Notes on the Future Fund and Meeting Its Unfunded Liability

General

The Future Fund is an independently managed Federal Government sovereign wealth fund established in 2006 to fund Government Defined Benefit superannuation and thus to strengthen the Australian Government's long term financial position. At 30 June 2019, the Future Fund was valued at A$162.5 billion.

The legislation establishing the Future Fund describes its main object as being 'to strengthen the Commonwealth's long-term financial position'. While legislation permits withdrawals from the fund from 1 July 2020, the government indicated in 2017 it intends to allow the fund to continue to accumulate until at least 2026/27 before making withdrawals. The Investment Mandate for the Future Fund is to target a benchmark return of at least the Consumer Price Index + 4 to 5 per cent per annum over the long term, while taking an acceptable but not excessive level of risk.

The current target total return was 6.6 %, based on a CPI of 2.1 % and an investment return of 4.5 %, but possibly now less with CPI below 2 %.

A Board of Guardians is responsible for deciding how to invest the assets of Future Fund.

The Board consists of a Chair and six other members. Members are appointed by the responsible Ministers, in accordance with legislation, and selected for their expertise in investing in financial assets, managing investments and corporate governance.

Board members are appointed on a part time basis for a term of up to five years and are eligible to be reappointed. The current Board Members are:-

Hon Peter Costello AC (Chairman)
Ms Carolyn Kay
Mr John Pontoon AO
Dr Jane Wilson
Ms Erin Flaherty
Mr Michael Wachtel
Mr John Fraser

Future Fund Performance

The Future Fund has achieved high Financial Year performances; it started with $60.5B when setup in 2006 and reached $162.5B on 30 June 2019. It achieved an 11.5 % return for the 2018/19 Financial Year and had a 10 year annualised performance of 10.4 **%.**

Perhaps the best assessment of performance is Jonathan Shapiro's article of 31 August 2019 for the Financial Review, which is now quoted:-

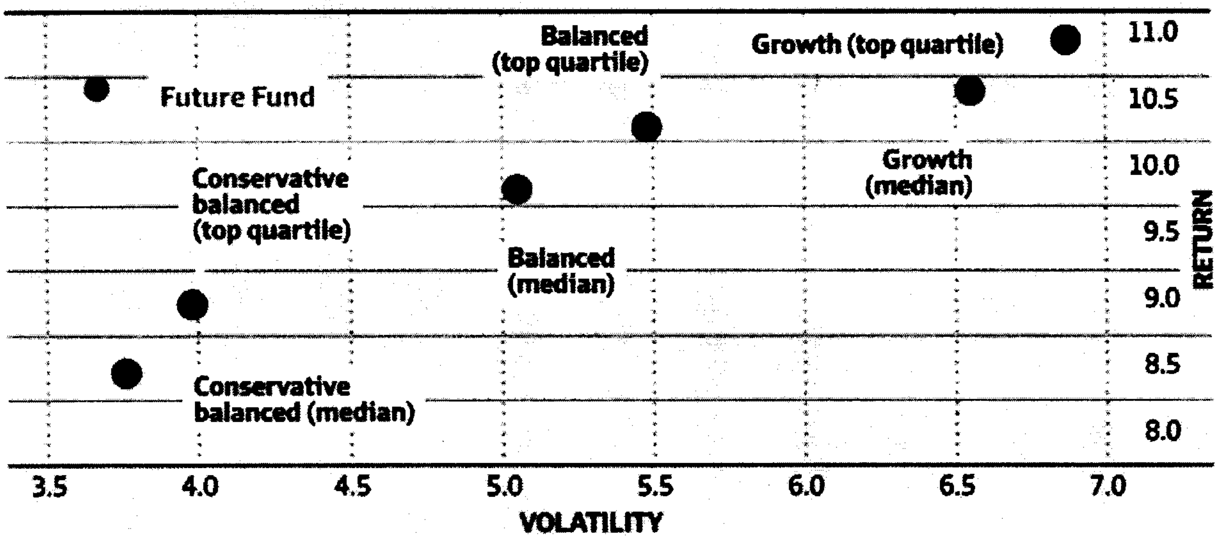
"Behind the Future Fund's $16b year

The Future Fund beat the nation's top super funds over 12 months yet did so by taking half the risk. How did the $162.5 billion behemoth pull it off?

Australia's sovereign wealth fund has pulled off a rare feat this year: it's weathered a period of uncertainty to make money for the nation's taxpayers in both rising and falling markets.

The Future Fund has achieved this through a combination of timely calls, and allocations to hedge funds and private equity managers while investing in improving its internal structures and upgrading its technology to help it respond better to changing conditions.

10-yr risk & return, Future Fund & superannuation options, tax adjusted (% pa)



SOURCE: FUTUREFUND

The fund this week reported an impressive 11.5 per cent return over the 2019 financial year as its assets swelled by $16 billion to $162.5 billion.

The fund's chairman Peter Costello and managing director David Neal stressed that the double-digit returns came even as it was fretting about the dangers posed to markets by central bank policies and rising trade tensions between the US and China.

It has done so by taking, half the 'risk' of a traditionally diversified portfolio or median super fund, as measured by the volatility of its returns.' If you look out across the world, in this volatile market it would be among the top 10 per cent of pension funds and sovereign funds,' Sovereign wealth and pension fund expert Ashby Monk of Stanford University says.' The Future Fund has taken a whole-of-fund approach. To be supportive of active management and taking a long-term view is proving to be wise,' Monk says."

The *Future Fund Investment Mandate Direction 2017* requires that the Future Fund Board adopt a benchmark average return for the Future Fund of "at least the Consumer Price Index (CPI) +4.0 to +5.0 per cent per annum over the long term". In striving for this benchmark return, the Future Fund Board may pursue an acceptable, but not excessive, level of risk. So it has done remarkably well

Unfunded Liability to be met by the Future Fund

The present situation is that the Federal Budget meets the retiree requirements for Commonwealth Defined Benefit Superannuation schemes. The Future Fund was setup to replace the Budget Outlay by 2020 or earlier, but in 2017, it was apparent that the Unfunded Liability (UL) exceeded the worth of the Future Fund. So it was decided that there would not be any withdrawals from the Future Fund until 2026/27.

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Following the review of the CSS/PSS and the Military Superannuation Schemes as at 30 June 2017, Mercer, as the Designated Actuary under the Future Fund Act advised the Government in July 2018 of the Target Asset Levels (TAL) for the Future Fund. These were:-

2017/18 FY	**$180.2B**
2018/19 FY	**$186.9B**
2019/20 FY	**$193.7B**

The TAL represents at the start of a financial year, the balance of the Future Fund expected to be required to offset the Present Value of the Federal Government's projected UL which have accrued in the relevant schemes up to that point of time.

So as at 30 June 2019, the Future Fund has a worth of $162.5B and the UL needs are $193.7 B (using a newly adopted discount rate of 5 %, rather than the previously used rate in 2014 of 6 %). The lower the discount rate used, the higher the UL. This discount factor change would have increased the UL by 15-20 %. Thus the previously used 6 % discount rate would have made the Future Fund more able to meet the required UL. The UL will be reviewed again after 3 years, i.e.at 30 June 2020.

We will now consider the background reports covering long term costs for the CSS/PSS and the military schemes, as well as the appropriate discount rate further.

ACPSRO represents only Civil and Military superannuation retirees.

PSS and CSS Long term Report 2017 of Department of Finance prepared by Mercer

The Report is of over 50 pages and is a comprehensive report. It reports on the situation at 30 June 2017 and projects the UL for 40 years.

The Report states that the total Unfunded Liability estimate of the PSS and CSS at 30 June 2017 was $137.8B. The UL had been estimated 3 years earlier at $109.8B. The 2017 UL included $20.3B as a result of adopting a discount rate of 5 %, rather than the previously used 6 % i.e. a 17 % increase in the UL.

The projected UL over 40 years initially increases from $137.8B to a total UL of about $175B after 15 years followed by a steady decline to about half the current UL by 2057.

Projected annual outlays initially $6B increase to about $12B and then fall away to about $9B. However, outlays are only 0.3 % of GDP initially and steadily fall away to 0.07 % of GDP.

Military Superannuation Schemes Review of Long Term Costs prepared by Australian Government Actuary

The Report is 90 pages long, comprehensive and follows the same approach as Mercer for the PSS/CSS. The Report covers the MSBS, DFRB, DFRDB and ADF Cover. It notes the closure on 1 July 2016 of the MSBS.

So the Federal Government has no open Defined Benefit schemes, presuming the other minor DB schemes have closed.

The Report states that the total Unfunded Liability estimate for all the Military schemes at 30 June 2017 was $83.1B. The UL had been estimated 3 years earlier at $57.5B. The 2017 UL included $14B as a result of adopting a discount rate of 5 %, rather than the previous 6 % i.e. a 20 % increase to the UL. (However, there is a UL figure given in the Report of $65B –an $18B increase for a discount rate of 6 %. Thus an increase in the UL of 28%)

The projected UL over 40 years increase steadily from $83.1 B in 2017 to $244B in 2055.

Projected annual outlays initially $2.346B in 2016/17 increases steadily to $14.416B by 2054/55. However, outlays vary from 0.13 % of GDP initially and reach 0.14 %, but fall slightly to 0.12 % of GDP at the end of the period.

Discount Rates for Determining UL

Economist use a discount rate when determining the Present Worth of future annual costs, generally over a period of 40 years. So what is appropriate here?

In the past, with higher long term bond rates, the practice was to adopt 6 % for the discount rate and sometimes even higher if higher borrowing costs were expected. Thus, the adopted discount rate can be quite arbitrary.

The 2017 UL Reports were written at a time of much lower long term bond rates; for example the US 30 year bond rate was about 3-4 %. So the Reports adopted a lower 5 % discount rate.

There is a classic case here of the Future Fund itself actually funding future outlays.

The Future Fund is to finance the annual outlays on Defined Benefits in due course and its continued performance will determine its adequacy as it will slowly and with variability deplete. Past performance of the Future Fund has been over 10 % pa and it has a target return of over 6 % pa. So there seems to be a strong case to adopt at least a 6 % discount rate. This reduces the UL, as

we have stated by some 15-20 %. The Future Fund would then virtually be able to fund future annual outlays on the DB schemes.

Future Needs and Strategy of the Future Fund

The Federal Government is providing the present outlays for Commonwealth DB superannuants from the Budget, and is also allowing the buildup of a sovereign fund for the same purpose; i.e. a double provision.

A change in the discount rate to 6 % or higher would make the Future Fund more able to self-fund its future needs. The Future Fund has a value of $162.5B at the 30 June 2019, while the UL at 30 June 2019 is higher - a total TAL of $193.7 B, as advised by Mercer. The Future Fund currently with only $162.5B has a deficiency of $31B. It would take about 5 years for the Future Fund to equate with the future UL at a 6 % discount rate, i.e. 30 June 2024.

The Federal Government has been advised that it should not withdraw any money from the Future Fund until 1926/27 on the basis of its inadequacy adopting a lower 5 % discount rate. If a higher 6 % discount rate, comparable to the target return, then the time for Future Fund use is shortened by about 2 years. If the Future Fund continues earning with a return of 10 % pa, then it will equate with the UL after about 3 years from 2019, using a discount rate of 6 %, i.e. 2022.

On the other hand with the questionable focus on surpluses, the Government is proposing to credit Budget revenue with Future Fund annual surpluses; although the intention is to leave annual surpluses in the Future Fund to still grow the Future Fund. This deferment of withdrawals decision should be reviewed to reduce Budget outlays.

As recipients, Commonwealth DB retirees are subject to the inadequacy of the CPI compared to street prices and are losing purchasing power progressively, while other recipients are more appropriately indexed, such as Age Pensioners.

There probably should be a review of the discount rate; an early changeover to the Future Fund with any excessive outlays thereafter supplementarily funded from the Budget would be much lower in Federal Government costs.

There is then an easier case for the adoption of an adequate indexation system for recipients, which the Government could then adequately afford, as it would stop the double provision for DB superannuation.