

30 April 2015

Hon Bill English
Minister of Finance
Parliament Building
Private Bag 18888
WELLINGTON

Dear Minister

ANNUAL LETTER OF EXPECTATION

Thank you for your letter of 5 March 2015 setting out your expectations of the Guardians of New Zealand Superannuation (“Guardians”) and of our 2015/16 Statement of Performance Expectations.

Shareholder returns

We note the Minister’s focus on the importance of Crown Financial Institutions (CFIs) achieving long-term performance objectives.

The New Zealand Superannuation Fund (“Fund”) has now been invested for more than 10 years. Its annualised returns since inception in 2003 have been very strong: as at 31 March 2015, it had returned 10.2% p.a. over its lifetime. It also remains ahead of its key performance benchmarks, having:

- exceeded the passive Reference Portfolio benchmark by 1.14% p.a. (\$3.5 billion); and
- exceeded the Treasury Bill return, a measure of the Government’s cost of debt, by 5.60% p.a. (\$12.9 billion).¹

Looking back, as is expected with a long-term, growth-oriented fund, annual returns have varied, ranging from -22.14% during the 2008/09 year to 25.83% in 2012/13. We note that the opportunity to ‘buy low’ during the Global Financial Crisis has provided the foundation for the Fund’s strong performance since then.

Looking forward, we stress the importance of taking a long-term view of Fund performance. We expect the Fund to be well rewarded over time for the prudent level of risk being borne. Based on current portfolio settings we expect the Fund will return 8%-9% p.a. over the long term.

Crown Risk Management

We will continue to provide information and support to Treasury as part of the work-stream to understand and test the resilience of the Crown balance sheet.

Investment Management Expenses

We note your expectation that costs incurred in implementing our investment strategy are appropriate in the context of managing Crown assets. Controlling costs is central to maximising investment returns for the taxpayer. We only invest actively when we have a high level of confidence that doing so will generate stronger risk-adjusted net returns than the low-cost,

¹ Returns are provided unaudited, after costs and before NZ tax.

passive equivalent. We continue to focus on managing fees paid to external managers and achieving operational efficiencies.

Investment Review

We note your comment regarding scrutiny by the Crown of larger investments. We will continue to use the Quarterly Report to provide information on the reviews of such investments.

Use of derivatives

We note your expectation that Crown Financial Institutions should use derivatives judiciously. Our approach reflects these expectations. We continue to shift our portfolio exposures between physical and synthetic access points according to whichever option is the most cost-effective and efficient at the relevant point in time. Where we do use derivatives, comprehensive liquidity monitoring and reporting, and counterparty risk management measures, are in place. Board reporting processes for derivatives include confirmations from management that the use of derivatives has been judicious.

Crown Financial Institutions Collaboration

We note your expectation that the Crown Financial Institutions will continue to collaborate in order to drive operational synergies and cost efficiencies. Collaboration between Crown Financial Institutions remains an important focus for us with ongoing collaboration amongst both the investment and non-investment parts of the business, particularly in relation to responsible investment.

New Zealand Superannuation and Retirement Income Amendment Bill

Thank you for your support of the Bill through its second reading. We also appreciate the efforts of The Treasury. We look forward to the passing of the Bill within the year.

Independent Performance Review of the Guardians

We note that your expectations regarding the implementation of the recommendation of the Promontory Report, and will continue to provide progress updates via our Quarterly Reports. We expect all matters to be addressed by 30 June 2015.

Crown Treaty obligations

We note your expectations regarding the disposal of land holdings and will incorporate these into our internal processes and documents.

Lessons from Oak Finance investment

We have completed an internal review of the Oak Finance Investment. This review was undertaken by our Head of Portfolio Risk and reported to the Board.

Our review concluded that the specific situation was unprecedented and unforeseeable. The separation of Banco Espirito Santos' (BES) senior loan obligation from our BES default protection was unprecedented and, we believe, resulted from unlawful actions by the Bank of Portugal. We are pursuing legal action to rectify this situation in both England (firstly) and Portugal, and have been advised that we have a strong legal case. We are joined by the other seven investors who made up the full senior loan.

Our review also concluded that our investment policies and processes had been followed appropriately. We have concluded, however, that it would be useful to introduce some additional processes. We have described these in our March 31 2015 Quarterly Report to you.

General Expectations

We acknowledge and understand your expectations regarding joint ventures; the Statement of Performance Expectations; Official Information Act requests; and 'no surprises' policy. We are not preparing a Statement of Intent this year.

On behalf of the Board, I would like to thank you for your support of the Guardians' independence. The Guardians' ability to invest the Fund on a commercial basis, free of political interference, is an important endowment and continues to be central to the Fund's success.

Yours sincerely

A handwritten signature in black ink, appearing to read 'G Walker', written in a cursive style.

Gavin Walker
Chairman