2019/20 Annual review of the Guardians of New Zealand Superannuation

About the Guardians of New Zealand Superannuation

The Guardians of New Zealand Superannuation is an autonomous Crown entity responsible for managing the New Zealand Superannuation Fund. The Fund comprises a pool of assets on the Government’s balance sheet.

The purpose of the Fund is to reduce the tax burden of superannuation for future taxpayers. It was created as a way to partly pre-fund future retirement benefits, which will help smooth the cost of New Zealand Superannuation between today’s taxpayers and future generations.

The New Zealand Superannuation and Retirement Income Act 2001 requires the Guardians to manage the Fund on a prudent, commercial basis, consistent with:

- best-practice portfolio management
- maximising returns without undue risk to the Fund as a whole
- avoiding prejudice to New Zealand’s reputation as a responsible member of the world community.

The Guardians are also responsible for the Elevate NZ Venture Fund (the Elevate Fund). The Elevate Fund was launched in March 2020, with the objective of increasing capital availability to young, innovative New Zealand companies, and developing New Zealand’s venture capital markets to function more effectively. Although the Guardians have responsibility for the governance and oversight of the Elevate Fund, it is managed externally by NZ Growth Capital Partners (NZGCP).[9]

Governance arrangements

The board of the Guardians has seven members and is chaired by Catherine Savage, whose term ends in March 2021. She will be replaced by Catherine Drayton. Matt Whineray has been the chief executive since July 2018. The entity employed 155 full-time-equivalent staff as of 30 June 2020.

Financial overview

The Fund achieved a return of 1.7 percent in 2019/20 (after costs but before New Zealand tax), significantly lower than the 7 percent return in 2018/19. The economic shock of COVID-19 had a large effect on the Fund’s annual performance in 2019/20. It recorded a profit before tax of $679.8 million, compared with $2.818 billion in 2018/19.

[9] The Economic Development, Science and Innovation Committee has conducted the 2019/20 Annual review of New Zealand Growth Capital Partners Limited.

Just over half of the Fund is managed passively in line with its reference portfolio,[10] with the remainder actively managed. The Fund under-performed its reference portfolio benchmark by $923 million, or 2.08 percent, in 2019/20. Many of the asset classes held by the Fund under-performed in 2019/20. The Fund is underweight in bonds, which performed strongly in 2019/20.

Over the long term the Fund expects to outperform its reference portfolio by 1 percent each year. Since it began in 2003, the Fund has outperformed its reference portfolio by 1.21 percent. Returns over this period have averaged 9.63 percent per annum (after costs but before New Zealand tax), with the Fund outperforming its reference portfolio benchmark by $7.8 billion.

As at 30 June 2020, the size of the Fund was $44.8 billion, up $1.68 billion from a year earlier, after costs but before New Zealand tax. This included Government contributions of $1.46 billion in 2019/20. Just over $7.2 billion of the Fund is invested in New Zealand, including Kaingaroa Timberlands, Kiwibank, NZ Gourmet, and rural land.

The Government has contributed a total of $17.8 billion to the Fund since 2003. Following the outbreak of the global financial crisis in 2008, Government contributions were suspended in 2009 as the Crown accounts deteriorated, but were restarted in December 2017. We were told that the Fund would have been approximately $26 billion larger as at 30 June 2020 if Government contributions had continued throughout this time. The estimated returns foregone because of that were about $12 billion. The Government is projected to contribute a further $2.12 billion in 2020/21 and $2.42 billion in 2021/22.

Withdrawals from the Fund to help pay the cost of New Zealand Superannuation are expected to start from around 2034/35. The size of the Fund is expected to peak in the early 2070s as a proportion of GDP. Based on current Treasury projections, at its peak, the Fund will provide around 19.5 percent of the total net cost of New Zealand Superannuation through capital withdrawals and the Fund's tax contributions.

Audit results

The Auditor-General issued a standard audit report for the Guardians and the Elevate Fund, while issuing a non-standard audit report for the Fund. The report is non-standard to draw to readers' attention the disclosures in the Fund's financial statements and performance information regarding the impact of COVID-19 on the Fund's accounts.

We were pleased to note that the Auditor-General rated the Guardians as "very good" across the management control environment, financial information systems and controls, and performance information and associated systems and controls. There were no recommendations made for improvement in any of these areas.

10 The Guardians use a "reference portfolio" to benchmark the Fund's active investment. The reference portfolio performance expectation is set at the 90-day Treasury bill rate plus 2.7 percent (changed to 2.8 percent in July 2020). The Treasury bill rate is the cost to the Government of contributing capital to the Fund, instead of using this capital to repay debt.

The outbreak of COVID-19 had a significant effect on the Fund

We were told that the Fund lost around $13 billion in value following the outbreak of COVID-19, falling from $48 billion on 19 February 2020 to $35 billion in March 2020. During this time, the Fund managers rebalanced the portfolio using contrarian strategies (buying undervalued assets and selling overvalued assets), and were able to benefit from the volatility. The Guardians told us that, since the March 2020 low, the Fund has returned more than 50 percent, and is currently valued at $54 billion. The Guardians told us that the low interest rate environment has reduced their expectations of returns.

Elevate NZ Venture Fund

The Guardians of New Zealand Superannuation administer the Elevate Fund following the enactment of the Venture Capital Fund Act 2019. The Elevate Fund assists the development of New Zealand's venture capital markets by providing venture capital to New Zealand entities. The Elevate Fund is managed on the Fund's behalf by New Zealand Growth Capital Partners (NZCGP). The Government has made an initial commitment of $259.5 million, with a total of $300 million in contributions expected.

We asked whether there was a benchmark return for the Elevate Fund against which its performance can be evaluated, as there is for the Fund. We were informed that the policy objectives and legislative framework for the Fund did not include any return requirements. The purpose of the Fund is to see capital flow into the venture capital markets and assist with their development. A minimum financial return requirement could result in these objectives not being met.

We were interested in how much had been allocated to date from the Fund, and were told that $72.5 million had so far been committed. Three fund managers have been appointed by NZCGP to manage the Elevate Fund, and these managers are required to have a New Zealand connection. We were told that these fund managers had raised an additional $280 million from private markets for venture capital market investments.

Review of the reference portfolio

During the financial year, the Guardians undertook its statutorily required five-yearly review of the Fund's reference portfolio. This portfolio is one of two key benchmarks against which the Fund's performance is compared. The other key benchmark is the Treasury bill measure, which is a rate of return 2.8 percentage points per annum above the 90-day Treasury bill rate on a moving average basis over a 20-year period.

The reference portfolio is a notional portfolio created of low-cost, listed investments which matches the Fund's long-term horizon and risk profile. The adopted reference portfolio consists of 75 percent global equities, 5 percent New Zealand equities, and 20 percent fixed income assets. In 2009 the Minister of Finance directed the Fund to consider opportunities to increase the allocation of New Zealand assets in the Fund. This was a factor behind retaining a 5 percent weighting for New Zealand equities in the reference portfolio. This is a higher weighting relative to the size of New Zealand's equity markets on a global basis.

Currently just over half the Fund matches the asset allocations within the reference portfolio, and the remainder of the Fund is actively managed. We were told that the Fund compares its returns against the reference portfolio benchmark to assess the additional value created through tactical and active investing, especially during times of market volatility as seen during the 2019/20 financial year.

We were interested to hear whether there was a change in the benchmark return with the change in the reference portfolio. We were told that the Fund's long-run expectations of a 7.8 percent return (on average) did not change with the review of the reference portfolio.

Divesting from Israeli banks

We asked the Guardians about the Fund's recent decision to divest from five Israeli banks on responsible investment grounds. The Guardians noted that the Israeli banks were providing financing for construction of Israeli settlements in the Occupied Palestinian Territories, and that New Zealand had co-sponsored a 2016 United Nations Security Council resolution calling for the cessation of such settlement activity. Under their governing legislation the Guardians are required to manage the Fund in a way that avoids prejudice to New Zealand's reputation as a responsible member of the global community.

Some members were concerned about possible inconsistencies in investment approaches between countries, and how those decisions could adversely affect New Zealand's international relationships. The Guardians informed us that they apply their Responsible Investment Framework to divestment decisions. The Framework is publicly available, as are the Guardians' divestment decisions and reasoning.

The Guardians explained that a number of factors are taken into account when deciding to divest or exclude an investment class. They include international conventions, New Zealand law, Crown actions and material statements of public policy, along with the company's own involvement and activities. The Guardians told us that they have a "no surprises" policy, and inform the Minister of Finance, the Treasury, and the Ministry of Foreign Affairs and Trade of significant policy decisions.

We were told that investment exclusions were made under either a category (or product) exclusion or a conduct exclusion. Category exclusions are associated with a certain activity, such as the manufacture of tobacco or cluster weapons. Conduct exclusions occur when the company concerned does not meet the Fund's standards of behaviour. The Fund uses the United Nations Global Compact in deciding which companies are not meeting its standards of corporate behaviour. The Compact sets out standards of corporate behaviour across a number of areas, including business conduct, human rights, labour standards, climate, and the environment.

We asked how the decision about Israeli banks compared with other Fund investment decisions, such as those made in China, given reports around the treatment of the Uyghurs in the Xianjiang region. In regards to concerns in respect to the Uyghurs and other minorities in the Xianjiang province, the Guardians informed us that they were working with other Crown financial institutions (such as the Accident Compensation Corporation and the

Government Superannuation Fund Authority) on a common approach to engage with companies to review their supply chain connections.

Approach to wellbeing and inequity

We were interested in the Fund's approach to wellbeing and inequity and whether these were included in its performance metrics or Responsible Investment Framework. We were told that the Fund's mandate is set out in legislation and does not include any specific wellbeing factors. Despite this, the Guardians believe that environmental, social, and governance issues (including climate change) are fundamental to the Fund's long-term returns, and these factors are incorporated into their investment strategy.

Climate change is an investment risk

Climate change is seen as a specific investment risk to the long-run performance of the Fund. The Fund's Climate Change Investment Strategy, which was first established in 2016, guides investment decisions.

One of the aims of the strategy is to reduce exposure to fossil fuel reserves and emissions. The Guardians informed us that the Fund has no material long term holdings of fossil fuel reserves, apart from a relatively small international private equity investment, which was in the process of being wound down. No further investments in fossil fuel reserve companies were being contemplated. The Fund is investing in a number of companies that were mitigating or addressing climate crisis.

The Guardians reassessed their climate change approach during the 2019/20 financial year. As a result, they set new carbon targets for the Fund. By 2025, they expect:

- to reduce carbon emissions intensity for the Fund by at least 40 percent
- to reduce the carbon reserves of the Fund by at least 80 percent, relative to the original reference portfolio.

Investment opportunities in New Zealand

The Fund is one of the largest institutional investors in New Zealand, with domestic investments valued at just over $7.2 billion. This was an increase from $6.3 billion a year ago, with some significant transactions occurring during the year. The Fund invested $300 million in a hotel portfolio, and purchased a 50 percent stake in Asia Pacific Health Group (New Zealand's largest pathology business) in 2019/20.

We asked the Guardians about the reduction in the proportion of the Fund invested in New Zealand assets. The proportion of funds invested in New Zealand has fallen from 21.3 percent in 2009 to 18.4 percent in 2019/20 (in value terms), despite the increase in the dollar amount of its New Zealand investment portfolio. We were told that a reason for this was the strong performance of the Fund's global equity, resulting in the proportion of the investment portfolio held in New Zealand declining.

The Fund's largest New Zealand exposure is an investment in Kaingaroa forest, along with Canada's Public Sector Pension Investment Board and a number of central North Island iwi.

Other significant New Zealand investments include a shareholding in private companies like Datacom and Kiwibank. The Fund was also involved in the Hobsonville housing development (with Ngāi Tahu as an investment partner), and has farming and horticultural assets, along with a large New Zealand listed equity portfolio. We were told that the Fund is actively looking for further New Zealand investments, especially in the private growth company sector.

The Guardians expressed interest in continuing discussions with the Government on the Auckland light rail proposal. They believe that the proposal they put forward was the best model for that type of investment, where a long-term investor would have aligned interests with the Crown around build quality and ongoing operations.

No asset allocation for digital currencies at present

We asked whether the Fund is investing in digital currencies or whether they feature in its investment strategies. The Guardians told us that there is not an asset allocation for digital currencies at present. It was something that they were thinking about, particularly around the issue of valuing currencies and in the context of the long-run value of different markets.