Plenary
Funds Management

Derivatives Risk Statement

Document Details

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Document master located:	PFM Corporate SharePoint

Version Control

Version	Date	Notes
1.0	18 November 2021	Approved

Issue Details

Version	1.0
Status	Approved
Date	18 November 2021

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2. Introduction

Executive Summary

This Derivatives Risk Statement ("**DRS**") articulates Plenary Funds Management Pty Ltd ("**PFM**")'s approach to managing risk associated with transacting in derivatives. It applies to all PFM managed investment schemes, including both funds and separately managed accounts ("**SMA**"), where PFM provides investment management services.

Purpose

To provide clear policies, principles and guidance on the use and control of derivative instruments. It also details the processes and procedures for assessing compliance with the controls.

Scope

This policy applies to all PFM funds and SMAs.

3. Responsible Party

This DRS has been prepared by PFM. It applies to managed investment schemes where PFM provides investment management services. These schemes may be structured as funds or SMAs and may include domestic assets, international assets, or a combination.

The Board of PFM has ultimate responsibility for ensuring the use of derivatives is in accordance with the aims of this DRS.

4. Objective of the DRS

This DRS endeavours to summarise the various policies, principles and guidelines governing the use of derivatives. This extends to the controls which regulate their use and the processes for assessing compliance with those controls.

The use of derivatives should not be considered in isolation, but rather as part of the overall investment strategy of a managed investment scheme. Further guidance is provided in both the governing documents of the scheme, Hedging Policy and any other hedging strategy papers.

This DRS is available to all staff and clients. It will be provided to all clients as part of the disclosure documents produced before transacting with them.

The Head of Funds Management for PFM will coordinate the review of this DRS by the Investment Committee ("**IC**") at least annually to ensure that it remains current and compliant with all applicable laws governing PFM's relevant activities and functions including obtaining approval from the relevant stakeholders and Board.

5. Definition of Derivatives

A derivative is "a financial contract whose value depends on, or is derived from other assets, liabilities or indices (the underlying asset)".

Broadly, derivatives fall into two different categories:

- Over the Counter ("**OTC**") derivatives – privately negotiated contracts
- Exchange traded derivatives – standardised contracts traded on centralised securities exchanges

Derivatives instruments are varied and capable of serving several purposes. Common instruments include forwards, options and swaps.

In the ordinary course of business, PFM will primarily utilise OTC derivatives.

6. Relationship to Investment

PFM seeks to optimise the performance of managed investment schemes by endeavouring to maximise returns while balancing appropriate levels of risk. These efforts are guided by the investment strategy of the managed investment scheme which are set out in the relevant Investment Management Agreement ("**IMA**"), investment mandate, information memorandum, constitution or other governing documents.

This DRS should be read in conjunction with the governing documents of a given scheme. The utilisation of derivatives and the types of derivatives should be consistent with the investment strategy and objectives of the given scheme. To the extent that the governing documents are inconsistent with this DRS, the governing documents will prevail to the extent of the inconsistency.

7. Purpose of Derivatives

Derivatives are typically used in portfolio management for risk management or performance enhancement. The utilisation of derivatives forms part of the overarching investment strategy of a managed investment scheme.

Derivatives may be used in the following circumstances:

1) Hedging

- Manage risk, reduce volatility or help to minimise impact of fluctuations in market values

2) Transaction Efficiency and Cost Reduction

- Achieve transaction efficiencies
- Quick and cost efficient management of investment holdings

3) Tactical Investment Reasons

- Adjust security, sector or asset class exposures within the parameters set in the investment strategy of the fund or SMA
- Manage the impact of significant transactions on portfolio valuations
- Manage credit and currency exposure.

8. Restrictions on Derivatives

The following guiding principles govern the use of derivatives:

- the use of derivatives must not be inconsistent with the investment strategy, objectives and any other restrictions outlined in the governing documents, Hedging Policy and / or strategy papers;
- derivatives should not be used in a manner inconsistent with applicable legislation or regulatory requirements;
- derivatives are not to be used to leverage a managed investment scheme except where permitted by the investment strategy;
- appropriate asset cover should be in place to meet any obligations arising from the use of derivatives;
- adequate liquidity must be maintained to meet derivative settlement commitments; and
- derivatives should be executed / instructed by staff appropriately trained and qualified in the use of such instruments.

Derivatives are not to be used as a speculative investment tool. This includes engaging in the following conduct:

- increasing net exposure of the fund or SMA beyond the limits prescribed in the governing documents, Hedging Policy, and / or strategy papers;
- acting beyond the risk threshold of the particular fund or SMA;
- taking uncovered derivative exposure; and
- using derivatives to leverage the fund or SMA where not permitted by the investment strategy.

The use of derivatives is restricted by various controls including:

- limits and constraints in the governing documents, Hedging Policy and any other derivative strategy materials outlining how derivatives should be used;
- only derivative instruments approved for trading can be traded;
- approval by the IC is required to trade instruments which are not authorised by the Hedging Policy; and
- monitoring, which is the responsibility of the Fund Accounting and Tax team, Portfolio Management team and any external service provider. Breaches are reported in accordance with appropriate protocols per the Incident Management and Breach Reporting Policy.

The use of derivatives must also have regard to liquidity constraints, the potential difficulty in closing a derivative position, and the difficulty quantifying the exposure, among other factors.

The Hedging Policy also establishes guidelines for how debt and currency related risks are to be managed. It provides guidance on appropriate hedging instruments and specifies acceptable risk exposures.

9. Monitoring of Risk

The key risks associated with the use of derivatives, together with relevant controls applied by PFM, are outlined below.

Market Risk

The risk of adverse movements in markets (including asset prices, volatility, or other market variables), including where this risk pertains to the underlying asset, derivatives, or the reference rate or index to which the derivatives relate. Market risk arises by virtue of a holding in a financial instrument which has exposure to movements in interest rates, or prices of a security or the broader market.

Market risk is to be considered in the context of the risk profile of the given scheme. To understand the risk exposure, regard should be had for the effective exposure of the fund or SMA to changes in market values of that derivative position.

In order to protect against market risk, PFM rely on the following:

- ongoing marked-to-market / fair value movements (as appropriate);
- adherence to any fund or SMA-specific derivative exposure ranges / limits;
- ungeared funds and SMAs, except where expressly provided for in the investment strategy;
- ongoing monitoring of open derivative positions to ensure they remain within designated ranges and limits;
- constraints on authorised derivative instruments per Hedging Policy;
- requirement for IC approval for any new derivative instruments;
- periodic stress testing may be undertaken from time to time; and
- the Portfolio Management team, Fund Accounting and Tax team and Compliance Manager are responsible for monitoring the use of derivatives against existing policies, guidelines and this DRS and reporting any breaches in line with the Incident Management and Breach Reporting Policy.

Basis Risk

The risk that the value of a derivative will not move in line with the underlying asset value.

In order to protect against basis risk, PFM rely on the following:

- when a derivative contract is entered into, consideration is given to the likelihood that the price of the derivative will move in line with the underlying asset and will assesses whether the level of basis risk is acceptable;
- ongoing management of derivative positions and their relationship to the underlying asset; and
- In the event of a material divergence between the derivative and the underlying asset, altering the derivative risk exposure to minimise basis risk volatility.

Liquidity Risk

Broadly, there are two types of liquidity risk which are considered when investing in derivatives:

1) Market Liquidity Risk

- The risk that a particular position may not be able to, or cannot easily be unwound or offset due to inadequate market depth or market disruptions.

1) Funding Liquidity Risk

- The risk that future cash flow obligations arising from derivatives may not be able to be met (e.g. margin call)

In order to protect against liquidity risk, PFM rely on the following:

- ongoing oversight by Portfolio Management as well as Fund Accounting and Tax teams to ensure exposures and positions are consistent with the investment strategy;
- consideration given to market depth of an instrument prior to the IC approving the use of a new derivative;
- ongoing monitoring of derivative market depth; and
- appropriate cash levels are forecasted and maintained having regard to the need to fund deposits and margin calls equal to the impact of a considered maximum movement of the net (short plus long) derivative position.

Counterparty (Credit) Risk

The risk that a counterparty will be unable to perform its contractual obligations under a derivatives contract.

This risk can be higher in the case of OTC derivatives. In order to support OTC derivatives, formal documentation will be executed (including an International Swaps and Derivatives Association agreement ("**ISDA**")).

Further controls include:

- PFM's outsourced derivative broker will only execute derivative transactions with approved brokers / counterparties;
- monitoring individual counterparty aggregation risk across an asset, fund, SMA and PFM;
- ongoing evaluation and monitoring of brokers / counterparties for their cost efficiency, execution certainty and creditworthiness;
- ongoing monitoring of counterparty limits in respect of dealings in aggregate for all clients;
- adherence to credit risk tolerances;
- Group Legal and Compliance oversight of OTC legal arrangements; and
- secure storage of transaction and settlement details.

Legal Risk

The risk that a derivative contract will not be legally enforceable.

Contributing factors to this risk include:

- the legal capacity and authority of a counterparty;
- insufficient or unenforceable contract documentation; or
- the transaction breaching regulatory requirements.

In order to protect against legal risk, PFM rely on the following:

- standardised documentation, confirmation and settlement procedures for exchange traded derivative transactions;
- assessment of legal capacity of OTC counterparties; and
- where possible, standardised documentation for dealings in OTC derivatives (e.g. ISDA).

Operational Risk

The risk that inadequate or failed internal processes, people, controls and systems will result in a material loss.

PFM has a Risk Management Framework Policy and a Compliance Framework Policy outlining principles and procedures for managing risk and compliance matters. The Risk Management Framework Policy considers the various elements necessary for effective risk management including the risk assessment, monitoring and reporting processes. The Compliance Framework Policy outlines compliance management principles, the incident management process (including breach reporting), as well as the various compliance roles and responsibilities of parties throughout the organisation. Compliance with internal controls and processes are monitored on an ongoing basis by the Compliance Manager who oversees adherence to internal policies and procedures, guided by the compliance manual. Compliance matters are reported to the Head of Funds Management and the PFM Board as appropriate.

In order to protect against operational risk, PFM rely on the following:

- independent compliance monitoring such as exposure limits monitoring and mandate compliance;
- the authority to use derivatives is dictated by the PFM Delegations of Authority ("**DoA**"). It is also subject to the Hedging Policy and relevant governing documents;
- internal procedures require that each trade order is lodged by at least two authorised staff (as determined by the DoA), with a minimum one person preparing the trade order another reviewing before lodgement;
- defined monitoring and reporting procedures;
- custody services primarily performed by external independent custodian. The custodian will perform custody and settlement functions, hold physical investments and record derivative positions;
- ongoing reconciliation of cash and derivative positions to third parties to enable identification and resolution of discrepancies; and
- daily recording and back up of all systems.

10. Foreign Currency Exposure

Where investing in assets denominated in a foreign currency, foreign currency asset exposure will arise. These exposures form part of the investment strategy of the given fund or SMA and must be managed appropriately. Typically, PFM will undertake currency hedging consistent with the Hedging Policy, governing documents and any other derivative related strategy paper of a given scheme. Collectively, these documents provide guidance as to how currency risks should be managed and are supported by the overarching principles and guidelines set out in this DRS. For the avoidance of doubt, the same guiding principles for managing derivative risks specified in this DRS apply to managing currency risk.

11. Personnel Management

PFM ensures that all personnel engaged in the placement, management and administration of derivative positions as part of the ongoing management of a scheme are appropriately skilled and qualified to do so. This is assessed in the initial recruitment phase. Ongoing 'on the job' training is also provided to ensure staff maintain an appropriate standard of knowledge and expertise.

In order to manage risk associated with personnel, PFM rely on the following controls (in addition to the operational controls outlined above):

- only staff with appropriate knowledge, skill, experience and expertise are authorised to place, manage and administer trades in derivative instruments;
- all authorised staff are required to participate in relevant training from time-to-time;
- remuneration is only linked to the use of derivatives to the extent they form part of PFM's overall ability to deliver on its investment strategy; and
- there is an appropriate separation of duties and reporting lines.

12. Assessment of Controls

The Head of Funds Management, together with the Compliance Manager, are responsible for implementing, reviewing and monitoring the controls outlined in this DRS on a regular basis to ensure they remain appropriate and effective. Where there is a breach of this or any other policy (including the associated controls), it will be dealt with in accordance with the Incident Management and Breach Reporting Policy.

The Group Legal and Compliance team and Compliance Manager monitor ongoing compliance with this DRS via a regular process of compliance attestation by the individuals involved in the management and administration of derivatives, confirming that the controls and procedures described in the DRS have been adhered to. Any issues or exceptions are reported to the PFM Board.

PFM is subject to internal and external audit reviews which consider the internal control environment (including controls pertaining to derivatives). The outcome of these audit reviews are communicated to the PFM Board with appropriate action taken to rectify deficiencies identified and implement improvements.

The PFM Board has ultimate responsibility for ensuring that this DRS is adhered to and continues to be appropriate.

13. External Audit

This DRS is subject to an external audit per the requirements in the IMA, information memorandum, constitution or other governing document requirements

14. Reporting

Board Reporting

The Board of PFM will be provided with such reports as are necessary to enable them to discharge their responsibilities. These reports will be consistent with the broader compliance reporting obligations outlined in the compliance manual, including those addressing the adequacy of internal controls.

Client Reporting

All current and potential clients receive regular reports on their investments, including:

- this DRS and any subsequent updates made to this DRS;
- regular reporting on asset exposures including the impact of derivatives; and
- any matter that in the professional judgement of PFM is a significant occurrence in relation to the use of derivatives.

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