# Australia's Future Fund

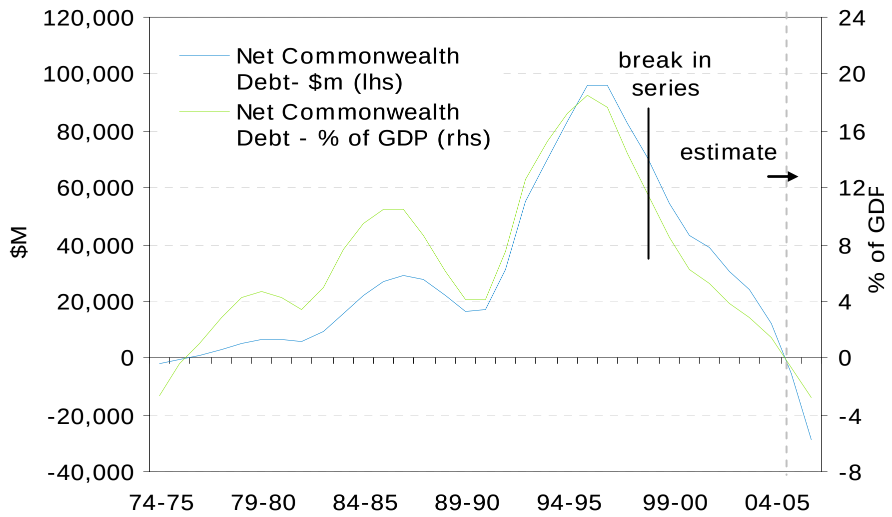
**27 June 2007**

**Author:**

**Cherelle Murphy**
Senior Economist, Markets
+61 3 9273 1995
cherelle.murphy@anz.com

The Future Fund was a policy decision taken by the Commonwealth Government during the 2004 federal election campaign. In anticipation of the elimination of net debt, the Government said it would invest future surpluses for the purpose of offsetting the Government's own unfunded superannuation liabilities. Although these liabilities are not included in the Government's definition of its debt, it could be argued that they always should have been.

**Figure 1: Net Commonwealth Government debt has been eliminated**




Source: ANZ Investment Bank and Budget Papers, 2007-08

The Commonwealth Government is concerned about its ability to meet future liabilities given the ageing population and growing health costs. An Intergeneration Report examining the fiscal pressures on future governments was released in the 2002-03 Budget. **It projected fiscal deficit of 5% of GDP by 2041-42 if no policy action were taken.** The exercise was repeated this year and although several demographic changes and policy alterations have improved the outlook, the fiscal future still looks dire. The fiscal gap is projected to be around 3.5% of GDP by 2046-47. The Future Fund was established as part of a broader policy initiative to start reducing costs and limiting sources of future spending.

Australia's Future Fund is no different, in theory, to the sovereign wealth funds of other nations. **It is a vehicle designed to invest the fortunes of today to ease difficult fiscal conditions of the future.** But its very specific purpose narrows how its assets can allocated, unlike many other country's sovereign wealth funds. Under Government policy, assets can only be drawn from the Future Fund to meet superannuation payments and the expenses of the Fund. Payments can only be made from the Fund from 2020 or once the Fund has accumulated enough assets to meet the unfunded liabilities.

## Commonwealth superannuation liabilities

**The Military Benefits Superannuation Scheme will continue to accumulated liabilities well beyond 2046-47.**

The Government's superannuation liabilities have been accrued under the Government's Commonwealth Superannuation Scheme, the Public Sector Superannuation Scheme, the Defence Force Retirement Benefit Scheme and the Military Benefits Superannuation Scheme. Other than the Military Benefits Superannuation Scheme, these defined benefit superannuation schemes have now been closed to new members and replaced by fully funded accumulation schemes. The liabilities of the funds that have been closed will eventually fall in value. However the Military Benefits Superannuation Scheme will continue to accumulated liabilities well beyond 2046-47.

The 2007-08 Budget, which was released in May 2007, showed that the liabilities had grown beyond the Government's previous estimates. This was mainly due to growth in the superannuation liabilities of Defence Force personnel. Anecdotes suggest that due to labour shortages in the defence industry, retired defence personnel have gone back to work; resurrecting their superannuation accounts. Unfunded superannuation liabilities were re-estimated at $148B by 2020, up from the $140B estimate made in the 2006-07 Budget. **By 2046-47, the liability is expected to be $200B.**

**Figure 2: Commonwealth Government Superannuation Liabilities**

| | 2006-07 | 2007-08 | 2008-09 | 2009-10 | Estimate by 2019-20 | Estimate by 2046-20 |
|---|---|---|---|---|---|---|
| $M | 102,166 | 105,951 | 109,639 | 113,358 | 148,000 | 200,000 |

Source: Budget Paper No.1 and Budget Overview 2007-08.

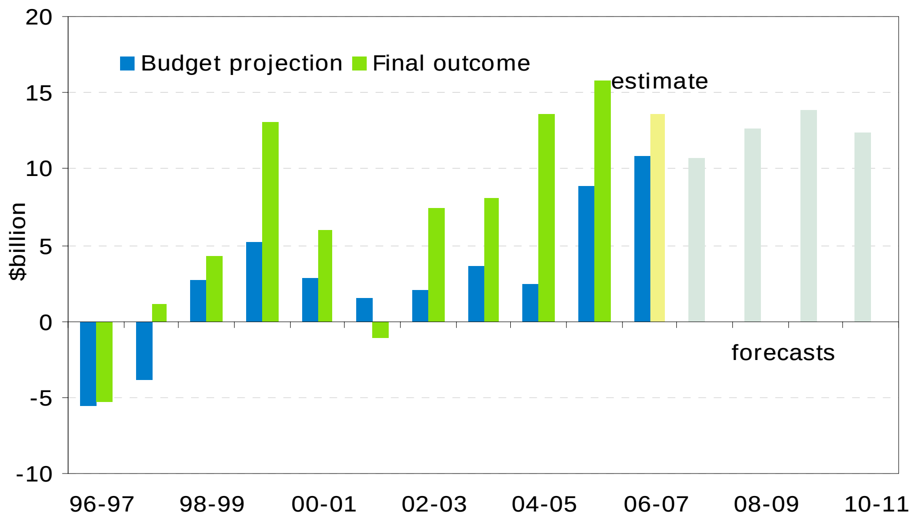
## Future Fund on target

**We estimate that it may only take one more surplus injection to allow the Future Fund to hit its notional target of $148B by 2019-20.**

Despite the reassessment, **we estimate that it may only take one more surplus injection to allow the Future Fund to hit its notional target of $148B by 2019-20.** This is because the Future Fund's asset base has also grown much faster than expected due to last year's stronger than expected surplus and the Telstra share price appreciation (the Future Fund holds 17% of the company).

This is an important outcome for financial markets as a large chunk of the $52B which is currently held in cash, Telstra shares and fixed interest will soon be invested in a mix of cash, fixed interest and equities, including illiquid and private equity investments. In a May 16 speech, chairman of the Future Fund, David Murray said the Future Fund would be operational by the end of June.

**Figure 3: Better than expected surpluses boost Future Fund's capital base**




Source: ANZ Investment Bank and Budget Papers, various issues

The Future Fund is facing significant top-ups in the year ahead.

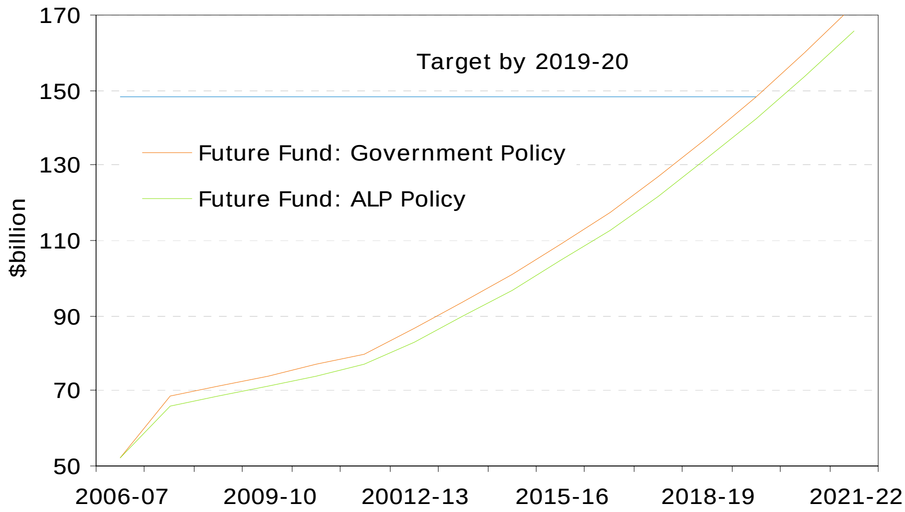
The Future Fund is facing significant top-ups in the year ahead. The second instalment of Telstra sale proceeds, which are worth around $6.5B will be paid to the Government by May 2008 and deposited into the Future Fund sometime soon after. Part of the 2006-07 surpluses will also be deposited in the Fund. In a post-Budget speech, the Treasurer Peter Costello said $1 or $2B of the surplus would have to be retained to make loans and meet the Government's costs of in-year financing but the remainder will be deposited in the Future Fund.

The maximum likely will be around $7.5B, as $5B of the estimated $13.6B surplus for 2006-07 has been allocated to the Higher Education Endowment Fund. However, as shown above, the Government may get more in revenues than it currently expects and so the surplus may again be bigger than estimated at this point.

We expect the balance of the Fund will be around $80B by 2011-12.

**We expect the balance of the Fund will be around $80B by 2011-12**. This is based on the Government's estimate of a $52B balance in the Future Fund at June 30, plus the Government's estimated earnings over the forward estimates period, a $7B deposit from the 2006-07 surplus and approximately $6.5B from the second instalment of Telstra receipts. That assumes no more surpluses are deposited beyond 2006-07 and is in line with an estimate made by the Future Fund's general manager Paul Costello at a February 2007 Senate Estimates Committee. If the Fund were then to grow at a nominal rate of 8% pa until 2019-20, we estimate that it could reach $148B and meet the Government's target.

**Figure 4: Future Funds' projected value**



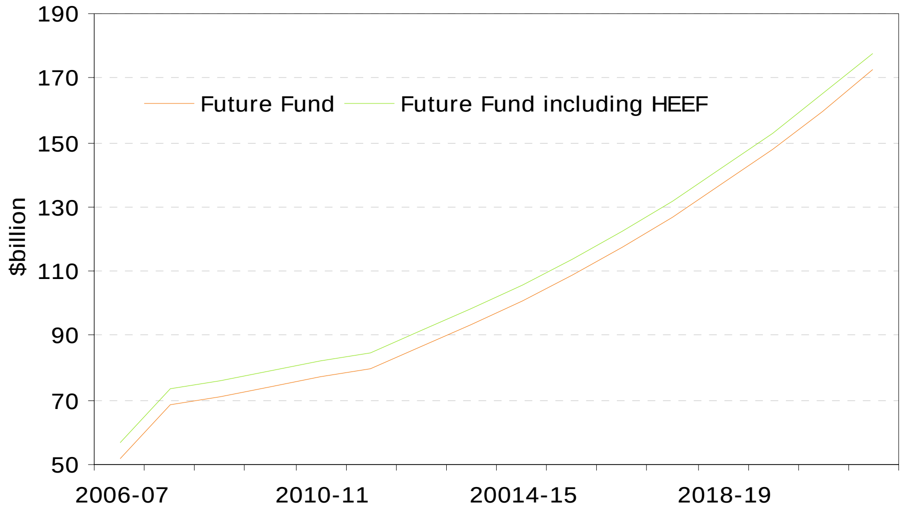

Source: ANZ Investment Bank and 2007-08 Budget Papers.

Assumptions: Nominal growth of 8%pa from 2012-13, ALP National Broadband Network established in 2007-08, no surpluses injected after 06-07.

## Higher Education Endowment Fund

The $5B allocated from the 2006-07 Budget surplus for the Higher Education Endowment Fund represents funds that would otherwise be deposited into the Future Fund. For the financial markets, however, the consequences are minimal. Like the Future Fund, the HEEF will be managed by the Future Fund's Board of Governors, although each year its earnings will be devoted to capital works and research facilities by the Minister for Education, Science and Training. This is in contrast to the Futures Fund's earnings, which will accumulate in the Fund under current Government policy.

**Figure 5: Future Fund plus HEEF**




Source: ANZ Investment Bank and 2007-08 Budget Papers.

Assumptions: Nominal growth of 8%pa from 2012-13, no surpluses injected after 06-07.

## Investment mandate

The Government issued the investment mandate to the Board in May 2006. **The Board must only invest in financial assets and adopt a long-run real rate of return of at least 4.5%,** although a lower return has been deemed acceptable in the short term as the Board implements its investment strategy. The investment mandate also said the Board must "determine an acceptable but not excessive level of risk for the Fund" and determine its approach to corporate governance in line with international best practice for institutional investment.

**The Fund will not be able to take a controlling stake in companies or hold more than 20% of any foreign publicly listed company.**

The Fund will not be able to take a controlling stake in companies or hold more than 20% of any foreign publicly listed company. Murray also said at the May 16 speech that it may not own any more than 21% of any one company. In relation to Telstra, the Board must take the direct equity transferred to the Fund from the Government, but not otherwise invest directly in the company.

The Government also specifically mandated that the Board not cause any abnormal change in the volatility or efficient operation of Australian financial markets, or affect the Government's reputation in the markets. The Future Fund managers are unlikely to disclose any details of the Fund's asset allocation.

## The Australian Labor Party's Future Fund policy

**It is likely that a Rudd Government would have other infrastructure investment plans for the Fund, which would mean less capital to flow directly into financial markets.**

The 2007 Federal election is likely to be held in the fourth quarter of 2007 and the ALP has a strong lead in the polls. Hence it is possible the Future Fund may be directed by ALP policy as early as October this year. **The Australian Labor Party said it would use $2.7B of the Future Fund (in principal drawing from the Future Fund's share in Telstra) to partner with the private sector and partially finance a national broadband network**. That would shave around 5% from the current capital in the fund, meaning it would not reach $148 billion until about 2020-21 under our assumptions, as in Figure 5.

The ALP has not opposed the Government's policy to deposit $5B from the 2006-07 Budget surplus into the HEEF, although the Party has not said it would see the policy through if it won Government. If it chose instead to deposit the $5B into the Future Fund, the projections outlined above would result in a balance of $148B about a year sooner than under the Government's policy according to our assumptions.

The ALP has also floated the idea of using some of the earnings of the Future Fund for investment in infrastructure. More detail on these plans is likely to emerge as the 2007 Federal election approaches.

**ANZ Research**

## ANZ Research

**Saul Eslake**
Chief Economist
+61 3 9273 6251
eslakes@anz.com

## ANZ Investment Bank



| | | | |
|---|---|---|---|
| **Warren Hogan**<br>Head of Research<br>+61 2 9227 1562<br>hoganw1@anz.com | **Sally Auld**<br>Senior Interest Rate Strategist<br>+61 2 9227 1809<br>aulds@anz.com | **Tony Morriss**<br>Senior Currency Strategist<br>+61 2 9226 6757<br>morria15@anz.com | **David Croy**<br>Strategist, UK<br>+44 20 7378 2070<br>croyd@anz.com |
| **Cherelle Murphy**<br>Senior Economist, Markets<br>+61 3 9273 1995<br>cherelle.murphy@anz.com | **Patricia Gacis**<br>Fixed Income Analyst<br>+61 2 9227 1272<br>gacisp@anz.com | | |
| **Sarah Percy-Dove**<br>Head of Credit Research<br>+61 2 9227 1142<br>percydos@anz.com<br>ANZIB | **John Manning**<br>Senior Credit Analyst<br>+61 2 9227 1493<br>manninj1@anz.com<br>ANZIB | **Bradley Bugg**<br>Senior Credit Analyst<br>+61 2 9227 1693<br>buggb@anz.com<br>ANZIB | |



## Economics



| | | | |
|---|---|---|---|
| **Tony Pearson**<br>Head of Australian Economics<br>+61 3 9273 5083<br>pearsont@anz.com | **Amy Auster**<br>Head of International Economics<br>+61 3 9273 5417<br>austera@anz.com | **Paul Braddick**<br>Head of Financial System Analysis<br>+61 3 9273 5987<br>braddicp@anz.com | |
| **Julie Toth**<br>Senior Economist Industry<br>+61 3 9273 6252<br>tothj@anz.com | **Jasmine Robinson**<br>Senior Economist International<br>+61 3 9273 6289<br>robinsj7@anz.com | **Ange Montalti**<br>Senior Economist<br>+61 3 9273 6288<br>montalta@anz.com | **Mark Rodrigues**<br>Senior Economist Australia<br>+61 3 9273 6286<br>rodrigum@anz.com |
| **Katie Dean**<br>Senior Economist, International<br>+61 3 9273 5466<br>deank1@anz.com | **Amber Rabinov**<br>Economist<br>+61 3 9273 4853<br>rabinova@anz.com | **Alex Joiner**<br>Economist<br>+61 3 9273 6123<br>joinera@anz.com | **Riki Polygenis**<br>Economist<br>+61 3 9273 4060<br>polygenr@anz.com |
| **Fiona Allen**<br>Business Manager<br>+61 3 9273 6224<br>allenf@anz.com | **Cherelle Murphy**<br>Senior Economist, Markets<br>+61 3 9273 1995<br>cherelle.murphy@anz.com | | |



## ANZ New Zealand



| | | | |
|---|---|---|---|
| **Cameron Bagrie**<br>Chief Economist<br>+64 4 802 2212<br>bagriec@anz.com | **Khoon Goh**<br>Senior Economist<br>+64 4 802 2357<br>Khoon.goh@nbnz.co.nz | **Sean Comber**<br>Economist<br>+64 4 802 2286<br>combers@anz.com | **Steve Edwards**<br>Economist<br>+64 4 802 2217<br>edwards1@anz.com |
| **John Bolsover**<br>Industry Economist<br>+64 4 496 8757<br>bolsovej@anz.com | **Kevin Wilson**<br>Rural Analyst<br>+64 4 802 2361<br>Kevin.Wilson@NBNZ.CO.NZ | **Mark Elliott**<br>Technical Analyst<br>+64 9 357 4080<br>elliottm@anz.com | |



I