NZSUPERFUND

Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

TITLE:

Guardians of NZ Superannuation and New Zealand Superannuation Fund

2017-18 Review

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EVENT | PRESENTATION:

Finance & Expenditure Select Committee, 20 February 2019

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Agenda

- Our role and mandate
- Investment approach
- Investing in New Zealand
- Benchmarking
- Performance
- Outlook
- Scenario:
  - Re-occurrence of the GFC

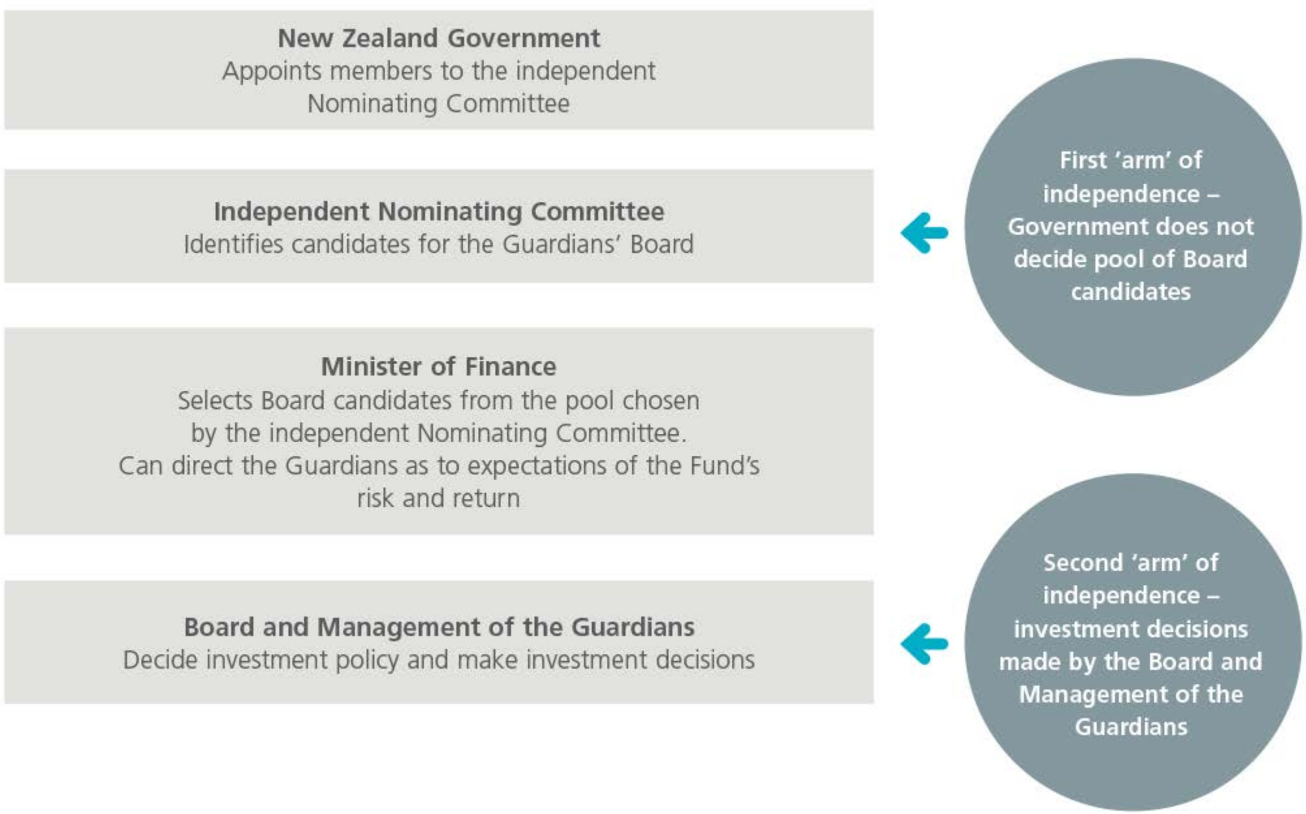
Where we fit in – part prefunding Tier 1

Tier 1 **Tier 2** **Tier 3**

- The NZ Super Fund is expected to pre-pay approximately 20% of NZ superannuation costs by 2040
- Contributions were suspended from July 2009 and restarted in December 2017

Governance framework

- The Guardians of NZ Superannuation is an autonomous Crown entity, legally separate from the Crown, and operates at double arms' length from Government
- The Guardians manage and administer the Fund. The Fund is the pool of Crown assets



Mandate

- **Mandate** (Act of Parliament):
  - The Guardians must invest the Fund on a prudent, **commercial** basis and must manage it in a manner consistent with:
    - Best-practice portfolio management;
    - **Maximising return without undue risk** to the Fund as a whole; and
    - Avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

Investment approach

We look to utilise the Fund's liquidity profile, long-term investment horizon and governance strength

- We construct a portfolio that balances our highest estimated return with financial risk → the best likelihood of success
  - First capital withdrawals not currently scheduled until 2034-35
  - Strong weighting towards growth assets (because we can ride out short-term volatility)
- Principles and advantages of long-term investment:
  - A clear purpose + long horizon, highly liquid, operationally independent
  - Discipline and capacity to stay the course - governance
  - Transparency and clear communication with stakeholders
  - Focus on best-practice, including environmental, social and governance (ESG) factors

Investing in New Zealand

- Ministerial Directive (2009)
  - "…that opportunities that would enable the Guardians to increase the allocation of New Zealand assets in the Fund should be appropriately **identified** and **considered**…"
  - "This direction is not intended to be **inconsistent** with the Guardians' duty to invest the Fund on a prudent commercial basis, in accordance with section 58 of the Act, and the above paragraph is subject to that duty."
- As at 31 December 2018, $5.8 billion was invested in New Zealand, 16.2% of Funds Under Management - if the Fund had a passive approach to investing it would hold 0.1% in NZ assets
- The Fund is one of the largest institutional investors in NZ and plays a significant role in NZ's capital markets
- Investments include Kiwibank, Datacom, Fidelity Life, NZ Gourmet, Kaingaroa Timberlands, Metlifecare, NZ dairy farms, housing, NZ equities and (via external managers) in expansion capital and infrastructure
- Our NZ Direct investment team has set up an Investment Hub to drive domestic deal flow in NZ by leveraging our experience and advantages – this includes working towards partnerships with Māori investment organisations

Investing in New Zealand

As at 30 June 2018 around 2% of the Fund's $6 billion New Zealand investment portfolio was invested in infrastructure.

- Infrastructure is an appealing investment because of its attractive, consistent returns and yield, defensive characteristics, and diversification benefits.
- In May last year the Fund, together with CDPQ Infra, made an unsolicited proposal to the Government, offering to invest in the Auckland Light Rail project.
- Our preferred procurement model is the Public-Public Investment (PPI) model.
- PPI is a model where a public investor and the Government form a partnership to take joint equity interest in a major project. The public investor, in this case NZSF/CDPQ, assumes end-to-end responsibility for the project and the vast majority of its risk.
- We have pitched to be involved in the Government's KiwiBuild scheme, and are currently exploring investment opportunities in large scale housing infrastructure development and modular/pre-fabricated housing.

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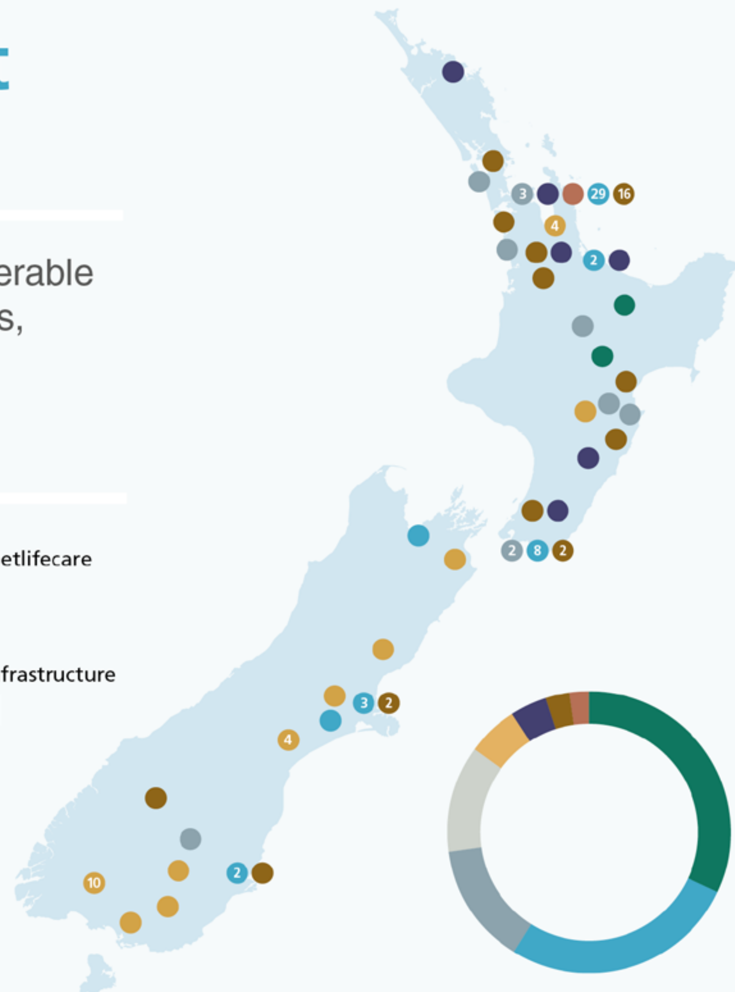
Investing in New Zealand

Where we invest in New Zealand

Over time we have built up a considerable portfolio of New Zealand investments, currently valued at $6 billion.



NUMBER OF INVESTMENTS PER SECTOR

- Forestry 2
- Rural Land 25
- Metlifecare 1
- Other Private Companies 4
- NZ Equities / Active & Passive 46
- Infrastructure 1
- Expansion Capital & Private Equity Real Estate 29

INVESTMENTS BY VALUE

- Forestry **32%**
- NZ Equities / Active & Passive **27%**
- Other Private Companies **14%**
- Fixed Income **12%**
- Rural Land **6%**
- Metlifecare **4%**
- Expansion Capital + Private Equity Real Estate **3%**
- Infrastructure **2%**

Correct as at 30 June 2018.
The Fixed Income sector has not been included on the map.

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Benchmarks

We benchmark against best practice industry principles, measures and relevant global peer funds

<table>
<tr><th></th><th>Internal measures and mechanisms</th><th>External measures</th><th>Stakeholder engagement</th></tr>
<tr><td>Cost structure</td><td>By business unit
By investment opportunity
Holistic view of fees</td><td>CEM Benchmarking Survey
Hay remuneration database</td><td rowspan="6">Peer fund engagement:
• 3Cs: Comparison, collaboration and co-investment

Global expertise</td></tr>
<tr><td>Governance</td><td>Reference Portfolio Review
Internal Audit</td><td>Independent Reviews ‘04, ’09, ’14, ‘19 (in process)
OAG special performance audit (‘08)
SWF GAAP
Select Committee Reviews</td></tr>
<tr><td>Performance</td><td>NZ T Bill rate + 2.7%
Reference Portfolio + 1.0%</td><td>Performance against both measures published monthly</td></tr>
<tr><td>Transparency</td><td>Website
Annual Report
OIA</td><td>Sovereign Wealth Institute’s Transparency Index</td></tr>
<tr><td>Responsible Investment</td><td></td><td>UNPRI assessments</td></tr>
<tr><td>Risk</td><td>Risk Committee Reviews
Risk Registers
Investment Risk Limits
Target Liquidity Level</td><td>CEM Benchmarking Survey</td></tr>
</table>

Reference + Active = Actual Portfolio

Growth-oriented portfolio, majority passive, highly diversified

REFERENCE PORTFOLIO

ACTUAL PORTFOLIO – 30/06/2018*

*excludes the impact of any strategic tilts.

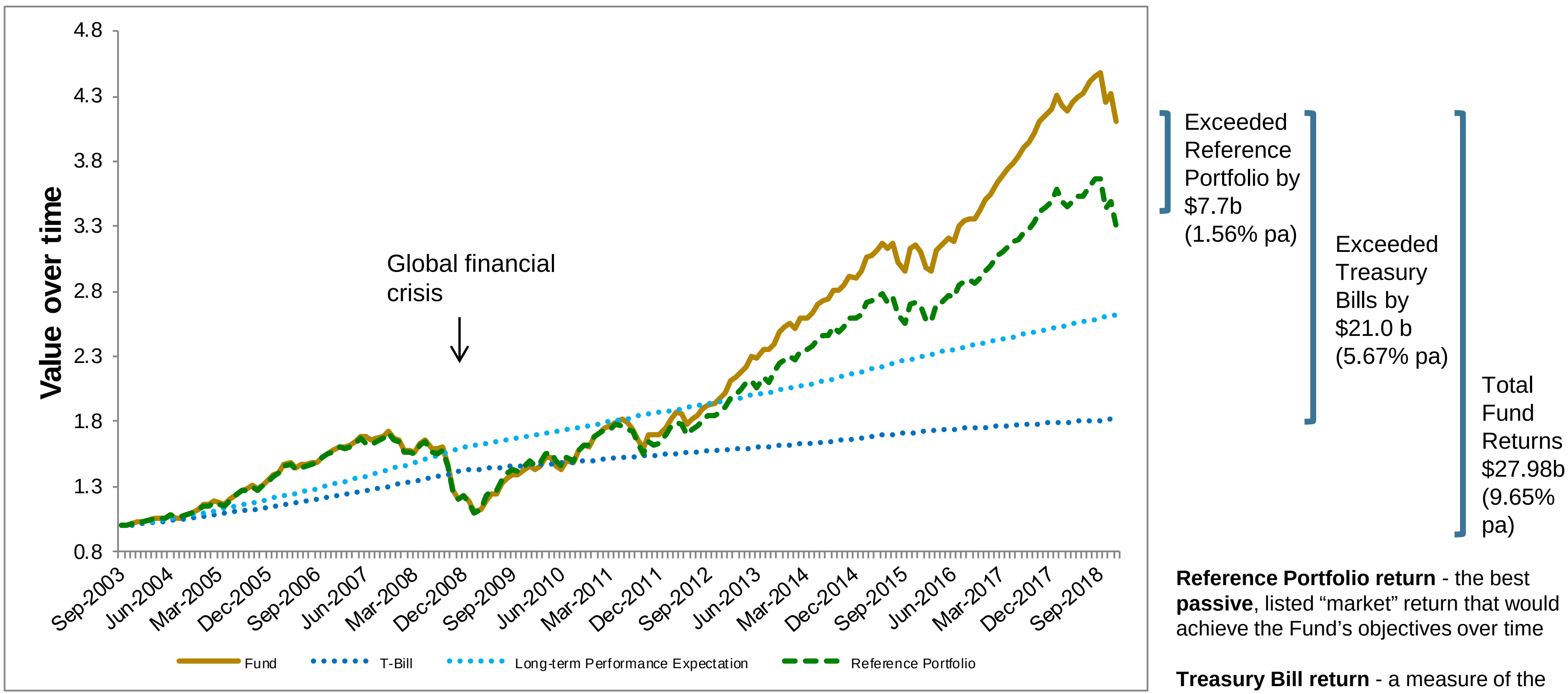
Performance

Performance as at 31 December 2018	Last 10 years	Since inception
Contributions received	$2.37 billion	$15.88 billion
Returns (after fees and foreign tax, and before NZ tax)	$28.15 billion	$27.98 billion
NZ tax (paid) / received*	$(5.07) billion	$(6.39) billion
Other movements**	$0.07 billion	$(0.05) billion
Closing Fund balance as at 31 December 2018	**$37.42 billion**	

* Tax 'received' covers any instances of refunds for overpayment of tax
** Other movements relate to transactions other than tax paid or received e.g. tax expense, movements in reserves

Performance

This graph shows what has happened to the first dollar invested in the Fund over time.



Reference Portfolio return - the best **passive**, listed "market" return that would achieve the Fund's objectives over time

Treasury Bill return - a measure of the cost to the Government of contributing to the Fund instead of paying down debt

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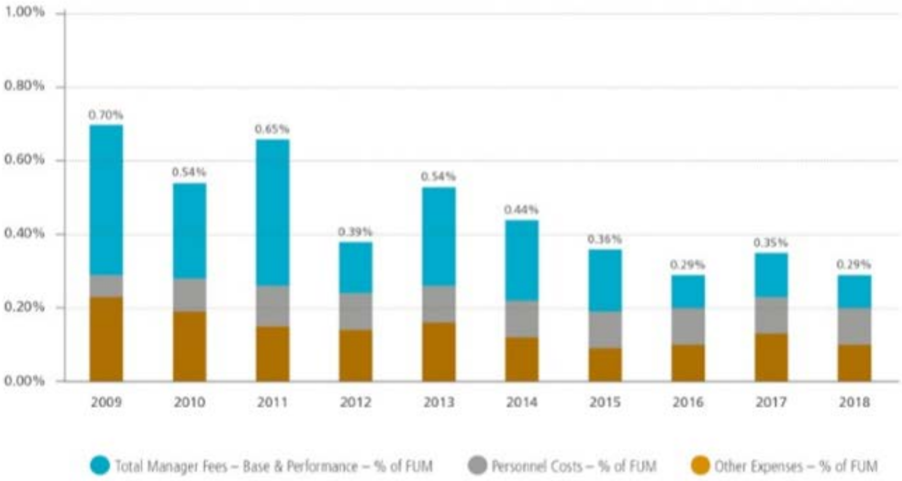
Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

Cost

CEM (Cost Effectiveness Management) Benchmarking is the global leader in benchmarking pension and sovereign wealth funds

- CEM's latest report found our net value-add was above the median of our peers and costs were below the median – both for the 12 months to December 2017 and over the five year period
- The Fund's costs as a percentage of assets have reduced over time
- This has been driven by a reduction in manager fees and advisor costs, offset by increased performance fees and personnel costs (in-sourcing decision making)



Global peer engagement

- Systematic programme of engagement with peer funds: Compare, collaborate, co-invest
- Hosted the International Forum of Sovereign Wealth Funds in New Zealand in November 2016
- These activities are designed to mitigate the distance and scale challenges inherent in running a (comparatively small) global investment Fund from New Zealand – ensuring we operate at global best practice standards

ESG integrated into the investment process

Environmental, social and governance factors, including climate change, are integrated into the investment process

As share owners, we manage ESG through collaboration, engagement and, in some cases, exclusions

Our performance on ESG is measured through global benchmarking

Climate change is an investment risk

CLIMATE CHANGE INVESTMENT RISK STRATEGY

GOAL

A portfolio more resilient to climate-related risks.

TARGETS

By 2020: to reduce the carbon emission intensity of the Fund by at least 20%; and reduce the carbon reserves of the Fund by at least 40%.

PRINCIPLES

1 — Whole portfolio
Manage climate risks and opportunities of the whole portfolio.

2 — Consistency
Be as consistent as we can across all investments (listed and unlisted; active and passive).

3 — Best tools
Use the full range of tools available to us. There is no single solution.

WORKSTREAMS

REDUCE
Reduce exposure to fossil fuel reserves and carbon emissions.

ANALYSE
Incorporate climate change into investment analysis and decisions.

ENGAGE
Manage climate risks by being an active owner through voting and engagement.

SEARCH
Actively seek new investment opportunities, for example in renewable energy.

Climate strategy implementation

Reduce, Analyse, Engage, Search

- At the end of June 2017 NZ$950 million was moved away from companies with high exposure to carbon emissions and reserves into companies with lower carbon risk
- Based on a bespoke carbon measure for listed equities developed in partnership with MSCI ESG
- We continue to hold some companies with carbon exposure where they are engaging and managing the risks
- We may continue active investments in companies with carbon exposure
- Not an exclusions strategy
- Carbon exposure was highly concentrated in a relatively small group of companies.
- In 2017/18 our focus turned to reducing the carbon exposure of the Fund's actively managed equity holdings. A low carbon approach was implemented within the Fund's emerging markets equities mandates.

Outlook

- Over the long term we expect average returns of approximately 8% a year, based on current portfolio settings
- Fund continues to be strongly weighted to growth assets – we are prepared to weather short-term volatility for a better long-term return
- The Fund's advantages (our endowments) – long-term horizon, known liquidity, operational independence and Crown ownership – give important advantages as an investor
- Operationally, we are focused on:
  - Fewer, deeper relationships with external investment managers
  - Increased direct investment where we have an advantage, including in NZ
  - Scalability and efficiency as the Fund continues to grow in size

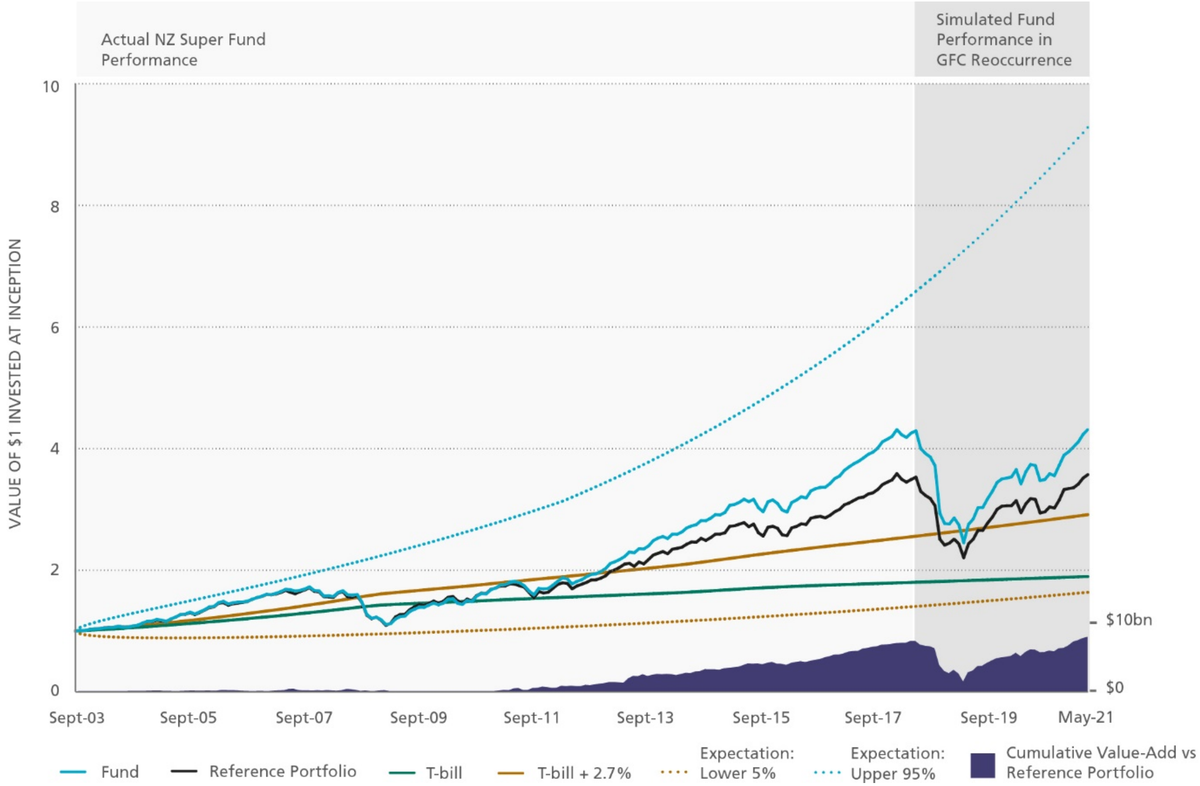
In a market downturn

Given the level of market exposure chosen, the Fund may suffer large financial losses in a market crisis. It is largely unavoidable that a growth-orientated portfolio such as the Fund will fall in these periods.

- By taking on the market risk associated with growth assets, the Guardians accepts the risk that markets may experience sharp drops in value.
- In the event of a market drawdown, the active strategies may add or subtract value to the Fund.
- However, in return for taking this market risk, the Fund will earn higher returns in the long-run.
- The Fund is well-placed to wear such losses, as there is no immediate need to withdraw capital from it. Short-term losses can be treated as “paper losses” with little long-term ramifications for the Fund’s ability to fulfil its purpose.

Scenario: re-occurence of the GFC

The graph shows the simulated NZ Super Fund performance if the Global Financial Crisis (GFC) period returns were to reoccur.



Note: the Guardians regards this as an “extreme” shock to the portfolio, and only expects such an event to occur once in every 50-100 year period.

Scenario: re-occurence of the GFC

From peak to trough (a ten-month period), we estimate the Fund would lose $20.3bn (-52.6%) in a repeat of the GFC. The notional Reference Portfolio benchmark would fall by -44.7%.

The Fund expects to recoup any investment losses in a GFC scenario over a recovery period – although we can’t know how long this would be

- The GFC was characterised by both an unusually sharp drawdown and rapid recovery in financial market values – the fund recovered portfolio losses within 20 months
- This is a relatively rare occurrence; recoveries from significant market crises can often take longer than this.
- The Guardians believe that equity markets eventually mean-revert to higher fair values following transitory periods of crisis.
- The Guardians believes that short-term losses tend to be temporary and less material for a long-term investor. This belief relies, however, on stakeholder support for staying the course through periods of poor performance.