

**Schroder Investment Management Australia  
Limited**

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**Derivatives Risk Statement  
Part B  
1 July 2011**

## **Introduction**

This document sets out the Derivatives Risk Statement (“DRS”) of Schroder Investment Management Australia Limited (“Schroders”) which has been designed to meet the APRA principles as set out in the Prudential Practice Guide SPG 200 – Risk management. This document applies to all portfolios where Schroders acts as responsible entity and or provides investment management services.

### **1. Responsible Party**

This DRS has been prepared by Schroders. The effective date of this DRS is 1 July 2011. This DRS replaces the previous DRS with an effective date of 1 July 2009. The SIMAL Board approved this DRS on 24/06/2011.

This DRS applies to the management of derivatives with respect to superannuation entities and managed investment schemes and discretely managed portfolios, where Schroders acts as responsible entity and or provides investment management services. All funds managed are, for the purposes of this DRS, referred to as “portfolios”.

The portfolios managed by Schroders may include domestic assets, international assets or a combination of the two. Where portfolios include international assets, Schroders may appoint investment advisers generally from Schroders PLC and its subsidiaries. The investment adviser is responsible for making the investment decisions for a portfolio, subject to specific investment guidelines. The entity appointed as investment adviser depends upon the nature of a specific mandate.

Where an investment adviser is appointed and that investment adviser utilises derivatives, the board of directors of Schroders is responsible for ensuring the investment adviser has appropriate processes and controls to ensure that their use of derivatives is in accordance with the aims of this DRS.

Additionally, Schroders as the responsible entity of registered managed investment schemes has outsourced fund accounting functions in respect of all of its funds. References throughout this DRS to the Operations Department should be read as references to Schroders and its third party service providers. It should be noted however, that Schroders retains responsibility for these functions.

### **2. Objective of this DRS**

This DRS summarises the policies in place for the use of derivatives, including the controls on their use and the processes for assessing compliance with those controls. Taken as a whole, these policies, controls and processes are intended to ensure the appropriate use of derivatives. Schroders’ view is that derivatives should not be considered in isolation, but as part of the investment strategy of the fund as a whole, having regard to the risk/return characteristics of all assets in the investment portfolio.

This DRS is subject to annual review both internally and by independent auditors and will be updated as required. It is available to all staff and has been read and understood by all those who are responsible for managing, monitoring or implementing the investment process.

### **3. Definition of Derivatives**

For the purposes of this DRS, a derivative is defined as:

“a financial asset or liability whose value depends upon, or is derived from, other assets, liabilities or indices (‘the underlying asset’)”.

For the purposes of this DRS, derivatives include but are not limited to:

- (a) Exchange traded futures contracts, options, warrants and futures on options;
- (b) Credit default swap agreements (including index credit default swaps); and
- (c) Over The Counter (“OTC”) forward rate agreements, options, swaps (including currency swaps) and contracts for difference.

Exchange Traded Funds and Low Exercise Price Warrants (LEPOs) (which are typically used by international funds) are specifically excluded from the definition of derivatives for the purpose of this DRS. Additional types of derivatives may be added to this list after appropriate review and consideration as set out in Clause 7 B (f) of this DRS.

### **4. Relationship to Investment**

Schroders seeks to maximise returns within acceptable levels of risk, in accordance with the investment strategy of each portfolio. This DRS should, therefore, be read in conjunction with the relevant constitutions, offer documents or investment management agreements for the portfolios being managed.

Derivatives should not be viewed as a separate asset class but must be consistent with the investment objectives and strategy of the particular portfolio.

### **5. The Use of Derivatives**

Schroders considers that as with any investment, derivatives must fulfil the following criteria:

- (a) an investment must be intended to support the overall investment strategy of a portfolio;
- (b) the purpose of making a specific investment must be consistent with the investment objectives of a portfolio; and
- (c) all investment guidelines in respect of each portfolio must be complied with.

In meeting these requirements, Schroders may use derivatives for the following purposes:

- (a) hedging the portfolio against the risk of adverse movement in market prices and thereby adjusting volatility;
- (b) hedging the portfolio against the risk of adverse movements in exchange rates;
- (c) adjusting the duration of a fixed interest portfolio;
- (d) separating alpha and beta for alpha porting purposes;
- (e) to generate additional return for certain strategies by adjusting credit, duration or asset exposures or by creating synthetic exposures;

- (f) adjusting asset and or credit exposures within the parameters set in the investment strategy; and
- (g) achieving transactional efficiency through:
  - reducing the cost of achieving a required exposure;
  - achieving market or individual exposure that may not be currently available due to timing or liquidity constraints;
  - assisting in implementation of changes in asset allocation;
  - assisting in the achievement of best execution of security transactions; and
  - providing more efficient entry to or exit from markets where physical liquidity is constrained.

## 6. Restrictions on the Use of Derivatives

Investment powers in relation to the use of derivatives may be limited. In respect of discretely managed portfolios, these restrictions will be contained in the investment management agreements and for trusts and managed investment schemes, within the constitution and disclosure documents. Restrictions may also be contained in legislation or regulatory requirements relating to a specific portfolio.

Schroders has also specified that the following restriction will be applied to all portfolios.

- (a) Derivatives cannot be used to gear (or leverage) a portfolio except in the case of a specific authority (eg. Hedge funds). Gearing occurs where derivatives create an exposure to markets that could only otherwise be achieved through investment in the underlying security beyond the level of funds under management.

Derivatives should be fully backed by cash, securities that can be readily converted to cash within the settlement period or underlying physical positions on a delta adjusted basis.

In relation to Fixed Income portfolios:

- the portfolio will be considered not to be geared provided it is within its duration limits and has not made any borrowings; and
  - provided the derivative positions are cash settled, or , in the case of physically settled positions, not intended to be held to maturity, only the mark-to-market is required to be backed.
- (b) Whether derivatives are used for the purpose of hedging or efficient management of portfolio:
    - Sufficient liquid assets must be available to meet the settlement commitments.
    - Derivatives cannot be used to create an overall short position exceeding 100% of the market value of the underlying physical securities and cash.

Where appropriate, Schroders will consider the net exposure of similar derivative products in assessing the effective exposure of the portfolio.

A database of investment guidelines and restrictions is maintained and the control processes in place to ensure that these restrictions are adhered to are outlined below.

- (a) Within Schroders all details of portfolio restrictions contained in constitutions, disclosure documents and investment management agreements, including those guidelines relating to derivatives, are maintained on a central database administered by Corporate Governance. Details of new and amended restrictions are circulated to all personnel

responsible for managing, implementing and monitoring the investment process. The portfolio manager is responsible for ensuring compliance with restrictions.

- (b) Corporate Governance is responsible for ensuring that restrictions contained in new or amended investment guidelines are capable of being monitored. Daily system generated reports are used to monitor compliance with Schroders' derivatives policy on gearing and cover.

## **7. Monitoring of Risk**

There are various types of risks associated with derivatives. These can be broadly categorised under the headings of market risk, liquidity risk, credit risk, legal risk and operations risk. These risks and the processes used to monitor them are described below.

### **A) Risk Management Responsibilities**

Schroders' internal structure ensures clear identification and segregation of responsibilities as outlined below.

- (a) Portfolio managers are responsible for making and implementing investment decisions, including those relating to derivatives. They are divided into asset class groups and the head of each asset class reports directly to the Chief Executive Officer in Australia and the relevant Global Head of Asset Class in other Group offices.
- (b) Responsibility for the processing and settlement of transactions and the independent valuation of all portfolios has been outsourced to Schroder Investment Management (Singapore) Ltd (SIMSL), which functions independently of the portfolio managers.
- (c) Corporate Governance is responsible for monitoring compliance with all limits, restrictions and regulations. Corporate Governance reports to the Compliance Committee and the Chief Executive Officer. The Compliance Committee monitors regulatory and guideline compliance, with minutes of the Committee's meetings being provided to the Schroders Management Committee pursuant to delegated powers from the Schroders Board.
- (d) It is the role of the relevant line management to implement the derivative risk management framework and the associated policies and standards within the businesses and throughout the Group using the systems and tools provided. However, the Schroders' Group Derivatives Risk Committee monitors the implementation of the derivative risk management and control environment through:
  - Approving new derivative instruments after ensuring that key operational risks have been identified and mitigated;
  - Maintaining a group-wide new instrument register, listing all derivative instruments that have been approved by the Committee.

### **B) Market Risk**

Market risk is the risk of adverse movements in markets (including asset prices, volatility, changes in the yield curve or other market variables) for the underlying asset or the derivatives or the reference rate or index to which the derivative relates. Market risk arises through the holding of any financial instrument, physical or derivative, which creates exposure to movements in interest rates, or prices of a security or market.

The market risk associated with the use of derivatives is assessed in the context of the risk profile of the total portfolio. The mark-to-market value of a derivative does not give an indication of the effective exposure of the portfolio to changes in market values of that derivative position. The effective exposure of a portfolio which is achieved through a derivative position reflects the equivalent amount of the underlying security that would provide the same profit or loss as the derivative position, given an incremental change in the price of the underlying security. In other words, a derivative position is translated into the equivalent

physical holding, or its market value, which provides a meaningful measure in respect of asset allocation. Effective exposure to any security is the sum of the market value of physical securities, the underlying market value represented by adjusted market value of futures contracts and the delta adjusted effective exposure derived from an option position.

Specific procedures used by Schroders to control market risk are as follows:

- (a) All derivative positions are marked-to-market daily. This valuation is calculated independently of investment management personnel.
- (b) Portfolios will not be geared, as described above, except in the case of a specific authority.
- (c) Asset allocation targets and exposure limits specified in investment management agreements, constitutions and offer documents include both physical and derivative exposures of the portfolio. Portfolio managers must manage portfolios to these target allocations.
- (d) Duration targets for fixed income portfolios will include the net effective exposure of all derivatives, and the portfolio managers will ensure the portfolios meet any set duration range.
- (e) Portfolio managers monitor the open derivative positions closely, and with the exception of temporary market volatility, where movements in market value take the exposure to any class of asset outside the set guidelines, portfolio managers will take steps to rectify the position as soon as possible.
- (f) All new classes of derivative instruments and the use of any new derivative exchange must go through the new instrument review process with a final review by the Chief Executive Officer, the portfolio manager of the portfolio involved and Corporate Governance prior to the instruments being traded. New instruments must also be approved by the Group Derivatives Risk Committee to ensure that key operational risks have been identified and mitigated. Any such use is subject to the specific guidelines and restrictions for each portfolio. The review of any new instruments includes consideration of all aspects of the instrument, in particular the physical base or make-up of the instrument, flexibility, liquidity, counterparty risk, trading methodology, legal structure and required documentation. Where international investment is carried out by a related party of Schroders, similar considerations are given to new instruments and specific permission for their use is sought both locally in the relevant jurisdiction and from Schroders.
- (g) Both the portfolio manager of the portfolio involved and Corporate Governance are responsible to monitor the use of derivatives against established guidelines and this DRS.
- (h) In times of high market volatility or in cases where derivatives expose the portfolio to higher levels of market risk, the portfolio managers may undertake periodic stress testing to ensure compliance with the investment management agreements, offer documents, constitutions and this DRS given a reasonable range of adverse market movements.

## C) Basis Risk

Basis risk is the risk that the value of a derivative will not move in line with the related physical position. Examples of where basis risk occurs are:

- (a) the value of a portfolio of Australian equities that does not move in line with the value of the Share Price Index future for which the fund is based upon, which may be due to the differences in weighting of the assets in the portfolio and those in the index; and
- (b) a portfolio of fixed interest securities with five years to maturity may have its duration adjusted with either three year bond and bank bill futures or ten year bond futures and the value of the fixed interest security portfolio does not move in line with the value of the futures position.

Basis risk is controlled in the following manner:

- when a derivative contract is entered into, the portfolio manager takes into consideration the likelihood that the price of a derivative will move in line with the underlying physical position and assesses whether the level of basis risk is acceptable; and
- management of the derivatives on an on going basis as part of the daily portfolio review by the portfolio manager.

## D) Liquidity Risk

There are two types of liquidity risk that arise from investing in derivatives. These are:

### *Market Liquidity Risk*

Market liquidity risk is the risk that an investment manager may not be able to, or cannot easily unwind or offset a particular position due to inadequate market depth or disruptions in the market place.

### *Funding Liquidity Risk*

Funding liquidity risk is the risk that an investment manager may not be able to meet the future cash flow obligations from the derivative activities such as meeting margin calls on futures contracts.

The process by which liquidity risk is managed is as follows.

- (a) Prior to entering into any new derivative instrument, the portfolio manager will consider the market depth of that instrument as part of the review and sign-off process.
- (b) The portfolio manager is responsible for monitoring market depth on an ongoing basis.
- (c) Appropriate cash levels are maintained in portfolios dependent upon the composition of that portfolio. At a minimum, sufficient cash reserves and cash equivalent instruments are maintained in the portfolio to fund deposits and margin calls equal to the impact of a considered maximum movement of the net (short plus long) derivative position.

## E) Counterparty (Credit) Risk

Counterparty risk is the risk that a counterparty will fail to perform contractual obligations, that is in default either in whole or part, under a contract.

Over the counter derivatives have significantly higher counterparty risks compared with those traded through exchanges. Where derivatives are entered into on an "over-the-counter" basis, formal documentation will be executed (including an International Swaps and Derivatives Association agreement ("ISDA")). In addition, Schrodgers will only enter into derivatives contracts with approved counterparties. All counterparties must be submitted for detailed credit review and establishment of specific dealing limits by the London based, Group Agency Credit Committee. Approved dealing limits apply in respect of dealing in aggregate for all clients and are reviewed regularly to ensure adequacy. Limit usage is monitored on a daily basis.

## F) Legal Risk

Legal risk is the risk that a derivative contract will not be legally enforceable. A number of factors contribute to legal risk and include:

- (a) the legal capacity and authority of a counterparty to enter into a contract;
- (b) the contract documentation being insufficient or unenforceable; or
- (c) the transaction breaching regulatory requirements.

Schroders' process for managing legal risk is as follows:

- Exchange traded transactions are subject to market standard documentation, confirmation and settlement procedures. Participants in the exchange are subject to regulation. Under these regulations the capacity of Schroders to deal on behalf of clients is established before transactions are undertaken.
- Evidence of the legal capacity of the counterparty to enter into a new class of derivative transactions is sought prior to entering into any over-the-counter derivative transaction and legal advice sought if required.
- Standard documentation is used where possible when dealing in over-the-counter derivatives, for example, the ISDA standard. Alternatively, specific documentation may be developed and is subject to independent legal advice.

## G) Operations Risk

Operations risk is the risk that deficiencies in the effectiveness and accuracy of the information systems or internal controls will result in a material loss. Schroders' organisational structure separates the investment management and operations functions of settlements, monitoring, reporting and control. The processes used to manage operations risk include:

- (a) authorisation of derivative transactions by the relevant portfolio manager;
- (b) confirmation of derivative contract notes sourced from third parties by operations personnel independently of the portfolio managers;
- (c) reconciliation of derivative transactions to external information ensuring completeness, accuracy and timeliness of accounting entries;
- (d) use of independent pricing sources in all derivative valuations;
- (e) daily back up of all systems; and
- (f) internal regulation of all staff dealing on personal accounts.

## 8. Currency

Foreign currency exposures arise from investment in assets denominated in foreign currency. These exposures are considered to be part of the investment strategy of the individual investment portfolio and either Schroders or the responsible investment adviser manages the currency exposure.

The principles in this DRS for derivatives are applied to the management of foreign currency exposures and the use of foreign currency derivatives. Derivatives used for foreign currency management will be subject to limits and ranges that are consistent with each portfolio's level of currency risk. However, due to the nature of currency hedging (use of proxy currencies and targeting a 100% hedge ratio) negative currency positions may arise on an effective exposure basis. The Portfolio Managers are responsible for monitoring the appropriateness of any proxy currencies used to ensure that the basis risk is minimised.

## 9. Personnel Management

Schroders ensures that all personnel engaged in the management and administration of derivatives positions are appropriately skilled and qualified for positions held. The recruitment process includes appropriate testing of technical abilities and personality profiles at both the dealing and operational levels. Schroders carries out ongoing 'on the job' training and education to ensure that staff maintain a high level of knowledge and skill. Details of staff who are permitted to deal in derivatives are maintained by Corporate Governance.

All investment decisions are taken by portfolio managers who are responsible for defined sectors of the portfolios managed. Each portfolio manager reports directly through to the head

of that sector and ultimately to the Chief Executive Officer. Performance reviews are carried out annually and consider not only the investment performance of portfolios managed but may also include the portfolio manager's compliance with limits, controls and agreed procedures. Remuneration consists of a base salary plus an incentive component, the latter being based upon the outcome of the annual review.

The parameters determined as part of the investment strategy of the portfolio preclude unauthorised positions being taken by individual staff members. Administrative personnel are not remunerated on the basis of portfolio performance.

As previously described, there is appropriate separation of staff reporting lines.

## **10. Assessment of Controls**

Schroders is subject to internal audit and ongoing reviews which address the control environment of its investment management operations. Internal audit is independent of Schroders and reports directly to the board of directors of each of Schroders and Schroders plc in the UK. It uses a risk based approach to determine the extent of audit coverage for each area of the business. Control weaknesses are communicated by a report to management and a specific plan for remedying those weaknesses must be agreed between internal audit and management.

Schroders is also subject to external audit in respect of its internal controls.

The management of Schroders is responsible for ensuring that internal controls are appropriate and operating effectively.

The compliance monitoring process includes checks to ensure that controls are being maintained. Any breaches of limits or other restrictions are notified to the Chief Executive Officer and the Compliance Committee. Corporate Governance maintains a log of all breaches. Prompt corrective action is taken in respect of any breach.

The board of Schroders has approved this DRS and attests to its sufficiency. The Board is ultimately responsible for ensuring that this DRS is adhered to and continues to be appropriate.

## **11. External Audit**

This DRS is subject to annual external audit.

## **12. Reporting**

### **A) Internal Reporting to Board of Directors**

Schroders will provide such reports as are necessary to the Board of Directors of Schroders to enable them to fulfil their responsibilities. The Board receives reports on the adequacy of internal controls, including notification of all material breaches.

### **B) Client Reporting**

All clients and interested parties receive regular reports on their investments in the Schemes, including:

- (a) the provision of this DRS and any subsequent changes made to this DRS;
- (b) regular reporting on asset exposures including the impact of derivatives; and
- (c) any matter that in the professional judgement of Schroders is a significant occurrence in relation to the use of derivatives.

Copies of this DRS are made available to relevant parties upon request.