States of Guernsey
Committee *for* Employment & Social Security

Governance Framework Document for Common Investment Fund

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**The appendices are not available in the public version of this document as they contain commercial information.*

Introduction

This document is prepared to provide the Committee *for* Employment & Social Security ('**the Committee**') and its Investment Sub-Committee with written documentation of the governance framework in place for the investment of the assets of the Common Investment Fund.

The document will be reviewed and updated on an annual basis, or on significant change in investment strategy or governance processes.

An annual framework can be found in Appendix F. This acts as a guideline for the Committee's annual governance processes. The appendices are not available in the public version of this document as they contain commercial information.

In preparing this document, the International Social Security Association (ISSA) Guidelines for the Investment of Social Security Funds have been considered and incorporated where appropriate.

This Governance Framework will be formally reviewed on an annual basis at the beginning of each calendar year.

Date of last review: May 2018

1 Purpose and Aims of Common Investment Fund

1.1. Constituent Funds of the Common Investment Fund

The Committee has the mandated responsibility in Law to control and manage three funds:

1. **The Guernsey Insurance Fund;** a contributory social insurance scheme to provide financial assistance during old age, bereavement, incapacity, unemployment, maternity and death.

   The law governing this scheme is the Social Insurance (Guernsey) Law 1978, as amended. The Law sets out the rules, scope, delegated powers and authority for the effective management and control of the scheme and its funds. This scheme is financed by social insurance contributions from employees, employers, self-employed persons and non-employed persons. Contributions paid into the fund are supplemented by a States Grant amounting to 15% of the contributions paid in.

2. **The Guernsey Health Service Fund;** a contributory health insurance scheme to provide prescription drugs, specialist medical care and GP consultation subsidies.

   The Law governing this scheme is The Health Service (Benefit) (Guernsey) Law 1990. Contributions to the fund come from employees, employers, self-employed persons and non-employed persons, by way of statutory allocations of contributions initially collected alongside contributions to the Guernsey Insurance Fund. Contributions paid into the fund are supplemented by a States Grant amounting to 12% of the contributions paid in.

3. **The Long-term Care Insurance Fund;** a contributory long-term care insurance scheme to assist with the costs of care in private nursing and private residential homes.

   The Law governing this scheme is The Long-term Care Insurance (Guernsey) Law, 2002. Contributions to the fund come from employees, self-employed persons and non-employed persons, by way of statutory allocations of contributions initially collected alongside contributions to the Guernsey Insurance Fund. There is no States Grant to the Long-term Care Insurance Fund, nor is there any contribution from employers.

1.2. Purpose of the Common Investment Fund (CIF)

The Common Investment Fund (CIF) combines the financial assets of the Guernsey Insurance Fund, the Guernsey Health Service Fund and the Long-Term Care Insurance Fund into one single investment fund. The three funds are essentially financed on a pay-as-you-go basis, although each fund has significant reserves, particularly the Guernsey Insurance Fund. The CIF is, therefore a 'buffer fund' that can be called upon in circumstances where benefit expenditure and administration costs, exceed income from social insurance contributions and States Grants.

1.3. Explicit ownership of the Assets

The ultimate owner of the Common Investment Fund is the States of Guernsey, acting through the Committee *for* Employment & Social Security.

2 Legal Context

2.1 What is the legal mandate of the Committee for the administration of the Investment Funds?

Section 100 of the Social Insurance (Guernsey) Law, 1978, as amended, Section 1 of the Health Service (Benefit) (Guernsey) Law, 1990 and Section 1 of the Long-term Care Insurance (Guernsey) Law, 2002 mandate the Committee to control and manage the 3 constituent funds of the Common Investment Fund, including the power to delegate the investment functions to professional fund or investment managers.

Monies forming part of the constituent funds of the Common Investment Fund may be invested in any investments which are for the time being authorised by the States.

2.2 Authorised Investments

(References in this sub-section to 'the Social Security Department' and 'the Department' should be read as 'The Committee *for* Employment & Social Security' and 'the Committee'.)

Resolution of the States No. XIII on Billet d'Etat XV of 2011, pursuant to Section 100(4) of the Social Insurance (Guernsey) Law, 1978, Section 1(7) of the Health Service (Benefit) (Guernsey) Law, 1990 and Section 1(7) of the Long-term Care Insurance (Guernsey) Law, 2002

'The Social Security Department (hereinafter referred to as "the Department") shall be authorised to invest monies forming part of the Guernsey Insurance Fund, the Guernsey Health Service Fund and the Long-term Care Insurance Fund in investments of any or all of the following descriptions:

a) Bonds

Debentures, debenture stocks, loan notes, unsecured loan stocks, bonds, structured products, secured loans and short-term interest bearing instruments (such as certificates of deposit, bills and commercial paper), issued or guaranteed by, and interest bearing deposits with:

i) any Government of any country or territory, or

ii) the States of Guernsey, or

iii) any local authority or other public body in any of the above countries or territories, or

iv) any building society in the United Kingdom, or

v) any supranational institution,

vi) or any company incorporated in any country or territory.

b) Equities

Equity stocks and shares, whether nil paid, partly paid or fully paid, of companies incorporated in any country, provided that they are traded on or under the rules of a Stock Exchange recognised for this purpose by the Treasury and Resources Department.

c) Property

Real property or interests in real property including:

i) commercial property,

ii) residential property,

iii) land for residential or commercial use,

iv) agricultural land,

v) forestry,

vi) any form of pooled investments for categories i) to v), including, but not limited to, limited partnerships, property unit trusts, fund of property unitised vehicles, Sociétiés d'Investissement à Capital Variable (SICAVs) and real estate investment trusts.

d) Derivatives

Derivative instruments based on financial securities, currencies or financial markets such as options, warrants, futures contracts, swaps, forward foreign exchange contracts, and contracts for differences, whether quoted on a stock market or an exchange or over the counter.

e) Pooled Funds

i) any form of pooled investment including, but not limited to, a limited partnership, unit trust, SICAV, fund of funds or exchange traded fund,

ii) policies issued by a properly constituted insurance or assurance company.

f) Other Assets

The following assets may be held:

i) Hedge funds of any type including fund of hedge funds,

ii) Infrastructure assets of any type, including Private Finance Initiative investments,

iii) Private equity,

iv) Currency and currency overlays,

v) Pooled funds where the underlying assets are commodities.

Other Controls

The Department will set detailed controls on position, size and quality of all investments to ensure that the Fund is properly and fully diversified by individual security and asset type.

Additional Powers

The Fund has power to:

i) sub underwrite or underwrite a new issue,

ii) enter into stock lending arrangements with financial institutions,

iii) guarantee the obligation of a company owned or partly owned by the Fund,

iv) borrow on a temporary basis to a maximum of 5% of the total market value of the Fund,

v) enter into arrangements for a common investment fund with other Funds under the control and management of the Social Security Department.'

2.3 Reports by the Actuary

Section 102 of Social Insurance (Guernsey) Law, 1978, as amended, Section 20 of the Health Service (Benefit) Guernsey Law, 1990, as amended, and Section 26 of the Long-term Care Insurance (Guernsey) Law, 2002 provide that an actuary appointed by the Committee shall review the operation of those laws at intervals not exceeding five years.

On each such review, the actuary shall make a report to the Committee on the financial condition of those funds and the adequacy or otherwise of the contributions payable to support the benefits payable, having regard to the liabilities of those funds under the respective Laws.

The actuary appointed by the Committee shall be:

i. A Fellow of the Institute of Actuaries; or
ii. A Fellow of the Faculty of Actuaries; or

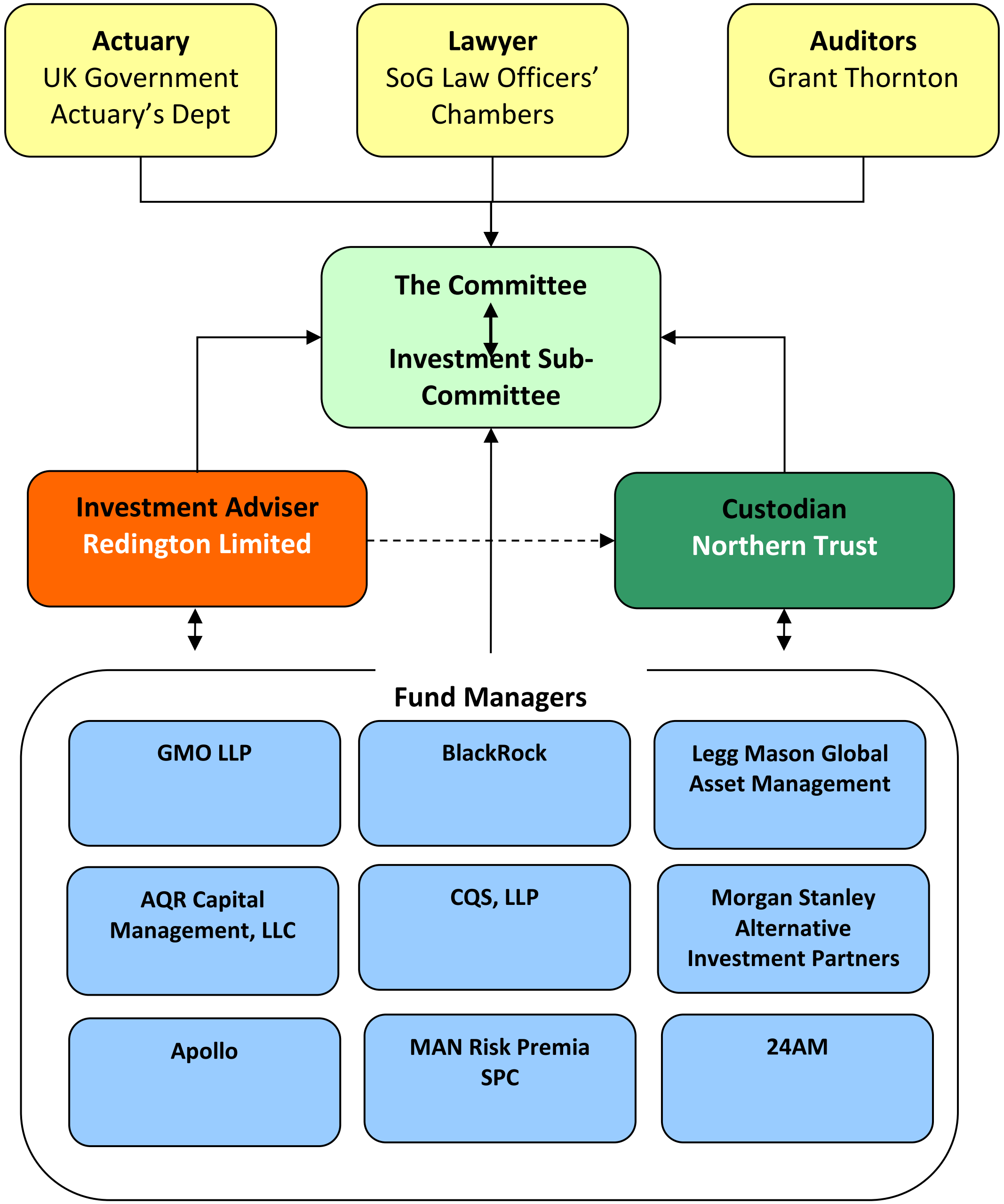
iii. A member of such other body or the holder of such other qualifications as may be prescribed.

The Committee shall, as soon as is practicable, lay before the States a copy of every report of the actuary made in accordance with the above provisions of the Laws.

3 Stakeholders

3.1. Flowchart of different stakeholders

Please see next page


Actuary
UK Government Actuary's Dept
Lawyer
SoG Law Officers' Chambers
Auditors
Grant Thornton
The Committee
Investment Sub-Committee
Investment Adviser
Redington Limited
Custodian
Northern Trust
Fund Managers
GMO LLP
BlackRock
Legg Mason Global Asset Management
AQR Capital Management, LLC
CQS, LLP
Morgan Stanley Alternative Investment Partners
Apollo
MAN Risk Premia SPC
24AM

3.2 Roles and Responsibilities of the Stakeholders

3.2.1 Actuary

The UK Government Actuary's Department is currently appointed to perform the actuarial duties for the Committee.

The Actuary will be responsible for, among other things:

- Performing the five-yearly reviews (or more frequently as required) and advising on the appropriate contribution levels.
- Liaising with the Committee on the suitability of the assumptions to be used in the reviews.
- Advising the Committee and Investment Adviser of any changes to cash flow requirements.

The Actuary is appointed by the Committee, acting through the Chief Secretary, and is accountable to the Committee for the work that is undertaken.

3.2.2 Legal

The States of Guernsey Law Officers' Chambers provide legal advice to the Committee in connection with all matters concerning the Common Investment Fund.

3.2.3 External Audit

The States of Guernsey and other related bodies prepare accounts on an annual basis. These accounts will then be subject to audit, prior to being presented for approval at a meeting of the States of Deliberation.

Accounts pertaining to the Social Security Funds will be prepared in accordance with prescribed accounting standards and will be audited in that regard. Appropriate accounting policies will be selected for adoption by the preparers of the accounts, in order that they meet the requirements of the accounting standards.

It is important that the users of the accounts are able to determine the current value of the assets and liabilities from the financial investments. The audit process will provide a level of confidence that the reported totals reflect the financial position at a given date and show the income and expenditure for that financial year. The States periodically contracts with an external supplier, to provide that audit service on an annual basis. It is expected that the audit will focus on risk and consider this when evaluating the systems, procedures and the amounts reported within the financial standards.

3.2.5 The Investment Sub-Committee (ISC)

The Committee has consitituted an Investment Sub-Committee comprising:

President of Committee
Vice-President of Committee
Ordinary Member of Committee
Non-States Member of Committee (non-voting)

The Investment Sub-Committee is supported by an external adviser and civil service staff.

The Committee has authorised the Sub-Committee to execute decisions that have the unanimous support of the three voting members of the Sub-Committee. In the event of a matter not having unanimous support, the matter will be escalated to the Committee for its consideration.

3.2.6 Investment Adviser

The Investment Adviser will advise on the following matters in relation to the Common Investment Fund:

- Investment strategy, including:
  - Overall target investment return and risk
  - Strategic Asset allocation and set-up of strategic benchmark
  - Classes and types of assets

  - Cash flow management and rebalancing
- Fund Managers
  - Selection and de-selection of Fund Managers
  - Investment management agreement and fees
  - Performance of Fund Managers
- Governance
- Responses to queries raised by the Committee, the Investment Sub-Committee and officers
- Other
  - Custody of assets
  - Custody and agreements and fees
- The Adviser will be the first point of contact and intermediary for questions from Fund Managers and global custodians relating to advice on the investment and custody of the Common Investment Fund,
- The Adviser will prepare and present quarterly performance reports at meetings in Guernsey with Sub-Committee Members and officers.

The Adviser will also attend the annual review visits to each of the Fund Managers.

3.2.7 Custodian

The Custodian will be responsible, among other things, for:

- Core custody services including:
  - Safe keeping of assets
  - Trade settlements
  - Income collection
  - Corporate action processing

  - Proxy voting
  - Tax reclamation
- Monthly performance analytics and Quarterly Executive Reporting
- Monthly valuation reporting and sign off reconciliations.

The Custodian is accountable to the Committee. In all instances, it requires formal instruction from approved signatories of the Committee for account changes and asset transfers.

The current Custodian is Northern Trust Global Services Limited (Northern Trust).

3.2.8 Fund Managers

In general, the role of each Fund Manager includes, but is not limited to:

- Day-to-day management of the invested assets in accordance with the objectives and guidelines outlined in the governing documentation
- Reporting of valuation, performance and investment strategy on a regular basis
- Meeting with the Investment Sub-Committee to explain the performance and investment strategy on at least an annual basis
- Exercising any voting rights in respect of the equity investments held
- Informing the Investment Sub-Committee and its Investment Adviser immediately of:
  - Any material change in the knowledge and experience of those involved in managing the Scheme’s investments.
  - Any change in senior personnel assigned to the management of the portfolio
  - Any breach of investment restrictions agreed between the Committee or Investment Sub-Committee and the Fund Manager from time to time.
  - Any serious breach of internal operating procedures.

Each Fund Manager is directly accountable to the Committee, and has the authority to make decisions on the investments within the terms of the governing documentation.

Each Fund Manager is required to be authorised under the FSMA and to provide the expertise necessary to manage the investments of the Fund.

Fund Managers manage either segregated portfolios, which are run specifically for the Committee or pooled funds, in which the Committee owns units of a shared investment pool in accordance with Investment Management Agreements. Details of the specific funds are contained in the appendices. The appendices are not available in the public version of this document as they contain commercial information.

3.3 Appointment of third party stakeholders

When appointing third parties to provide services to the Committee, a number of factors will be considered. Where appropriate, the Committee may request advice from an independent third party. There are three main stages to this process:

- Desktop due diligence on long-list
- "Beauty parade" of short-list
- Appointment

More detail on the three stages is shown in the table overleaf for different third party providers:

	Investment Managers	Advisers* (actuary, investment adviser)	Custodian
Desktop due diligence on long-list	Investment approach Fee levels Performance Record Team expertise Operational capability Investment vehicle Organisational strength	Services offered Approach to advice Fee levels Organisational structure	Regulatory framework Financial security Segregation of assets Service levels Fee levels Operational capability

Beauty parade of short-list	Meet up to 3 managers depending on the size of the investment May accept a direct recommendation from the Investment Adviser if appropriate	Depending on the nature of the service, a beauty parade may be required	Meet up to 3 providers, focusing on security of assets and added-value services
Appointment	Legal review of appointment and governing documents Agree investment guidelines if appropriate	Legal review of appointment documents Seek independent references Agree nature of services to be provided	Legal review of appointment documents Establish Service Level Agreement

* Note: The auditor is appointed by the States' Policy and Resources Committee

3.4 Process for ongoing review of Performance

3.4.1 Fund Managers

The Investment Sub-Committee, or its Advisers, will regularly review the activities and performance of the Fund Managers to satisfy themselves that each continues to carry out their work competently and has the appropriate knowledge and experience to manage the assets of Scheme to produce the expected returns.

The Investment Sub-Committee aims to meet with each of its Fund Managers at least annually. As part of this review, the Sub-Committee will consider whether or not each Fund Manager:

- Has outperformed or underperformed its particular return benchmark;
- Is carrying out its function competently;
- Has regard to the suitability of each investment and each category of investment; and
- Has been exercising its powers of investment in accordance with its objective, and in line with its guidelines.

If the Investment Sub-Committee is not satisfied with a Fund Manager, it may specify a required level of improvement over a specified period. The Investment Sub-Committee may, alternatively, immediately deselect the Fund Manager.

3.4.1.1 Measurement of Fund performance returns

Each Fund Manager's actual return performance will be measured, where applicable, against three parameters. These are:

- Benchmark: A standard against which a fund's performance is measured, usually an index
- Target: The objective outperformance in excess of the benchmark by a fund
- Governance comparable: An alternative benchmark, usually shown when a fund does not have a market benchmark (e.g. has a cash benchmark instead)

3.4.2 Advisers

The Committee, through its Investment Sub-Committee, will monitor all the Advisers on an ongoing basis, considering the quality of advice and level of service received.

In the case of the Investment Adviser, to ensure continued performance of the adviser there is an annual client satisfaction review, where members of the Sub-Committee are asked to complete a questionnaire on and discuss the services delivered by the Investment Adviser so that any areas for improvement can be identified.

3.4.3 Custodian

The Investment Sub-Committee will monitor and assess the performance and delivery of the custody in two ways:

i. Annual meeting with the Custodian to assess operational issues, new developments and Key Performance Indicators.
ii. As and when required, by engaging an independent Custodian Monitoring expert to assess and benchmark the Custodian service levels, including asset safety, fees and currency exchange rate charges. This option, if taken, would be a joint exercise with the States Policy & Resources Committee as both Committees share a common Custodian.

4 Investment

4.1 Investment Strategy

The investment strategy is to ensure the long-term sustainability of the States of Guernsey Common Investment Fund to meet future benefit obligations.

4.2 Investment Objective

The investment objective is to achieve as high as possible an expected return (as estimated by the investment advisor on a “best estimates” basis) while managing risk within a target level set, and periodically reviewed, by the investment sub-committee. When considering which asset classes to use to build the portfolio, considerations such as complexity, illiquidity and reputational risk will also be taken into account.

A description of the major asset classes is included at the end of the glossary.

4.3 Investment Tactics

The investments are managed by selected Fund Managers who are accountable for their performance against agreed targets. Most Fund Managers have the freedom to rotate investments within their area of investment within agreed ranges specified in their mandate, and to the extent that is feasible, the Investment Sub-Committee delegates tactical asset allocation to the Fund Managers. This is due to the Investment Sub-Committee's belief that Fund Managers are better positioned to monitor and assess markets on an ongoing basis.

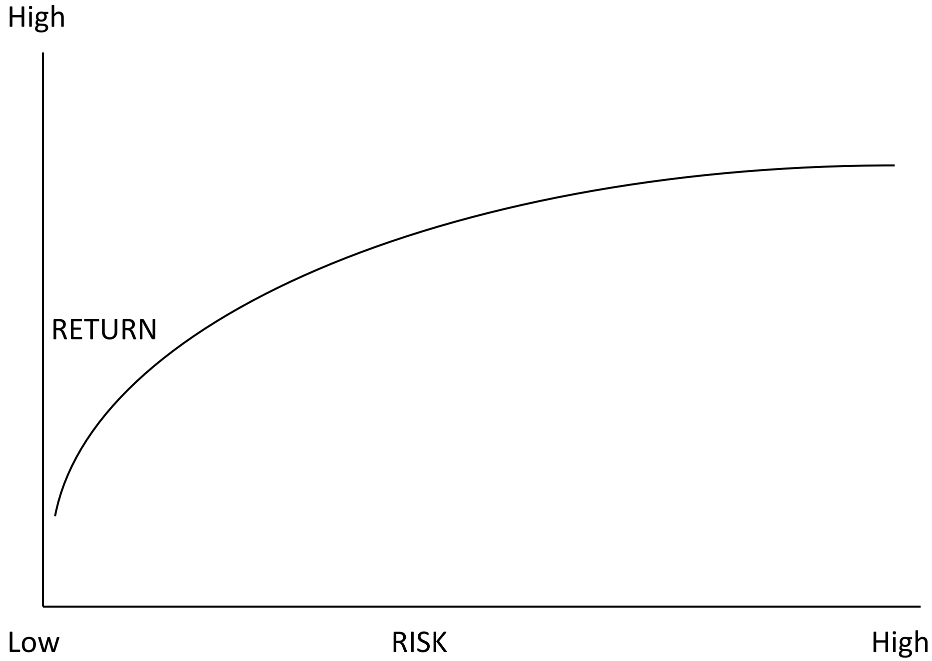
4.4 Investment Principles

The ultimate aim of the fund is to provide a buffer if social insurance contributions are not sufficient to meet benefit payments in any one year. Therefore, in determining the investment strategy for the Common Investment Fund, the Committee has set the following investment principles:

- Sufficient liquidity should be maintained to enable benefits to be paid when required
- The fund should be invested to provide a reasonable return with an acceptable level of risk
- Assets should be diversified by asset type, geography, return driver and manager to control risk
- Stock-level decisions will be delegated to investment managers, within appropriate ranges, through the use of segregated mandates or pooled funds
- The Committee or Investment Sub-Committee will only set, and make changes to, the investment strategy after taking appropriate advice
- Investment decisions will consider the long-term nature of the liabilities, and assumptions made by the Actuary in the actuarial reviews.

4.5 Risk-Return Relationship

In order to meet the Fund's risk and return objectives, the assets will be invested in a diversified range of underlying asset classes. Each has a varying degree of risk and expected return.



The above graph gives a guide to the relationship between the risk and the expected return of an asset class. The department will invest in a range asset classes across the spectrum, from low risk/ low expected return assets to higher risk/ higher expected return assets.

A summary of the main asset classes is included in the glossary.

4.6 Asset Allocation Principles

The Fund invests through each of its underlying managers in order to invest the assets consistently with the investment principles stated in 4.4. The table below explains in more detail how these principles are applied at the asset class level:

Diversification	The Fund's assets are diversified across a wide range of asset classes and within asset classes, across sectors and types of investment. This diversification is intended to reduce volatility in the Fund's asset returns as asset classes and stocks are not fully correlated in their price movements. By diversifying the Fund's portfolio, changes to economic conditions would not be expected to affect each element of the portfolio in an equal magnitude and direction. As a result, falls in one asset class/stock can be tempered by another asset class/stock rising and vice versa. This should smooth and reduce the volatility of the portfolio over an economic cycle.
Rotation	Rotation is the concept of moving between stocks and asset classes in order both to achieve higher returns and protect against asset risks over the economic cycle (3 to 5 years). The Committee does not believe that a manager will be able to "time the market" and be invested in the best performing asset class at all times, however it does believe certain managers have the skill to allocate to appropriate asset classes based on prevailing market conditions. The aim of this is to avoid overvalued asset classes and increase allocation to undervalued asset classes when the opportunity arises, as the risk-return relationship changes over time. Responsibility for rotating between asset classes is left to the underlying managers, within the constraints of their investment mandate.

Hedging	Hedging is the concept of establishing a position in one market in an attempt to offset exposure to price changes or fluctuations in another position or market. It can be used to remove risks that are unrewarded or undesirable and to tailor the risk profile of the investments. This will normally have a cost associated with it, which should be balanced with the potential benefits from the protection that it offers.
Appropriate use of active managers	Active managers aim to outperform a benchmark or index by exploiting market inefficiencies. Typically, a skilful manager will generate superior returns by buying undervalued stocks and selling overvalued ones. The Committee will use active managers appropriately, where it believes the potential for added value out-weighs the additional costs.

The Fund combines these principles to create the overall investment strategy by investing via appropriate managers and mandates. It is important to note that by investing in this manner, it is to be expected that returns will perform differently to equities in most circumstances. For example, in a market where equities are rising strongly, the Fund would be expected to underperform equities, while in volatile markets, or when equities are falling, it would expect to outperform. The intention is that the outcome will be better risk adjusted returns over a full investment cycle, and better protection against loss in adverse market conditions.

4.7 Overall Target Return of the Fund

The overall target return for the Fund has been set at 3m Libor +3.5%. The ISC believes that over the longer term it will be possible to achieve this asset return at a volatility level in the region of 7%. This broadly equivalent to the expected return on equities with approximately half the longer-term volatility.

4.8 Strategic Asset Allocation

The overall fund objective is underpinned by a strategic asset allocation as summarised in the table below. The strategic asset allocation has been created to attain as high as possible an expected return (as estimated by the investment advisor on a "best estimates" basis) within a set risk tolerance. The Investment Sub-Committee has expressed a risk tolerance in the region of 12% Value-at-Risk (or [7%] asset volatility) within which to set the strategic asset allocation. Detailed information regarding each of the Fund Managers can be found in the Appendices. The appendices are not available in the public version of this document as they contain commercial information.

Asset Class	Allocation (%)	Cash	Equity	Fixed Income	Hedge Funds	Other*
Equity	**15**					
BlackRock Structured Equity	12		100%			
BlackRock EM Equity	3		100%			
Fixed Income	**32**					
Legg Mason Broad Bonds	8	10%		90%		
CQS Multi-Class Credit	9	5%		95%		
M&G Alpha Opportunities	11	20%		80%		
Apollo Total Return Enhanced Fund	4	11%		78%		11%
Liquid Alternatives	**38**					
GMO Dynamic Asset Allocation DGF	10	21%	55%	19%		5%
AQR Diversified Risk Premia	15					100%
Man Diversified Risk Premia	13					100%
Illiquid Alternatives	**15**					
Morgan Stanley Diversified Alternatives	15	13%	7%	18%	44%	18%
Cash	**0**					
BlackRock Liquidity Fund	0	100%				
Total Allocation	**100**	**7%**	**40%**	**25%**	**10%**	**15%**

*The majority of this category is made up of "Diversified Risk Premia" ("DRP") strategies, which is a type of strategy that gains exposure to a basket of traditional and alternative risk premia via using a quantitative, systematic trading approach. While the underlying instruments in DRP strategies are straightforward (equities, bonds, commodities and currency), the use of leverage and long/short positions for implementation makes it difficult to provide a physical allocation breakdown in a meaningful way for this type of strategy._Please note that the Expected Returns shown above can change over time with changing market conditions.

The Fund is currently going through the process of transitioning into the Strategic Asset Allocation outlined above, which is expected to be finalised by mid-2018. The most recent actual asset allocation has been set out in Appendix B of this document. The appendices are not available in the public version of this document as they contain commercial information.

4.9 Review of Investment Strategy

- The components of the investment strategy will be monitored on an ongoing basis throughout the year, and the Investment Adviser may bring tactical investment opportunities to the attention of the Investment Sub-Committee when they arise.
- The Strategic Asset Allocation will be monitored by the Investment Sub-Committee each quarter following the receipt of a strategy report from the Investment Advisers.
- The strategy will be reviewed on an ongoing basis to ensure it is in line with the stated objectives, and also taking into account any changes to the Actuarial assumptions as and when such information is available.
- Every 5 years, in line with the Actuarial Valuation, a full strategy review will be conducted to ensure that the objectives of the Fund are still appropriate.

4.10 Rebalancing Process

Rebalancing involves moving funds within the portfolio so that the asset allocation remains aligned to the strategic allocation. The Investment Sub-Committee is not concerned by short-term fluctuations, but should the allocation diverge substantially from the strategic allocation and be outside the guiding ranges set out in the table under section 4.8, the Sub-Committee Department will consider rebalancing the funds back towards the strategic target, taking into consideration practical and operational implications of such rebalancing. This is monitored in the quarterly reporting.

5 Risk Management

5.1 What do we mean by risk?

Risk is the possibility that an event or situation arises that reduces the likelihood of the Committee's investment funds achieving their financial objectives. There are many different types of specific risk. To aid understanding, these risks can be grouped into categories, some of which are described in the table below:

Type of risk	Description
Governance (5.2)	The risk associated with poor governance – essentially this occurs where there is a failure to act as issues emerge.
Financial exposure (5.3)	Financial exposure risk is the potential for losses (compared to objectives) from falling asset values resulting from market movements.
Performance (5.4)	Performance risk is associated with the poor performance of appointed Fund Managers and other providers.
Demographic exposure (5.5)	The risk of an increased cash flow requirement from the Fund resulting from demographic changes, such as an increase in life expectancy, or reduction in working population.
Operational control (5.6)	The risk associated with losses resulting from weak controls, process or security

Each of these areas should be considered. However, the existence of the latter four is the reason the first exists – governance risk is essentially the failure to act as a result of the emergence of one of the other types of risk.

5.2 Governance Risk

Governance is the framework within which other risks are considered. The result of this consideration should, where appropriate, lead to action. It is therefore worth being clear at the outset that:

- Objectives are well understood (as this is the reference compared to which risk will be calculated)
- Fund manager and other provider mandates are well defined

- Fund managers and providers are asked to articulate how their strategies might perform in different market and economic conditions.

Once this is done, the risks in the other areas can be defined and evaluated properly. The focus should then become on designing metrics and benchmarks that are consistent with the conditions identified above. This will make deciding to act more straightforward.

5.3 Financial Exposure Risk

There is a wide range of financial exposures that are worthy of monitoring. This in itself can be a challenge. To reduce the risk of governance being impaired through too much information, it is important to consider what the purpose of reviewing financial exposure should be.

By definition, all modelling is an approximation of reality based on assumptions. Therefore, a single approach to risk measurement is insufficient. Models are useful tools to help understand risk and sensitivities, but even the most sophisticated models have their limitations.

The Department considers financial exposure risk through three lenses:

"Value-at-Risk" (or "VaR"): The Value-at-Risk measures the minimum fall in the value of the assets in a worst-case scenario over the next year.For the Fund, a worst-case scenario is measured as a "1-in-20 bad year". While this metric is a very useful relative measure of risk, it can underestimate the occurrence and severity of "tail risk"; i.e. low probability events with a high impact (such as the 2008 financial crisis). As such it is not a perfect risk measure and needs to be complemented with other risk measures.

Stress test scenarios: Scenario stress tests evaluate the Fund's susceptibility to 'what if' stress test scenarios, such as a large change in interest rates or a repeat of the economic conditions following the 2008 financial crisis. Stress tests are particularly useful because they complement the VaR analysis by looking at the type of "low probability/high impact" events that might be underestimated by VaR.

Market volatility: The third lens assesses the expected level of volatility in the asset classes invested in, based on historical data.

In assessing suitable mandates to invest in, the Investment Sub-Committee will also apply a qualitative assessment of the strategy to ensure the results are sensible, defendable and meet the non-financial needs of the Sub-Committee. These qualitative risks include consideration of:

5.3.1 **Country risk** – the risk of an adverse influence on investment values from political intervention is reduced by diversification of the assets across many countries.

5.3.2 **Currency risk –** is managed by the investment managers within those portfolios where currency exposure is allowed

5.3.3 **Concentration risk –** the risk of an adverse influence on investment values from the concentration of holdings is reduced by the diversification of the assets.

5.3.4 **Mismanagement risk –** the risk of unsuitable investment activity by the Investment Managers. This is addressed in the agreements with the Investment Managers which contain a series of restrictions. The activity of the Investment Managers and their processes are monitored regularly by the Advisers on behalf of the Department.

5.3.5 **Default risk –** the risk of income from assets not being paid when promised. This is addressed through restrictions for the Investment Managers e.g. a minimum credit rating of the bonds they are allowed to buy and use of active management for lower rated bonds to minimise the default risk.

5.3.6 **Organisational risk –** the risk of inadequate internal processes leading to problems for the Investment Sub-Committee. This is addressed through regular monitoring of the Investment Managers and Advisers.

5.3.7 **Counterparty risk –** the risk of the counterparty to an agreement not carrying out his side of the deal. Where derivatives are used, the risk of counterparty default is reduced through the requirement in the relevant documentation that regular collateral or margin payments be made. It is also considered in the selection of counterparties and the incorporation of protection mechanisms in the documentation in the event of a downgrade in credit quality of an existing counterparty**.**

5.3.8 **Cash flow risk –** addressed through the monitoring of the cash flow requirements of the Investment Sub-Committee to control the timing of any investment/disinvestment of assets.

5.3.9 **Transition risk** – the risk of paying unnecessary costs or being at increased risk of adverse market movements, when transitioning assets from one Manager or asset class to another. This risk is mitigated by organising transitions in a structured fashion with the advice of the Advisers or by using a specialist transition Manager, if appropriate**.**

5.4 Performance Risk

As well as financial exposure risk, poor performance of Fund Managers and providers, including the Investment Adviser, can also have a significant effect. The table below identifies the risk mitigants:

Principles	Description
Objectives should be clear	It should be well understood what the objectives of Fund Managers and providers are and the time horizon over which these operate.
Evidence of skill and its basis should exist	There should be evidence that added-value is skilful (rather than lucky or the result of a persistent systemic position). The basis for skill – i.e. what it is and why it is expected to persist – should be clear and understood. If this evidence does not exist, it is difficult to have confidence in the ability of performance to be delivered.
Decisions should be made within constraints	All mandates involve constraints within which the Fund manager or provider must operate. It is important that operations are within the mandate and that there have been no breaches (or any breaches have been rectified quickly).
Characteristics of performance should be understood in advance	It is important to understand in advance how the Fund Manager or provider is expected to perform in a range of different conditions, in order that returns generated over various time horizons may be interpreted effectively.

The ISC takes advice from its Investment Advisor prior to appointing Fund Managers. All Fund Managers sign an Investment Management Agreement (IMA) with the Committee. IMA's set out the legal mandate in terms of objectives, constraints and the roles and responsibilities of all related parties. The ISC monitors Fund Managers' performance to ensure they are delivering their objectives in line with their mandates. More detail on the governance process for reviewing Fund Managers and advisors can be found in Section 3.4.

Review of historical performance

Having set the performance tolerances above, these can be measured on a regular basis by comparing actual performance with the target, benchmark and where appropriate a Governance comparable figure (i.e. the Fund Manager's performance might be exaggerated or impaired because of factors that affect all similar managers in the same way).

5.5 Demographic Risk

Financial exposure risks are important, but the impact of demographics on the commitments of the funds may be just as relevant. The demographics risks may affect the drawdown from the Fund in a number of ways:

Source	Description
Mortality	Where benefits are related to death, the value of the benefit will be driven by this. This is particularly an issue in relation to the provision of pensions, where payments are made until the death of the beneficiary. Improvements in life expectancy would naturally result in paying out more than expected, which represents a risk to the Fund.

Ill-Health	Some benefits relate to the incidence of ill-health, for example where this is in respect of invalidity or long-term care costs. Changes in this can result in paying benefits for longer, or greater overall levels of benefits.
Structure of population	The ability to finance the various funds is affected by the level of contributions, which in turn is related to the structure of the population. Therefore, a long run risk to the Fund is the relationship between those "paying" for the benefits and those receiving them.

These risks are important in absolute terms, but can intensify when combined with financial risks. For example, the "intensity" of an increase in longevity is magnified if the investment return on the Fund is expected to be lower. This has a very real effect on the risks of the Fund, if it affects the recommended contributions. Hence, these risks are not only about their effect on the long-term cost, but also on the effect of the incidence of contributions in the short/medium-term. The Actuarial Reviews that are undertaken at least every five years provide relevant information for this type of risk.

5.6 Operational Risk

Operational risks can be either internal or external. Internal risks mainly refer to cash flow management. The Committee must ensure it plans for future cash flows and that all payments will be made in a timely manner.

Where funds are required to be moved quickly, the Committee needs access to at least two signatories at short notice, one from the A list and the other from the B list of authorised signatories. The Committee will maintain a minimum of 3 A list signatories and 3 B list signatories in order to reduce the risk of not being able to act quickly on an investment or disinvestment.

External risks primarily relate to the process and control errors caused by external parties, such as Fund Managers, custodian or advisers. These risks are mitigated by thorough research and due diligence.

6 Regular Reporting

6.1 Reporting Principles

The Investment Sub-Committee recognises the considerable amount of information available in connection with investment of the assets. It is important to be aware of the various investment portfolios and to receive the necessary information for performance reporting, accounting and audit purposes. It is also essential to organise reporting to allow the decision-makers to focus on the important information.
The Sub-Committee has organised the reporting system to distinguish between Executive Governance and Secondary reporting. Reports that are included as Secondary reports generally give an extra level of detail that is generally not required for the day to day governance of the fund, but can be useful if questions arise from the primary reporting or more detail is required.

The Executive Governance Reporting function will aim to provide insightful and effective executive summary information supported by the data contained in the Secondary reporting. This will focus on achieving the following:

- **Consolidation** -- The Executive Governance Reporting will support effective governance through summarising all the information on investment performance in a single comprehensive document.

- **Focus** -- The information in the Executive Governance Reports will be focused on the particular investment strategy of the Investment Sub-Committee and will be relevant to the issues faced by the decision-makers.

- **Priority** -- Governance Reporting is an important tool in helping the Investment Sub-Committee to prioritise areas for consideration and potential action. Given the volume of information available, it is important this reporting allows the decision-makers to order their time effectively.

- **Insight** -- The information provided in Executive Governance Reporting should pass the “does this tell me something” test? As well as quantitative analysis which can help with attribution of areas of relative success and failure, the reporting will address organisational issues at the various appointed Fund Managers and providers.

- **Context** -- This level of reporting will also seek to reference current market conditions and the impact on strategy of shorter as well as longer term trends.

The table below provides a summary of this reporting structure and provides examples of the reports available at the two levels of reporting.

Frequency	Executive Governance Reports	Secondary Reports Available
Monthly	Monthly Valuations	Manager Monthly Holdings Statements NT Asset Valuations
Quarterly	Investment Strategy Report Manager Monitoring Report	Individual Manager Reports
Ad-Hoc	Briefing Notes and Manager updates	Manager commentary Manager Operational Reports e.g. SAS70 or equivalent

6.2 Format of Reporting

More detail on each of the Executive Governance Reports is shown below:

6.2.1 Monthly Valuations

- Provide a valuation of the total assets split between the different Fund Managers and mandates
- Compare the proportionate allocation of each to the strategic allocation

To be provided by Northern Trust within 16 working days of month end.

6.2.2 Quarterly Governance Report

A comprehensive report which aims to provide the majority of the information required for the governance of the investments. It includes:

- Exception reporting to highlight key areas that the Investment Sub-Committee should be aware of
- Summary of general asset-class performance and overall market commentary
- Total Fund performance vs objective over quarter, year, 3 years and since inception (including a graph of cumulative performance)
- Performance of the total strategy relative to a Least Cost Governance Solution to assess the value of the Investment Sub-Committee's decisions, the advisers and the active managers relative to a simple passive strategy
- Asset valuation page showing;
  - Valuation of assets at the beginning and end of the quarter split by Fund Managers and mandate
  - Details of any cash flows/transitions between funds
  - Independent reconciliation of asset movements
  - Comparison of actual asset allocation and the strategic benchmark
- Manager Research Page highlighting any changes/concerns with the Fund Managers' processes, teams or organisation, using a traffic light system
- Detailed performance of each Fund Manager and mandate relative to its benchmark over the quarter, year, 3 years and since inception
- Monitoring of asset allocation for each Fund Manager, where appropriate, to ensure these remain within the agreed tolerance ranges
- A forward plan to monitor regular investment tasks

Executive Report to be provided by Northern Trust within 20 working days of the quarter end. The Investment Advisor will also provide a Governance Report one week before the quarterly ISC meetings.

6.2.2 Investment Adviser's Quarterly Strategy and Risk Reports

The Investment Adviser will report quarterly on the risk and return characteristics of the investment strategy using a range of different analytical risk tools. This report may also highlight any changes in the investment strategy over the year and consider whether any further changes may improve the risk return profile.

6.2.3 Manager Monitoring Report

The Investment Adviser will report quarterly on the performance of the managers that hold the Fund's assets, showing the 3-month, 12-month and "Since Inception" return of each investment. This report will also aim to provide a qualitative judgement on each manager, including factors such as the Ethical, Social and Governance views incorporated by the manager and/or within the asset class.

6.2.4 Quarterly Public Statement

A public statement is issued each quarter to all Members of the States of Guernsey and to all local News Media. The quarterly statement reports the valuation of the Common Investment Fund at the quarter-end. It also reports the performance over the quarter, 12 months and 3 years.

7 Fees

7.1 Fund Managers' Fees

A detailed breakdown of each Fund Managers' fees can be found in Appendix C (The appendices are not available in the public version of this document as they contain commercial information).
Where specific project activity has been agreed with the Investment Sub-Committee, separate fee arrangements will be approved in advance by the Sub-Committee and will be in addition to standard fees.

7.2 Investment Advisor's Fees

A detailed breakdown of the Investment Adviser's fees can be found in Appendix D (The appendices are not available in the public version of this document as they contain commercial information).

7.3 Custodian Fees

The current custodian, Northern Trust, charges a range of fees for different services. These are summarised in Appendix E (The appendices are not available in the public version of this document as they contain commercial information).

8 Other

8.1 Cash Flow Management

The Committee's contributory social security benefits operate essentially on a pay-as-you-go basis, where contribution income should be sufficient to meet benefit outgoings. After many years of surplus, when reserves have been allowed to accumulate for investment, a long-term period of operating deficits has now been entered. Based upon the 2011 Actuarial Review, the deficits will progressively increase, reducing the approximate 5-fold cover of the Guernsey Insurance Fund (5 years' annual expenditure) down to a 2-fold cover by around 2040.

In view of the foregoing, cash flow management, including increased use of short-term fixed income, will feature increasingly in the management and governance of the Common Investment Fund.

8.2 Social and Ethical Investment

The Investment Sub-Committee acknowledges the benefits of Social and Ethical Investment, but has no asset allocation specifically in those areas by way of specialist funds. The Sub-Committee's policy is that social, environmental or ethical considerations are taken into account at the discretion of the Investment Manager. However, the Sub-Committee Department expects that the extent to which social, environmental or ethical issues may have a financial impact on the portfolio will be taken into account by the Investment Managers in the exercise of their delegated duties.

8.3 Currency Exposure

The Investment Sub-Committee recognises that there is a potential risk associated with investing in assets that are not in the same currency as the liabilities. The Sub-Committee generally leaves currency hedging decisions to the discretion of the Fund Managers, whose performance is judged on their Sterling return.

8.4 Use of Derivatives

The Investment Sub-Committee allows the use of derivatives, provided that they are used for risk management, and not for speculation. Fund Managers will use derivatives primarily for efficient portfolio management and currency hedging within the portfolio. Any specific derivative based investment will only be considered after appropriate training has been undertaken and it can be demonstrated that the investment is in line with the Committee's Investment Principles.

8.5 Training of Investment Sub-Committee Members

The Investment Sub-Committee will meet regularly with its Investment Adviser. In addition to receiving training by way of briefings, the Sub-Committee will request training in specific areas as considered necessary.

Glossary

Term	**Description**
Actuary	Individual or firm that assesses the financial impact of risk and uncertainty
Adviser	A firm or person who provides advice to a client
Alternatives	Investments in assets where drivers of return are different from mainstream asset classes such as equity and bond markets. Examples include property, hedge funds, commodities and private equity
Benchmark	A standard against which a fund's performance is measured, usually an index, e.g. FTSE 100
Collateral	Assets that are offered to secure a derivative's market value and which become subject to seizure on default
Counterparty	The party holding the other side of the derivative contract, usually an investment bank
Custodian	An organisation, usually a bank, that holds the shares and bonds that make up the portfolio
Derivatives	Contract between two parties which has a value dependent on the price movements of an underlying asset or variable. Can be used for hedging or efficient portfolio management
Fixed Income	An investment which obliges the issuer to make payments on a fixed schedule, e.g. a bond
Fund Manager	A firm or person who is responsible for buying and selling of stocks and/or bonds in a portfolio of assets
Fund Objectives	The risk and return objectives of a Fund. An example could be that the investment objective is to outperform inflation over five years, without losing more than 10% in any 12 month period.
FTSE	Financial Times Stock Exchange: provider of stock market indices.
Gearing	Scaling up of gains and losses. This can be done using derivatives or through borrowing
Hedging	Protection against a particular outcome (e.g. falling interest rates). Particularly useful for risk management
Liquidity	Ability of an asset to be sold quickly without causing significant movements in the price
MSCI	Morgan Stanley Capital International: provider of indices and other investment decision support tools
Portfolio	A collection of investments

Structured Equity	A collection of derivatives which give returns based on the performance of an underlying equity index
SAS70	Internal controls audit document used by auditors to ensure internal processes and systems are of sufficient standards for the purposes they are used for in the management of a fund
Volatility	Measure of the severity of change in the price of an asset or index. The most used measure of volatility is standard deviation

Asset Class Glossary

Asset Class	**Description**
Equity	Investment in the ownership of a company. Generally considered quite risky due to price and dividend volatility, however expected return is generally high to compensate for extra risk.
Government Bonds	Lending to a government. In return for an initial payment you receive a string of coupons and a redemption payment. Returns are generally low for developed economies and higher for less developed economies depending on the perceived risk of default.
Corporate Bonds – Investment Grade	Corporate bonds are similar to government bonds in structure, but involve lending to a company, so return or yield is expected to be higher. Investment grade bonds are issued by more stable companies with credit ratings of BBB and above.
Corporate Bonds – High Yield	Similar again to government bonds in structure. High yield bonds are issued by companies with credit ratings of BB and below. Investment return is expected to be higher than for Investment Grade bonds due to higher risk of default. A high yield bond would be less risky and hence have lower expected return than an equity holding in the same company.

Alternatives	The term “alternatives” can include a wide range of asset classes employing different strategies, with the aim of providing diversification to equities and corporate bonds. Alternative assets can be divided into liquid and illiquid alternatives as follows: Illiquid alternatives: Real assets (e.g. infrastructure), property, private equity, insurance-linked securities, and private debt. Such assets aim to gain access to an illiquidity premium. Liquid alternatives: “Diversified Growth Funds“ and “Diversified Risk Premium” strategies. These strategies invest in standard liquid asset classes (primarily bonds, equities, and commodities), but in a way that provides an alternative and diversifying risk/return profile of the assets in question.
Multi-Class Credit	Multi-Class Credit is an investment strategy where the manager has the flexibility to dynamically allocate across multiple credit asset classes. This approach is typically benchmark agnostic and relies on security selection and asset allocation decisions as its primary drivers of return.