Guardians of New Zealand Superannuation

Post Hearing Questions and Answers

2 March 2023

The Committee notes the change to sustainable finance in the last year and the work being done to embed this into the Guardians' way of working in the future:

128. Please describe for the committee the competitive advantage of moving to the sustainable finance approach (while also keeping a focus on maximising returns). What work is being done or has been done to quantify this advantage in terms of returns? What challenges has this shift in approach created for the Guardians and what is it doing about these?

129. What observations (and advantages) in the global environment has the Guardians observed with sustainable finance and how will this influence and benefit their approach?

Please note – answers to 128, 129, 130 and 131 relate specifically to the NZ Super Fund.

Answer 128 and 129:

In 2020 we began work on a review of our responsible investment strategy to ensure it was "fit for the future, feasible to implement, and orientated to maintaining our social license to operate over the medium to long term". The decision to undertake the review followed the 2019 independent review by Wills Towers Watson of the Guardians and the NZ Super Fund. The independent review found that the Guardians' "current approach to ESG integration and stewardship is impressive and, in our view, aligns with best practice in these activities". It noted, however, that "RI is a developing area with positive momentum and so there is a need for the Guardians to continue to evolve and innovate to maintain their position as a leader in this area".

Part of the RI Compass work was to review what our legislated mandate requires the Guardians to do. The legislated mandate requires us to "invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with—

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

Work undertaken as part of the review ("Resetting the Responsible Investment Compass") confirmed that the global direction of travel is towards sustainable finance, a development from the responsible investment approach which has been best practice for the past 20 years.

Whereas the focus of responsible investment is the impact of environmental, social and governance risks on the portfolio, sustainable finance considers those factors in addition to the impact of the portfolio on global environmental and social outcomes.

Our research found that sustainable investment is emerging best practice in global portfolio management. It also found that the responsible/sustainable investment field is evolving very rapidly, that stakeholder expectations are increasing and that the Guardians' key stakeholders expect us to maintain a leadership position in responsible investment, particularly in the New Zealand context.

The Guardians has been among the global leaders in responsible investment because of our early adoption of the United Nations-backed Principles of Responsible Investment, our investment belief that environmental, social and governance (ESG) factors are material for long-term returns and because of our Climate Change Investment Strategy announced in 2016. Our sustainable investment focus is consistent with maintaining an appropriate leadership position. We believe that there is a competitive advantage in being best practice.

Our Climate Change Investment Strategy identified the significant investment risk represented by climate change on our portfolio holdings, and the strategy sought to both mitigate that risk through reducing exposure to high carbon intensity companies, and to increase our investment in companies benefiting from the transition to a low carbon energy system globally. these investments were one of the largest contributors to our value add in the 2022 financial year, through development of wind and solar generation in the USA.

In addition, the research established that we are able to improve the ESG components of the portfolio without compromising returns. Our research found that requiring improved ESG performance does not reduce returns and there is some weak evidence that it might enhance returns. The Guardians' Board concluded we can advance sustainability outcomes while fulfilling our financial purpose and delivering strong long-term returns, meeting all three requirements of our mandate.

130. Please provide an update on the impact investment workstream and progress in 2022/23 (given its importance to the Guardians' purpose of delivering strong returns).

We have developed a plan to increase impact investments and to continue to integrate impact into our investment processes. Impact investment is investing with an intent to deliver both measurable positive social and/or environmental impacts alongside required financial returns. Our priorities this year include developing clear criteria in terms of impact from the perspectives of materiality, measurement, monitoring and reporting. Our intention is, through this work, to build on the progress we have made in terms of impact investment, through our review of investment opportunities and risk budget allocation, and embed impact investing within our business-as-usual approach. In order to avoid any risk of greenwashing, we have developed strict internal criteria for impact investments. It is worth noting that aside from investments in development of renewable electricity generation, it is difficult to achieve scale in impact investing, which is something that we will continue to monitor.

The most obvious current example of a potential impact investment is the work we are undertaking in partnership with Copenhagen Infrastructure Partners (CIP) to explore the potential for large-scale offshore wind energy in the South Taranaki Bight. Subject to feasibility, an initial planned 1GW development would represent over 11% of New Zealand's current electricity demand capacity and could power over 650,000 homes. We believe the project could potentially later expand to 2GW, further helping to meet strong projected growth in demand for electricity in New Zealand.

131. **We note the Guardians have reported the sustainable finance approach will take three to five years to embed. Please explain what this three to five work programme looks like in practice and the intended milestones to be achieved in 2022/23.**

Our work to embed a sustainable investment approach is part of a multi-year program which started a number of years ago, specifically:

- Phase 1, 2020 – 2021 - Our 'Resetting the Responsible Investment Compass" review . As a result, in June 2021 the Board agreed to embed sustainable investment into the fund and adopted a new organisational purpose statement: "sustainable investment delivering strong returns for all New Zealanders"
- Phase 2, 2021/22 focused on developing deeper detail in the three work streams of: strategy, governance and leadership; improving the ESG profile of the Fund; and impact investment. This included work on improving the sustainable investment characteristics of our passively held globally equities portfolio. As a result, in June 2022 we commenced work to transition the passive portfolio to new Paris-aligned indices.
- In early 2022/23 we completed the transition to Paris-aligned indices for the Fund's passive portfolio, which is the largest part of the Fund's assets. We are now focused on options to improve the ESG profile of our actively managed equities portfolio, which we refer to as the multi-factor portfolios. These portfolios consist of approximately 2,000 listed securities which are actively managed by external managers. These managers are already tasked with matching our carbon reduction targets. We are now working with them to improve the ESG profile of the mandates they manage for us.

The final area of work, which will be undertaken in 2023/24, will focus on the options available to embed sustainable finance within our fixed income holdings, which make up a relatively small part of the Fund's portfolio.

Alongside these efforts we are focused on building knowledge about sustainable investment across the whole team, determining performance measures for external and internal reporting, and rolling out sustainable finance in personal objectives and individual development plans.

The data tools and services available in relation to sustainable investment will continue to evolve and we will need to continuously monitor and adapt to developments in a manner consistent with maximising risk-adjusted returns.

The Committee notes the investment results across both mandates in the NZ Super Fund and Elevate Fund:

132. **Please update the Committee on the investment projections for the NZ Super Fund and Elevate Fund in 2022/23 and how they are tracking against forecasts.**

NZ Super Fund

The Fund's investment performance is measured in two ways:

- relative to the NZ 90-day Treasury Bill return – the return from taking market risk
- relative to a passive Reference Portfolio benchmark – the value added by the Guardians' active management.

We expect that the Reference Portfolio benchmark will return at least the Treasury Bill return plus 2.8% over any 20-year moving average period. This is our long-term performance expectation. On top of this we expect our value-adding, active management of the Fund to add a further 1% p.a., on average.

It is not possible to forecast financial market returns in a meaningful way over short periods and it is for this reason that we use our long run equilibrium expectations in relation to the reference portfolio and Treasury Bills in our Statement of Intent and Statement of Performance Expectations.

The following table provides updated performance figures for the Fund as at 31 December 2022.

	Quarter to Decembe r 2022	6 months to December 2022	2021/22	Last 5 years	Last 10 years	Last 15 years	since inception (sept 2003)
Fund returns (1)	5.96%	1.60%	-6.99%	6.53%	11.02%	8.64%	9.48%
NZ Treasury Bill return	0.89%	1.44%	0.77%	1.16%	1.82%	2.45%	3.36%
Net Return (2)	5.07%	0.17%	-7.75%	5.37%	9.20%	6.19%	6.12%
Reference Portfolio return (1)	5.03%	-0.15%	-14.24	4.17%	8.40%	6.57%	7.80%
Value add (3)	0.93%	1.75%	7.25%	2.36%	2.62%	2.07%	1.68%

1. After costs before NZ tax
2. Actual return less Treasury Bill return
3. Actual return less Reference Portfolio return

As discussed during our select committee appearance, 2021/22 (the third column in the table) was a difficult year with a significant downturn in global markets resulting in negative returns. Despite poorly performing markets, our active investment strategies enabled the Fund to significantly outperform the market, achieving a value add of 7.2% or $4.5 billion (our second largest ever percentage and largest ever dollar value add).

Given our choice of a growth-oriented reference portfolio (i.e. with 80% equity exposure) as being appropriate to meet our purpose, we expect a significant range of performance outcomes from year to year. As we note in our Annual Report Statement of Performance, in a 1-in-100 year event, we expect the performance of the reference portfolio to be equal to or worse than –30.5%. The outcome in the 2022 financial year was –14.24%.

The first six months of the current financial year (2022/23) have seen a strengthening of global markets. The strength of this performance is illustrated in the first two columns of the table, where we continue to deliver positive value add (1.75% year to date) and have returned to achieving positive net returns (0.17% year to date).

The Fund’s size as at 31 December 2022 was $58.2 billion.

The last column in the table is the most important, as it shows the Fund’s performance since inception (September 2003). Our net return over Treasury Bills is 6.12% and value add versus the Reference Portfolio is 1.68% (both as at December 2022). We are tracking well above both our long-term performance expectation of a net return of 2.8% and our expectation that we will add value of more than 1% p.a. through active management.

Elevate

The performance of Elevate, as a venture capital fund based on a fund of funds model, is considered on a quite different basis from a long-term global growth fund such as the NZ Super Fund.

Forecast financial statements are not required in respect of the Elevate Fund under its governing legislation. We understand this policy decision was based on a range of reasons, including Elevate's market development objectives, the unpredictability of venture capital markets and the fact that the natural cycle of a fund of funds is that it will make investments whilst incurring costs over an initial deployment period, but generate its returns only once its underlying funds began to realise their investments – typically from around year 7. This creates what is known as a 'J-curve' return profile – the "J" meaning that there will be negative returns in the early years of a fund as costs are incurred before investments are realised and revenue booked.

As such, over the initial deployment period the main focus is on creating a portfolio of quality underlying funds, optimising the portfolio across those funds, catalysing private capital into the New Zealand venture capital market and developing underlying managers.

Elevate had a solid year in 2021/22 in respect of those measures. As at the end of that financial year it had made firm commitments of $181 million into seven underlying funds, with 34% of total commitments having been called (i.e. paid into the underlying funds). At that time their portfolio comprised 69 companies.

Since then, commitments increased to $198 million, with 46% called (as at 28 February 2023) and there are an additional 21 companies in the portfolio (as at 30 September 2022).

An important performance indicator for a fund such as Elevate is Total Value to Paid In (TVPI). As at 30 June 2022, TVPI gross of management fees and fund costs was 0.92, and net of costs 0.86. As at 30 September 2022 the figures were 0.99 and 0.91, respectively. The Elevate underlying funds are still very early in their life cycle, and this is broadly what we would expect to see given the j-curve return profile described above.

In terms of investment projections, Elevate now has capacity for 1 or 2 further fund commitments. The issue now framing up future investment projections, as Elevate is reaching capacity, is the question of where the remaining $40 million of the Fund will be sourced and what are the funding options beyond that if it is to maintain momentum and its growth trajectory in order to continue to grow the domestic venture capital market and contribute to building innovative industries in New Zealand. This is an issue the Guardians is working closely with NZGCP and officials at MBIE and Treasury on. See further in our response to question 135.

As would be expected at this stage of the Fund's development, there have been no investment realisations to date. It is anticipated that there will be no realisations for at least two to three years.

133. Considering the negative investment results in 2021/22 for the NZ Super Fund, what are the current risks to the Guardians investment strategies and what mitigations are in place?

The investment performance for the 2021/22 year is within the range of expectations for a fund with the growth orientation of the NZ Super Fund. We expect that global equity markets will be volatile over time. Our modelling of the return of the Fund's reference portfolio estimates there is a 5% chance of a –18.4% return over one year and a 5% chance of a -9.3% return over three years. The performance of the Fund's actual portfolio over both period remains well within these modelled estimates.

In analysing the Fund's 2021/22 performance it is important to keep in mind that the Fund significantly outperformed the market in terms of its active investment strategies i.e. it had a positive value add result. It is also important to note that market volatility is to be expected, and our long-term focus enables us to ride out this volatility. Indeed, for long term investors such as the NZ Super Fund, who are able to invest opportunistically, volatility actually provides investment opportunities.

The two major risks for a long term investor are loss of stakeholder support and management of liquidity (i.e. the ability to pay obligations as they come due). There are also other risks including counterparty and credit risk, and risks associated with appointment of investment managers, which are managed through our risk management practices.

The key mitigant to the first risk, loss of stakeholder support, is transparency. We look to ensure that stakeholders understand why we have selected the portfolio we have and understand the expected performance of the NZ Super Fund portfolio through time, including that there will be years when investment returns are negative, and where value add will be negative also. The key mitigant in terms of liquidity risk management to is to ensure that we have sufficient short-term liquidity (i.e. cash and liquid securities) to cope with the expected range of short-term market movements, given the growth orientation of our portfolio and our foreign currency hedging program. We establish a liquidity risk appetite with the Board and monitor this closely. We manage our investment manager selection process through due diligence and ongoing monitoring and have a robust process to manage and monitor performance of our direct investments. Another risk we face is our ability to attract investment talent in what is a highly competitive and mobile global labour market. While we are not in a position to match salaries and packages offered internationally, we work hard to position ourselves as an employer of choice, to trade off New Zealand's lifestyle advantages, and connect with returning expats.

With investing, of course, the taking of risk is associated with achieving returns. In making active investments we take "active risk", in that there is a chance that the Fund will perform better or worse than, or show more volatility, than the reference portfolio. It is important that we prudently and commercially manage this active risk – both in total and how it is allocated to specific investment opportunities. Our risk budgeting process also ensures our active risk is allocated across 28 opportunities providing diversification benefits in how we allocate active risk. Our total budget for active risk is 4% (i.e. we expect that the standard deviation of active returns is 4%). The size of this risk budget is a decision of the Board, based on advice from management. In 2002 we undertook a five-yearly review of the size of the size of the total risk budget and how it is allocated across investment opportunities. Effectively this involves asking ourselves what is the best way to ensure we are managing risk so as to maximise the Fund's risk adjusted active return (a more detailed discussion on active risk and its management can be found on pages 48 – 50 of our 2022 Annual Report).

134. How confident is the Guardians in achieving the rate of return required for the longer term (considering the negative results in 2021/22)? Is the NZ Super Fund on track to realise the Treasury's projections of being worth more than $150 billion by 2035?

We remain highly confident that the Fund will exceed its long-term performance expectation. This is to deliver returns 2.8% above the New Zealand Treasury Bill (T-Bill) return over any 20-year moving average. As we approach our 20-year anniversary (September 2023) we continue to perform well above this – 6.12% above the T-Bill rate as at 31 December 2022.

As has been well canvassed, 2021/22 was a difficult year, with weak markets and a challenging international economic and geo-political environment. Despite this, the Fund's active investment strategies we managed to significantly outperform the market and add significant value in relation to the reference portfolio. It is important to note that the reference portfolio is structured so that, over the long-term, we expect market returns to meet the Fund's mandate. Our capacity to deliver well above that level is the value we add (1.68% p.a. since inception) and a key reason for our confidence that the Fund is on track to meet its mandate.

It is important to note that this long run performance is not guaranteed – we take investment and market risk to achieve the purpose of the Super Fund. "Risk" means that there is a range of potential outcomes, and some of those would mean not achieving the desired fund returns. We cannot achieve our purpose without taking risk, but that risk means that we also may fail to achieve the purpose.

It is also important to note that, for investors with a long-term focus, weak market conditions represent an opportunity. With liquidity well managed, we do not face the necessity to realise what are paper losses and instead are in a position to invest counter-cyclically, identifying and taking advantage of under-valued assets.

Treasury's projections are updated six monthly and reflect both actual Fund size and projections for a number of variables including earnings on NZ Super Fund assets, GDP and expenditure on NZ Superannuation. The latest model (Dec 2022) forecasts the Fund being worth $138 billion in 2035. At that point the Fund balance will represent 21% of GDP.

135. Given the challenges in the global and local markets, what do the Guardians see as the challenges for young companies and what do the investment strategies and support from NZGCP look like in practice to ensure a strong pipeline is maintained?

Under the fund of funds approach through which Elevate operates, each of the entities involved has a clearly delineated role. The Guardians' responsibility is to govern the Fund and oversee NZGCP to ensure best practice investment management. NZGCP, which manages the Fund on the Guardians' behalf, allocates the Fund to external fund managers. The fund managers operate the underlying funds, investing in New Zealand growth companies – providing management and governance support and advice.

There are many challenges facing companies which have moved past their start-up stage and into the growth phases of their development. Alongside their specific business, operational and commercial challenges, these typically include the risks associated with scaling, growing too fast, access to talent and specialist skills, an increased quantum and complexity of compliance, and the risks and difficulties involved with entering into, and growing in, international markets. It is important that the fund manager businesses are well resourced and experienced in administering and supporting their investee businesses in confronting these challenges – including through accessing the support provided by a range of other

Crown entities. We understand these more general challenges are included in the issues which will be covered in the report being produced by the Startup Advisers Council.

A key challenge for growth firms, that is more directly related to our role with Elevate, is the ongoing access to capital in order for them to continue their growth trajectory and remain competitive against well-funded offshore competitors. If insufficient funds are available, early-stage companies will need to significantly reduce or even curb their growth plans and potential (reducing productivity and potentially missing the market opportunity) or migrate offshore.

There are challenges in terms of the availability of growth capital within the New Zealand market and eco-system. In a difficult international environment, New Zealand venture capital funds are experiencing increasing difficulties in raising capital. Compounding this, while overseas venture funds had been becoming increasingly interested in New Zealand, there is no certainty they will remain active in a more challenging market, with there being concerns (and some early evidence supporting this concern) that they will refocus on their home markets.

As noted in question 132 and during our discussions with the committee, Elevate will have committed materially all of its initial Crown contributions during this period of more challenging market conditions. Sourcing the currently unfunded $40 million of the initial commitment would enable Elevate to make investments into an additional one or two more funds. Without additional funding it would then need to move from active origination/deployment into a period of portfolio management, until such time as it is able to realise investments, providing capital for further funding activity. NZGCP does not currently expect any material realisations until year seven of the Fund, meaning this portfolio management phase would last for several years. Given that the New Zealand venture capital eco-system remains in its own early-stage phase, with significant development, deepening and maturing still necessary, this would have a material constraining and contracting impact on both the New Zealand venture market and funds, and on innovation and productivity. This is a priority issue for the Guardians, NZGCP and the Elevate Fund.

Over the longer term other funding related factors could also be considered, such as better enabling or encouraging other institutional investors, such as KiwiSaver funds for instance, to diversify their portfolios and invest in venture capital and private equity markets and consideration of other regulatory settings that encourage investment in early stage markets.

Beyond market conditions, Elevate's future return profile is likely to depend to a significant extent on the level of continuing government support for early stage markets and other policy initiatives. For instance, Elevate depends on a pipeline of quality growth companies maturing to the venture funding stage and this in turn depends on a range of supportive conditions including availability of support through initiatives such as NZGCP's Aspire mandate. We understand officials at MBIE and NZGCP are in discussion on these issues.

136. Please share the findings of the Conviction Review with the committee and what NZGCP has done to address previous issues in governance, personnel and culture.

The Guardians assesses the Elevate Fund's externally-appointed investment manager, NZGCP, in accordance with the usual conviction process that we apply to all our external manager relationships.

In summary, NZGCP has continued to address previously identified issues regarding governance, personnel and culture. A new CEO (Rob Everett) has been appointed and there has been the establishment of a Chief Investment Officer (James Pinner). These personnel changes and the process improvements that followed have resulted in the Guardians' conviction in NZGCP improving.

Specific improvements include:

- Improved risk management protocols with conflict and commitment policies in place
- Risk register in place and being updated regularly
- Automated attestation process in place
- HR policies updated and approved.

We have received high levels of cooperation and transparency from NZGCP staff.

As it contains information of a commercially sensitive nature to the Guardians, NZGCP, and the Elevate Fund, we consider the Elevate Conviction Review document to be commercial in confidence and, if the Committee determines it would like to receive it, request it be considered secret evidence.