



# **Derivative Risk Management Statement Part B**

**28 July 2005**



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# 1. Principles

## 1.1 Responsible party name

This statement has been prepared by Invesco Australia Ltd ('Invesco', 'we', 'us' or 'our'), ABN 48 001 693 232, AFSL 239916. It covers all managed investment schemes for which Invesco is the responsible entity, portfolios where investment management services are provided by Invesco, and pooled superannuation trusts for which Invesco acts as trustee under superannuation legislation.

## 1.2 Objective

We recognise our obligation to act in the best interests of our clients. To affirm this obligation, we have prepared this Derivatives Risk Management Statement (DRMS) that outlines the principles that we apply in using derivatives.

This statement summarises our policies on the use of derivatives and the controls in place. It also sets out the processes for assessing compliance with the policies and controls which aim to ensure the proper use of derivatives. Please note that we stress test all relevant portfolios. Further discussion on stress testing is contained in paragraph 3.2.

## 1.3 Definition of derivatives

We define derivatives as financial contracts whose values depend on, or are derived from, assets, liabilities, indices, or other derivatives. Derivatives include, but are not restricted to, forwards, futures, options, share ratios, warrants, swaps, and structured notes.

## 1.4 Relationship to investment strategy

Derivatives may not be used to override the overall investment strategy of the collective investment or portfolio. The DRMS should be read in conjunction with all relevant documentation.

### *Collective investments:*

For collective investments, the DRMS should be read in conjunction with any Product Disclosure Statement, trust deed, constitution, and the Fund Reference DRMS.

### *Individually managed portfolios:*

For individually managed portfolios, the DRMS should be read in conjunction with the management agreements and investment mandates.



## 2. Use of derivatives

### 2.1 Purpose of the use of derivatives

The use of derivatives is part of our investment process. The following summarises the range of possible applications of derivatives in our approach to investment management.

*Risk management:*

- to hedge an asset or portfolio against a fluctuation in market or currency values;
- to control the impact on portfolio valuations of market movements caused by transactions;
- to provide a more certain distribution of portfolio returns over given time frames.

*Transactional efficiency:*

- to reduce transaction costs;
- to achieve the best execution of security transactions;
- to obtain prices that may not be available in the market in underlying securities;
- to adjust asset exposures within defined parameters;

*Value added strategies:*

- to adopt strategies that will benefit from changes in market volatility;
- to extract preferred components of security value;
- to adopt strategies that will benefit from changes in the relationship between financial securities.

### 2.2 Restrictions on the use of derivatives

We translate constraints in legislation and regulations, trust deeds, constitutions, management agreements, and investment mandates relating to the use of derivatives into strategy and management guidelines for each portfolio. These allow efficient implementation in accordance with the risk management practices detailed in the following sections. A list of approved instruments is maintained and updated regularly.

As is the case with restrictions on investment of other assets, the investment manager for a portfolio is required to make investment decisions for the portfolio that are consistent with the guidelines.

We devote resources to maintaining and configuring computer systems to assist in management of investment restrictions, including the use of derivatives.



## 3. Risk management

### 3.1 Allocation of responsibilities

Our internal structure is designed to ensure clear identification and segregation of functional responsibilities within and between reporting business units. Members of our investment teams are accountable for the analysis and management of risk according to the guidelines summarised in this section.

The following outlines the broad structure of our organisation and the allocation of responsibilities within that structure. This provides further background to the specific elements of risk management outlined below.

- Invesco is organisationally configured into separate investment teams. Each team has a direct and independent reporting line to the Head of Investments.
- Internal processes are clearly documented with accountabilities defined at each stage. Each process has a designated process owner who is directly accountable for all functions within the process.
- Within the investments teams, there is a clear delineation between the analysis, strategy, dealing, and portfolio management functions. There is a clear delineation of responsibilities between those implementing investment decisions, and those processing and reporting those decisions to clients.
- Operation services are provided by our internal operations groups. These groups comprise Operations, Legal and Compliance, Finance, Human Resources, Information Technology, Performance, and Marketing (which includes client reporting).
- Within Invesco and National Custodian Services (NCS - see glossary of terms), there is a clear delineation between performance, pricing, and settlement functions.

Where we engage external managers to carry out part of an investment process for which we are responsible, we ensure that appropriate risk management controls are in place, consistent with the principles of this statement.

### 3.2 Market risk

We define market risk as undiversifiable risk that relates to the asset market as a whole (also described as systematic or beta risk). The process by which we assess, monitor, and control market risk is as follows:

- Investment mandates specify the investment strategy and management guidelines for each portfolio. Investment managers compare total portfolio exposures to these guidelines.
- There are systems in place to measure market risk. Portfolio reports, which delta expose all derivative positions, are prepared daily for use by investment managers.
- Investment managers stress test portfolios where derivative or other positions have the potential to significantly alter portfolio values upon market movement. The frequency of testing and methodology used depends on the type of portfolio and the extent of derivative positions.
- Portfolios will not be geared unless allowed in the mandate. To avoid gearing the manager must at all times have suitable arrangements in place with respect to net derivative positions (delta-adjusted in the case of options) to ensure that either cash is available or non-equity like assets exist within the portfolio that can be readily converted to cash sufficient to meet all actual or prospective obligations. A geared position is defined as one in which this condition is not met.
- Investment managers monitor cover-for-net derivative positions to ensure that:
  - either cash is available or assets exist within the portfolio that can be readily converted to cash sufficient to meet all potential obligations; or
  - assets exist within the portfolio or are available as a reasonable hedge for the position.



### 3.3 Basis risk

We define basis risk as the potential for loss (or profit) arising from any failure of the prices of derivative securities to track precisely either the theoretical values calculated from the prices of the underlying securities on which they are based, or to track precisely the underlying securities for which they are a hedge. The process by which we manage basis risk is as follows:

- Futures—Investment managers monitor active positions using information sourced from brokers and other third parties.
- Options—Where options are not traded on market, investment managers generally calculate option valuations using an option calculator, although sometimes receive valuations from third parties.

### 3.4 Liquidity risk

We define liquidity risk as the risk that an investment may not be easily converted into cash with little loss in market value and minimum delay. The process by which we manage liquidity risk is as follows:

- Investment mandates incorporate guidelines that specify minimum cash levels. These will typically depend on the type of portfolio, the investment strategy applied, and the specific needs of investors.
- Investment managers monitor and manage the levels of liquidity maintained in portfolios.
- Investment managers monitor movements in derivatives to ensure that margin calls can be met.
- Investment managers monitor the degree of liquidity for approved instruments to ensure that they can, if needed, be converted to cash within acceptable timeframes at reasonable prices.

### 3.5 Counterparty risk

We define counterparty risk as the risk that a party to a contract will not perform to the terms of the contract. The process by which we manage counterparty risk is as follows:

- Where investment mandates specify counterparty limits, investment managers review portfolios on an ongoing basis to ensure that they conform with mandate requirements.
- We maintain a list of approved clearing-houses, and use clearers of high creditworthiness for all futures and options on futures transactions. Alternately, clients may specify their own clearers.
- We maintain a list of approved instruments. Transactions involving instruments outside the list must be separately authorised.
- We maintain a list of approved counterparties. Transactions involving counterparties outside the list must be separately authorised.
- As required within each mandate, internal guidelines limit the level of exposure to a single counterparty at any point in time.
- The use of standard form ISDA contracts is encouraged. All contracts with counterparties (including ISDA contracts) must be signed off by the Legal and Compliance team before a transaction can be entered into. In the case of unusual transactions involving non-standard contracts or new counterparties, the Legal and Compliance team may require that external legal sign-off is obtained prior to the transaction being entered into. All original documentation is stored at an off-site document storage facility with copies maintained at our offices.
- Any regulatory requirements in dealing with counterparties will be notified to the relevant unit or staff member by the Legal and Compliance team. The relevant team or staff member will then be responsible for complying with the requirements.
- Our Legal and Compliance team also independently verifies compliance with counterparty restrictions as part of its periodic surveillance program.



### 3.6 Operations risk

We define operations risk as the risk that deficiencies in the effectiveness and accuracy of internal procedures and controls will result in a material loss. The process by which we manage operations risk is as follows:

- Our organisational and reporting structure ensures complete separation of functions between the investment teams and operational services provided by both the Finance and Operations teams and NCS. Internal processes for Invesco and NCS are clearly documented, with accountabilities defined at each stage. Each process has a designated process owner who is directly accountable for all functions within the process (refer to 3.1).
- Internal procedures require verification by operations of dual signatories to every transaction. We maintain a list of authorised signatories.
- NCS as provider of administration functions, is required to undertake daily reconciliations of derivative positions.
- Derivatives are valued in a manner consistent with current market practice. Derivatives are valued at market value and exposures are stated on a delta adjusted basis.
- The market value of unlisted investments, including derivatives, is usually obtained from independent external sources by NCS.
- We do not hold the assets of any portfolio in Invesco's name, rather we have appointed custodians to do so on our behalf.
- The Legal and Compliance team systematically checks internal controls and procedures.
- We comply with all relevant requirements under the Superannuation Industry (Supervision) Act and Regulations, and the Corporations Act, and are subject to reviews by the Australian Prudential Regulation Authority and Australian Securities and Investments Commission.
- Our compliance rules govern all staff trading. Staff who elect to engage in investment activities on their personal account are required to follow formal internal regulations.
- We maintain a detailed security plan to ensure high level security in all areas of the business.
- Our information systems are subject to audit by internal or external auditors. We also have in place a comprehensive business continuity plan to enable it to deal with systems failure effectively and with minimum disruption or risk to the business.
- Recovery systems are in place for all key data.



## 4. Personnel management

### 4.1 Human resources policy

Our human resources policy is designed to ensure that we maximise our intellectual capital by employing and developing high calibre individuals within all areas of our business.

- In recruiting new staff, we pay particular attention to the professional skills and experience for the position. We consider the qualifications and experience, quality, and style of the individual, and seek to ensure that the person will support our desired corporate culture.
- We ensure that all staff are appropriately qualified and trained to perform their key functions, and in specific cases, we impose minimum qualification requirements and require staff to be registered with approved bodies. The Legal and Compliance team organises regular seminars for staff on their key areas of responsibility. Staff are also encouraged to undertake formal further training and education such as post graduate university or Securities Institute of Australia courses.
- All staff receive a base salary and participate in an incentive scheme. The allocation of the scheme to staff members is based on each individual's performance in his/her allocated role and is contingent on the individual complying with the terms and conditions of his/her employment with Invesco.
- We evaluate staff through an annual performance appraisal process. The appraisal process measures staff performance against agreed key result areas. Where appropriate, the key result areas will include compliance with relevant legal/regulatory requirements and client mandates. The appraisal process contributes to staff remuneration and future career development.
- Our incentive schemes and staff appraisal processes are designed to discourage staff from gaining personal reward or advancement for any activities that could result in risks outside client mandate conditions and internal controls.
- Our staff are held accountable for their areas of responsibility. This is only possible where the responsibilities within and across units are clear to the staff members and to management. We have and continue to devote significant effort to clarifying and refining processes. The Legal and Compliance team plays a role in this to ensure that there are no gaps in the processes and the processes themselves are adequate and involve appropriate staff members.

### 4.2 Compliance rules

The Legal and Compliance team is responsible for monitoring the preparation and dissemination of the various policies and procedures that govern the way in which we carry on business, including the DRMS. A copy of this DRMS is distributed to staff involved in the management and administration of derivatives and is placed on the compliance section of the intranet. Staff involved in the management and administration of derivatives have read and understood this statement.



## 5. Compliance

### 5.1 Assessment of controls

- Individual team heads and process owners are responsible for ensuring ongoing review and refinement of internal procedures and controls.
- The Legal and Compliance team monitors the suitability of the DRMS in relation to APRA and other regulatory requirements, and advises individual team heads of any changes required.
- A committee comprising individual team heads and process owners across the business, including a member of the Legal and Compliance team, reviews this statement to ensure that internal procedures give effect to all the principles of this statement.
- The Legal and Compliance team performs reviews on an ongoing basis to ensure that appropriate controls are maintained in all areas. These are also subject to review by independent auditors and regulatory authorities.
- Our escalation procedure requires any material problems to be brought to the immediate attention of the Chief Executive Officer and Chief Operating Officer.
- This statement is approved by the Board of Directors of Invesco. The Board also attests to its sufficiency, monitors ongoing compliance, and ensures its continued adequacy.

### 5.2 Audit

This Derivatives Risk Management Statement will be reviewed annually by an external auditor, in accordance with Australian Prudential Regulation Authority guidelines. The external auditor is required to sign off that the DRMS exists, that the major procedures in the DRMS have been followed and that any changes have been approved. The audit is performed in accordance with Australian Auditing Standards.

### 5.3 Reporting

- We report to the entities responsible for portfolios managed by us, in accordance with the terms agreed under the relevant trust deed, constitution, or investment management agreement.
- The reporting principles followed in relation to Australian Prudential Regulation Authority Guidelines for Derivatives Risk Management include:
  - ensuring that details of any changes to the Derivatives Risk Management Statement are provided to relevant trustees as and when they occur;
  - ensuring that regular reports on aggregate portfolio exposures are provided including the impact of the derivative positions;
  - ensuring that a report is provided when in our professional judgement, there is a significant occurrence in relation to the use of derivatives.



## Glossary of terms

**Analyst** – an investment specialist who has specific responsibility for research.

**Dealer** – an investment specialist who has specific responsibility for dealing functions.

**Investment Manager** – an investment specialist in a particular asset class or other investment function who is responsible for research, investment decisions, and the implementation of those decisions.

**Investment Strategist** – an investment manager who is charged with the formulation of strategy for a particular type(s) of portfolio(s).

**Legal and Compliance team** – team responsible for legal and compliance functions within Invesco.

**NCS (National Custodian Services)** – an entity within the National Australia Bank Group to which some of the operational functions have been delegated by Invesco.

**Process Owner** – the person responsible for the overall implementation of a designated process.

**Processes** – documented functions performed by designated teams.

This statement was approved by Invesco on 28 July 2005.

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