure resulting from derivatives for the purposes of determining compliance with portfolio exposure limits; and

The amount of derivatives in a portfolio is limited by either limiting exposure to individual counterparties or limited by specifying total derivative exposure in the portfolio.

Procedures

Valuation

The value of derivatives, which comprise futures and options contracts, are measured on an effective exposure basis;

The value of other derivatives are measured on a best practice basis; and

Revaluations of derivatives will be undertaken on at least a weekly basis.

Instruments

Derivative instruments traded on recognised exchanges may be entered into.

Over-the-counter options, interest rate swaps, forward rate agreements may also be entered into or held in the portfolio subject to each counterparty having an appropriate credit rating as measured by a recognised rating agency for counter party risk and appropriate contractual arrangements (for example, an ISDA agreement) being in place between the manager and each counter party.

The ARH Board recognises that, where it invests in pooled products offered by fund managers, it may be indirectly investing in derivatives. All fund managers are required to provide the ARH Board with a copy of their policies relating to derivatives securities trading risk and to manage their derivative exposures in accordance with those policies.

DERIVATIVES – FOREIGN EXCHANGE CONTRACTS

Policy

Derivatives relating to foreign exchange may be used for the purposes of managing and hedging currency exposures held within the DFA and for the purposes of purchasing or selling foreign currencies required for the settlement of foreign exchange transactions. Derivatives are not to be used to leverage the DFA, which would require the ARH Board to borrow on behalf of the DFA.

The net exposure to foreign currencies (after taking into account hedging positions) in the relevant portfolios are to be in accordance with the ARH Board's hedging policy for that asset class.

In general and where applicable, currency exposures are aggregated into major currency blocs (as approved by the ARH Board) and hedged back into NZ Dollars.

Procedures

Foreign exchange hedging contracts may be entered into only with counterparties that have credit ratings approved by the ARH Board and measured by a recognised rating agency for counterparty risk.

Contractual arrangements (for example, an ISDA⁹ agreement) must be in place between the fund manager and each counterparty in a form suitable to the ARH Board.

Appropriate operational ranges will be established with fund managers around the determined hedge ratio to avoid excessive costs of continually adjusting the hedge to the precise hedge ratio.

Each Fund Manager must have risk management policies and procedures in place that address counterparty risks suitable to the ARH Board.

⁹ International Swaps and Derivatives Association

H MANAGEMENT OF CREDIT, LIQUIDITY, OPERATIONAL, CURRENCY, MARKET, AND OTHER FINANCIAL RISKS

Introduction

Risk management is a central function of any organisation charged with the oversight of financial assets.

For an organisation such as ARH there are many potential sources of risk and because of the size of the fund, the financial consequences of failure to adequately address those risks could be significant.

This section provides a high-level overview of the standards and procedures adopted by the ARH.

Policy

The Board will set a risk budget for the DFA that is consistent with the legislative requirement to maximise return without undue risk, and with the objective of outperforming inflation, as measured by the Consumer Price Index, by 5.5% p.a. over 20-year rolling periods.

The Board has determined the quality of all of its risk management procedures must be of best-practice standard.

Standards (Definitions of risk)

Credit risk

Credit risk (or **Counterparty** risk) is the risk of default by the **counterparty** to a particular transaction.

Liquidity risk

Liquidity risk is the risk that a security cannot be sold when required or the price achieved is significantly different from the quoted price.

Under the current investment structure fund managers are constrained to listed securities and/or instruments which are readily liquidated.

Operational risk

Operational risk is the risk of financial loss due to mismanagement, error, fraud or unauthorised use of techniques and/ or financial products.

Currency risk

Currency risk is the risk that the foreign currency denominated assets will lose value due to the effect of an adverse exchange rate movement.

Market risk

Market risk is the risk of adverse movements in an asset market (including asset prices, volatility, changes in the yield curve or other market-related variables) for the underlying asset.

Procedures

Credit risk

Credit risk is managed by requiring managers of global fixed interest investments must:

- (a) ensure the average credit quality within the manager's portfolio is within agreed guidelines;
- (b) that exposure to different tiers of credit (including unrated debt) are within agreed guidelines; and
- (c) the maximum permitted exposure to any one issuer is within agreed guidelines; and
- (d) the long-term debt of all entities in which the manager invests is either rated by an approved recognised rating agency or, if it is not-rated, is constrained to the maximum permitted exposure to such debt.

Liquidity risk

Liquidity risk is managed by:

- (a) requiring managers to invest primarily in securities traded on **recognised exchanges** with specified maximums for unlisted securities;
- (b) requiring managers, within the terms of their individual contracts, to hold diversified portfolios; and
- (c) limiting the credit rating of all fixed interest investments to minimum levels.

Operational risk

Operational risk is managed by:

- (a) engaging an independent global custodian to separate the investing function (undertaken by the Fund Managers) from the transaction settlement, recording and reporting of investment activities (as undertaken by the global custodian);
- (b) requiring Fund Managers and the custodian to:
 - i. provide the Board with third party covenants or assurances against these events;
 - ii. have in place insurance arrangements to cover claims in those events; and
 - iii. have in place, and regularly confirm the existence and efficiency of, internal policies and controls to address those risks;
- (c) establishing a system of compliance reporting by investment managers and the custodian to the Board;
- (d) establishing an audit and risk committee of the Board, with responsibility for recognising and controlling operational risk; and
- (e) establishing an effective business continuity plan in conjunction with the custodian.

Currency risk

Currency risk is managed by:

- (a) establishing a foreign currency hedging policy for each foreign asset class (as described in the Statement of Investment Policy and Objectives);
- (b) specifying the bounds within which each Fund Manager may take on currency exposures relative to their benchmark; and
- (c) engaging one or more currency execution agents to transact the DFA's foreign exchange transactions, including both spot and forward transactions, at the most favourable rate.

The instruments Fund Managers may use, and the credit worthiness of the **counterparties**, are detailed in the investment management agreements with respective Fund Managers. Any forward contracts entered into must be with entities that have an appropriate minimum credit rating as determined by an international credit rating agency for **counterparty** risk and appropriate contractual arrangements (for example, an ISDA agreement) must be in place between the currency manager and the **counterparty**.

Market risk

For the DFA as a whole, risk is managed in the manner described in Section E above.

Market risk is further managed by requiring Fund Managers to manage their portfolios within defined market exposure limits. Those limits include (as appropriate):

- (a) limits on the percentage weight of any individual company in the portfolio relative to its benchmark weight;
- (b) limits on aggregate investment in companies not represented in the benchmark;
- (c) limits on investment in any individual company not represented in the benchmark;
- (d) limits on the maximum investment in any individual company;
- (e) duration limits relative to the duration of the benchmark; and
- (f) maximum limits on exposure to single entities.

ARH is generally invested in pooled investment products where the above limits are met by the specific mandates for the pool.

I VOTING RIGHTS

Active Management

Policy

Fund Managers are required to give full consideration to all voting opportunities and shall vote on all substantive issues affecting the DFA.

Fund Managers must vote on those issues in the best interests of the DFA and in accordance with the Fund Managers' voting guidelines.

Any conflicts or inconsistencies between the best interests of the DFA or of the Fund Managers' guidelines, shall be referred to the ARH Board.

Standards

A 'substantive issue' is one which has the potential to materially affect the value of the Board's investment in that entity in the near future. Fund Managers are required to establish and adhere to voting guidelines.

Each year the Fund Manager must update those guidelines and provide a copy to the Board. Material changes to the voting guidelines must be advised in writing to the Board.

Procedures

The procedures shall be in accordance with the Fund Managers' guidelines and procedures. Where appropriate, Fund Managers will be required to report all voting decisions to ARH on a quarterly basis.

J VALUATION OF ASSETS NOT REGULARLY TRADED

Generally, the investments of the ARH Board are to be regularly traded on recognised exchanges.

Where investments are held that are not regularly traded on recognised exchanges, for example unlisted pooled investments or over the counter derivatives, for financial year-end independent pricing will be obtained on material investments (either through the ARH Board's custodian or from another source).

For monthly valuations, the ARH Board will either:

- Obtain an independent price for each security; or
- Use the Fund Managers' prices, if an independent price cannot be obtained

K PROHIBITED INVESTMENTS, CONSTRAINTS

Prohibited or Restricted Investments

Except as required to control risks (as set out under section H above) and in accordance with the ARH Board's investment guidelines there are no specifically prohibited or restricted investments. However each investment management contract specifies those investments that constitute permitted investments and Fund Managers may not invest other than in those permitted investments.

Specific written authorisation from the ARH Board is required to invest outside of the prescribed permitted investments. The ARH Board will consider such investments as they arise on application from the investment manager.

Investment Constraints and Limits

The ARH Board has developed constraints and limits in respect of each investment class to control risks (see section H above). It has also determined limits to the exposure to each investment class to ensure the investment objective of the DFA is not compromised by excessive deviation from the DFA's strategic asset allocation.

CURRENT PORTFOLIO MANAGEMENT STRUCTURE

ASSET CLASSES

The Diversified Financial Assets Portfolio (DFA) shall be invested in the following general asset classes:

- Global Equities;
- Global Bonds; and
- New Zealand cash denominated securities

In addition, the currency exposure associated with international investing will be managed and exposures to the asset classes will be constrained around their strategic benchmark.

The ARH Board has determined that the Strategic Asset Allocation for the DFA is as follows:

Asset Class	Strategic Asset Allocation %
Global Equities	50
Total Growth Assets	50
Global Bonds	40
New Zealand Cash	10
Total Income Assets	50
Foreign Currency Exposure (50% of Global Equities)	25

Global Equities

- the strategic benchmark allocation is to be 50% of the total DFA;
- the strategic benchmark for monitoring purposes will be the MSCI World Index with net dividends reinvested, and 50% hedged back into NZ dollars (NZ\$). (The benchmark indexes for specific individual Global Equities mandates may differ from the asset class benchmark index. Servicing of the Australasian market has meant that most products are managed to the World excluding Australia);
- Global Equities are to be managed actively; and
- Five (5) specific mandates have been established as set out in the table below and described in the SIPO.

Global Bonds

- the strategic benchmark allocation is to be 40% of total DFA;
- the benchmark index for portfolio monitoring purposes is to be the Barclays Capital Global Aggregate Index hedged back to New Zealand dollars (NZ\$);
- at least two (2) active Fund Managers are to be appointed;
- Fund Managers will be measured and monitored relative to the benchmark hedged back to New Zealand dollars; and
- Fund Managers will attribute performance first to the two broad factors: (1) the performance of the Fund Managers relative to the appropriate index in non-NZ\$, and (2) the hedging process applied to the foreign (non-NZ\$) currency exposures back into NZ\$.

New Zealand Cash

- the benchmark portfolio allocation to New Zealand Cash is 10% of the value of the DFA; and
- Fund Managers appointed to manage equities and fixed interest mandates have their own restrictions on the amount of Cash to be held within their portfolios at any time.

PORTFOLIO CONSTRUCTION FOR THE DFA

Asset Class	Type	Style	% of the Asset Class	% of the Total DFA
Global Equities	Large Cap¹⁰	1 manager - Core	40	20
		1 manager - Value	20	10
		1 manager - Growth	20	10
	Small Cap¹¹	1 manager - Small Cap	15	7.5
	Emerging Markets¹²	1 manager - Emerging Markets	5	2.5
Global Equities Total			100	50
	Foreign Exchange Hedging to be carried out on 50% of Global Equities leaving an exposure to foreign currency of 25% of the total portfolio			
Global Bonds	1 manager focussing on macro-economic themes and sectors		50	20
	1 manager focussing on corporate and sovereign credit themes and more micro than macro		50	20
Global Bonds Total			100	40
	Foreign Exchange Hedging to be carried out on 100% of Global Bonds, leaving an exposure of 0% to foreign currency on these assets.			
New Zealand Cash Total	1 manager, NZ based		100	10
Total DFA				100

¹⁰ Large Cap = Stock with a market capitalisation of among the largest within a market, eg. the capitalisation of one of the top 100 companies in the UK represented by the FTSE 100 Index. In the US it is defined as a stock with a market capitalisation of over US\$5 billion (Mercer).

¹¹ Small Cap = Stock with a market capitalisation of among the smallest within a market, although the definition of what is small is to some extent arbitrary. In the UK, it is usually defined as a stock with a capitalisation below that of the top 350 companies in the UK as represented by the FTSE Small Cap Index (Mercer).

¹² Emerging Market = Financial market in a developing or newly industrialising country. Such markets can deliver high returns due to the rapid pace of industrialisation, but can be risky due to low liquidity, lack of reliable information and potential instability (Mercer).

ASSET ALLOCATION AND REBALANCING

Asset allocation is to be managed passively - that is, no attempt will be made to add value by deliberately and actively over-weighting particular asset classes at the expense of others. However, developments in tactical asset allocation or strategic tilting will be actively monitored with respect to their applicability to the DFA.

Each month the DFA's actual asset allocation will be checked against the rebalancing ranges. Asset allocations will be allowed to fluctuate within their permitted rebalancing ranges and taking known cash flows for the next month into account. Transactions will be undertaken to ensure compliance with those rebalancing ranges.

The permitted ranges relative to the strategic benchmark allocations within which the actual allocation may vary before rebalancing is required are detailed in the SIPO.

CURRENCY MANAGEMENT

Global Equities

The currency hedge ratio for Global Equities in the benchmark portfolio is to be 50% hedged to New Zealand dollars (NZ\$). The DFA is assumed to be exempt from NZ tax.

The hedge ratio will be permitted to vary between +5% and -5% around the hedge ratio before being required to be re-balanced to be within that range.

The hedge will be implemented by taking currency hedging positions only in currencies represented in the global equities benchmark index; and the currency exposure will be managed passively by a specialist currency manager.

The individual Global Equities Fund Managers will report through the ARH custodian who will then report directly to the passive currency overlay manager.

Global Bonds

The Global Bonds portfolio currency hedging benchmark will be to be fully hedged to New Zealand dollars (NZ\$).

Currency hedging management back into NZ\$ will be implemented by the same Fund Manager(s) who manages the associated global bonds mandate.

ASSET CLASS BENCHMARK INDEXES AND RETURN PERFORMANCE TARGETS

Global Equities:	% of Portfolio	Benchmark Indexes	Target Value Added
- Core	20	MSCI World NDR Index ex- Australia	2% to 3% over the long term
- Value	10	MSCI World NDR Index ex- Australia	3%pa over market cycle
- Growth	10	MSCI World NDR Index ex- Australia	3%pa over full market cycles (3 to 5 years)
- Global Small Companies	7.5	S&P Developed (ex-Australia) SmallCap Index	Greater than Index over rolling 3 to 5 years
- Global Emerging Markets	2.5	MSCI Emerging Markets Index	3%pa over rolling 5 years
Total Growth Assets	50		
Global Bonds			
- Macro	20	Barclays Capital Global Aggregate Index (100% Hedged to NZ\$)	1.25%pa gross
- Credit / Micro	20	Barclays Capital Global Aggregate Index (Hedged to NZ\$)	0.75% to 1%pa gross
New Zealand Cash	10	NZX 90 Day Bank Bill Index	0.15%pa
Total Income Assets	50		
Foreign Currency Exposure	25		