Zurich Investment
Management Limited

Derivatives Risk Management Processes (DRMP)

Contents

1. Purpose of the DRMP

The purpose of this document is to set out the processes established for the use of derivative investments in relation to the investment strategy of Zurich Investment Management Limited.

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2. The Entity Responsible for the DRMP

ZIM is the entity responsible for producing this DRMP. ZIM is licensed to provide certain financial services including:

- Operating registered managed investment schemes; and
- Dealing in interests in registered managed investment schemes.

ZIM does not currently directly deal in derivatives. Currently ZIM either:

- Outsources investment management activity for underlying assets of the schemes which it operates to external investment managers (ZIM receives advice relating to some assets and has delegated functions to external investment managers pursuant to individual Investment Management Agreements (IMA) and related investment mandates); or
- Invests scheme assets into other managed investment schemes managed by an external responsible entity (RE) (ZIM only holds units in such managed investment scheme and the external RE's processes for use of derivative investments in relation to the underlying assets are governed by the external RE's DRMP equivalent).

ZIM may also outsource investment operations and currently uses JP Morgan (Chase) Bank to provide it with certain custodial services.

This DRMP applies to all collective investment schemes (including registered managed investment schemes) operated by ZIM that is managed by an external investment manager on behalf of ZIM (the Schemes). Where the context requires, "Scheme" also refers to any individual portfolio of underlying assets of a particular scheme which is managed by an external investment manager.

Zurich Financial Services Australia Limited ABN 11 008 423 372 (ZFSA) is the parent company of ZIM. ZFSA is a part of the global Zurich Insurance Group and provides resources to ZIM as part of its core business lines.

3. Objectives of this DRMP

ZIM believes that derivatives play an important role in the investment management process. This DRMP provides a summary of the processes (that include controls) in place to ensure the proper use of derivatives in relation to the Schemes. Derivatives can be used for a variety of purposes, including (but not limited to) the following:

3.1. Hedging

Derivatives can be used to ''hedge''. Hedging can protect the value of a Scheme against market fluctuations, for example, the foreign currency exposure of a portfolio investing in overseas assets. Hedging can also reduce the volatility of a portfolio;

3.2. Tactical Reasons

Derivatives might be used to effect a strategy change, for example, to adjust the duration (the sensitivity of interest rate movements) of a Scheme investing in fixed interest assets;

3.3. Transactional Reasons

Derivatives can be used to control the impact on the value of a Scheme due to market fluctuations caused by significant transactions;

3.4. Investment Reasons

Derivatives may be used for investment reasons such as to create an income stream from option premiums;

3.5. Cost Reasons

Derivatives might be used to obtain pricing advantages over the physical market. Alternatively, the use of derivatives may reduce the transaction costs involved in achieving a desired exposure to an asset class.

Currently the following types of derivatives may be used:

- Exchange traded futures and options traded on the Australian Stock Exchange ("ASX"), the Sydney Futures Exchange ("SFE") or other internationally recognised exchanges; and
- Over-the-counter ("OTC") derivatives with approved counterparties of sufficient creditworthiness, measured against the relevant Standard & Poor's ratings and as defined by ZIM.

4. Overall Investment Strategy

The use of derivatives will be consistent with, and subordinate to the investment strategy of each of the Schemes. Derivatives are not considered in isolation, but as part of the overall investment strategy and ZIM's investment operations. The overall investment strategy for each Scheme, and in particular the use of derivatives, is governed by and can be found in:

- IMA's and related investment mandates for each particular Scheme; and
- Any relevant offer documentation relating to a Scheme, including Product Disclosure Statements which are provided to those parties who invest in the Schemes.

5. Requirements on the Use of Derivatives

ZIM is subject to a number of requirements regarding the use of derivatives including but not limited to the following:

- the use of derivatives for a specific Scheme is permitted by the Constitution, any IMA or other governing or offer documentation of the relevant Scheme;
- derivative positions are accounted for on a market value basis. Where option or option related derivatives are involved, exposure is determined on a delta-weighted basis. Derivative exposures are calculated on an effective exposure basis;
- derivatives are not to be used to leverage (gear) the Schemes. Schemes valuations are monitored daily;
- the net exposure of the Scheme to an asset class is not to go outside the Scheme's investment strategy as set out in the trust deed or Constitution, IMA or other governing or offer documentation of the Scheme;
- the net exposure of the Scheme to derivatives must not to go outside the Scheme's investment strategy as set out in the Constitution, IMA or other governing or offer documentation for the Scheme;
- the use of derivatives is not to put the Scheme in a net short position;
- there are to be sufficient assets in the Scheme to support the underlying liability of those derivative positions in the form of assets of the kind required to be delivered under the contract or other contracts or assets which substantially offset the underlying liability of the contract or cash or immediately realisable assets. Net positions are considered where relevant;
- market moves or cash flows can alter the impact of derivative positions in the Scheme. Where this occurs, measures are to be taken so that the Scheme shall be realigned as soon as practicable to remove any breaches of requirements;

- Exchange traded derivative transactions must be traded and cleared on the ASX or through associated clearing houses, or other internationally recognised exchanges and associated clearing houses; and
- OTC derivatives may only be used where the counterparty is of sufficient credit worthiness.

5.1. Other considerations include

Legislation and Regulations: Restrictions or limitations on the ability of ZIM to use derivatives may be contained in relevant financial services legislation, regulations, regulatory and/or prudential requirements. Legal advice is available to ensure that requirements are reflected in all IMA; and that legal or contractual obligations are taken into account to ensure that restrictions on the use of derivatives are complied with, are subject to proper oversight and monitoring; and that adequate levels of reporting is provided to the relevant Risk, Compliance, and Audit Committee and/or the ZIM Board.

ZIM monitors and obtains regular representations from the external investment managers regarding their use of the derivatives and on their overall compliance with requirements.

6. Risk Management Considerations

There are various types of risk associated with the use of derivatives. ZIM's investment management structure is designed to ensure a clear segregation of responsibilities. For example:

- external investment managers conduct all dealings in relation to the underlying assets of the Schemes;
- external investment managers perform processing and matching functions. Investment operations are undertaken by ZIM and its external custodian JP Morgan. Together they perform key back-office functions including trade settlement, pricing and portfolio valuation functions in relation to the Schemes;
- the external investment managers are required to report on Scheme performance to ZIM and provide other information (including derivatives exposures) in accordance with requirements, on a regular basis.

Listed below is a description of the main types of risks associated with the use of derivatives or relating to an investment where derivatives may be issued to manage risk. Each heading provides information on how each type of risk is assessed and monitored.

6.1. Market Risk

Market risk represents the risk of adverse movements in markets (i.e. asset prices, volatility, changes in yield curve, implied option volatility or other market variables) for the derivatives or the underlying asset, reference rate or index to which the derivative relates. Holding any security, (physical or derivative), that creates exposure to movements in prices of a security or market creates market risk. Derivatives are included in a Scheme on a fully paid up exposure basis. If a Scheme holds options, or option related derivatives, exposure is determined on a delta weighted basis.

6.2. Valuation

All derivative positions are marked to market by the external investment managers on a daily basis or as required, dependent on the nature of the derivatives used. Any breaches of the relevant derivatives exposure restrictions are reported to ZIM. For the external investment managers who actively use derivatives, the valuation of derivatives is to be consistent with current industry market practice. Valuation sources are independent, including those for OTC derivatives and derivatives which do not trade in any significant volume.

Derivative positions held are regularly reconciled to external sources; systems used to control derivatives are consistent with systems used by the external investment managers; and procedures covering the operation of controls, including the use of derivatives are in place, communicated to relevant personnel and reviewed on a regular basis.

6.3. Gearing

The Schemes are not permitted to gear. Scheme valuations are monitored daily.

6.4. Asset Ranges

Where a Scheme comprises more than one asset class, the relevant Constitution, IMA and the offer documentation may specify a maximum and minimum exposure for each asset class. The actual exposure for each asset class is calculated by taking into account both the exposure of the physical asset class and the net effective exposure of derivatives to that asset class. Schemes are regularly reviewed by ZIM to ensure compliance with requirements.

6.5. Adequate Cover

Schemes must at all times have sufficient assets to support the underlying liability of the derivative positions. This will consist of assets of the kind required to be delivered under the contract, or assets which substantially offset the underlying liability of the contract, or cash or immediately realisable assets. Net positions are considered where relevant.

6.6. Stress Testing

Stress testing is to ascertain the impact on the value of the Schemes under various different market circumstances. The stress testing will test the impact of different market scenarios on the total funds (including derivatives), and is performed periodically by the relevant external investment manager. Stress testing is used to evaluate significant strategy changes, such as shifts in asset allocation, Scheme holdings or derivative positions.

6.7. Basis Risk

Basis risk is the risk that a derivative instrument or position will not move in line with the underlying position. The external investment manager will generally review, monitor and assess basis risk. Such reviews can include:

- the suitability of the derivative positions as a hedge against the underlying exposure;
- periodic stress testing, or other appropriate testing of the Scheme; and
- close monitoring of the Scheme’s performance characteristics.

6.8. Liquidity Risk

There are two basic types of liquidity risk inherent in utilising derivatives:

- Market Liquidity

  Market liquidity risk is the risk that the external investment manager may not be able to unwind or offset a particular position at or near the previous market price, because of inadequate market depth or due to a disruption in the marketplace.

- Settlement Liquidity

  Settlement liquidity is the risk that the external investment manager will not be able to manage the investment strategy of the scheme to meet its future financial obligations resulting from its derivative activities (e.g. meeting margin calls on futures contracts).

ZIM assesses and monitors liquidity risk by appointing external investment managers that have procedures to ensure that they:

- choose well-established instruments that have a track record for liquidity and reviewing markets on which they are traded on an ongoing basis;
- use a number of high quality counterparties and adhering to counterparty limits as per the IMA;
- analyse future cash settlement periods for all investment transactions and matching cash-flow where appropriate in accordance with IMA requirements. This ensures there is sufficient cash or cash equivalent securities to enable the close out of the positions at any point of time; and
- prohibit leveraged positions.

6.9. Counterparty (Credit) Risk

Counterparty risk is generally defined as the risk that a counterparty (the other party with whom a derivatives contract is made) will fail to perform contractual obligations (i.e. default in either whole or part) under a contract. Counterparty risk is also referred to as credit risk. Counterparty risk is minimised by requiring the external investment managers under the relevant IMA that they:

- deal on recognised domestic and international stock and futures exchanges;
- deal with counterparties that meet the minimum credit worthiness requirements; and
- deal with such counterparties within the established limits.

These requirements are monitored on a regular basis to ensure that counterparty risk is within the limits stipulated by the relevant IMA.

6.10. Legal Risk

Legal risk is the risk that the counterparty's performance obligations will be legally unenforceable. For example, legal risk may relate to:

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

ZFSA Corporate Governance recognises the different types of legal risks between exchange traded derivatives and over-the-counter traded derivatives. Requirements identify and document relevant controls in the IMA with the external investment manager. The IMA may contain clauses relating to the use of exchange traded and OTC derivatives. ZIM regularly obtains representations in relation to the external investment managers' compliance with their IMA.

6.11. Operational Risk

Operations risk is the risk that deficiencies in the effectiveness and accuracy of the information systems or internal controls will result in a material loss to a Scheme. Operations risk exists because of human error, systems failures, inadequate procedures and internal management controls, and disasters. Effective control over operations risk requires an appropriate organisational structure and an effective set of procedural controls. ZIM monitors and receives regular representations on the effectiveness of internal controls through external investment managers meetings, compliance and risk management reports and via external audits on the adequacy of internal controls. To minimise operations risk, ZIM has appointed external investment managers that have policies and procedures relating to the separation of dealing, administration, settlement and investment management functions.

6.12. Currency Risk

Assets that are invested in an overseas currency will create foreign exchange rate exposure. Currency risk in relation to derivatives is managed under the same principles as it is for other assets and in accordance with the relevant IMA restrictions. This foreign exchange exposure is monitored by ZIM on a regular basis.

6.13. Personnel Management Risk

The effective operations depend on the processes ZIM has in place in relation to personnel management. Personnel involved in investment monitoring and compliance have clearly defined responsibilities, and have the necessary skills and experience to carry out their responsibilities diligently. Training and education programs are undertaken for ensuring that all personnel continue to maintain the necessary levels of expertise to perform their responsibilities.

ZFSA Risk Management & Compliance personnel undertake regular monitoring of relevant processes, have segregated reporting, are independent from individuals who deal in derivatives and have sufficient expertise and resources to perform required duties.

ZIM has a system of performance management, which is consistent with that of ZFSA. This includes career development, performance counselling, performance standards and appraisal, rewards and recognition. Remuneration policies do not provide incentives for excessive risk taking. The DRMP is made readily available to all relevant staff and there is training for staff on requirements and on the DRMP obligations generally.

ZIM only appoints external investment managers who have adequate personnel management systems in place. Relevant IMA's include termination clauses detailing circumstances where an external investment manager can be terminated.

7. Assessment of Controls

The specific details of the control processes implemented by ZIM in relation to the use of derivatives have been described in previous sections of this DRMP. ZFSA Corporate Governance, and other areas of the business, where appropriate, advises ZIM on key areas, including changes in legislation and regulations. Assistance is provided on the design of appropriate controls and review processes as required. Assistance is provided to ZIM with its assessment of key strategic and operational risks and with the implementation of requirements, systems etc. for the effective management of operational risks. In addition, the ZIM Compliance Assurance Manager oversees the ongoing monitoring of matters specifically identified by the Risk, Compliance, and Audit Committee or ZIM Board.

The ZIM Board is responsible for maintaining an adequate and effective internal control environment. Any material breaches of requirements and the action taken to remedy the situation is reported by Risk Management & Compliance to key stakeholders immediately and in summary to the ZIM Unit Linked Investments Committee (ZULIC). The Risk, Compliance, and Audit Committee and the ZIM Board are provided with regular reports on each Scheme's monthly summary derivative exposures in accordance with their reporting requirements. The Board approves significant policies concerning the use of derivatives.

8. Audit

The DRMP or related requirements can be subject to routine reviews by the ZFSA Group Audit Department. They remain independent from the day to day operational management of ZIM. The ZFSA Group Audit Department prepares reporting on its findings in relation to a requirement that is subject to audit review. Audits are conducted in accordance with Australian Auditing Standards.

9. Definition of Derivatives

A derivative can be defined as:- a financial contract or obligation which is based on the value of an underlying reference price, rate or index which relates to equities, bonds, interest rates, currencies, credit, natural catastrophes, weather and commodities. It can take the form of a put or a call option, forwards, futures, swaps, warrants, share ratios and other composites and derivatives thereof. For purposes of this definition, it does not include options embedded in typical insurance contracts such as cash surrenders, re-instatements nor those in common investment securities (for example bonds with call provisions or conversion rights). Derivatives can be more volatile than the underlying cash instruments and exposures can be multiples of the actual invested amounts. The types of derivatives that can be used for each asset sector are specified in the relevant IMA.

10. Glossary of terms

Call option	An agreement that gives an investor the right (but not the obligation) to buy an underlying security at a specified price within a specific time period.
Cash Instruments	These are assets that are cash or can be converted into cash immediately. Examples are bank accounts, marketable securities, and treasury bills.
Cash surrenders	The amount, before adjustments, that the owner of a life insurance policy is entitled to receive if the policy does not remain in force until the insured's death.
Composites	Made up of other components.
Conversion rights	The right to translate a convertible security into a predetermined number of shares.
Delta	The ratio comparing the change in the price of an underlying asset to the corresponding change in the price of a derivative.
Delta weighted basis	An options position equal to the market value of the underlying security multiplied by the delta.
Derivatives	Per meaning given at the relevant paragraph of this DRMP.
Duration	The measure of the price sensitivity of a fixed-income security to an interest rate change of 1%. Calculation is based on the weighted average of the present values for all cash flows.
Effective exposure (EE) basis accounting	The value of the underlying instrument of a derivative.
Forward rate agreement (FRA)	A forward contract that determines an interest rate to be paid or received on an obligation beginning at a start date sometime in the future.
Fully paid up basis accounting	Value is based on the underlying security not being subject to further calls for capital.

Fully paid up exposure basis	Accounting for a derivatives value based on its effective exposure.
Futures	A financial contract that encompasses the sale or purchase of financial instruments or physical commodities for future delivery.
Gearing/ leveraging	Occurs where the level of market exposure to derivatives exceeds the market value of the Scheme.
Hedging	Per meaning given at the overall Investment Strategy paragraph of this DRMP.
Implied option volatility	The estimated volatility of a security's price. In general, increases when the market is bearish and decreases when the market is bullish. Implied volatility is used in calculating an option's premium.
Investment strategy	Per meaning given at the relevant paragraph of this DRMP.
Investment Management Agreement	An agreement which details investment parameters.
Market risk	Per meaning given at the relevant paragraph of this DRMP.
Marked to market	Recording the price or value of a security, portfolio, or account to reflect its current market value.
Modified Duration	A formula that expresses the measurable change in the value of a security in response to a change in interest rates, the change is usually measured against a 100bps (1%) movement in interest rates.
Net position	The difference of all purchase and sales of derivatives.
Net short position	A Net Position where the derivative positions are net sales.
Over-the-counter (OTC)	A security which is not traded on an exchange. Participants negotiate directly with one another as to the specifications of the security.
Put option	An agreement that gives an investor the right (but not the obligation) to sell an underlying security at a specified price within a specific time period.
Reference rate	The underlying index or rate upon which a floating-rate security is based.
Security	As defined at section s.761A of the Corporation Act 2001.
Share ratios	A relative performance contract. The contract pays an amount based on the difference between the performance of a stock and the performance of a market index.
Swaps	Refers to an exchange of one financial instrument for another between two parties. This exchange takes place at a predetermined time.
The Constitution	Means the Constitution (as amended) for each ZIM Scheme.
Warrants	A derivative security that gives the holder the right to purchase securities (usually equity) from the issuer at a specific price within a certain time frame.
Yield curve	A graphic line chart that shows interest rates at a specific point for all securities having equal risk, but different maturity dates.

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