# CORRECTED VERSION

## STANDING COMMITTEE ON FINANCE AND PUBLIC ADMINISTRATION

**Inquiry into departmental and agency performance and operations**

Melbourne — 27 April 2009

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Witnesses

Mr A. Hawkes, director,

Mr J. Pascoe, chief investment officer and acting chief executive officer,

Mr B. Davidson, chief operating officer, and

Mr M. Ashbolt, head of client services, Victorian Funds Management Corporation

**The CHAIR** — I declare open the public hearing of the Legislative Council Standing Committee on Finance and Public Administration. Today's hearing is in relation to the inquiry into departmental and agency performance and operations specifically related to the Victorian Funds Management Corporation.

I welcome Mr Alan Hawkes, a director of the VFMC; Mr Justin Pascoe, acting chief executive and chief investment officer; Mr Brett Davidson, the chief operating officer; and Mr Malcolm Ashbolt, the head of client services, VFMC.

For the information of witnesses and the committee, Mr Brian Tee will be substituting for Mr Matt Viney for the purposes of today's hearing.

All evidence taken at this hearing is protected by parliamentary privilege as provided by the Constitution Act 1975 and further subject to the provisions of Legislative Council standing orders. Any comments made outside the precincts of the hearing are not afforded parliamentary privilege.

All evidence is being recorded by Hansard, and witnesses will be provided with a proof version of the transcript in the next couple of days. I would now invite you to make an opening statement, if you wish, and the committee will then proceed to questions. Thank you.

**Mr HAWKES** — Thank you, Chair. Thank you for the opportunity to present today. I am Alan Hawkes. I am a government-appointed board member to the Victorian Funds Management Corporation. I am also chair of the audit and risk committee. I would like to extend an apology from our acting chair, Ms Melda Donnelly. She is unable to be here today and has asked me to attend and describe the Victorian Funds Management Corporation's performance for 2007–08 year to you.

Also today we are represented by Mr Justin Pascoe, who is our acting chief executive officer and is chief investment officer of the Victorian Funds Management Corporation. I seek your indulgence to refer to it from now on today as VFMC rather than Victorian Funds Management Corporation.

**The CHAIR** — Certainly.

**Mr HAWKES** — Also with me is Mr Brett Davidson, who is our chief operating officer, and Mr Malcolm Ashbolt, head of client services.

We would like to make a short presentation to you to set the framework and the scene, if we may. You have a copy of it in front of you, and I believe it will also be on the screen there for others to see. I will move across to Mr Pascoe, who will run through some of the presentation.

**Overheads shown.**

**Mr PASCOE** — Good morning everyone. Thank you for this opportunity. I will begin, if I may, with some background to VFMC just to set the scene for today's proceedings. VFMC was established under state legislation in 1994. Our current minister is Mr John Lenders, the Treasurer of Victoria. VFMC reports to the minister through the Department of Treasury and Finance. It has an independent board and operates under an arms-length investment mandate.

Our clients are state-related entities, as per the VFMC act. On page 4 we have set out for you a client profile of VFMC. We have three broad types of clients: insurers, represented to the left, which represent approximately 47 per cent of our assets as at 30 June 2008; superannuation or pension fund clients, also representing 47 per cent of our assets as at 30 June 2008; and then some other institutions, including university and other endowments, making up the remainder of the assets that we manage. We are very proud to be working with each and every one of these institutions, as they provide important services for the state of Victoria.

The Treasurer's vision for VFMC is that we be a centre of investment excellence that delivers superior investment outcomes for our clients and leads the development of the Melbourne funds management industry. We are very excited by this challenge.

VFMC's stated goals, which are taken from our annual report, are set out on page 6. Our first goal is to meet the individual client investment objectives based on their liability profiles. Given this liability focus for our investments, I have actually often used the term sovereign liability fund to help describe VFMC's operations.

A second objective is to maximise long-term returns on state assets with a risk profile in line with our stakeholders stated risk tolerances. We also seek to maximise the advantages of scale and long-term nature of the state's balance sheet. By doing these three things we believe we will be able to build that centre of investment excellence here in the state of Victoria.

Throughout my career I have often been told that the investment industry is guilty of using a lot of jargon, so I am hoping that the next couple of slides will be able to give us some terminology that we can use in the remainder of proceedings today. I hope those will be helpful.

Beginning in the top left-hand corner of page 7, as I have said, the liabilities are the cornerstone of much of what we do for our clients. This is true for many investors globally. Those liabilities frame our clients' objectives. Those typically are stated in terms of a required return for our clients and an appropriate time horizon over which to manage the investment portfolio. We combine our understanding of liabilities with the objective, time horizon and various market forecasts regarding returns, risks and correlations, or the way in which assets move together, to set a strategic asset allocation. An example provided on this slide is 60 per cent equities and 40 per cent bonds. That characterises an investment strategy to be adopted for a client on a long-term basis.

That strategic asset allocation is then implemented by an investment team — in our case, VFMC's investment team. We invest the money into markets, using both external and, as we speak today of VFMC's operations, also internal investment management programs. The custodian performs a very important part of the overall program and holds the assets of our clients and therefore plays a key role in the safekeeping of those assets for our clients. The performance results achieved — in the bottom left-hand corner — are primarily driven by market movements. We do as best we can within the market environments to add value for our clients.

We report to our clients and ultimately compare our performance at a total portfolio level with the objectives that have been given to us over an appropriate time horizon. Ultimately the returns that we generate come back to complete the circle and the assets are used to meet the liabilities of our clients.

We also wanted to set out an example of such a client objective, and we have done that at page 8 — for example, CPI plus 5 per cent. Again, I am using jargon: CPI being the consumer price inflation index. Some investment alternatives that investors have available to them are set out on this page. Cash we believe would have a return in the order of CPI plus 2 per cent to 2.5 per cent on a long-term basis. Index-linked bonds, another investment alternative, might be reasonably expected to have a long-term return in the order of CPI plus 3 per cent; infrastructure investments, CPI plus 6 per cent; and equities, a long-term return in the order of CPI plus 7 per cent. We can continue looking at various other investments in this framework.

We need to consider not only returns but also the risks associated with the various investments and the correlation between different investment classes — that is, the way in which they tend to move in relation to each other.

In thinking about all those different investment alternatives that we have available to us, what I hope this slide highlights is that we cannot invest simply in cash and index-linked bonds in order to achieve the objectives of clients who are seeking to achieve in the order of CPI plus 5 per cent. So we need to construct balanced portfolios that trade off risks and returns. Our client boards recognise this and sign off on the expected risk/reward trade-off reflected by the strategic asset allocation mix. Again, this takes a very long-term view in its establishment.

To represent the operations of VFMC from 1994, its inception, through to 2006, I have often used the terminology VFMC version 1.0. Under that construction the client boards set their investment objectives and the strategic asset allocation mix. They did this using their own investment consultants. In VFMC version 1.0, VFMC acted as an implementer of that investment strategy, essentially acting as a manager of external managers. All the investments were outsourced and all VFMC decisions were subject to a board approval process. At that time there were many manager relationships. The investment performance results that were achieved over that period up to 2006 were in line with the performance benchmarks on a before-fees basis over a 10-year period. They were in the top 25 per cent of comparable funds over that period.

Moving forward, after an independent strategic review in 2005 by the consulting firm Access Economics, VFMC evolved to a new model, version 2.0. It began to be implemented in 2006 and is what we are operating under today. In this construction client boards still set the investment objectives, but VFMC now develops the strategic asset allocation decision in determining the mix of assets that will be used to achieve those investment objectives. Under this construction there has been a considerable broadening of the asset classes used and the instruments invested in, with the aim of delivering a more diversified portfolio for our clients, with increased linkages to inflation in particular, given the nature of their liabilities.

What we have set out here on page 10 is the average strategic asset allocation for department of treasury and finance clients across a number of different asset classes. This is an average, and each of the individual client portfolios differs as a result of their different objectives and different time horizons, but DTF clients represent approximately 95 per cent of the assets that VFMC manages on a day-to-day basis.

As we have outlined in our annual report, the move from version 1.0 to version 2.0 of VFMC resulted in some changes in the recommended investment strategies that are adopted by our clients. On page 11 we have highlighted the strategic asset allocation as at 30 June 2007 and contrasted that with the strategic asset allocation under version 2.0 at the end of June 2008. There has been an increase in the amount of inflation-linked assets in the portfolio and a reduction in the exposure to equities. This difference in portfolio has resulted in an improvement in returns across that period in the order of 2 per cent or approximately $700 million of benefit to the state of Victoria, by our calculations.

Moving to page 12, VFMC version 2.0 combines internal and external investment management capabilities. We now have fewer external manager relationships, and we synthesise multiple perspectives of information flow to manage portfolios internally as well. Our investment team operates under delegations from the VFMC board, and we currently have a team of 30 investment professionals, with a total staff of 67 people.

In managing our clients' assets we focus very much on the total portfolio. That is how our success is ultimately determined, by comparing our total portfolio performance versus the clients' objectives over an appropriate long-term time horizon. Consistent with standard industry practice, VFMC does not comment on individual investments, instead focusing on total portfolio results. We have, under some circumstances where transactions have involved purchases of assets from listed entities that were therefore required to note the sale, confirmed our involvement in those transactions.

We believe our advantages, as shown on page 14, are as follows: we seek to maximise the advantages of scale and access to the world's best investment views and resources. We believe that these combine with our long-term investment horizon to provide some unique insights.

When it comes to making specific investment decisions our investment team is driven by the following four key investment belief statements: the first is that we only take risk where we have the expectation of that risk being rewarded; secondly, that fees, taxes and transaction costs really matter to the outcomes achieved by our clients; thirdly, markets from time to time mis-price assets that create opportunities for us to add value; and finally, that the implementation and execution of our ideas is critical to the results that are achieved.

The investment team that I lead operates under delegations from the VFMC board, and these are a crucial part of our ability to respond quickly as an investment manager in our own right. I believe this is one of the key differences between version 1.0 and version 2.0 of VFMC's structure. These delegations are supported by detailed internal review processes and reporting. We have a total risk allocation committee for setting portfolio recommendations. That represents the various asset class heads within the VFMC investment team and is chaired by the CIO. We also have an executive investment committee that has representation of various other stakeholders within VFMC's business, from operations, legal, client servicing, risk and investments. That committee is chaired by the CEO.

To illustrate our governance structure we have included the following chart on page 16, which I hope is helpful. Beginning from the bottom we have the day-to-day functions within VFMC's business, the chief investment officer, head of client services, head of legal and compliance, and the chief operating officer reporting up to the chief executive officer, who ultimately reports up to the board and then through to the Treasurer.

We have a number of internal management committees, several of which I have already outlined, but I would also add we have an operational risk management committee which reports up to a board subcommittee, of which Mr Hawkes is the chair, the audit, risk and compliance committee. As I believe is standard industry practice we also have an independent subcommittee covering remuneration and nominations. On a day-to-day basis, though, the VFMC team operates under delegations from the board, independent of the Treasurer, and we have several internal oversight functions to monitor our activities.

On page 17 I would like to make the point that managing risk is a very important part of our business, and VFMC and its board are committed to effective compliance and risk management. Our risk framework includes a compliance strategy, risk management processes and of course is consistent with the Victorian government's risk management framework. Our framework is supported on a day-to-day basis by appropriate internal policies and procedures.

Our business also involves heavy investment in operations and systems, and they form a critical link between our investment team, settlement operations, the custodian, our clients and our stakeholders. These operations and systems support reporting to clients, DTF, the VFMC board and internal management. They allow us to make investment trade instructions and settle trades for our clients as well as support risk monitoring and risk management functions within our business. Again, VFMC's operations and investment teams are further supported by appropriate policies and procedures where we target industry best practice.

We have a portfolio management system that supports our internal investment functions and the related operational aspects. The capabilities of this system include tracking portfolio positions, order management when we are buying and selling shares, trade execution and compliance of our portfolios. Trade settlement and custodial interfaces are also parts of the system and facilitate accurate investment reporting. This portfolio management system was required to support the move from VFMC 1.0 to VFMC 2.0 which incorporates the internal management of parts of our clients' portfolios.

I would now like to move to analyse VFMC's financials which are included in the annual report. Looking at these in the 2007–08 period, it is a period that has seen continued growth in head count to support the internal investment program and the broadening of the investment portfolio to achieve greater diversification for our clients. As at 30 June 2007, VFMC had a total of 44 staff including 19 investment professionals. At the end of that financial year there was a total of 67 staff including 30 investment professionals. That period also saw significant investment in systems and data to support the internal investment management capabilities that have also been required. These developments have been explained to and supported by our clients.

On page 22 we set out the profit and loss as per the annual report, and while VFMC has been profitable — and I believe these are modest levels of profit — they achieve the government's objective which has been set for us to deliver a return consistent with the Victorian government bond yield on the capital that underpins VFMC's business.

Page 23 sets out the balance sheet of VFMC for the 2007–08 period with total equity appropriate to support our ongoing investment operations. We have a secure balance sheet. It is important to note that the assets that we manage sit on our clients' balance sheets or in investment trusts not on VFMC's balance sheet.

Moving to investment performance, which is the ultimate goal of VFMC, on page 25 we set out our investment results for the period ending 30 June 2008 and compare those with the median or average return of a comparable universe of managers. VFMC's results are on the bottom line of the table being minus 8.06 per cent return for the one year ending 30 June which compares quite favourably to the minus 10 per cent return achieved by the average manager in this survey. Across a five-year period our 10.5 per cent return has lagged slightly behind the return of the average manager in that space, but I believe that it is appropriate for an organisation like VFMC to be slightly more conservative. We are comfortable not quite keeping up with our competitors in very positive markets and doing better than the competition in very challenging times.

The following six pages show total portfolio returns versus objective by client, and we have asked our clients' permission to include these in our reports. We will look through these one by one, but five out of six of these clients are ahead of objective as at 30 June 2008. On page 26 one of our superannuation clients with an objective of CPI plus 5 per cent over rolling five-year periods is demonstrated. Page 27 shows a chart for another superannuation and pension client. This chart was included in the annual report for 2007–08.

**Mr BARBER** — Those lines are quarterly returns, not your rolling five-year — —

**Mr PASCOE** — Those are rolling five-year periods.

**Mr BARBER** — The actual line is — —

**Mr PASCOE** — That is a rolling five-year period.

**Mr BARBER** — A quarterly return rolling five-year period.

**Mr ASHBOLT** — It is rolling five-year returns at each quarter end.

**Mr PASCOE** — Yes.

**Mr ASHBOLT** — The bars represented on the chart are the objective. CPI plus 5.5 per cent is represented by the green bars on the chart. The lines are our investment results.

**Mr GUY** — Are they the latest figures you have available? Is March 2009 available as well?

**Mr PASCOE** — March 2009 figures are not available at this time. We are in the process of reporting to our clients.

**Mr GUY** — Okay.

**The CHAIR** — Carry on, Mr Pascoe.

**Mr PASCOE** — Moving on to the Parliamentary Contributory Superannuation Fund, a very important client, again, the results on page 28 are ahead of target. The Transport Accident Commission, with a longer period there — CPI plus 5 per cent over a rolling 10-year period — is modestly behind objective at 30 June 2008. Then on the following two pages — pages 30 and 31 — are our other two insurance clients. Over their five-year rolling periods their results again at that point in time are ahead of their objectives, but we do acknowledge the fact that that will not always be the case.

**The CHAIR** — Thank you, Mr Pascoe, for that very detailed presentation, and Mr Hawkes for the introduction. I will now proceed to questions.

I note the operating statement for 2007–08 shows VFMC's revenue being essentially from three sources: management fees, security lending fee revenue and interest revenue. Can you outline the drivers of the management fee revenue? What is that based upon — the management fee that VFMC itself receives?

**Mr PASCOE** — As with most investment management firms, the revenues are based on, typically, assets under management.

**The CHAIR** — So it is effectively a proportion of funds management?

**Mr PASCOE** — Yes.

**The CHAIR** — So it does not necessarily reflect returns on those assets? It reflects the aggregate value of the assets?

**Mr PASCOE** — Indirectly it encapsulates returns on those investments. As markets go up and markets go down, the fees charged in dollar amounts will change as the underlying assets change.

**The CHAIR** — Hence the decline from 2007 to 2008?

**Mr PASCOE** — Yes.

**The CHAIR** — Is that a consistent basis across clients? It is a fixed percentage of assets?

**Mr PASCOE** — It varies slightly from client to client, but the framework, the methodology, is consistent across clients, yes.

**The CHAIR** — And securities lending fee revenue — I assume that was securities that the VFMC lent to other parties to cover short selling and then charged a fee for it? Is that the basis of that?

**Mr PASCOE** — Yes, that is a program that is managed by the custodian, and that is very carefully managed with collateral, supporting any stocks that are lent out by the custodian, and the revenue that is received by the custodian for lending those shares out is passed on to the clients of VFMC.

**The CHAIR** — When you refer to the custodian, does that refer only to the VFMC trusts as distinct from assets managed on behalf of other clients?

**Mr PASCOE** — It includes assets managed on behalf of other clients, yes.

**The CHAIR** — So the full board of funds under management?

**Mr PASCOE** — Broadly speaking, yes.

**The CHAIR** — And how are those decisions arrived at as to whether you will or will not engage in the lending of securities? Are the clients consulted on that, or what is the process there?

**Mr PASCOE** — We are operating under delegations from the majority of the clients and so that is the decision that can be made by VFMC management and its board.

**The CHAIR** — So at the time you enter into a relationship with your client one of the delegations that they may give you is the delegation to lend securities and you then engage in that activity?

**Mr HAWKES** — Ultimately it is a board decision as to whether to participate in that marketplace, and the board has therefore supported that through the 2007-08 year.

**The CHAIR** — Is that a decision that is made on a case-by-case basis or is it a decision that is made at the start of the year as in 'Yes, we will engage in lending securities'?

**Mr HAWKES** — It is a broadly-based decision as to whether the organisation will participate on behalf of its clients in the securities lending market or not. During the 2007-08 year the decision was made to participate in that market, and our external custodian controlled those investments for us.

**The CHAIR** — What were the reasons that the board decided to participate in 2007-08?

**Mr HAWKES** — I should defer to our chief investment officer who treats this as another asset class. It is a market-based mechanism and there is a reward for the risk involved, and the balance that the chief investment officer has to take is: was the risk reasonable and was the reward appropriate? And the judgement was that yes, it was.

**The CHAIR** — The reward being the fees earnt?

**Mr HAWKES** — Correct.

**The CHAIR** — And the risk being the potential for the securities that are lent to diminish in value as a consequence of short selling?

**Mr PASCOE** — More the risk management around the appropriateness of collateral being held by the custodian as part of their management of the program.

**The CHAIR** — So the impact of the resulting short selling is not considered as one of the factors when deciding whether to engage in security lending?

**Mr PASCOE** — In normal market circumstances the practice of short selling is believed to improve the overall efficiency of markets, but in extreme periods there have been some concerns around the activities of short sellers and their potential impact on certain names in the short term. But in managing the risks we look at the operations of the custodian, the types of collateral that they hold when somebody borrows the stocks, what sorts of instruments are they posting with the custodian as security, effectively guaranteeing the return of those shares that are ultimately owned by our clients, and we monitor those operational risks with the perceived rewards from the fee revenue achieved through the lending program, and we monitor that on an ongoing basis.

**The CHAIR** — Has the board continued that practice beyond 2007-08 into the current year?

**Mr HAWKES** — Chair, we are now heading into the area of individual assets and individual assets classes, and because there is a potential market impact from our disclosures of these things I am going to struggle with heading into that sort of line of questioning. It would be very hard for us to breach that relationship we have between our clients and ourselves. It is just a very difficult area for us.

**The CHAIR** — Okay, Mr Hawkes, I take that on board. Perhaps it is something we should look at post 30 June and bring VFMC back to review the current financial year in six weeks' time. The amount of fee revenue that was gained from lending was relatively modest, about $1.7 million. Does that reflect a proportion of the value of the shares or the securities that were lent?

**Mr PASCOE** — Yes.

**The CHAIR** — Can you give us an idea of the total value approximately that was subject to lending over the 2007-08 year? Was it a big proportion of your total portfolio?

**Mr PASCOE** — Not at all. It actually reflects a very conservatively run program, with very strict requirements around the collateral to be posted by the people borrowing shares. So VFMC's instructions to the custodian around the types of collateral that would be received are very, very strict by industry standards, and as a result the utilisation — the amount of available securities that were lent — was actually quite low, which we believe is a good thing. We wanted to make sure that the program was run on a very conservative basis, and as part of managing that risk reward trade-off.

**The CHAIR** — Can you quantify that? Approximately, is it $500 million, is it $1 billion, is it $2 billion, is it $50 million?

**Mr PASCOE** — Perhaps it is better to take that question on notice and we can get back with those figures.

**The CHAIR** — Thank you. I would like to ask you about — and this is probably to Mr Hawkes, as a member of the board — the issue of executive remuneration. The Public Accounts and Estimates Committee produced some material in its last report on financial and performance outcomes around the bonus structure for VFMC principals — the investment staff as distinct from the other staff. Can you outline how the performance bonus system works for VFMC principals?

**Mr HAWKES** — Yes.

**The CHAIR** — And what performance is assessed for the payment of those bonuses, that type of thing?

**Mr HAWKES** — Yes. The remuneration structures of the Victorian Funds Management Corporation are approved by the Treasurer, with advice from the State Services Authority. The remuneration structures consist of a base salary, a short-term incentive structure and a long-term incentive structure, and that is based upon the performance of the funds over time. As you would readily recognise, I cannot talk about individual persons' remuneration, and I would refer you to the annual report for information that we are allowed to disclose in relation to the 2007–08 year for specific numbers.

**The CHAIR** — You talk about the mechanism for the short-term and long-term incentives, how they work, how they are determined and which staff will get which level of assessment. The information you would have seen published in the Public Accounts and Estimates Committee report had three bands of performance — fully meets expectations, exceeds, and significantly exceeds — with appropriate bands for those.

**Mr HAWKES** — Yes.

**The CHAIR** — Firstly, is that relating to the short-term or the long-term incentives, or both? And how are staff allocated to those particular bands?

**Mr HAWKES** — I do not have that particular document in front of me, Chair, but I would believe that relates to the short-term incentive program.

**The CHAIR** — Right.

**Mr HAWKES** — And that is describing a position where each individual staff member is reviewed in terms of personal performance for a year. The long-term incentive program is based along the lines of our long-term benchmarks and the manner in which staff have contributed to performance compared with those benchmarks. So yes, it is investment performance that impacts upon the long-term incentive program.

**The CHAIR** — And the short term?

**Mr HAWKES** — The short term is based partly on their contribution to the investment performance, but we are more interested as an organisation in the long-term performance in funds management activities. So the short-term investment program will be based more upon overall contribution to the organisation.

**The CHAIR** — And in relation to those short-term decisions and remuneration, page 36 of the annual report shows that for the senior executive, which I assume would cover most, if not all, of your principal staff, base remuneration was aggregate at $1.1 million, total remuneration was just under $1.9 million, so roughly a pool of $800 000 between base and total remuneration. I appreciate that a senior officer departed and no doubt there were other entitlements paid out with that. But the issue that was raised by the Public Accounts and Estimates Committee was the apparently large pool that was paid the previous year on incentives. At that stage it was $411 000, which averaged $68 000 per officer. Would that have been a mix of long and short-term incentives?

**Mr HAWKES** — I believe not.

**The CHAIR** — That would only be short term?

**Mr HAWKES** — I believe there would be no long-term incentive payments in that amount.

**The CHAIR** — And in the annual report we are looking at today, that $800 000, which is the apparent difference between base and total, would that also be only short term?

**Mr HAWKES** — Yes, it would be a short-term incentive program.

**The CHAIR** — So the short-term incentives are a fairly substantial part of the remuneration package?

**Mr HAWKES** — There may be other items in the margin between total remuneration and base salary, so I cannot comment in relation to the proportion of that amount that would be a short-term incentive. I just do not know the numbers, and I do not think we would have them with us here today. I am sure we have not got them here with us today.

**The CHAIR** — Would you be able to take on notice that question as to the breakdown between total and base remuneration, as to how much was accrued benefits for departing officers, et cetera, and how much was the incentive scheme?

**Mr HAWKES** — Yes, I can take it on notice, certainly. I am very willing to do that. I would alert you to the fact that the Department of Treasury and Finance, in its disclosure principles in financial statements, sets the guidelines on what we can disclose in this regard. So we would need to take that into consideration in answering your question. But I am very happy to take it on notice and we will have a look at it for you.

**The CHAIR** — Thank you. Are all VFMC principals engaged as employees on a PAYG basis?

**Mr HAWKES** — In the year 2007–08, is that your question?

**The CHAIR** — Yes.

**Mr HAWKES** — Yes, as far as I am aware.

**The CHAIR** — So their remuneration is paid as ordinary salary?

**Mr HAWKES** — Correct, yes.

**The CHAIR** — Given you asked the question about the year, I will ask the question: is it still the case?

**Mr HAWKES** — Yes. I hesitate only because we occasionally employ contractors to work on things like IT installations.

**The CHAIR** — I am talking about the key investment officers.

**Mr HAWKES** — I see. Yes, no question in my mind.

**The CHAIR** — So whoever took home a package of $750 000 in 2007–08 paid a lot of tax.

**Mr HAWKES** — If there was such a person, yes.

**The CHAIR** — The highest band on your annual report is one officer collecting $740 000 to $749 000.

**Mr HAWKES** — I would imagine he met his tax obligations to the Australian government.

**The CHAIR** — On a PAYG basis he would have paid a lot of money. One of the issues in 2007–08 was the large staff turnover of key officers. I understand the head of international equities, the head of global small caps and the head of hedge funds all parted in 2007–08. We have since had the CIO depart. We have just had the CEO depart. Is there any systemic reason for those substantial senior departures from that area?

**Mr HAWKES** — I will speak on behalf of the board to start with, and then if others wish to comment, they may. The board monitors staff turnover very closely. There is regular reporting to the board on staff turnover. I would say from my experience it is an industry where staff turnover might be higher than in some other industries. People do move. In our case we can benefit from that because we are building a centre of investment excellence in Victoria, and we are looking for the best executives that we can find in the marketplace.

Fortunately the Treasurer and the government have approved a salary structure that enables us to attract the best people in Australia. On the question of staff turnover, at our board meetings that have considered this over the last 12 months we have been pleasantly surprised to find that our staff turnover is less than in the industry generally. The percentage of staff lost compared with total staff is lower. It has happened that there have been some notable staff departures. We would put that down to normal industry moves.

**The CHAIR** — But presumably not remuneration, given the structure we have spoken about previously.

**Mr HAWKES** — We do not believe so.

**The CHAIR** — You would be aware of Mr de Bever's comments about government interference in decisions of the VFMC. Does the board have a view on that?

**Mr HAWKES** — No, they are Mr de Bever's comments. I cannot comment on his comments. I will leave that to him.

**The CHAIR** — Do you agree with them?

**Mr HAWKES** — No, I do not. I believe the board relationship with government is very sound and is very proper.

**Mr PASCOE** — Perhaps I could add as Mr de Bever's replacement that I also disagree with those comments. I have no interference from government in performing my duties.

**The CHAIR** — Thank you. I am conscious of the time. I need to give my colleagues a chance.

**Ms BROAD** — Thank you for your attendance today and your presentation. If I take you to the annual report, I think it is pretty clear from the report that since VFMC was formed in 1994 during the time of the former Kennett government perhaps little has changed in terms of the structure and operations of the VFMC over that time, including the utilisation of external fund managers for clients' assets, up until the relatively recent change where taking on VFMC internal responsibilities for strategic asset allocation for the clients that are listed in the annual report on page 3 was quite a significant change. Because it is a very significant change to that proportion to date at least of in-house management, I would invite you to outline to the committee progress in implementing that change and how you assess the direction that that is taking.

**Mr PASCOE** — Thank you very much for that question. There are a number of dimensions to our in-house management program. The first and I believe probably most important is the development of those strategic asset allocations on an individual basis with our clients to reflect their client objectives and the nature of their liabilities. I would again come back to the decisions that were made around the strategic asset allocations to diversify the portfolio into other asset classes, increasing the inflation-linked component of their portfolios and reducing the amount invested in equities generally. Over that period under review that contributed by our calculations to approximately a $700 million benefit compared to what it would have been if no change in the strategic asset allocation decisions had been made. I think that is a significant achievement regarding the in-house management capability.

When it comes to the actual implementation of those strategic asset allocations on behalf of clients, in some asset classes we have embarked on managing those assets internally. That would include the management of some infrastructure investments. As a result we have built our investment team significantly over the period to fully support those investments and to allow us to make additional investments going forward. So infrastructure is an asset class that we do manage internally. We have also been undertaking a program of building our capability to manage Australian shares, the top 50 companies, on an internal basis. That has been progressing very, very well.

Our motivation in doing that is that we believe we can achieve good outcomes for our clients and actually do those at a lower cost than paying external managers to manage those assets for us. All those in-house programs that we are undertaking are consistent with industry best practice on a global basis. We are looking at similar organisations around the world and effectively benchmarking ourselves against those, learning from those experiences and to some extent looking to replicate their structures to deliver best practice to our clients in Victoria.

**Ms BROAD** — The annual report outlines that over the period covered by the annual report this task involved the migration of some $14 billion of assets, which is a very sizeable task indeed. Can you indicate for the benefit of the committee what was the impact on the operation of the organisation in managing that task? The report indicates that the first phase was in place by 30 June, which was a good date.

**Mr PASCOE** — Yes. It was indeed a very busy period. The bulk of that $14 billion of assets was really related to changing that strategic asset allocation mix across the period. It was a significant undertaking from the investment team and also all parts of VFMC's business — the legal and compliance department and the operations department. It was very much a team effort and one that was very well executed by all parts of VFMC's business. Again, that change in the strategic asset allocation mix has had a very significant benefit for our clients in aggregate over that period. We believe and we are proud to say that those efforts have resulted in benefit for our clients and that is ultimately what we are here to try to do.

**Ms BROAD** — You have referred a couple of times to the performance relative to the previous way of managing clients' assets. Can you just outline in a bit more detail those comparisons in terms of the outcomes that have been achieved?

**Mr PASCOE** — Sure. I think the key benefit has been in reducing the exposure in the portfolio to the equity markets, which have suffered significant declines, but also increasing the inflation component in portfolios to more closely align the portfolios that we are running to the nature of our clients' liabilities. Pension payments and so forth tend to have an indexation component to their payments, so that $100 being paid today is linked to inflation to protect the purchasing power of that $100 for our retiree. When we are constructing client portfolios we need to try to reflect the nature of those ongoing obligations into the future. I come back and say that the key benefit has been diversifying into alternative asset classes, away from the equity markets which have suffered some fairly significant falls, as everyone would be aware.

**Ms BROAD** — Could I ask what has been the reaction of the clients you have listed there to the changes, the impact on them, to the extent you are able to divulge that?

**Mr PASCOE** — Sure. I believe the clients have been quite supportive of the developments within the VFMC model. It would be disingenuous of me to say that clients are happy to be achieving negative returns in any period, but it is the way in which we are structuring the portfolios on a long-term basis that is important, reflecting the nature of the clients' liabilities. We are doing our best to interact with our clients to explain the results that have been achieved. They are broadly supportive of developments of VFMC, understanding that the general financial and economic environment has been very challenging and that compared to other comparable funds in the marketplace VFMC is actually doing a relatively good job, compared to the results being achieved by other funds in the marketplace.

**Ms BROAD** — Perhaps finally, in order to make this transition and build this capability internally, it has clearly had an impact on the internal resources that VFMC has required to deliver this work. Can you outline for the benefit of the committee just what the impact has been in terms of the capability that VFMC has had to put in place in order to implement this very significant change to operations?

**Mr PASCOE** — Indeed. I think it is a very important point to understand. Not all the benefits are actually tangible. We have added to the head count over the period of review, increasing the number of investment professionals in particular from 19 to 30. But managing assets internally also places additional requirements on the legal and compliance components of our business and the operations side of things. We have needed to proportionally grow all parts of VFMC's business, increasing the head count from 44 at the beginning of the period to 67 at the end. So there is a significant increase in personnel required to undertake those management programs as well as investments in systems and data to support all of that.

I believe that managing assets internally also gives you very powerful insights into what is happening in the world but also in terms of your interactions with external managers as well. When you are running portfolios internally and seeing how individual companies are behaving, how price activity is occurring within the marketplace, whether markets are liquid or illiquid, all of those sorts of insights that you gain from actually managing money internally within VFMC give you an exponential benefit in terms of your interactions with the rest of the marketplace. So through external managers, the brokers who help transact in the marketplace for us, and also provide research and other services to VFMC, we are able to access ideas that we can incorporate or synthesise into our own views of the world in shaping portfolios for our clients that reflect the best investment views and resources available on a global basis. It has been a great result and therefore a benefit to VFMC, in my opinion.

**Mr BARBER** — What is VFMC's attitude or policy in relation to proxies' votes on resolutions at AGMs — the sorts of governance and CEO remuneration matters that come up from time to time?

**Mr PASCOE** — I might pass that question across to Mr Ashbolt, who leads our internal efforts in those programs.

**Mr ASHBOLT** — VFMC in Australian equities in particular votes all its shares in the ASX 300, so for the top 300 stocks in Australia VFMC will vote on all the resolutions. To vote we take advice from two independent, external advisers. Generally our preferred stance would be to vote with the directors and management. Ultimately the directors and management have the best insights into the management of the company and the running of the company, and the directors are charged with that oversight. However, there are times where the advice we receive is, or our view is, we need to take a counter view. We take the advice from the two external advisers. If they are in agreement either, say, to vote against a director's resolution, we will generally follow that advice. If they are split — one is for and one is against — then we will form our own independent view.

**Mr BARBER** — A different question: what would you call your MER for each of these investments, and who would we best compare you with if we wanted to benchmark that?

**Mr PASCOE** — Our MER is our management expense ratio, which includes a number of components: the costs of VFMC; the fees that we pay to external managers for delivering their services. As outlined in the annual report, our MER for the period under review was approximately 0.55 per cent, or 55 basis points. We believe that is reasonably competitive in the marketplace, and we do compare ourselves with a variety of other organisations.

**Mr BARBER** — With industry super funds?

**Mr PASCOE** — They operate a slightly different model to us, but we are mindful of the impact of our MER on client outcomes. However, for example, through the period we believe the 2 per cent benefit through our diversification of the overall portfolio was a significant benefit to the clients. We look at things on a net of fees outcome, so that 2 per cent benefit versus the cost is still a significant benefit to our clients.

**Mr BARBER** — You are just a bit like a big industry fund, and a lot of what you are running here are really industry funds, so are they not the best comparators really? I can pull my super out of one thing and stick it into another one as an individual.

**Mr PASCOE** — Individuals will make those comparisons. We make a number of assessments around what we think is industry best practice, and we are managing a number of programs internally on a long-term basis. We think that is the right thing for us to be doing, and that will help us to deliver some very good outcomes for our clients over the long term.

**Mr ASHBOLT** — If I may just add something there, one of the big determinants of the MER, the management expense ratio, is your asset allocation. Our clients are long-term investors — —

**Mr BARBER** — Because of transactions costs or — —

**Mr PASCOE** — No.

**Mr ASHBOLT** — No, partly, but also if you invest in Australian equities, for example, and you invest on a passive basis — you just want to buy it relatively cheaply — you can just get exposure to the market and you will ride the volatility of the market up or down. If you invest in unlisted markets or private markets or whatever, then it changes the fee ratio. Our clients are long-term investors. That is one of our key advantages that Mr Pascoe alluded to and spoke of before. We can take advantage of that long-term nature and invest in assets that will realise its value over a longer period, and part of the 2 per cent additional value that Mr Pascoe spoke of was that change in the mix from selling our Australian equities and moving into inflation-sensitive assets that provided that 2 per cent extra return to our clients.

So to come back to your direct question 'Are we comparable to industry funds?', it depends on the asset allocation mix. That will be the biggest determinant, or one of the biggest determinants, between one fund and the next on what your cost base is. Our clients are long-term investors — insurance clients, defined benefit schemes — different to an industry fund or defined contribution scheme that has a different liquidity requirement and therefore a different asset allocation mix.

It is very hard, even watching the advertisements on television, to compare apples with apples between the for-profit and industry funds — riding up escalators and down escalators. It is very hard to get a true picture.

**Mr BARBER** — So if you were to be rated by *Personal Investor* magazine, there would not really be a table for you?

**Mr ASHBOLT** — Not really, I would not think, because it is apples and cricket balls. It is chalk and cheese.

**Mr BARBER** — You are saying you are unique in the financial world? That is fine. One final question if you can answer it: the different boards that you are assisting have objectives such as CPI plus 5 per cent or average weekly ordinary time earnings plus 2 per cent. Do they just come up with that and you try and achieve it? Or given that we have some varying approaches there for things that effectively all come back to the taxpayer eventually, what is your role? Do you have a view on that sort of thing?

**Mr PASCOE** — Those objectives are typically driven by the nature of the clients' liabilities and the obligations that sit with those, so if the liabilities are linked to CPI or average weekly earnings, that will typically frame the type of objective that gets passed to us by our clients' boards.

**Mr BARBER** — So it is just passed on?

**Mr PASCOE** — With a full understanding of where it is coming from — the liability nature — and our job is to try and develop a strategy that best suits that sort of return objective but also the risk tolerance of that institution as reflected by its board.

**Mr BARBER** — I guess I am seeing a bunch of firefighters and ambulance officers here, and then I am seeing a bunch of parliamentarians, and they have some different risk tolerances. Is that what you are telling me?

**Mr PASCOE** — Yes.

**Mr HAWKES** — Mr Barber, the benchmarks are not invented by VFMC. They are put to us by our clients, and they decide what is the best benchmark for us to achieve so that they can meet their liabilities in the long term. It is hard for us to comment on whether it should be average weekly or ordinary time earnings or CPI, and it is very hard for us to comment on why it should be 5 per cent or 4 per cent. It is not our role to do that.

**Mr BARBER** — Sure, but then there are a lot of ways to skin a cat, aren't there? In some ways you do want to know why they came up with that because there are a lot of different ways you can deliver?

**Mr HAWKES** — Yes, absolutely, and as Mr Pascoe was saying, we have a fairly good understanding of how they have determined those, but then it is up to VFMC to achieve those.

**Mr KAVANAGH** — I would like to thank you for coming in this morning and presenting. In the presentation you gave us you have the Treasurer's vision for VFMC, which includes 'delivering superior investment outcomes'. What do you regard as 'superior'? What is your view of 'superior'?

**Mr HAWKES** — The answer to your question is in the results. The results have shown that we can achieve long-term performance in the top 25 per cent of funds managers in similar framework to ourselves. It is hard to get like for like because we are managing a varied group of clients in terms of insurers and superannuation, but in that we have achieved in the top quarter of funds managers, we think that is something to be proud of and something that is worth maintaining.

**Mr KAVANAGH** — You have told Mr Barber that you cannot really compare your performance with others though, haven't you? There is no table.

**Mr HAWKES** — Sorry, I missed the question.

**Mr KAVANAGH** — You have just told Mr Barber that there is no way of comparing your performance with any comparable organisation?

**Mr HAWKES** — In terms of the management expense ratio, we believe that is true. We believe management expense ratio is a matter for our client satisfaction.

In terms of measuring funds performance over time, there are funds in the marketplace that we will try and benchmark against; it simply is not pure, but we do claim — and I believe quite rightly from the board's perspective — that we are in the top quarter of respondents.

**Mr KAVANAGH** — But you have said that your performance in that respect is a little lower than the average, achieving 10.48 per cent in comparison with the comparable universe of managers — whoever they are — achieving 10.66 per cent.

**Mr PASCOE** — Over that five-year period, that is right, but over the three-year period the result is ahead of the average manager. It is very period-specific and so what we endeavour to do in working with our clients is take a very long-term approach to reviewing performance numbers relative to their objectives.

As I said in my remarks, I feel comfortable within a very strong period that the 10.5 per cent return compares very favourably to a CPI plus 5 per cent type of objective. If you were to take an average CPI of something in the order of 2.5 per cent, that is a 7.5 per cent return, so we are, broadly speaking, comfortable with what is a very slight lag relative to the average manager during those periods whilst trying to be conservative in a very challenging environment.

**Mr KAVANAGH** — You have also said that you think you maximise your advantages of scale and access to the world's best investment views and resources.

**Mr PASCOE** — Yes.

**Mr KAVANAGH** — What are the word's best investment views and resources? And how do you decide who they are?

**Mr PASCOE** — That is an excellent question. We listen to many, many people. There are reputations — obviously very important — so we listen to implicitly the views of others regarding which firms, in terms of investment management, in terms of research capabilities et cetera are leaders in their field, and we certainly seek to engage with those and compare their views with other views in the marketplace and the views of our own internal team.

So it is generally something that is very difficult to quantify, but success over a long period of time and a very strong reputation would be key ingredients in terms of our definition in that regard.

**Mr KAVANAGH** — In one 12-month period, between 30 June 2007 and one year later, you increased your staff by more than 50 per cent.

**Mr PASCOE** — Yes.

**Mr KAVANAGH** — You explained why, but can you tell us how you assess whether that was the correct thing to do or not, and whether they have performed to justify that extra expenditure?

**Mr PASCOE** — Sure. It is a significant undertaking, as in terms of changing the investment portfolio, adding people into VFMC's business, is an incredibly important undertaking. So the senior management team and our human resources area have done a great job in identifying good people to bring into the organisation to match the objectives of the organisations — the diversifying of the portfolio to include other asset classes that we can invest in to result in more diversified portfolios.

That is a very important initiative and we believe that that has been successful for clients, as indeed are the operational aspects of our business. We need to support all parts of our business appropriately, and we need to add people in order to do that.

**Mr KAVANAGH** — You need the people to do that, but how do you assess their performance?

**Mr PASCOE** — Individuals have — —

**Mr KAVANAGH** — Not so much individuals, but the wisdom of that decision to increase your staff by more than 50 per cent — how do you decide that that was a good decision and it was worth doing that?

**Mr HAWKES** — Ultimately I would say it is down to portfolio performance for the clients — how well did the Victorian Funds Management Corporation perform before they changed, and afterwards? The results that are coming through for the one-year and three-year term are looking very, very good. The 5 and 10-year term is looking to be average compared with market, and that is what you would expect when you are using an average of fund managers to manage your funds. You are dispersing the returns, effectively, across the industry.

So at the early stages — and we reiterate, we are more concerned about long term — in a very stressed global market, it is working well. The board is remaining very cautious at the moment, given the uncertainties in the market, and we all become nervous of negative numbers. But it looks at the moment to be very comforting, this decision to change.

**Mr KAVANAGH** — Thank you. Could I just ask: this comparable universe of managers that you mentioned, who are they?

**Mr PASCOE** — They are not named individually. Surveys typically aggregate a number of different participants and calculate summary statistics. So these are comparable, in this case, Australian institutions.

**Mr HAWKES** — And in fact survey companies make their money by averaging the data so that individual numbers are protected to individual entities, so we would not know in most cases.

**Mr KAVANAGH** — So this would be the equivalent of the VFMC in New South Wales or other states, would it?

**Mr PASCOE** — It is a broad base of funds in the marketplace with broadly similar strategic asset allocations. So it is difficult to identify — —

**Mr KAVANAGH** — In Australia?

**Mr PASCOE** — Iis provided for illustrative purposes.

**Mr ASHBOLT** — And the source for the data is Intech, which is an independent company; it is an independent asset consulting firm that publish their performance data.

**Mr KAVANAGH** — Do they publish who the other comparable managers are?

**Mr PASCOE** — If you buy their survey.

**Mr HAWKES** — They do not like the survey participants to be disclosed outside of those who have bought the survey.

**Mr KAVANAGH** — Thank you.

**Mr GUY** — I have a couple of quick questions in relation to the VFMC's relationship with government. I am interested in the processes that you have in place in terms of reporting the performance of the funds you are managing to the government, to the Treasurer and to the Premier. Is there a process that you have in place?

**Mr ASHBOLT** — I can go first. We report through the Department of Treasury and Finance and provide them with quarterly and monthly performance data, as we do to our clients. So we report to our clients formally each month and quarter, and present to them, and to DTF we also provide similar performance data; and we will meet with DTF officials to review the operations of VFMC.

**Mr GUY** — Do you meet with the ministers officers directly?

**Mr ASHBOLT** — I have from time to time, yes.

**Mr GUY** — And with the ministers chief of staff?

**Mr ASHBOLT** — Yes.

**Mr GUY** — The Treasurer's chief of staff?

**Mr ASHBOLT** — Yes, some — —

**Mr GUY** — Do they request copies of those monthly updates as well?

**Mr ASHBOLT** — No.

**Mr GUY** — So they go straight to the department?

**Mr ASHBOLT** — They go through to DTF.

**Mr GUY** — The Treasurer's office would have those, and the government would obviously have those through the department; the department would have those, fair enough. Presumably it is right. Do they have any feedback to you, or does the government directly have any feedback to you about the investments that the VFMC is making?

**Mr ASHBOLT** — No, and I should just expand on what these reports actually cover and the detail. Consistent with what Mr Pascoe spoke about on what we are trying to achieve, which is the total portfolio performance, the reports to our clients and to DTF are at the total portfolio level. We report to DTF on the total portfolio performance for what we call the Treasury clients — the clients that have performance data shown here.

We will provide information on an aggregate basis, as a total we have provided some data here on the aggregate asset allocation — aggregating all of those; we provide those. We do not provide information on specific investments. We do not delve into what our holding is in BHP or National Australia Bank et cetera. That is not the level of detail that we report to DTF. Certainly I have not had any discussions whatsoever in that regard with anyone from the Treasurer's office.

**Mr GUY** — What is the time period of the update? What is the most recent one? How soon after do they provide those updates back to the government? Is January 2009 coming in on 1 February?

**Mr ASHBOLT** — What is the speed? Generally the way the cycle goes we will report to our clients on a quarterly basis, which is the more detailed; the monthly ones are brief. But the quarterly ones are generally around the end of the next month, so we are in the process now of reporting to our clients. There are client reports, which are done first. The process is we will report to our clients first. Those reports went out at the end of last week, and we will meet with our clients to review the reports and the performance over the next few months.

**Mr GUY** — So the March updates went out last week?

**Mr ASHBOLT** — To our clients; the DTF report has not yet been done. It generally runs about week 6 after quarter end, thereabouts, and that is when we start getting the aggregate performance figures.

**Mr GUY** — For the quarterly aggregate?

**Mr ASHBOLT** — Yes.

**Mr GUY** — In terms of the performance material that is going to government — does government have feedback to you as to what is happening? Is there a process where government provides feedback to VFMC? Or is there never feedback from government to VFMC about its investments or about the performance of investments?

**Mr HAWKES** — Chair, I am just wondering whether we can align Mr Guy's questions with the 2007–08 year, which is the subject of the — —

**Mr GUY** — You can do that, or you can come back in seven weeks and we can do it all again for another day.

**Mr TEE** — If the committee chooses to ask him to come back.

**The CHAIR** — Mr Guy's question relates to operations of the VFMC — —

**Mr GUY** — Over the last year and the next year current.

**Mr HAWKES** — I would just like to make sure that we are answering the question — —

**The CHAIR** — If you would like to answer in the context of 2007–08, please do so.

**Mr HAWKES** — Fine.

**Mr ASHBOLT** — Sorry, I have forgotten the last question.

**Mr GUY** — Okay, if that is the case — what is the process that you have in terms of contact with the Treasurer's office and the Premier's office, and those offices giving you feedback on your investments?

**Mr ASHBOLT** — There is no process; there is no feedback.

**Mr GUY** — There is no feedback ever from the Treasurer or the Treasurer's advisers about investments made by the VFMC or its performance?

**Mr ASHBOLT** — The way the process works is that our feedback is through the Department of Treasury and Finance. We provide written reports to them. We have regular dialogue with the Department of Treasury and Finance. There are discussions at times with the Treasurer's office on the broader operations of the VFMC — I presume at the board level as well — but on investment matters, no, there is not a process for us to brief the Treasurer's office. There is no feedback from the Treasurer's office to us on investments; it is through the DTF.

**Mr GUY** — With hundreds of millions of dollars in investments they give you no feedback whatsoever about performance?

**Mr HAWKES** — Is that a question, Mr Guy? I am struggling with the question.

**Mr GUY** — It was not actually addressed to you, Mr Hawkes; it was addressed to Mr Ashbolt.

**Mr ASHBOLT** — I suppose it is open to the most appropriate person.

**Mr GUY** — If that is the case, we will open it all up to all of you, if you like. Are you saying that the Treasurer's office gives you no feedback whatsoever on your investment portfolio?

**Mr HAWKES** — Correct.

**Mr GUY** — I take it you were on the board — —

**Mr HAWKES** — In terms of individual investments?

**Mr GUY** — I take it you were on the board when Mr Leo de Bever was employed.

**Mr HAWKES** — Yes, that is correct.

**Mr GUY** — He became Victoria's highest-paid public servant. We were talking before about $750 000. When Mr de Bever, who had a good career overseas, resigned and stated there was too much interference from the Victorian government, he was making it up?

**Mr HAWKES** — I cannot comment on Mr de Bever's thoughts.

**Mr GUY** — It seems extraordinary that he would make that claim and then you would sit before this committee and say there is no feedback from the Victorian government to the board nor its senior officials in relation to the performance of the VFMC. I simply ask: is there feedback from the government or its Treasurer or its ministers in relation to the performance?

**Mr TEE** — You have asked that three times now.

**The CHAIR** — Mr Tee — —

**Mr GUY** (to Mr Tee) — Listen, are you asking the question or am I asking the question?

**The CHAIR** — Mr Guy, Mr Hawkes is answering the question.

**Mr HAWKES** — In relation to the communications between the government and Victorian Funds Management Corporation, we provide performance reports through the Department of Treasury and Finance. We presume that those are presented on to the Treasurer. The Treasurer has the right to get in touch with us and talk about those performance reports whenever he or she decides. In terms of individual investments, I can say that there is absolutely no control or direction coming from our responsible minister back to us.

**Mr GUY** — Feedback?

**Mr HAWKES** — Can you describe 'feedback' to me? Do you mean a general commentary?

**Mr GUY** — When the Treasurer picks up the phone to you and says, 'This is going well. This is not going well. Can you give me an update on X, Y and Z in your portfolio?'.

**Mr HAWKES** — There may well have been such conversations of a general nature on how well we are doing. But in terms of specific discussions, giving any sort of directions to Victorian Funds Management Corporation on its role as a manager of assets, the Treasurer does not do that.

**Mr GUY** — At the risk of coming around in circles yet again I will pause, and I will come back, Chair.

**The CHAIR** — Thank you, Mr Guy. It is 11.30; we are halfway through the hearings, so I propose to break for 5 or 10 minutes, and then we will resume with Mr Tee's questions.

**Hearing suspended.**

**The CHAIR** — We will resume with questions from Mr Tee.

**Mr TEE** — Thank you for making yourselves available today. I want to start by following on, I suppose, from the questioning that Mr Barber took us to in terms of the approach by your various clients who will come to you and say that the nature of their work is such that they need a return — whether it is CPI plus 4 per cent or CPI plus 5 per cent or average weekly earnings plus 4 per cent, as in the case of WorkSafe. My interest is in the next part of the decision-making process. Once you have decided what the outcome is, that then involves a greater or lesser risk in terms of the investment you need to allocate that money to in order to get the returns. Is there then a dialogue with the client in terms of where in broad terms you will invest their funding and what the risks are of putting them in that? I suppose I just want to get a sense of how that is played out and the role that you have and the role that the clients have got in terms of that decision in where to ultimately invest it.

**Mr PASCOE** — Absolutely. I believe it is very much a partnership. It is important to go through a discussion up-front in terms of understanding the investment objective and the nature of the liabilities, what it is that we are trying to achieve, and for the clients to embrace the approach that we propose to them in the management of their assets. So it is a detailed discussion, to go through the nature of the different asset classes that are being invested in and understanding of various aspects, our forecasts regarding the likely returns on those investments but also a key understanding of the volatility or, as people would typically say, the risks associated with making investments into those asset classes.

We make those investments on a long-term basis, but we also need to understand that on a day-to-day, week-to-week and month-to-month basis markets are volatile and we make sure that the clients understand the nature of those investments as a key part of the process. Then our reporting back to the clients also relates to the objectives and the performance that is being achieved.

**Mr TEE** — I suppose, then, that there is a measure in terms of your success and that is on a client-by-client basis — and you have that there.

**Mr PASCOE** — Indeed.

**Mr TEE** — The other measure, I suppose, is a comparison then, which you have provided, of your overall performance and that of the industry. It strikes me that there is a slight disconnect. The question is: would your clients be more conservative, in the sense that in the good times they want to take risks but they do not want to be pushing the envelope too far, in the sense that they do not want to be too far ahead of the pack in terms of the risk that you take, but in the bad times they would not want to lose as much? Are they prepared to cut back on the gains, provided that when the bad times come the losses are not as great? Am I describing it?

**Mr PASCOE** — I believe that is a fair characterisation, yes. In aggregate, it is a generalisation, but it is a fair characterisation, yes.

**Mr TEE** — It is for that reason that the five-year performance, which reflects I suppose that boom time or thereabouts, is slightly under the market would not be something that would concern your clients?

**Mr PASCOE** — No.

**Mr TEE** — Because ultimately, when the down time comes, you are ahead of the pack?

**Mr PASCOE** — That is right.

**Mr TEE** — So in summary I suppose the outcome there in terms of your performance really reflects where your clients would like to place themselves in the risk allocation?

**Mr PASCOE** — Yes, correct

**Mr TEE** — The other question is that in going through the report I noticed that you had signed the UN Principles for Responsible Investment. I am wondering what that involves and what impact that has on your decisions in terms of where you invest?

**Mr PASCOE** — I might ask Mr Ashbolt to describe the UNPRI and the VFMC's involvement there.

**Mr ASHBOLT** — The VFMC signed the UNPRI in July 2007. The UNPRI, the principles for responsible investment, are an initiative of the UN that was started in 2005. It was developed on the premise that for institutional investors worldwide there is a growing body of evidence or growing support of evidence that corporate behaviour — environmental, social, governance — does play a part in shareholder return.

It is very hard to quantify, and it is very hard to be time specific, but better governed companies should perform better than poorly governed companies. I suppose it is as simple as that. The UNPRI is a statement of intent. It shows us as an institutional investor with the intent that we will actively encourage the promotion of the principles that companies should behave responsibly across the ESG, or environmental, social and governance issues.

There are a number of institutions both within Australia and globally that have signed it. I think there were over 350 institutions that have signed the UNPRI. With regard to what it imposes upon us, it is a statement of intent. It is not prescriptive. It does not mean 'You will do this'. It is a statement of our principles that we support the initiatives of the UNPRI. There are six broad principles, and I can quickly run you through them or perhaps I can forward you a statement. It is available on the website if you do want to see them, or I could perhaps forward them to the committee in the fullness of time.

**The CHAIR** — Thank you.

**Mr ASHBOLT** — But they are a statement of intent. Broadly it is about communicating our practices, what we are doing and promotion of the practices. For ourselves we report to our clients on what we have done under the UNPRI each quarter, under the six principles. It deals with proxy voting, that we as an institutional investor should vote our shares, rather than just delegating them back to management to vote — that we should actively vote our shares.

The UNPRI is, I think, an important statement. It does not dictate our investments. It does not mean we will invest in this company and not that company, but it means we want to engage with corporate Australia and globally about improving their practices, because we have the view that, as I said up-front, a better managed company will deliver longer term shareholder returns.

**Mr PASCOE** — If I might add, it is consistent with our objective of being a centre of investment excellence and benchmarked to global best practice.

**Mr TEE** — The other question I have is that on page 7 of your presentation you talk about Custodian; just for my benefit are you able to explain who or what Custodian is and what they do?

**Mr DAVIDSON** — Custodian is National Custodian Services, which is a division of National Australia Bank. They are primarily the custodian of all our clients assets, and they provide other services such as performance reporting and process and settle all transactions.

**The CHAIR** — Thank you, Mr Tee. Mr Pascoe, on page 39 of the annual report you have a table setting out funds under management as at balance date. Are you able to give the committee an update to 31 December 2008 of that table?

**Mr PASCOE** — I am prepared to do so, yes. Sorry, the date was 31 December?

**The CHAIR** — Yes, the end of the calendar year.

**Mr PASCOE** — It is $32 billion.

**The CHAIR** — And you will be able to give us a breakdown by client in due course?

**Mr PASCOE** — Yes.

**The CHAIR** — I would like to go back to an issue that was raised by Mr Guy about the relationship between government and the VFMC. I guess maybe Mr Hawkes is the best person to answer. Documents released under FOI show that on 14 July 2007 the Treasurer, who was then John Brumby, wrote to the VFMC requesting that global life settlements be included as an addendum in the IRMP. I understand that not long after that the VFMC made its investment in Life Settlements Wholesale Fund, otherwise known as the death fund. Would it be normal for the Treasurer to write such a letter to the VFMC, making recommendations like that?

**Mr HAWKES** — I do not have the letter in front of me, I am sorry, but would you — —

**The CHAIR** — I do not either.

**Mr HAWKES** — I am not alert to the specific wording of it, Chair, sorry.

**The CHAIR** — The brief from DTF — I think this is from DTF — is that a 14 July 2007 letter from the Treasurer, then John Brumby, to the VFMC requests to include global life settlements as an addendum in the IRMP (investment risk management plan) which, as I said, preceded the VFMC's investment in that particular product. I was just wondering is it normal for the VFMC to receive — particularly in the context of the discussion we had with Mr Guy before — for the Treasurer to make such recommendations?

**Mr HAWKES** — As I say, I am struggling a bit because of not having that letter in front of me. Is there some way we can come back to you on that when we have a look at it?

**The CHAIR** — Yes, if you are happy to take that on notice and the circumstances of that correspondence.

**Mr HAWKES** — Yes, I think so. I think it would be best, because then we can give you an informed answer. I think that would be best.

**The CHAIR** — Thank you. I want to go to a matter raised by Mr Barber in relation to the voting of proxies, the voting of shares and securities held by the VFMC on behalf of clients, and Mr Ashbolt spoke about that earlier. Again, documents we have received under FOI from the VFMC show where the VFMC has elected to vote its entitlements. There is a recommendation from management, and then there is the actual vote which may not be the same as the recommendation from management. Can you outline the circumstances where a vote could be taken which does not reflect the recommendation from management? Is that a board decision?

**Mr ASHBOLT** — No, it is a management decision. The VFMC will take advice from two external advisers.

**The CHAIR** — Yes.

**Mr ASHBOLT** — They are CGI Glass Lewis and RiskMetrics; they are independent. CGI Glass Lewis is a global organisation; Riskmetrics is more a domestic organisation. They are specialist proxy voting advisers, and they provide advice to a number of Australian and international institutions. They will have dialogue with the company, and they will put forward a recommendation on each of the resolutions. Our policy is that if both advisers are in agreement — for example, they are against the resolution being put forward by the directors — then the recommendation is to vote against the resolution. Generally, we will follow that.

**The CHAIR** — I understand that.

**Mr ASHBOLT** — If they are split — one is for and one is against — then we will form our view, and that will be done by a number of people within VFMC. We will then enter that into the system and the process will follow. We will then lodge it, and it may be either for or against depending on the specifics.

**The CHAIR** — There is a column here that refers to management recommendation. What exactly is that?

**Mr ASHBOLT** — Sorry?

**The CHAIR** — These are the documents setting out individual resolutions for each company and how VFMC voted.

**Mr ASHBOLT** — Okay, yes.

**The CHAIR** — There are two columns; one is 'management recommendation', and the other column is 'how voted'. There are some instances where they are not the same.

**Mr ASHBOLT** — Right, yes.

**The CHAIR** — I am seeking to understand what each column is.

**Mr ASHBOLT** — Okay. The first column would be management of the company, and the second column is how VFMC has voted.

**The CHAIR** — Right, so if the item coming up at an AGM was not a management resolution and they chose to vote against it, that would be reported?

**Mr ASHBOLT** — Generally you would find in the first column that they would be for most of them because that is the management of the company. The company is putting forward a resolution to the shareholders for XYZ with the support of the directors and the management. How the VFMC has voted will be in the next column. A lot of them will be 'for', because they are just housekeeping matters.

**The CHAIR** — There is no board involvement from VFMC in how proxies are voted?

**Mr ASHBOLT** — No. There is board involvement in the VFMC policy on proxy voting, but not the specifics on the application of the policy. Individual company resolutions are not put to the board of VFMC.

**The CHAIR** — I raise the question specifically in relation to Rio Tinto where there was a resolution to vote for the election of Michael Fitzpatrick as a director of Rio Tinto at the time when he was, of course, the chairman of VFMC. I understand from your evidence that the decision to vote in support of that resolution would have been made entirely independently of Mr Fitzpatrick. He would have had no input into that decision?

**Mr ASHBOLT** — That would be my understanding, yes.

**The CHAIR** — Mr Hawkes? Do you have anything from a board perspective?

**Mr HAWKES** — The board would not have got involved, and the chair would not have got involved in that decision.

**The CHAIR** — Thank you. Can I ask you about staff recruitment? I assume that is a board matter, Mr Hawkes? In your presentation there was a diagram showing a remuneration nominations committee. What is its function?

**Mr HAWKES** — It consists of non-executive directors of the board. It assists the board in determining the chief executive appointment. It assists the board in the review of chief executive performance, and then decisions are made at board level in relation to the chief executive's remuneration. Of course it does not get involved in appointments to the board because that is a government matter, not a board matter. We do not make decisions about who is on the board and who is not.

**The CHAIR** — That was one of my questions. The board has no role in making recommendations to government as to who should be appointed to the board as you would expect with a private-sector entity?

**Mr HAWKES** — It is quite different to the private-sector entity. The Department of Treasury and Finance would assist the government in finding suitable candidates. They cast far and wide in their search for the most appropriate candidates for any board. Our board does not make recommendations in relation to specific candidates for board membership of VFMC.

**The CHAIR** — In effect the first you know that a particular person is joining your board is when it is announced by the Treasurer?

**Mr HAWKES** — I am trying to think of an example where that is not so, and I cannot think of one, so I would say — —

**The CHAIR** — For example, your new chairman Mr Fraser, who is coming soon.

**Mr HAWKES** — I did not know it was Mr Fraser until there was an announcement.

**The CHAIR** — There is no role for the board in identifying, 'We need a person with these skills' et cetera?

**Mr HAWKES** — Sorry. The remuneration nominations committee assists the board in undertaking performance reviews of the board, and skills mixes are an important component of the board and its composition. Developmental opportunities should also be identified for board members as we progress through time. The remuneration nominations committee would assist the board in identifying development opportunities — call it 'training'. In certain circumstances it might detail to the Department of Treasury and Finance whether we have identified a vacancy for a particular skill. But it is general advice, and it is based upon our annual board performance review.

**The CHAIR** — And it does not extend to proposing names as potential directors?

**Mr HAWKES** — No, I cannot think of a circumstance where the board has ever decided that it should put a name forward. It just does not happen.

**The CHAIR** — And as far as executive recruitment, such as Mr Bone's or the CIO vacancy, for example, what type of process would the board undertake to fill a CEO or that type of vacancy?

**Mr HAWKES** — The board, firstly, makes its judgement on the suitable qualities and skills that are needed and the experience needed in a chief executive for the organisation at its current state and for its planned performance for the future. The board then determines whether external consultants' advice is needed in finding an appropriate person, and then would tender amongst the community of executive search consultants for the most appropriate firm to undertake the services that are required by the board at that time.

That is done on a fully value-for-money basis, and we would then expect that firm to put forward a list of candidates for board consideration, and the board would establish a small panel, and most likely the panel would be the remuneration and nominations committee, to review that list and to conduct some interviews of selected candidates.

**The CHAIR** — Does the board or the committee of board members request that certain candidates be included on the short list by the executive search company?

**Mr HAWKES** — The board does not make such decisions. The board does not put forward nominated persons. It is up to the executive search company.

**The CHAIR** — So the only people you consider as a committee, as potential candidates, will be those identified by the executive search company?

**Mr HAWKES** — Yes.

**The CHAIR** — Does the government play any role in senior appointments, either in being advised of nominations before they are appointed or considering nominations?

**Mr HAWKES** — No, the government does not get involved in that process. The point at which the government does get involved is the conversion of the candidate to a board member, because in our organisation the chief executive is managing director, and directorial appointments are by government, so we will put forward the preferred candidate, and the government does have the right to decline to appoint that person as a director.

**The CHAIR** — Which would be very unfortunate.

**Mr HAWKES** — I will just keep moving on that point! But there is no process or any case in the past where the government has come to the VFMC and said, 'We want a particular person there'.

**The CHAIR** — And in the case of the CIO there is no role for government — the CIO is not a director, ordinarily?

**Mr HAWKES** — The chief investment officer is not a director for the organisation.

**The CHAIR** — So there is no role for government in the CIO's appointment?

**Mr HAWKES** — No — no role for government there.

**The CHAIR** — Is the CIO currently a director, given his acting CEO status?

**Mr HAWKES** — No. That is not so. The position is described as acting chief executive officer, but the director's position for managing director is currently vacant.

**The CHAIR** — How widely would the executive search companies undertake their search? Do you give them a brief as to the extent to which they should be searching for candidates? Is it an international search? Australia-wide?

**Mr HAWKES** — It does depend on the circumstances.

**The CHAIR** — Top level, for example.

**Mr HAWKES** — Top level position — it is the case that our former chief executive, Mr Sydney Bone did come from overseas. He was an Australian, but came back to Australia to join our organisation. So there were conversations between the executive search firm and Mr Bone in his overseas place, which was Hong Kong. So those conversations do occur.

**The CHAIR** — And indeed Mr Pascoe was ex-Hong Kong?

**Mr PASCOE** — I also came from overseas, yes.

**The CHAIR** — And you are under way with the current process for a new chief executive?

**Mr HAWKES** — Very early stages, Chair. I am not aware whether an executive search firm is having conservations overseas or locally at the present time. I cannot comment on that because I do not know.

**The CHAIR** — Can I ask about the VFM trusts as reported? Where do they fit within the context of the other investments you hold for clients? What are the trusts used for?

**Mr PASCOE** — To provide efficient access to various investments for our clients on a pooled basis.

**The CHAIR** — Right. So other investments are held specifically for individual clients, is that correct?

**Mr PASCOE** — Yes.

**The CHAIR** — But under the trust structure several of your clients will have a common interest in particular investments?

**Mr PASCOE** — Yes, and we have made a determination that that is the most effective way for the clients to access those particular investments.

**The CHAIR** — What type of investments would be included in the trust versus those held directly? What distinction?

**Mr PASCOE** — For example, the names tend to be a fairly good indication of what is in the trust; so there is the emerging markets trust which is a conglomeration of several mandates with emerging markets managers; small companies trust is similarly a way of providing our clients with access to global small cap managers.

**The CHAIR** — And the infrastructure funds— you have renamed those?

**Mr PASCOE** — Yes.

**The CHAIR** — Why is that?

**Mr PASCOE** — From infrastructure to?

**The CHAIR** — To investment trusts, from infrastructure 1 and 2 to investment 1 and 2?

**Mr PASCOE** — Yes, the underlying assets have not changed. It is just a renaming of the trust. There is no material reason for doing that.

**The CHAIR** — So in terms of the overall portfolio mix they would still be counted as infrastructure assets?

**Mr PASCOE** — Broadly speaking, yes.

**The CHAIR** — Notwithstanding the change in name?

**Mr PASCOE** — Right.

**The CHAIR** — What is VFMC's policy, in terms of board policy, with respect to investing in Victorian government projects — PPPs and the like?

**Mr HAWKES** — I think that is up to the chief investment officer, Chair, because it is up to the investment officer to make decisions on what are the most appropriate investments broadly. Did you want to — —

**The CHAIR** — There is no board position on that?

**Mr HAWKES** — There is no policy that says we should or we should not. It is a board policy to ensure that the investment officer is recommending the most appropriate investments for our client liabilities. If you would like a little more, I will defer to Mr Pascoe.

**The CHAIR** — Yes.

**Mr PASCOE** — There is certainly no directive to make investments in those types of projects. We evaluate the investments that come to us from various investment banks, various proposals that come to us, and we evaluate each of those on their merits and evaluate them considering the client's objectives, their liabilities and the permissible investments that we can make under our guidelines.

**The CHAIR** — The guidelines being from the client?

**Mr PASCOE** — Yes.

**The CHAIR** — What is the VFMC's exposure to government-related projects — PPPs and the like? Which projects are you invested in?

**Mr HAWKES** — I am sorry, Chair; I might appear to be a broken record here, but we are very cautious on talking about individual investments because of client agreements and funds manager agreements we have, and in terms of us being a very major investor in this marketplace, and market-based information can be very important to us as proprietary information. So I am just a little bit cautious on moving into the area of individual investments. I do not want to be obstructive; it is just the way we have got to operate.

**The CHAIR** — A major investor in Victorian government projects though? You said 'as a major investor' — —

**Mr HAWKES** — I am sorry — —

**The CHAIR** — Would you include Victorian — —

**Mr HAWKES** — I do not want to be led too much on whether we are or we are not. If we are, then it was an independent decision made through our investment processes through the executive staff.

**The CHAIR** — Mr Hawkes, these are some matters where the committee may reserve its right to come back to in closed session just to seek further information.

**Mr HAWKES** — Yes, absolutely.

**The CHAIR** — But at this time I will not pursue that. I would like to ask you about a couple of historic investments though that VFMC undertook, one of which was in Transurban and CityLink at the beginning of the financial year, where in the space of a month, according to the disclosure to the ASX, VFMC acquired around 25 million securities, which was nearly a doubling of your holding, at one particular time. Roughly at the time the securities peaked, at around $8, you suddenly, very quickly doubled your holding. Why was that? What is the background to that investment? I understand you have largely disposed of that now?

**Mr PASCOE** — Again, our practice is not to comment on the specifics of investment decisions, but at that time we were diversifying the portfolio broadly and there were some significant changes going on within the overall portfolio to, as I have said, increase the inflation-linked nature, so the infrastructure-type exposures within the portfolio, and tilting the portfolio away from equity-type investments.

**The CHAIR** — Another one of interest is Redflex, the red-light camera company. On 23 November, according to your substantial shareholder disclosures, VFMC acquired just under 2.4 million shares to become a substantial shareholder, of 5½ per cent of the shares on issue, which was done in a single day; in fact it was the largest day's trade in Redflex shares in the 10 years it has been listed on the Australian Stock Exchange. Why would VFMC be taking a position like that in a single day? What is the background to VFMC's decision to, again in the space of a single day, double the holding, in such a marked movement?

**Mr HAWKES** — I would very much like to answer your question, because I am sure it is a very straightforward answer, but we cannot answer in the specifics.

**The CHAIR** — Even the historic specifics?

**Mr HAWKES** — I might lean — —

**The CHAIR** — If you can answer — —

**Mr HAWKES** — To the advice of others here, but I am very reluctant to talk about the way in which decisions have been made on specific investments.

**The CHAIR** — Okay. I will not talk about market investments now. I have a couple of others, though, that I would like to touch on. There has been a lot of commentary around VFMC's investment in mortgage-backed securities associated with Members Equity Bank. Can you outline what process surrounded the VFMC's decision in terms of due diligence — whether the board had a role at that stage? If I understand your presentation correctly, in VFMC mark 1 there was a direct role for the board and in VFMC mark 2 there is a lesser role or no role. Could you outline the process surrounding that particular investment in terms of a due diligent process?

**Mr HAWKES** — Might we try to answer your question with the general processes that we have — —

**The CHAIR** — We can start with the general process.

**Mr HAWKES** — And then see where we get to? Would that be suitable and helpful for you?

**The CHAIR** — We are happy to start with the general process, Mr Hawkes.

**Mr HAWKES** — Let us start with the investment decision-making process.

**Mr PASCOE** — As a very large institutional investor we are presented on a daily basis with a variety of different investment opportunities. We have a large team of investment professionals organised by asset class to undertake due diligence on those investments. They are comparing those with comparable investments within their universe in terms of the risk and return nature of the investment. They will look at a variety of different issues, depending on which asset class that particular opportunity is related to and whether that opportunity is going to be managed internally or externally by other managers.

Broadly speaking, the due diligence process is focused on identifying the return that we expect from the investment opportunity and how it relates to the client's objectives and what else is already in the client's portfolio. In terms of specific investments, it may be that the security offers a particularly attractive yield or some characteristics that align themselves quite nicely with the sorts of objectives that a client is trying to achieve or the liabilities that they are trying to match.

Once the specific asset class has undertaken their view of the investment it is subject to peer review within VFMC at the total risk allocation committee, which the chief investment officer chairs, and the other asset class heads discuss the investment amongst themselves to review its investment merits. For some investments the executive investment committee, which is also an internal management committee to VFMC, looks at the opportunity before it proceeds to the investment stage.

There are many levels of review at which the review process can effectively be ceased as an opportunity is deemed not to be attractive or appropriate compared to other alternatives in the space or the objectives that we are trying to achieve. All of this is operating under delegations, from the VFMC board on a day-to-day basis.

**The CHAIR** — Thank you. How do you assess the integrity of an investment — that it is what it seems to be? I mean, you can assess it as an asset class, you can assess whether it fits with client needs and whether its risk return relative to other investment opportunities is acceptable, but how do you actually assess the integrity of a particular investment?

**Mr PASCOE** — That is part of our review process. There are degrees of judgement within that. Our legal department internally plays an important role in that in terms of reviewing the documents. But also having the appropriate expertise within the investment team is a very important part. People who have been experienced with similar transactions within their career is an important part of VFMC's evolution. We believe we have attracted the appropriate people to resource our team, to allow us to undertake that process and therefore undertake those sorts of investments.

**The CHAIR** — You indicated that process operates under delegation from the board. That is under VFMC mark 2?

**Mr PASCOE** — Correct.

**The CHAIR** — And prior, the board exercised those powers themselves — is that correct, under VFMC mark 1? Is that how I understand it, your presentation?

**Mr PASCOE** — Where VFMC version 1 encapsulated investments being managed externally. The typical decision that the VFMC would have been making on investment matters would typically relate to the appointment of investment managers, I believe, but I was not present at that time.

**Mr HAWKES** — I was — I am both mark 1 and mark 2, I suppose. Under mark 1 it was very much the fund of fund managers. We were appointing funds managers, and the board would receive recommendations from our own management on who should manage parts of the portfolio in the external spheres. That changed when we moved to a more direct investment.

**The CHAIR** — Mr Pascoe, in terms of your due diligence process, how does the process manage conflict of interest or perceived conflict of interest such as may exist where a VFMC director is also a director of an entity you about to invest in?

**Mr PASCOE** — We have focused very much on the investment merits of each decision.

**The CHAIR** — Are there Chinese walls between the board and the investment group, if I can use that term?

**Mr PASCOE** — Yes.

**Mr HAWKES** — From a board governance position let me say that the board has a clearly stated declaration of conflicts policy. The company secretary will give some advice to a particular director that there is something that may present a conflict of interest, and they will potentially not receive papers on the matter, andwithdraw from the board meeting by declaring a conflict of interest. There is really a dual layer here with management creating a separation from the board on such matters and the board itself having policy.

**Mr PASCOE** — But the investment team is ultimately judged on the investment performance results that are achieved. Therefore we take each investment decision that we are making very seriously and on a case-by-case basis, judged solely on the investment merits of that opportunity.

**The CHAIR** — In the case of the securities associated with Members Equity, the fact that two directors of VFMC either were or had previously been directors of associated entities of Members Equity — how would that have been handled?

**Mr HAWKES** — If we had that investment — and you may assume that we had; that is an assumption you are making — then both of those platforms of good governance that I have referred to would have applied.

**The CHAIR** — What would that have meant in a practical sense, because, if I understand Mr Pascoe, the decision to invest in those securities, if such a decision was made, would not have come before the board?

**Mr HAWKES** — That is a correct assumption. Management would have made its own decisions under its delegated authorities. If there was a reason for it to come to the board, then directors so conflicted would have withdrawn and would not have been presented with materials to make that judgement.

**The CHAIR** — Do directors and board members at any time engage with management on delegated powers, in terms of suggestions as to how those delegations are to be exercised?

**Mr PASCOE** — No.

**The CHAIR** — The other one, again from a due diligence point of view, that I would like to hypothetically talk about is the VFMC's investment in the Life Settlements fund. There is a lot of material on the public record about the manager of that product, in terms of histories of some of the directors and histories of the predecessor company of that manager being banned by ASIC from capital-raising activities et cetera. How does that factor in the VFMC's due diligence when deciding to invest in that product?

**Mr PASCOE** — It is part of a process that we go through. Without again going into specifics, some investments, for example, may have an ASIC-approved product disclosure statement that could be relevant as part of the due diligence process. But there is also — coming down to the characteristics of the investment — the return and risk trade-off that needs to be made as well. That forms the basis of the due diligence process.

Then in terms of the vehicle that is used, be it direct holdings, be it through a fund, there are a number of different structures that might be used. In the case of a pooled investment, there are often other documents or other relevant materials that could be included in the process as well.

**The CHAIR** — Presumably, though, in that instance, as one director was a discharged bankrupt, another had been banned by the Queensland Supreme Court from giving investment advice and the corporate entity itself had been banned by ASIC from certain capital raisings, surely that would be a red flag if you are considering investing in their product?

**Mr PASCOE** — There has been a history to the directors of the entities, and that has changed over a period of time. A lot of the materials have been bandied about. There are some aspects which are hard facts, but there is also a lot of material that is subjective. It is inappropriate for us to go into specifics of individuals in this forum, I believe. If that is all right, Chair.

**The CHAIR** — Thank you, Mr Pascoe. I am conscious of the time. Do any other committee members have matters they wish to raise?

**Mr GUY** — Yes. I would just like to follow up on the Life Settlements Wholesale Fund, which the Chair mentioned. I wonder if there is any update that you would be able to give to the committee as to the current status of VFMC's investments there?

**Mr PASCOE** — Our practice is not to comment.

**Mr GUY** — Okay. In terms of the process in investing in that fund, is there any comment you can make on the process for that particular investment?

**Mr PASCOE** — Could you clarify the question a little further?

**Mr GUY** — Was this a board decision, was this just the CEO's decision, was this a decision that had been flagged for some time, or was it a short-term decision — the timing, the lead-up to it?

**Mr PASCOE** — I understand. Again I come back to the broadbased restructuring of the portfolio to diversify clients' portfolios, so to invest in a number of alternative asset classes which have had a positive contribution in aggregate to our clients' outcomes. We have investigated a number of investments across a number of different asset classes. There was ongoing research into a number of different areas of investment opportunity on a global basis, and it was an ongoing review process that identified the Life Settlements base broadly as an area of potential investment opportunity.

**Mr GUY** — This investment by VFMC was made in August last year, I understand. What is the process? I think you might have outlined this before, so correct me if I am stating or asking the same thing. In terms of the process of updating government on the performance of this investment, this would have been done on a monthly or tri-monthly basis?

**Mr PASCOE** — Our reporting is based on aggregate performance, so it is part of normal total portfolio updates that we would give to our clients and other stakeholders.

**Mr GUY** — But in terms of what was sent to the Victorian department of Treasury regarding Life Settlements Wholesale Fund, how often would they have been updated about the performance of this investment?

**Mr ASHBOLT** — That specific investment; not on a specific basis to my knowledge.

**Mr PASCOE** — I do not believe on a specific investment.

**Mr GUY** — In terms of correspondence with the government — I know we asked this before, and the Chair made reference to a letter which Mr Hawkes is unaware of — in the financial year, as I know you are only willing to comment on the financial year, how often would there be written correspondence between the VFMC and the Premier and the Treasurer's office?

**Mr HAWKES** — On any subject; anything at all?

**Mr GUY** — Yes.

**Mr HAWKES** — I am sorry, I do not know.

**Mr PASCOE** — With the Treasurer's office?

**Mr GUY** — That is all right. I did not expect you to know off the top of your head.

**Mr HAWKES** — My goodness!

**Mr GUY** — But I thought there might have been an indication as to whether you are regularly in contact with them on a written basis. In terms of phone logs, do you keep phone logs when you speak to them?

**Mr PASCOE** — To the Treasurer's office, no.

**The CHAIR** — If there are no further questions, I have only one question, a contemporary performance question. Perhaps, Mr Pascoe, you can answer just on your recently published December 2008 investment performance results. Can you outline the quarterly result for diversified fixed interests. There is apparently a negative return of 10.8 per cent.

**Mr PASCOE** — Yes.

**The CHAIR** — On the face of fixed interest you would expect it to be — —

**Mr PASCOE** — It has been a very difficult period for the fixed income markets in particular. In terms of the global financial crisis, fixed-income-type securities have been arguably the most severely impacted as a result of the broad global financial crisis.

**The CHAIR** — There is a big difference between benchmark and VFMC's — a substantial difference. Does that reflect particular VFMC investments that we may have been discussing recently?

**Mr PASCOE** — We manage broad portfolios, so we try to diversify. We focus on typically the aggregate portfolio returns and aggregate asset classes, so we are balancing a number of investments within each asset class. But there are a number of investments throughout this very challenging period that have had challenging performance results.

**The CHAIR** — Thank you, Mr Pascoe. We recognise there is some difficulty in speaking on specific investments.

**Mr PASCOE** — I appreciate that.

**Mr HAWKES** — We do appreciate that.

**The CHAIR** — The committee will reserve its position as to whether we invite you back in a closed session to talk on some of those specifics. We thank you for your attendance this morning and your presentation.

**Mr PASCOE** — Thank you.

**The CHAIR** — It has been a very informative session and very well worthwhile. The committee will have a draft transcript to you in the next couple of days for any corrections you wish to make. On behalf of the committee, thank you all for your attendance this morning.

**Mr HAWKES** — Thank you, Chair. We appreciate that.

**Committee adjourned.**