ITEM 9(A) RI COMPASS PHASE 2 (2021/22) – FINAL REPORT

Paper type: ***For decision and approval***

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1 Purpose and context

1.1 This paper is the final report of the RI Compass Programme for 2021/22 and summarises outputs of the three workstreams.

1.2 The paper is for **discussion** and **noting, and** in respect of the ESG Profile workstream, for **decision** and **approval**.

2 Introduction and background

2.1 The RI Compass Programme was established in 2020 "to review our responsible investment strategy, consistent with our mandate, and to develop a pragmatic approach ready to meet future developments, one that is feasible to implement from the investment and back-office perspective".

2.2 In June 2021 the Board agreed that sustainable finance (**SF**) is consistent with the Guardians' financial purpose and the three legs of its mandate. It agreed to the adoption of a SF goal and an implementation roadmap:

Goal: *The Guardians incorporates sustainability considerations into investment decision-making and supports the development of a sustainable financial system.*

In broad terms, we will incorporate sustainable finance into managing the NZ Super Fund by:

(a) Integrating ESG considerations into investment decisions, with the intention of advancing sustainability outcomes whilst fulfilling our financial purpose;

(b) Considering the impact of ESG on our investments and the impact of our investments on society and the environment;

(c) Supporting the development of a sustainable financial system.

2.3 RI Compass Phase 2 is a strategic activity for 2021/22. The programme consists of three workstreams. This paper summarises the outputs of the three workstreams:

(a) **Strategy (WS1)** focuses on strategy, governance, leadership and communications;

(b) **ESG Profile (WS2)** has been the key workstream, analysing methodologies to improve the ESG profile of passive portfolios

(c) **Impact Investment (WS3)** developed an Impact Investment plan.

3 Key recommendation

3.1 The most significant recommendation for the Board's review relates to the ESG Profile workstream and proposes a change to the composition of the Reference Portfolio. The Investment Committee recommends that the Board substitute the existing customised

MSCI ACWI Index with another index that will provide broad global equity market exposure and go a long way towards achieving our goals under the sustainable finance strategy. The proposed index is the MSCI ACWI Paris Aligned Index.

3.2 While it is not perfect, the conclusion reached by the Investment Committee is that the Paris Aligned Index meets in all material respects our requirements for a benchmark, will provide us with the desired broad equity market exposure, thereby enabling the Board to make the total Fund risk decision for the Reference Portfolio and provides a solution for improving the ESG Profile of the Actual Portfolio. The use of a third party benchmark reduces operational complexity in terms of implementation, and provides benefits in terms of communication of our strategy.

4 Strategy (WS1)

4.1 Key areas completed by WS1 in 2021/22 were the integration of SF into the Guardians' purpose, vision statements and strategic goals, the Statement of Investment Policies, Statements and Procedures (SIPSP), the RI Framework, and developing communications plans for the implementation phase.

4.2 The final WS1 paper (available for ***optional reading***) includes a proposed internal governance arrangement for the third phase of the RI Compass in 2022/23. It is based on the strategy/leadership and Impact Investment activities being integrated into business as usual, with the implementation of the improved ESG Profile becoming the sole remaining workstream.

4.3 Next steps in implementation include determining SF performance measures for internal and external reporting (including impact measures, which are discussed in the Impact Investment Plan) and change management (which involves including SF goals in personal objectives, individual development programmes and the Guardians' incentive programme). Alignment of the incentives programme with SF goals will depend on the final decisions by the Board about methodology for implementing the improved ESG portfolio. It is anticipated that this work will be undertaken as part of the ESG Profile implementation in 2022/23.

5 ESG Profile (WS2)

5.1 The purpose of the ESG Profile workstream is to investigate options and propose a methodology that delivers measurably improved ESG outcomes for the Fund. In doing so, the Investment Committee (**IC**) and Board have previously agreed that we should be looking to retain existing passive equity *risk* exposures.

5.2 Analysis and debate on the topic has thrown up a number of important questions. Perspectives and options for addressing them are nuanced and with trade-offs. To provide the Board with an appreciation for the more salient issues and the trade-offs that result, this section presents a possibly ruthless summary. The hope is that this helps achieve a bird's eye view of decision criteria and findings. An analytical note motivating the questions raised and supporting the statements made is also available for Board members who wish to delve further, as ***optional reading***.

5.3 There are four issues that we wish to bring to the Board. In presenting these below, we also summarise Investment Committee perspectives.

5.4 **Question 1: Should the Reference Portfolio (RP) be considered sufficient for meeting our mandate?**

(a) This question was previously discussed by the IC in December 2021, prompted by the interim project finding that an assessment of the suitability of alternative ESG-forward solutions as RPs depends on how we interpret RP purposes and principles, and the precedence between these. Following IC debate, the Board heard from the CIO in February 2022 that the RP is best interpreted as an expression of risk appetite, a benchmark, and a communications tool rather than as an implementable alternative to the Actual Portfolio.

(b) In reviewing the final recommendations on ESG Profile, the IC revisited this question. It discussed whether even the *current* RP can be considered to meet our mandate. For example, the RP today is not the portfolio that maximises risk-adjusted return; we assign a risk budget for capturing active returns in the Actual Portfolio. Similarly, the existing benchmark has required constant tweaks in practice—e.g. with respect to carbon, poor ESG practice-based exclusions, and for compliance with Russian sanctions. Therefore, as views on best practice and on our mandate evolve, the IC considers that no RP can be expected to completely and consistently meet the mandate.

(c) Instead, it is appropriate to view the RP as directly answering our purpose—"*Sustainable investment delivering strong returns for all New Zealanders*". Further, the IC believes the RP is that portfolio that does a "good enough" job at relatively low cost of delivering on the three legs of our mandate and our purpose, whether that be desired risk-adjusted returns or desired sustainability outcomes. Taking this pragmatic perspective, an assessment of the suitability of an ESG-focused index as a RP benchmark is more straightforward.

5.5 **Question 2: What is the correct conceptual treatment of ESG Profile tracking error (TE)?**

(a) TE arises from active decisions (relative to RP), and good governance requires that it is properly owned and accounted for.

(b) If ESG Profile is indeed subsumed into the Reference Portfolio (as contemplated by the analysis to Question 1 in paragraph 5.45.4), then ESG-related TE is not created. Instead, the only TE that must be accommodated is that required to actually implement the preferred ESG solution—the gap between a new ESG-inclusive RP and its new Actual Portfolio counterpart. (See also Table 2.)

(c) However, if we prefer to not include ESG Profile considerations in the RP, the resulting TE must be accounted for. To address this, the IC discussed trade-offs between (i) the TE being assigned to a Policy Portfolio that sits between the Reference and the Actual thereby complicating reporting and the proxy system and (ii) inclusion of ESG Profile TE in the existing active risk budget, which results in possibly mis-aligned incentives as management takes on additional risk without the expectation of excess return.

(d) In summary, a Policy Portfolio introduces many additional complications (as per Table 1) which the IC has ultimately preferred to avoid.

5.6 **Question 3. What is the preferred ESG Profile solution?**

(a) Before identifying a preferred solution, we require an analytical framework for assessing candidates. That is, what is our practical definition of ESG Profile and the basis for decision-making? We recommend including financial performance and a *suite* of ESG metrics: aggregated scores, carbon data, revenue sources and other metrics related to sustainability outcomes or indicative of strong stakeholder interest. We find that custom solutions deliver a better ESG Profile, but off-the-shelf indices have lower implementation costs and complexities. We also recognise that solutions are unlikely to be static, and our assessment of suitability will continue to evolve with increased availability and uptake. On this basis, we recommend the

MSCI ACWI Climate Paris Aligned Index (MSCI PA) as a good candidate solution to the ESG Profile problem.

5.7 **Question 4: Is the preferred solution index an acceptable RP benchmark?**

(a) Finally, having identified the preferred solution, we turn to the question of whether this constitutes an acceptable RP benchmark (Table 1).

Table 1: A summary of issues and findings relating to Question 4. Specific reference is made to the MSCI ACWI Climate Paris Aligned Index (MSCI PA) index as a good ESG Profile candidate.

Issues		MSCI PA
RP design principles		
Simple	✗	Security selection based on multiple rules and optimisation, reducing understanding and transparency
Low cost	✓	[redacted]
Implementable passively	✓	Index calculated and published by well-regarded agencies; widely distributed on usual platforms
Diversified	✓	ESG indices feature smaller number of constituents (e.g. MSCI PA: circa 960) compared to ~8700 in the current NZSF Custom index. Such solutions may be considered diversified on grounds they match financial characteristics of current index
Appropriate risk and return	?	Available short histories less suited to modelling long-run Fund performance, resulting in lower-confidence RP decisions
Relevant to NZ investor	✓	No concerns
An equilibrium construct	✓	Only in settings with different investors, some having ESG preferences and others who do not
Objective selection criteria	✓	Well-defined rules published; subject to transparent governance structure
Representativeness	✓	Representative of the wider universe of securities available to investors covering geographies, sectors, and the cap spectrum.
Relevance	✓	No concerns
Investability	✓	Our preferred ESG indices are chosen from the current parent universe.
Acceptance by investors	✓	Well-recognised and widely accepted; but no market standard yet.
Framework		
Meets mandate	✓	Value-adding portfolio decisions to maximise risk-adjusted return and spend risk budget will continue. Exclusion management will still be required (but less so). Fund ESG Profile can be improved further in the Actual Portfolio.
Staff incentives	✓ RP	If solution included in the RP, there is no TE and management does not take on additional uncompensated risk (in expectation). However, we may choose to include

Issues		MSCI PA
		ESG Profile outcomes in management incentive objectives to add “ESG value” above that delivered by the RP.
	? Non -RP	If solution not included in RP, tracking error results. ESG Profile is not expected to provide excess return. If included in existing risk budget, management take on additional risk without expectation of return. TE requires addressing by either (a) creating a new risk budget (i.e. a Policy Portfolio) or (b) including ESG Profile outcomes in management incentive objectives or (c) some combination of the two.
Performance attribution and reporting	✓ RP	Replacement of one MSCI index for another unlikely to present attribution issues if no separate ESG Profile risk budget is created.
	✗ Non -RP	Attribution is more complex with a separate risk budget, i.e. a Policy Portfolio. To illustrate: Portfolio Completion has spent years building datasets to attribute performance and risk between RP, a post-proxy RP and the Actual Portfolio. Amongst other things, a Policy Portfolio will complicate proxy calculations and currency differences between portfolios will require address.
Implementation and PC		
Complexity	✓	Investment operations, portfolio risk, enterprise risk, data technology indicate that an index solution not likely to present significant issues
Market adoption	?	Wide market adoption helps facilitate derivative market liquidity and expands the set of counterparties. There is no liquid derivative market, impacting the speed and ease of equitizing our portfolio, though this is changing. NZSF can also help facilitate liquidity by being an active participant
Construction	✓	Available as ACWI, World, EM and SC components creating flexibility and implementation options
NZSF exclusions	✓	The fewer in-house exclusions we need to implement by a short exclusion swap overlay, the less tracking error, complexity and cost we incur. MSCI PA currently has only 9 names on our exclusion list that would need excluding.
Implementable alternative to actual	✓	Summary assessment of above.
Financial performance		
Beta and Volatility	✓	Predicted beta roughly 1 achievable. Vol estimate in line with benchmark.
Factor exposures	✓	No notable factor exposures.
Stress tests	✓	ESG indices perform in line with the broad market cap-weighted benchmark during (simulated) general equity market selloffs. When actual events are modelled (GFC, Covid shocks) ESG indices perform better than the ACWI IMI.
Misweights	✓	No consistent appreciable regional misweights. Sector misweights under 2.5% achievable.
Tracking error	? Non -RP	Tracking error is relevant if the index is not included in the Reference Portfolio.

Issues		MSCI PA
		MSCI PA: 1.2% relative to ACWI benchmark. Approximately halved to 60bps at Fund level, and slightly lower to NZSF custom index. See also Table 2.
Backtests	✓	Caveated by limited histories. Sharpe Ratio > 0.7; Information Ratio > 0.9; Sortino Ratio > 0.35. Acceptable downside performance.
ESG performance		
Number of securities	✓	MSCI PA: circa 960, resulting in a more tractable portfolio with lower RI cost of ownership.
ESG Score improvement	?	ESG score (overall) roughly +10% relative to ACWI benchmark. (Custom solutions deliver >20%.).
ESG momentum	?	ESG momentum measure not appreciably different from 0. (Custom solutions >10%.)
Revenues	✓	Improved revenue shares from alternative energy, reduced from fossil fuels. (Custom solutions better.)
Controversial holdings	✓	Few and manageable. (Custom solutions better.)
Carbon	✓	MSCI PA carbon footprint: 83% improvement in Scope 1 and 2 relative to ACWI benchmark. 26% improvement in Scope 3. 55% All Scope improvement. (Custom solutions better.)
NZ holdings	?	MSCI PA only has two New Zealand names.

5.8 The Table 1 above illustrates that an off-the-shelf index is available to fulfill most of our requirements. In terms of some of the shortcomings identified, we note:

(a) *Simplicity* – an off-the-shelf ESG index is not considered simple as it is based on multiple rules and optimization; however, our current NZSF Custom Index, although less complex, is also not simple with its various rules and exceptions that we have constructed ourselves and changed most years since we began implementing it in 2017. No simple index is likely available that fulfills multi-dimensional ESG Profile objectives.

(b) *Appropriate risk and return* – we rely on long time series of data to model risk and return, and to conduct confidence-building back-tests. It is inescapable that indices meeting our ESG Profile objectives do not offer long histories.

5.9 Finally, Table 2 presents analysis on tracking errors if the MSCI PA is selected to allow the Board to come to a view on the acceptability of these. We see that the bulk of the TE to the market-cap weighted portfolio (1.20%, and approx. 0.60% at whole-of-Fund level) will disappear, by definition, if the MSCI PA is chosen as the RP benchmark. The MSCI PA meets our carbon intensity requirements and currently only 9 further stocks will need to be excluded to meet either ethical or fossil reserve requirements (as compared to ~600 now), meaning that the 'implementation' TE is only 0.14%, which can be absorbed within existing Portfolio Completion Active Risk limits.

5.10 In endorsing to the Board the suitability of an ESG-forward off-the-shelf index such as the MSCI PA, the IC also acknowledged that:

(a) Views on the most suitable index will evolve over time, as will the index itself, including from our adopting it;

(b) We expect the reduction in NZSF-specific customisations and judgements and the third-party arms-length calculation of the index as an RP benchmark will be viewed positively by stakeholders including Treasury, in contrast to our current customized benchmark [redacted]

(c) Finally, if approved, an important part of the implementation of the index will relate to identifying and resolving liquidity issues, including monitoring counterparties and the ease of equitization.

5.11 Recommendations on the ESG Profile method are set out in Section 7 for Board approval. These include an evaluation and reporting framework for ESG Profile that draws on concepts identified in the "financial performance" and "ESG performance" sub-sections of Table 1 above.

Table 2: Tracking error analysis

	MSCI PA Index
A. Num. Stocks	circa 960
B. RI Ethical Exclusions and Fossil Fuel Reserves	
Num. Stocks in Index overlapping with B.	9[1]
Weight of above in index	1.12%
C. Carbon Intensity Exclusions	
Num. Stocks in Index overlapping with C.	0
Weight of above in index	0%
D. Carbon intensity reductions relative to MSCI ACWI IMI	
Scope 1 and 2	83%
E. Tracking errors (TE)	
Historical TE of Index to MSCI ACWI IMI	1.20%
Predicted TE of Index to NZSF Custom Index	1.32%
Predicted TE of (Actual Portfolio = Index - B - C) to (RP = Index)	0.14%

5.12 Subject to Board approval of the new index, we are currently assessing the feasibility of a 1 July 2022 benchmark implementation and will provide an update on our progress at the Board meeting.

6 Impact Investment (WS3) – previously known as 'Positive Investment'

6.1 The Impact Investment plan was **approved** by the IC on 26 May 2022. The objective of this plan is to build the Guardians Impact Investment activity over time (i.e. continue to integrate Impact Investments into our investment processes and increase the scale and/or scope of Impact Investments in the portfolio).

6.2 Before discussing the plan in more detail, we note that the IC also approved the following changes in order to be more consistent with the market:

(a) Renaming 'Positive Investment' as 'Impact Investment'

(b) Changing the 'Impact Investment' definition from:

Previous:

"An investment made with the intent that such investment provides both: measurable positive benefits to society and/or the environment; and the Guardians' (Fund's) required financial return"

[1] We currently make 598 RI ethical and fossil fuel reserve exclusions.

to New:

"an investment made with the intent to deliver both measurable positive social and/or environmental impacts, and the Fund's required financial return."

The changes are not material, but do align us with common industry usage. Using language consistent with industry practice will make for simpler communications of our activity in this area.

6.3 The Impact Investment plan focuses on three key areas: impact measurement and reporting; scaling up impact investment; influence and knowledge building. The recommendations made by the workstream for each of these three areas are summarised below. The full plan, which includes detailed implementation timelines, is available in **Appendix 1** of this paper.

Impact measurement and reporting

6.4 The plan covers criteria/thresholds for investments to qualify as Impact Investments, the types of impact to be pursued (broad impact or specific outcomes), Impact measurement frameworks and options for internal and external reporting.

6.5 We will include a link to an 'Impact Investment checklist' in the Investment Screen Template. This checklist is based on the criteria developed in the earlier work phase and will encourage investment professionals to explicitly address all aspects of the 'Impact Investment' definition / criteria before classifying something as an 'Impact investment'. There are other areas that are still under consideration by the workstream, such as the concept of 'Additionality', impact materiality thresholds and approach for existing investments. Once the criteria are fully established, we will reassess existing investments to determine which still qualify or may now qualify as Impact Investments.

6.6 We propose using an off-the-shelf framework for the measurement of impact (such as the Impact Management Platform (IMP) framework). The criteria to assess off-the-shelf solutions has been established and a recommendation on frameworks and tools will be finalised this calendar year. Having a robust framework to measure impact, alongside clear thresholds for the "Impact Investment" classification, will help us prevent "impact washing" risk (which is the main risk the market will face over the next 5 years according to Global Impact Investing Network).

6.7 We discussed whether there should be priority areas for Impact Investment. The conclusion is that we should remain open, but begin to signal some priority areas to guide search/reporting efforts, similar to our approach in specifying focus areas for engagement in our ownership activities..

6.8 In terms of internal reporting, we have developed a preliminary Impact Investment dashboard, to provide performance information to the IC and Board on a regular basis (six-monthly to the IC initially). The first iteration of the dashboard will be presented in Q3 2022, covering FY22 results. Impact Investment measures would be included in the broader annual Sustainable Finance report to the Board.

6.9 In terms of external reporting, we propose that we start with Case studies in the annual report (2023) and provide more detailed reporting as our capabilities and investment activity evolve.

Scaling up Impact Investments

6.10 The Impact Investment Market Review (available as ***optional reading***) confirmed that the market is growing and is investable via our existing framework, with access most likely via 11 existing Opportunities. Several Fund-wide initiatives and Access Point Strategies are expected to lead to more Impact Investment activity over time, including the Climate Change Search workstream, Infrastructure Strategy and Real Estate Strategy.

6.11 We concluded that an integration-based approach is the preferred way to access Impact Investments (access via existing Opportunities). Acknowledging that it is important to have a checkpoint to reassess our view, we will review progress and consider any significant adjustments required to continue to scale up our Impact Investments in June 2024.

6.12 Another finding of the Market Review is that impact deals tend to be smaller than conventional deals, although small investments can achieve significant impact. The preliminary conclusion is that we should focus on medium to high impact deals (where impact is meaningful), noting that calibration of these thresholds is still to be established. In terms of size, it is proposed that we follow the existing thresholds within Access Point Teams, which have been set for operational efficiency and best practice portfolio management. What this means in practical terms is that small deals (under NZ$100m) in most cases will likely only be accessible through Portfolio Investments or via external managers. However, if we require flexibility to consider smaller deals to access good managers, for example, then this should be referred to the CIO for decision.

Influence and knowledge building

6.13 The plan sets out a number of proposals to build connections in the Impact Investment space externally (i.e. peer engagement, conferences, etc.) and raise internal understanding / awareness (i.e. workshops and presentations).

7 Recommendations

ESG Profile Method

7.1 We request the Board consider the following **recommendations**:

(a) **Treat** the Reference Portfolio as one that is consistent with our purpose and the three legs of our mandate.

(b) **Approve** the selection of the MSCI ACWI Climate Paris Aligned Index as:

(i) a solution to improving the ESG Profile; and

(ii) the ESG-integrated Reference Portfolio benchmark index for the global equities asset class.

(c) **Approve***,* in principle, an evaluation and reporting framework for ESG Profile that draws on concepts identified in the "financial performance" and "ESG performance" sub-sections of Table 1 in Section 5.7 above.

Impact Investment

7.2 We ask the Board to **note** the Impact Investment Plan (as set out in section 6 on WS3).

Attachments

Appendix 1: Impact Investment Plan

Optional Reading

1. RI Compass Workstream 1 – Strategy, Governance, Leadership, Communications (#3391581)
2. ESG Profile Analytical Note (#3414017)
3. Impact Investments Market Review Summary (#3413867)

Appendix 1: Impact Investment Plan

Legend: ◷ = in progress; ✓ = done

Objective: build the Guardians Impact Investment activity over time

			Current focus — 2022 / 2023 — Scaling up	2023 / 2025 — Maturing; 2026+ — In our DNA
Impact Measurement & Reporting	Qualifying as an Impact Investment	in progress	Develop view on Materiality threshold, Additionality and approach for existing investments	
		in progress	Link to Impact Investment checklist in Investment Screen Template	
			Reassess existing investments in our portfolio for Impact Investment qualification	
	Types of Impact		Determine Impact 'priority areas'	Priority areas embedded / guiding Impact Investment search efforts
	Impact Measurement Frameworks	done	Establish criteria to assess Impact measurement frameworks	
		in progress	Select Impact measurement framework for in-house application and 'menu acceptable options' for external managers / counterparties	Framework application across active portfolio becomes part of BAU
	Reporting	in progress	Develop Impact Investment dashboard (internal)	Impact Investment dashboard becomes part of BAU
			Measures for Board Sustainable Finance Report (internal)	
			Case Studies in Annual Report (2023)	More detailed impact reporting in Annual Report (2024+) (i.e. Impact metrics / SDG mapping)
Scaling Up Impact Investments	Integration with Opportunity Framework	done	Impact Investments Market Review	
		done	Identify potential access points within Opportunity framework	Continuously monitor progress with Integration Approach via the Impact Investment dashboard
			Support Sustainable Finance training and Long Term Objectives around Impact Investments	Support Sustainable Finance training and Long Term Objectives around Impact Investments
	Other Initiatives			**2024 checkpoint:** reassess if we need other initiatives (i.e. targets, Separate IIM) to supplement Integration approach
	Impact vs Scale	in progress	Establish size & Impact thresholds	
Influence & Knowledge Building	External Engagements	in progress	Shortlist of peers / investors to connect with	Ongoing engagement in the Impact Investing community (NZ & International)
		in progress	Attend Impact Investing Events / Conferences	Attend Impact Investing Events / Conferences
			Memberships stocktake & prioritisation	Widen our involvement in key Impact-related memberships / broader representation at the Centre of Sustainable Finance
	Internal Communications		Impact Investment workshop	
			Investment Forum with Case Studies / presentations at monthly team meetings	