30 April 2012

Hon Bill English
Minister of Finance
Parliament Building
WELLINGTON

Dear Minister

ANNUAL LETTER OF EXPECTATION

Thank you for your letter of 6 March 2012 setting out your expectations of the Guardians and of the content of our 2012/13 Statement of Intent. As suggested in your letter, we have subsequently met with representatives of the Crown Ownership Monitoring Unit (COMU) to discuss your expectations in more detail.

Shareholder Returns

We note your focus on the importance of Crown Financial Institutions (CFIs) achieving long-term performance objectives and, where active management or other value-adding strategies are employed, achieving returns in excess of benchmarks.

The Fund's expected rate of return is to outperform 90-day Treasury Bills by 2.5%, averaged over rolling 20-year periods. We also measure the success of our active and value-adding strategies by comparing the Fund's returns to a notional, low-cost, passively-managed Reference Portfolio. Our expectation is that the Fund will comfortably exceed the returns of the Reference Portfolio over a rolling 20 year period.

With regard to your reference to a minimum three year period for measuring performance, for your information, the Fund has comfortably exceeded the above performance expectations for the three year period ended 31 March 2012, outperforming the Treasury Bill rate by 15.96% and the Reference Portfolio by 1.96%. A full breakdown is below.

Expected and Actual Fund Performance for the three years to 31 March 2012	
Expectations	
Annualised Treasury Bill rate of return	2.69%
Expected Fund return (Treasury Bill rate + 2.5%)	5.19%
Annualised Reference Portfolio rate of return net of costs and fees	16.69%
Actual Performance	
Actual annualised Fund return net of costs and fees	18.65%
Excess return over Treasury Bill rate	15.96%
Excess return over expected return (Treasury Bill rate + 2.5%)	13.46%
Excess return over Reference Portfolio	1.96%

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It is important to remember that, because of its weighting to growth assets, the Fund can experience large movements up and down. Over short-term periods, there will be times when investment expectations are comfortably exceeded (such as over the last three years) and times when they are not reached (as seen during the Global Financial Crisis). These shifts must be seen in the context of the long-term purpose of the Fund.

Our investment strategies are constantly reviewed to ensure they provide the best possible use of available capital. Active investment is only undertaken when we have a high degree of confidence it will reduce the Fund's risk levels, improve returns, or both.

Investment Review

The Board already receives regular retrospective reviews of all investment strategies to determine if the original investment objectives have been met and to learn lessons from what has happened compared with the pre-investment analysis. Given the trend to increasing investment by CFIs in non-listed investments, we agree that transparency and shareholder scrutiny of the success of major investments of this type is desirable. We will share the results of our reviews of major non-listed investments as part of our quarterly reporting to you.

Joint Ventures

The expectation that you be informed at an early stage of joint venture arrangements, especially where the arrangement involves another New Zealand government entity, foreign government or sovereign wealth fund, is understood and noted.

Risk Tolerances

Investment specialists from the Guardians have recently met with COMU on this matter. We look forward to further engagement and knowledge-sharing with officials.

Costs & Remuneration

We are conscious of the current whole-of-Government focus on cost management and fiscal prudence. Our 2012-17 Statement of Intent (SOI) outlines a range of activities to reduce cost and increase operational efficiency.

By international standards, the Fund is lower cost and creates similar net-value-add to its peers (as verified by CEM, the global leader in benchmarking pension and sovereign wealth funds, most recently in December 2010). Furthermore, while the Guardians operates in a market with a strong degree of competition for highly qualified personnel, we appreciate the importance of ensuring remuneration and costs are appropriate to a New Zealand as well as an international context.

The Guardians' remuneration framework, which was revised in July 2010, was benchmarked to relevant New Zealand salary comparisons using third-party data. It aims to attract and retain competent people, and align rewards with the achievement of financial and non-financial targets. Further information, including a high degree of detail on this matter, is available in our 2010/11 Annual Report.

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Importantly, the overall costs of managing the Fund (excluding external managers' performance fees) are forecast to decrease from 0.64% to 0.57% of expected average funds under management over the period of this SOI. If forecast performance fees are included, costs are projected to decrease from 0.79% to 0.75% of expected average funds under management.

Decisions to bring investment activities in-house (which may have implications for headcount) are only made when we are satisfied that this will be a more efficient and effective approach in adding value than using an external manager.

Yours sincerely

David May

David May
Chairman

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